Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements

OFFICE OF ECONOMIC ANALYSIS

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Executive Summary

The Public Company Accounting Reform and Investor Protection Act, otherwise known as the Sarbanes-Oxley Act (the "Act"), was enacted in July 2002 after a series of high-profile corporate scandals involving companies such as Enron and Worldcom. Section 404(a) of the Act requires management to assess and report on the effectiveness of internal control over financial reporting ("ICFR"). Section 404(b) requires that an independent auditor attest to management's assessment of the effectiveness of those internal controls. Because the cost of complying with the requirements of Section 404 of the Act ("Section 404") has been generally viewed as being unexpectedly high,[1] efforts to reduce the costs while retaining the effectiveness of compliance resulted in a series of reforms in 2007.

This report presents an analysis of data from publicly traded companies collected from an SEC-sponsored Web survey of financial executives of companies with Section 404 experience conducted during December 2008 and January 2009. The analysis of the survey data is designed to inform the Commission and other interested parties as to whether changes occurring since 2007 are having the intended effect of facilitating more cost-effective internal controls evaluations and audits, especially as they may apply to smaller reporting companies. The findings of the analysis relating to efficiency include evidence on the total and component compliance costs, the changes in costs over time, and the factors that help to explain why costs are lower or higher for some companies than for others. These findings include evidence of direct and indirect effects that management ascribes to Section 404 compliance, including evidence on intended benefits.

The 2007 reforms that are the focus of this inquiry include the SEC's June 2007 Management Guidance and its order approving the Public Company Accounting Oversight Board's (PCAOB) Accounting Standard No. 5 (AS5) (collectively referred to as the "2007 reforms"). We are primarily interested in whether and how companies' experience with Section 404(b) compliance changed following the reforms, yet this report also presents evidence on the implementation of both Section 404(a) and Section 404(b). This reflects the interrelationship between the two requirements. The survey was open to all reporting companies with relevant experience in complying with Section 404, recognizing that only large accelerated filers and accelerated filers are currently required to comply with both Section 404(a) and Section 404(b)

[1] *See, e.g.*, *Speech by SEC Staff: Remarks before the Practising Law Institute Fifth Annual Institute on Securities Regulation in Europe*, by Alan L. Beller, Director, Division of Corporation Finance (Dec. 5, 2005), available at http://www.sec.gov/news/speech/spch120505alb.htm ("The unexpectedly high costs of compliance with the internal control assessment, reporting and audit requirements have caused continuing focus on [companies who are deregistering].").

and, thus, have information on the overall cost of compliance with these sections. These experienced filers that responded to the survey tend to have public float in excess of $75 million, which is large compared to that of non-accelerated filers that are not yet required to comply with Section 404(b). The evidence on the experiences of larger companies may be useful in evaluating the extent to which additional improvements to the implementation of Section 404(b) should be undertaken before it becomes applicable to non-accelerated filers. Notwithstanding, it is important to highlight that the analysis in this report is not designed to provide compliance cost estimates for companies that have yet to comply with the relevant requirements of Section 404.

The general conclusion from the analysis of survey data is that compliance costs vary with company size (increasing with size), compliance history (decreasing with increased compliance experience), and compliance regime (lower after the 2007 reforms). Larger companies tend to incur higher compliance costs in dollar terms ("absolute cost"), while smaller companies report higher costs as a fraction of asset value ("scaled cost"). The evidence suggests that companies bear some fixed start-up costs of compliance that are not scalable. Some of these costs are recurring fixed costs, while others are one-time start-up costs borne in the first years of compliance that tend to dissipate over time. For companies complying with both parts of Section 404, the cost of complying with Section 404(b) is reportedly similar to the incremental cost of complying with Section 404(a) alone. The resource requirements of Section 404(a) and Section 404(b) compliance are quite different, however. The Section 404(a) cost is borne through increased internal labor and outside vendor expenses, while the Section 404(b) cost is experienced primarily through increased independent-auditor fees, according to the survey evidence.

The evidence also indicates that there is an economically and statistically significant reduction in Section 404 compliance costs following the 2007 reforms. This reduction is most pronounced among larger companies. More than half of survey participants (henceforth also referred to as "respondents") who answered explicit questions about the effects of the 2007 reforms report that the reforms led to a decrease in compliance costs, consistent with the objectives of the reform and the reported cost reductions. Nearly all respondents indicated that they relied on the Management Guidance and, of those, a majority found it to be useful. As a result of the Management Guidance, there has been a shift of effort among smaller companies toward evaluating the effectiveness of ICFR and away from the tasks of identifying risks to the company's financial reporting and identifying controls that address identified risks. These respondents, however, had a less favorable response to a question about the SEC's responsiveness to concerns about compliance costs.

The Web survey also included questions about respondents' perceptions of other potential effects of Section 404 compliance, including potential beneficial effects. Respondents ascribe some beneficial effects to Section 404 compliance. In particular, respondents were more likely to report *direct* benefits of compliance with Section 404 rules (i.e., improvements directly related to a company's financial reporting process, such as the quality of the company's ICFR), rather than *indirect* benefits of compliance (i.e., improvements indirectly related to a company's financial reporting process, such as the company's ability to raise capital). Respondents from larger companies and Section 404(b) companies tend to regard Section 404 compliance more favorably than those from their counterparts in almost every respect.

Before turning to a more detailed outline of findings, it will be useful to provide some background on the size and compliance categories of the companies that are the subject of the study. Throughout the analysis, respondents are partitioned based on the size of their company using the size thresholds that parallel the SEC's reporting thresholds.[2] Under SEC regulations—typically—*non-accelerated filers* have public float of less than $75 million; *accelerated filers* have public float between $75 million and $700 million; and *large accelerated filers* have public float of $700 million or more.[3] The evidence on the costs and benefits of Section 404(b) compliance is almost entirely from the last two groups, which are termed "large" and "medium/mid-sized" companies in this report, because "small" companies (with public float less than $75 million) were typically not yet required to comply with Section 404(b) at the time of the survey.[4] Following previous research, in some instances, the analysis of smaller companies focuses on those having a public float falling within a band above and below the $75 million threshold that distinguishes non-accelerated from accelerated filers.[5] In addition, to separate the

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[2] Size categories are determined by the company's market value of public float (henceforth, "public float") measured two quarters prior to the relevant fiscal year end date.

[3] It should be noted that this is a loose characterization of filer status—the actual definitions involve additional requirements. For the definitions of accelerated filers and large accelerated filers, see Exchange Act Rule 12b-2, 17 CFR §240.12b-2. Non-accelerated filers are companies that do not meet the Exchange Act definition of an accelerated filer or large accelerated filer. *See, e.g.*, "Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Periodic reports," SEC Release No. 33-8644 (Dec. 21, 2005), 70 FR 76626, available at http://www.sec.gov/rules/final/33-8644.pdf.

[4] *See infra* Part II.

[5] *Cf.* Peter Iliev, "The Effect of SOX Section 404 Compliance on Audit Fees, Earnings Quality and Stock Prices", Journal of Finance, forthcoming (2009), available at http://ssrn.com/abstract=983772 (examining companies with public float between $50 million and $100 million for similar reasons). This stands in contrast with the dollar thresholds—$75 million and $700 million—that delineate the different regulatory compliance categories (i.e., non-accelerated, accelerated, and large accelerated filers). While public float is not alone sufficient to determine a company's regulatory compliance category under SEC rules, it is clear that none of the companies that had a public float of less than $75 million around the time

effects of Section 404(a) compliance from those of Section 404(b), when appropriate the analysis partitions companies that were compliant with both Sections 404(a) and 404(b) in the relevant fiscal year (henceforth "Section 404(b) companies")[6] from those that are compliant with Section 404(a) only (henceforth "Section 404(a)-only companies").

A more detailed presentation of findings as answers to the central questions of the report follows:

Q1. How does the cost of complying with Section 404 vary across companies, and what factors influence a company's compliance cost?

The total cost of complying with Section 404 varies across companies depending on (1) the company's size, (2) whether the company is complying with Section 404(a) only or also with Section 404(b), (3) the company's experience in complying with Section 404(b), and (4) whether compliance occurred before or after the 2007 reforms. Specifically, the absolute compliance cost in dollar terms tends to increase with company size (measured by public float), but the cost scaled by asset value tends to decline as company size increases. As one would expect, total compliance costs are typically larger for companies complying with Section 404(b) in addition to Section 404(a). Longer experience with Section 404(b) compliance, however, is associated with a decrease in the typical reported costs (scaled by company assets). The cost of compliance tends to be lower after the 2007 reforms than before and this decrease is most pronounced among larger companies.

Q2. What is the observed trend in Section 404 compliance cost before and after the 2007 reforms?

The Web survey collected response data on audit fees, outside vendor fees, non-labor costs, and internal labor hours. These cost components were aggregated using conservative assumptions in order to obtain a dollar estimate of the total cost of compliance (see Section IV.a).

The evidence generally indicates that the typical total compliance costs have decreased from the year prior compared to the one after the 2007 reform and are expected to decrease further in the fiscal year in progress at the time of the survey. Among Section 404(b) companies, the mean total Section 404 compliance cost drops significantly from \$2.87 million pre-reform to \$2.33

of the survey would have had to comply with the auditor attestation requirements of Section 404(b) (unless they previously had public float above \$75 million).

[6] We relied on Audit Analytics for the information regarding whether a company filed a Section 404(a) report and/or a Section 404(b) report. We did not independently verify this information except in a few cases where the company's public float would indicate otherwise.

million post-reform, representing a 19 percent decline in the total compliance cost (see Table 8). The compliance cost is expected to be lower still, with a mean cost of $2.03 million, representing a combined decline of 29 percent (see Table 8). When reporting compliance costs by size category, the mean total compliance cost decreases from $769,000 to $690,000 among filers with public float lower than $75 million, but this difference is not statistically significant.[7] The reduction in compliance costs is more pronounced among the medium and large companies that are already required to comply with Section 404(b) (see Table 9).

The medians reveal similar patterns for the typical company in our sample.[8] The median total Section 404 compliance cost declines significantly from $1.19 million pre-reform to $1.04 million post-reform, a 13 percent decline (see Table 8). The median expected cost for the fiscal year in progress is lower still, at $905,000, a combined decline of 24 percent relative to the pre-reform median cost (see Table 8). For non-accelerated filers, the median total compliance cost decreased from $579,000 to $439,000, but, as with the means, the difference for these companies is not statistically significant.

When analyzing first-time compliance costs before and after the 2007 reforms, the results are mixed and the mean decrease in total costs is not statistically significant (see Table 13). In contrast, for companies in their second year of compliance with Section 404(b), both the mean and median compliance costs are significantly lower after the 2007 reforms than before.

Meanwhile, among Section 404(a)-only companies, the mean total cost also decreased from $425,000 pre-reform to $336,000 post-reform, but the difference is not statistically significant, and the median cost actually increased from $111,000 to $162,000. Both the mean and the median, however, are expected to decrease for the fiscal year in progress at the time of the survey (see Table 8).

Q3. How do the component costs of complying with Section 404 compare, and how have they changed since the 2007 reforms?

For Section 404(b) compliant companies, the largest cost component is internal labor costs—which can comprise more than 50 percent of the total compliance cost—followed by the estimated portion of total audit fees attributed to ICFR (404(b) audit fees), outside vendor fees, and non-labor cost (see Table 8). In general, every component cost declines after the reforms

[7] Filers with public float below $75 million complying with Section 404(b) may be either non-accelerated filers choosing to comply with Section 404(b) (although not required to do so) or accelerated filers whose public float has dropped below $75 million but remained above $50 million.

[8] Means and medians measure the central location of a distribution. For asymmetric distributions using medians instead of means, the weight placed on the extreme observations is reduced.

compared to the year before, and is projected to decline further in the fiscal year in progress (see Table 8). The most notable changes in the cost components between pre-reform and post-reform are observed in the outside vendor fees and the percent of the total audit fees attributable to ICFR (see Table 8). The mean outside vendor fee decreases by 29 percent from $438,000 pre-reform to $311,000. The median outside vendor fee decreases by 10 percent from $100,000 to $90,000. Both differences are statistically significant, and the outside vendor fees are expected to decrease significantly to a mean cost of $222,000 and median cost of $55,000 in the fiscal year in progress at the time of the survey (see Table 8). The mean portion of the audit fee that respondents attributed to the ICFR audit also decreases significantly by 21 percent from $821,000 to $652,000. This decline is expected to continue. Similarly, the median audit fee decreases by 13 percent from $358,000 to $311,000 and is expected to decrease to $275,000 (see Table 8).

Q4. What are the benefits of complying with Section 404, as reported by company executives, and how do they compare against the costs of compliance?

The survey asked the respondents to comment on the impact of Section 404 compliance on twelve characteristics relating to internal governance and investor confidence, of which six were considered direct effects of compliance and the remaining six indirect effects of compliance. The respondents recognized Section 404 compliance as having a positive impact on various dimensions of the financial reporting process, but were less inclined to recognize these improvements as affecting the companies' dealings with other capital market participants.

Furthermore, in an optional section of the survey, respondents provided their assessment of the cost-benefit trade-off of Section 404 compliance. The majority of respondents to this section perceive the trade-off to be negative to varying degrees. This perceived trade-off is more favorable among larger companies and, independently of size, improved following the 2007 reforms (see Table 15).

Among the characteristics that are most widely reported benefiting from Section 404 compliance is: the quality of the respondent company's internal control structure (73 percent), the audit committee's confidence in the company's ICFR (71 percent), the quality of the company's financial reporting (49 percent), the company's ability to prevent and detect fraud (48 percent), and the respondent's confidence in the financial reports of other companies complying with Section 404 (40 percent) (see Table 14). The majority of respondents 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 common stock. Finally, the perceived effect of Section 404 compliance on the efficiency of the operating and financial reporting processes and the timeliness of the company's financial statement audit varies widely: while a majority of respondents perceive no effect on these dimensions, non-trivial portions of respondents recognize a negative effect—that is, a reduction in the efficiency of the operating and financial reporting processes and/or the timeliness of financial statement audit (see Table 14). In the cross-section, larger companies were more likely to ascribe positive direct and indirect effects to Section 404 compliance than were smaller companies.

Q5. What are the reported benefits of Section 404 compliance from the perspective of financial statement users?

In order to obtain a more complete picture of the effects of Section 404 implementation, staff members from the SEC's Office of the Chief Accountant conducted separate in-depth phone interviews of a sample of 30 users of financial statements—including lenders, securities analysts, credit rating agencies, and other investors. Although the sample is admittedly smaller than that of issuers participating in the survey, the evidence gathered is useful because it provides the perspective of financial statement users on the effects of Section 404 compliance.

In general, financial statement users regard 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 the companies' financial reports. The users generally indicate that Section 404 compliance leads management to better understand financial reporting risks, put in place appropriate controls to address financial reporting risks, and address internal control deficiencies in a more timely fashion than in the absence of the disclosure requirement. Although, users offer divergent opinions regarding the extent to which disclosures of material weakness affect their decision-making process, most agree that severe weaknesses that could take years to remediate are likely to negatively affect their decision-making.

Users tend not to perceive the benefits of Section 404 compliance to vary with the size of the reporting company. Instead, many indicate that these benefits depend on a company's complexity and industry affiliation. At the same time, the users agree that variations in compliance requirements based on complexity and/or industry would likely be impractical. Finally, most users indicate that the benefits they perceive from Section 404 compliance have not changed substantially over time. This is an important finding since it indicates that the 2007 reforms, while intended to reduce certain duplicative efforts in conducting the evaluation of ICFR, did not at the same time change financial statement users' perception of the effectiveness of Section 404.

Regarding the Section 404(b) requirement, the general consensus is that the auditor's report on ICFR required under Section 404(b) provides an incremental benefit beyond the management's report because many respondents perceive the audit requirement to provide necessary discipline to the reporting process. Although some users express the concern that ICFR evaluation may divert management's attention from other important areas of their businesses, these respondents continued to believe that strong ICFR is necessary and that financial statements need to be of high quality and reliable.

Most users interviewed indicate that the process of compliance with Section 404 has become more efficient since the initial implementation in 2004 due to: (i) reduction in the level of documentation, (ii) improved communications between auditors and management, (iii) increased use of professional judgment in scoping and testing, (iv) more focus on higher risk areas, and (v) streamlining of audits subsequent to the first-time effort required by Section 404 compliance.

Q6. In what ways have the Commission's 2007 reforms affected the companies' procedures of complying with Section 404?

Nearly all respondents who completed an optional section of the survey requesting feedback on management's Section 404(a) experience responded that they used Management Guidance and found it to be useful (see Table 16). Those who responded indicate that both Management Guidance and Auditing Standard No. 5 have helped reduce the total cost of compliance, for companies in every size category (see Table 17). The respondents also indicate on average that Auditing Standard No. 5 resulted in a small decrease in the time it takes to complete the independent audit of ICFR (see Table 18). The perceived impact of AS5, however, varies with the size of the company and its experience with Section 404(b) compliance. Specifically, the perceived impact of AS5 on the time it takes to complete the independent audit of ICFR is significantly smaller among small filers and among companies with no previous experience with Section 404(b) compliance.

When asked to compare the changes in activities associated with management's evaluation of ICFR, the respondents indicate a slight decrease on average from pre-reform to post-reform in the number of risks subject to testing, the number of controls tested, but a slight increase in the level of documentation, the use of management's interaction with controls as evidence, reliance on evidence gained from self-assessment, and reliance on evidence from direct testing (see Table 21). Like much of the previous results, the responses varied significantly depending on the respondents' size. While smaller companies typically report an increase in every component, the changes reported by medium and large filers are not homogenous. Interestingly, however, the evidence suggests that the compliance process across companies of different size has become more homogenous following the 2007 reforms. Finally, the survey evidence indicates that companies are increasingly structuring their evaluations of ICFR with the intent of allowing the independent auditor to rely on their internal work (see Table 22), which is consistent with one of the goals of the 2007 reforms through Auditing Standard No. 5.

Some caveats about the analysis of Web survey data on Section 404 implementation

There are a number of caveats to consider when interpreting the evidence presented in this study, some of which are due to the inherent nature of survey data, while others are the result of the particular context in which the Section 404 survey takes place.

First, most, if not all, analyses of survey data are affected to various degrees by the following potential difficulties:

- *Self-Selection Bias (i.e., Non-response Bias):* Participation in survey research is generally voluntary. The process by which survey participants "select" to participate in a survey can bias the inference based on survey data, if the participants' (self-) selection process is such that particular segments of the population are systematically over- or under-represented. We conduct extensive analyses to test for the presence and the potential severity of the problem, particularly by investigating the extent to which key characteristics of the sample of respondents to the survey coincide or diverge from those of the list of companies identified as the target population (see Part III). We find that respondent companies are representative of the initial list of public companies identified for this study, particularly among Section 404(b) companies or within company size groups. We also find that the typical responses of voluntary participants in the survey are not significantly different from those of a randomly selected, stratified sample of companies that were the target of follow-up efforts to induce their participation. Overall, the evidence is consistent with the notion that the voluntary nature of the participation introduces no bias in the responses, at least relative to the separate treatment group where part of the decision to participate is a result of the follow-up effort.
- *Response Bias*: If there are no penalties for misrepresentation and survey participants have systematic incentives to be less than fully truthful, inference based on survey data (or any other self-reported information that meets those criteria) may not be accurate. A similar problem arises when survey questions are designed to elicit the participant's subjective perceptions on a particular subject and the participants' views are systematically biased. The portion of survey data that we could independently verify (i.e., audit fees) indicates that the participants' representations do not deviate substantially from what is reported in official

SEC filings.[9] Aside from this exercise, it is virtually impossible to assess the extent to which the remaining survey data may not be accurate. The nature of the survey questions varies, with some questions focusing on quantifiable items (e.g., internal labor hours) and others on directional perceptions (e.g., assessment of the effect of Section 404 on the quality of ICFR) and others still on directional/ordinal perceptions (e.g., assessment of the effect of AS5 on the amount of time it takes to complete the independent audit under Section 404(b)). The common element, however, is that these data cannot be independently verified, either because companies are do not keep a separate record of the figures provided (e.g., costs) or because the information provided is based on the respondents' perceptions which by their very nature are not verifiable. The analysis in this report provides a characterization of companies' experiences with Section 404 compliance that is based on survey participants' representations of their experiences.

Other caveats are specific to the analysis presented in this report, as they depend on the nature and timing of the survey. In particular:

1. The number of respondents from Section 404(b) companies that are non-accelerated filers and have usable data is relatively small—approximately 100 companies versus over 1,600 accelerated filers in the most recently completed fiscal year (see Table 9)—and there are reasons to believe the experience of these companies may not extend to other non-accelerated filers that are yet to comply with Section 404(b). Specifically, non-accelerated Section 404(b) companies that participated in the survey are either voluntary compliers or have been required to comply in the past as accelerated filers and must continue to do so because their float has not dropped below $50 million since. To the extent that these factors affect companies' experience with Section 404(b) compliance, one should be careful when extrapolating the results to non-accelerated filers that are yet to comply.
2. Non-accelerated filers were required to start complying with Section 404(a) at the end of 2007—after the reforms. Yet, a number of non-accelerated filers responding to the survey reported bearing Section 404 compliance costs prior to the reform. These respondents were contacted after the survey was closed to inquire about the nature of the information provided. These respondents indicated that their company began complying with Section 404 requirements prior to the Commission's public announcement that the compliance deadline had been extended and, thus, they viewed the resulting pre-reform costs reported in the

[9] The remaining discrepancies between survey- and filing-based audit fees can be explained by the broader definition of "audit fee" adopted for regulatory purposes.

survey as appropriately ascribed to Section 404(a) compliance. The analysis of non-accelerated filers' experience prior to the reforms should be interpreted with the caveat in mind that it may not be representative of what the typical non-accelerated filer would have experienced.

3. The characteristics of the internal governance structure and financial reporting process are likely to be important determinants of the companies' compliance experiences, including costs and benefits and the nature of the audit services they obtain under Section 404(b). To the extent that accelerated and non-accelerated filers display significant differences in these dimensions, it may not be appropriate to extrapolate the analysis of accelerated filers to non-accelerated filers.
4. All the cost figures presented in this analysis are based on survey respondents' characterization of the resources devoted to Section 404 compliance. As such, the general caveats above apply. Moreover, there are some aspects specific to our analysis:
   a. All estimates presented in this report are based on non-audited numbers based on the respondents' perception provided in the survey.[10] Moreover, the nature of the estimates is limited by the scope of the survey.[11]
   b. There are reasons to question the ability of respondents to provide an accurate breakdown of audit fees into Section 404(b) fees versus financial statement audit fees. Auditors interviewed by the SEC's OCA staff highlight this difficulty on the basis that, for Section 404(b) companies, the two audits are integrated and audit firms do not typically provide a breakdown of the fees. Based on conversations with issuers, however, it seems routine for them to request and obtain audit fee quotes that account for the incremental auditor's work under Section 404(b) requirements *before* the company begins complying with this section of the Act. Thus, it is possible that respondents' attribution of audit fees to Section 404(b) may be inaccurate, to the extent that they are based on quotes provided by auditors upon first-time compliance with this section and that such a breakdown does not apply in subsequent years of compliance

[10] For example, to the extent management has not designed a system to separately track internal labor hours associated with 404 compliance, providing such an estimate in response to this survey is subject to the perception of the individual respondent.

[11] So, for instance, whether the reported internal labor hours reflect the use of previously idle resources, the diversion of labor of existing employees from other tasks or the hiring of new employees would affect the definition of *incremental cost* of compliance. The survey, however, did not solicit this level of detail.

c. It is important to note that the estimates of internal labor costs presented in this report are based on an assumption about a reasonable hourly rate. The rate adopted for internal labor is $121 per hour, consistent with the rate quoted as of September, 2008 for a junior accountant cited in a report on salaries prepared by the Securities Industry and Financial Markets Association (SIFMA), to which the Commission frequently refers in its rulemakings.[12] This is at the low end of cost estimates that are provided in the SIFMA report for accounting and related services, and above the rate of $50/hour (or $100,000 for 2000 hours) that is assumed in a series of Financial Executives International ("FEI") reports of survey findings relating to the costs of compliance with Section 404 that date back to 2005.[13] Although our assumed rate is within the range of reasonable estimates for evaluating the overall costs of compliance, it is not intended for use in estimating the cost to an individual company. We have provided information sufficient for determining how the internal labor costs are affected by changes in the hourly rate—e.g., doubling (halving) the rate to $242 ($60.5) per hour doubles (halves) the associated labor costs—and by changes in internal labor hours, each of which may vary across companies.

d. Coates (2007), among others, highlights that implementation of the Sarbanes-Oxley Act "created new incentives for firms to spend money on internal controls" even where companies were required to invest such resources under the previous regulatory regime.[14] This observation is particularly relevant in the context of Section 404 implementation. In particular, Section 13(b)(2) of the Exchange Act requires companies to maintain effective ICFR, while Section 404 requires management to report on the effectiveness of ICFR. By this reasoning, it is conceivable that Section 404 may have given issuers incentives to spend more resources to meet the requirements of the Exchange Act, causing companies to bear "deferred maintenance" expenses to bring ICFR into compliance with those requirements. It is possible that survey participants include these costs in their assessment of the incremental costs due to Section 404 compliance. Whether this is the correct measure of the incremental costs of Section 404 compliance depends on the objective of the analysis. For example, issuers were required to be in compliance with Section 13(b)(2) of the Exchange Act prior to SOX, so the ICFR maintenance costs might not

[12] *See* SIFMA Management and Professional Salaries Data – Sept. 2008.

[13] *See infra* note 53.

[14] John Coates, IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 Journal of Economic Perspectives 91 (2007).

seem pertinent. From this perspective, Section 404 cost estimates that include the ICFR maintenance expenses overestimate the cost of compliance with Section 404—by including more than just the cost of reviewing ICFR and preparing the mandated disclosures. Alternatively, if the argument above is correct, in the sense that companies systematically shirk in complying with the Exchange Act requirements absent SOX, then the incremental *economic* cost of Section 404 compliance should include the aforementioned maintenance expenses that would not be borne absent Section 404. Similarly, it is worth noting that a parallel logic applies to the benefits of Section 404 compliance. That is, from an economic perspective, the incremental benefits of Section 404 include the improvements in ICFR resulting from the deferred maintenance that would not have occurred absent the new disclosure requirements of Section 404.

5. Participants in the survey provided their perceptions of the effects of Section 404 compliance, both on the financial reporting process and their company's interaction with capital market participants. The following caveats should be kept in mind for this part of the analysis:
    a. The assessment of the benefits is qualitative in nature, given the intrinsic difficulty of quantifying the benefits of Section 404 compliance in monetary terms, and not directly comparable to the cost estimates provided by the same respondents.[15]
    b. In addition to lack of comparability with cost estimates, the analysis of the survey responses about the benefits of compliance may be subject to response bias. In particular, the response bias would seem to be especially relevant when participants provide their assessment of how Section 404 compliance affects subjects outside the corporation (e.g., investors' confidence in the company's reports). The resulting analysis may be biased if the respondents' perception or their representation of those perceptions is biased. With this caveat in mind, the staff of the SEC's Office of the Chief Accountant (OCA) conducted in-depth interviews with individuals representing a variety of external users of financial statements to gather their views on the effects of Section 404. This effort complements the analysis of the views expressed by the companies participating in the survey, in combination providing a broader and more complete assessment of the effects of Section 404 on capital market participants.
6. In various parts of the survey, the participants provided information about their experience with Section 404 compliance over several years: the most recently completed fiscal year; the fiscal year prior to that, and the fiscal year in progress at the time of the survey. While

[15] *See id.* at 92 (noting that "the law's full costs are hard to quantify, and the benefits even harder, so any honest assessment of Sarbanes–Oxley must be tentative and qualitative").

responses referring to the participants' past experience reflect events that are certain, responses for the fiscal year in progress at the time of the survey result in estimates and perceptions that are intrinsically less precise, due to the inherent uncertainty about future events.

I. Introduction

This report presents an analysis of recent survey-based data on the implementation of Section 404 of the Sarbanes-Oxley Act of 2002. Section 404(a) of the Act requires management to assess and report on the effectiveness of internal control over financial reporting ("ICFR"). Section 404(b) requires that an independent auditor attest to management's assessment of the effectiveness of those internal controls. This report was requested by the Commission to help inform any decision to improve the efficiency and effectiveness of Section 404 implementation. The analysis examines whether, and to what extent, costs of implementation of Section 404 have declined after reforms undertaken by the SEC and PCAOB in 2007. Because those reforms were intended to improve both the efficiency and effectiveness of implementation, the report analyzes both the costs and the benefits of Section 404 implementation.

All companies with Section 404 compliance experience were invited to respond to the Web survey on a voluntary basis. The survey was launched in December 2008 and remained open through January 2009 to executives of companies with relevant compliance experience.

In part due to an extensive outreach effort, which included follow-up phone calls and email invitations, our response rate (about 35 percent) far exceeded those of other Section 404 studies (typically around 5 percent).[16] In addition, by merging the survey responses with financial data from commercial databases, we are able to analyze the aggregate response patterns in a style consistent with academic studies that have appeared in the financial economics literature and elsewhere. The economic analysis of Web survey data in this study contrasts with previous analyses of Web survey data in its greater scope, higher response rate, more complete documentation of findings, and in addressing the questions of potential selection bias that arise from the voluntary nature of the responses to the survey.

The remainder of this report is presented in five parts. Part II presents questions for research in the context of the institutional history of rulemaking under Section 404. Part III describes the Web survey design and administration and introduces the response data. The analysis of the Web survey response data appears in Part IV. In order to provide the reader with additional perspectives on the benefits and costs of Section 404 compliance, Part V provides a summary of findings from in-depth phone interviews of financial statement users and auditors conducted by the OCA. Part VI concludes.

[16] *See* note 39 and accompanying text.

II. Institutional Background and Questions for Research: the Sarbanes-Oxley Act of 2002 and the Commission's Rulemaking Under Section 404

Section 404 of the Sarbanes-Oxley Act directs the SEC to adopt rules requiring annual reports of companies with publicly traded securities, other than registered investment companies, to disclose management's assessment of the effectiveness of the company's ICFR and an auditor's independent attestation to the effectiveness of those internal controls. On May 27, 2003, the Commission voted to adopt rules pursuant to Section 404.[17] These rules laid out the elements required in each annual report under Section 404 and also required management to disclose any material weakness in the company's ICFR that may have been discovered during the ICFR's assessment process. The rules initially stated that accelerated filers (and large accelerated filers) should begin complying in their reports for fiscal years ending on or after June 15, 2004, and that non-accelerated filers and foreign private issuers should begin complying in their reports for fiscal years ending on or after April 15, 2005. Over the next several years, however, at various times the Commission extended the compliance deadlines for non-accelerated filers and foreign private issuers. During this period, practitioners updated their views on best practices and the Commission received recommendations from its Advisory Committee on Smaller Public Companies with regard to how to structure the Section 404 compliance process.

When the Commission first adopted rules under Section 404, the expressed objectives included enhancing the quality of reporting and increasing investor confidence in the financial statements. The Commission release cited as a benefit the improvement of "public company disclosure to investors about the extent of management's responsibility for the company's financial statements and internal control over financial reporting."[18] This is an important aspect of the financial reporting process because weaknesses in internal controls create more opportunities for intentional earnings management as well as unintentional accounting estimation and reporting errors.[19] According to the 2003 adopting release, with these rules, "investors will be able to better evaluate management's performance of its stewardship responsibility and the reliability of a company's financial statements and other unaudited financial information," and that "[i]mproved

[17] For more on SEC's regulatory history of Section 404 from 2003 to 2008, see Appendix A.

[18] *See* "Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," SEC Release No. 33-8238 (June 5, 2003) ("SEC Final Rule 2003").

[19] *See, e.g.*, William Kinney, Jr. & Linda McDaniel, *Characteristics of Firms Correcting Previously Reported Earnings*, 11 Journal of Accounting & Economics 71 (1989); Jeffrey Doyle et al., *Determinants of Weaknesses in Internal Control over Financial Reporting*, 44 Journal of Accounting & Economics 193 (2007).

disclosure may help companies detect fraudulent financial reporting earlier and perhaps thereby deter financial fraud or minimize its adverse effects."[20]

Concerns about the costs of complying with the requirements of Section 404 emerged and persisted over the first few years of implementation. By 2007, a number of organizations had published information regarding Section 404 compliance costs, with annual cost estimates ranging from $860,000 to $5.4 million per company depending on the source.[21] To address concerns about the costs of compliance, the Commission, during June and July 2007, issued Management Guidance[22] and approved the PCAOB's new audit standard, AS5, for use by public company auditors.[23] The 2007 reforms were intended to increase the efficiency and effectiveness of Section 404 implementation.

The Management Guidance described a top-down, risk-based approach to satisfying the requirements of Section 404. It was intended to reduce the costs of Section 404(a) compliance first by "allowing management to focus on the controls that are needed to adequately address the risk of a material misstatement of its financial statements"[24] and second by allowing management "to align the nature and extent of its evaluation procedures [such as evidence gathering, documentation effort, and testing the controls] to those areas of financial reporting that pose the highest risks to reliable financial reporting."[25] By stressing that "management should bring its own experience and informed judgment to bear" in the process of ICFR evaluation, the release encouraged more flexibility and discretion on management's part in complying with Section 404.[26] A companion release by the Commission also noted that the Management Guidance should help management to avoid the costs of excessive testing and documentation and allow smaller public companies to scale and tailor their evaluation methods and procedures to fit their facts and

[20] *See* SEC Final Rule 2003, *supra* note 18.

[21] *See* "Amendments to Rules Regarding Management's Report on Internal Control over Financial Reporting," SEC Release No. 33-8809 (Jun. 20, 2007) ("SEC Final Rule 2007") (citing publicly available surveys).

[22] *See* "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, Interpretation," SEC Release No. 33-8810 (June 20, 2007) ("Management Guidance").

[23] *See* "Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control over Financial Reporting that is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments," SEC Release No. 34-56152 (July 27, 2007) ("SEC Order 2007").

[24] *Id.* at 35,324.

[25] Management Guidance, *supra* note 22, at 5.

[26] *Id.*

circumstances.[27] The 2007 final release indicated that reliance on the Commission's Management Guidance is voluntary.[28]

In addition, on July 25, 2007—effective for audits of internal control for fiscal years ending on or after November 15 of the same year—the Commission approved PCAOB's AS5, which established a new standard for the independent audit of ICFR required under Section 404(b).[29] The expected benefits of AS5 included (i) allowing auditors to exercise their judgment, (ii) scaling the level of internal control testing to match the size of the company, (iii) eliminating unnecessary procedures for audit and allowing auditors to focus on matters they consider to be most important for internal control, and (iv) allowing auditors to use a principles-based approach to decide the extent to which they can rely on work already done by others, including the effort exerted by management in complying with Section 404(a).[30]

At the time of the 2007 reforms, the Commission did not quantify the economic impact of these reforms and received very few estimates from commenters. One estimate using an informal analysis was provided by a commenter who had expressed the view that implementation of the Management Guidance "could result in a reduction in company compliance costs of approximately 10 percent in the first year of implementation" and "an additional 15-20 percent cost reduction over costs incurred in the initial compliance year based on its own experience in conducting an evaluation of ICFR."[31] Two academic working papers have since investigated the impact of AS5 using commercially available data on audit fees. Dey and Sullivan (2009) report that the mean (median) Section 404 audit fee premium (Section 404 audit fees as a percent of total audit fees) for new accelerated filers in 2007 was 32 percent (37 percent) of audit fees and that this premium fell between 2006 and 2007.[32] Kinney and Shepardson (2009) examine the Section 404 audit fee premiums for 2004-2007, and report that the average percent increase in the

[27] *See* SEC Final Rule 2007, *supra* note 21.

[28] *See id.*

[29] *See* SEC Order 2007, *supra* note 23.

[30] *See* "SEC Approves PCAOB Auditing Standard No. 5 Regarding Audits of Internal Control over Financial Reporting; Adopts Definition of 'Significant Deficiency,'" SEC Press Release No. 2007-144 (July 25, 2007), available at http://Secgov/news/press/2007/2007-144.htm.

[31] *See* SEC Final Rule 2007, *supra* note 14 (citing a letter from the Computer Sciences Corporation). This letter is available at http://www.Secgov/comments/s7-24-06/s72406-208.pdf.

[32] *See* R. Mithu Dey & Mary W. Sullivan, "What Will Non-Accelerated Filers Have to Pay for the Section 404 Internal Control Audit?" (unpublished working paper, 2009), available at http://www.fdewb.unimaas.nl/ISAR2009/02_15_Dey_Sullivan.pdf. Their sample is restricted to newly accelerated filers (i.e., those who just crossed the $75 million threshold) and thus may provide a reasonable estimate of the Section 404 audit fee premium that the non-accelerated filers will have to pay when they comply with Section 404(b).

audit fees for first-time Section 404(b) companies, which were historically 114 percent, 100 percent, and 91 percent in 2004-2006 under Auditing Standard No. 2, was only 54 percent for 2007 after AS5 was issued.[33]

The economic analysis of survey data for this report was conducted primarily during 2008 and early 2009. Following the public announcement of the study in February 2008, SEC economists commenced a literature review and initial research design and retained a survey research consulting firm in late September 2008. The pre-testing of the survey questionnaire occurred in November 2008 and the Web survey was launched in early December 2008. A survey Webpage was posted on the SEC Website in mid-December and remained in place to encourage responses to the survey while responses were being collected, through January 2009. The response data were received for analysis by Office of Economic Analysis (OEA) staff during March 2009. During the following several months, data from a follow-on survey effort were collected and added to the main survey response dataset. The purpose of the follow-on effort was to increase the rate of response to optional sections of the survey about the perceived cost-benefit trade-off of Section 404 compliance and the perceived effects of SEC's Management Guidance.

The overall objective of the report is to document and discuss the empirical evidence that has emerged relating to the changes that have occurred since the 2007 reforms – from the perspective of the companies that have direct experience with compliance under Section 404. The specific questions posed through the Web survey are as follows:

Questions concerning compliance costs

- What is the cost of complying with Section 404, as reported by companies with compliance experience?
- How do these reported costs vary with the size of the company and whether it is Section 404(b) compliant?
- Has this cost of compliance declined in general and, more specifically, since the 2007 reforms?
- Does the reported cost, and the change in cost since 2007, vary with the size of the company?
- Does the reported cost vary by whether the company is Section 404(a)-only versus both Section 404(a) and Section 404(b) compliant?

[33] *See* William R. Kinney, Jr. & Marcy L. Shepardson, "Effects of Alternative SOX Regimes on Audit Fees and Material Weakness Disclosures for Smaller Public Companies: A Natural Experiment" 3-4 (unpublished working paper, 2009).

- What is the relation between scaled costs—measured using cost as a percentage of asset value—and company size as reported by companies with compliance experience?

Questions concerning compliance benefits

- What types of benefits do companies recognize as arising from compliance?
- Do these recognized benefits vary across companies, including companies of different sizes?

Questions comparing costs and benefits

- What are companies' perceptions of Section 404 compliance costs relative to perceived benefits (i.e., net benefits)?
- Have companies' perceptions of Section 404's net benefits changed over time and, in particular, following the 2007 reforms?
- Have companies considered going private or delisting from U.S. exchanges in response to the perceived burden imposed by Section 404 requirements?
- Do these considerations vary with the company's size and have they changed over time?

Questions concerning the effects of the 2007 reforms

- Have the 2007 reforms been relied upon and are they perceived to have affected or expected to affect the process (i.e., tasks and activities) by which companies comply with the requirements of Section 404?
- Do companies perceive the 2007 reforms to have improved the efficiency of implementation of Section 404 by lowering the associated compliance costs?

In addition to the analysis of Web survey data, this report presents insights obtained from in-depth phone interviews with selected groups of users of financial reports and auditors, which were conducted independently of the launch of the Web survey.

Questions from in-depth interviews of financial statement users and independent auditors

- What types of effects do various groups of users and independent auditors of financial statements recognize as arising from compliance with Section 404 requirements?
- Do users perceive their professional decisions and actions to be affected by whether companies are Section 404 compliant?

III. Web Survey Design, Administration, and Characteristics of Respondents

The primary source of data for this report is a Web survey administered in December 2008 and January 2009 and open to executives of corporations experienced in complying with the rules under Section 404. Special efforts were undertaken to encourage responses by selected subsamples of those companies during the period. Rather than attempt a census of all companies with Section 404 experience, we generated a list of companies likely to have sufficient experience to provide meaningful responses to questions about Section 404 compliance and for which data were available from public sources to facilitate the analysis of response statistics. The initial list was used in testing for differences between respondents and non-respondents, and as a sampling frame for the purpose of generating a random subsample of companies for a follow-on survey.

Initial list of companies. Our initial list of 8,215 companies was generated through a two-step process. First, we obtained a list of 12,663 annual report filers from the SEC's Office of EDGAR Information Analysis. This included all entities reporting on forms 10-K, 10KSB, 20-F, or 40-F in both calendar years 2006 and 2007. We removed from the list 1,898 asset-backed securities because these securities are not subject to the Section 404 requirements. Second, we required the availability of recent stock price data and other financial data from third-party data providers.[34] This final step reduced the list by almost a quarter, from 10,765 to 8,206. During the survey administration, an additional nine companies not identified by our screening petitioned to be included and were added to the 8,206 companies on the initial list. We use this updated list of 8,215 companies for purposes of comparing respondents with non-respondents.

Questionnaire. In determining the questions for inclusion in the Web survey, we considered both the questions used in other surveys, sponsored by professional associations,[35] and those

[34] We used Thomson ONE Banker to match the SEC's CIK identifier for each firm with Thomson's security identifiers – "ISIN" or "DSCODE." We used these identifiers to check for availability of pricing data on Datastream as of October 15, 2008.

[35] The cost of Section 404 compliance is reported in a series of prior surveys sponsored by professional associations dating back to the first year of compliance in 2004. *See, e.g.*, CRA International, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update* (Apr. 17, 2006) ("CRA (2006)"); CRA International, *Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update* (Dec. 8, 2005) ("CRA (2005)"); Financial Executives International, *FEI Audit Fee Survey Including Sarbanes-Oxley Section 404 Costs* (April 2, 2008) ("FEI (2008)"); Financial Executives International, *FEI Survey on Sarbanes-Oxley Section 404 Implementation* (May 2007) ("FEI (2007)"); Financial Executives International, *FEI Survey on Sarbanes-Oxley Section 404 Implementation* (March 2007) ("FEI (2006)"); Financial Executives International, *FEI Special Survey on Sarbanes-Oxley Section 404 Implementation* (March 2005) ("FEI (2005)"); Foley & Lardner LLP, *The Cost of Being Public in the*

examined by the academic literature[36] on Section 404 of the Act. In addition to questions about various components of the cost of compliance with Section 404, the Web survey included questions about the factors that may explain compliance costs, about the perceived effects of Section 404 compliance, and about the perceived effects of the 2007 reforms on the compliance process. Whenever appropriate, the survey questions were designed to gather data covering a three-year period: the most recent fiscal year for which the respondent's company filed an annual report with the Commission – most recently completed fiscal year, the fiscal year prior to the most recently completed fiscal year, and the fiscal year in progress at the time of the survey, i.e., the year following the most recently completed fiscal year. Depending on the respondent's filing history, the most recently completed fiscal year-end for which the respondent was able to provide information was either in 2007 or 2008.

Various steps were taken to ensure that the questions reflected the research objectives and were worded properly. Before launching the Web survey, three rounds of cognitive interviews—both in-person and over the phone—were conducted to obtain an initial assessment of the effectiveness of the survey instrument in eliciting the information it was designed to gather. The survey questions were grouped into several parts.[37] In order to reduce respondent burden and break-offs and increase the response rate, some sections of the survey – concerning the respondents' experience with the SEC's Management Guidance and their perception of the net benefits of Section 404 – were designated to be "optional" and placed later in the questionnaire. The respondents could choose to complete them after completing the initial sections.

Era of Sarbanes-Oxley (June 16, 2007) ("Foley & Lardner (2007)"); Foley & Lardner LLP, *The Cost of Being Public in the Era of Sarbanes-Oxley* (June 15, 2006) ("Foley & Lardner (2006)"); U.S. Chamber of Commerce, Center for Capital Markets Competitiveness, *Cost of SOX Section 404 Survey* (Oct. 31, 2007) ("U.S. Chamber of Commerce (2007)").

[36] Numerous academic studies have also investigated the economic consequences of Section 404. *See, e.g.*, Jagan Krishnan et al., *Costs to Comply with SOX Section 404*, 27 Auditing: A Journal of Practice & Theory 169 (2008); Vidhi Chhaochharia & Yaniv Grinstein, *Corporate Governance and Company Value: The Impact of the 2002 Governance Rules*, 62 Journal of Finance 1759 (2007); Ivy Zhang, *Economic Consequences of the Sarbanes-Oxley Act of 2002*, 44 Journal of Accounting & Economics 74 (2007); Haidan Li et al., *Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management*, 51 Journal of Law & Economics 111 (2008); Zabihollah Rezaee & Pankaj K. Jain, "The Sarbanes-Oxley Act of 2002 and Security Market Behavior: Early Evidence" (unpublished working paper, 2005) (finding positive abnormal returns associated with legislative events that increased the likelihood of the Act's passage), available at http://ssrn.com/abstract=498083; Iliev (2008) *supra* note 5; Dey & Sullivan (2009), *supra* note 32; Kinney, Jr. & Shepardson (2009) *supra* note 33; Michael W. Maher & Dan Weiss, "Costs of Complying with the Sarbanes-Oxley Act," (unpublished working paper) (2008), available at http://ssrn.com/abstract=1313214.

[37] Appendix B includes the Web survey questionnaire.

The questionnaire was designed in anticipation of matching the survey responses with other company characteristics obtained from third-party databases, including CRSP, Standard and Poor's Compustat, Thomson Financial's Datastream, EDGAR Online, and Audit Analytics.[38] In examining the changes in compliance experience around the 2007 reforms, the analysis uses the November 15, 2007 effective date of AS5 to define the compliance regime for each set of reported responses. Survey responses referring to fiscal years ending prior to November 15, 2007 are taken to reflect the experience of the company prior to the 2007 reforms ("Pre"), whereas responses referring to fiscal years ending on or after November 15, 2007 are taken to reflect the experience or expectations of the company after the 2007 reforms ("Post" or "Next"). A significant portion of the survey was designed to obtain data on how the Section 404 compliance process may have changed around the time of the reforms. The analysis of these data complements the costs and benefits analysis by providing unique insights into the activities and responsibilities entailed by Section 404 compliance and how these may have been affected by the 2007 reforms.

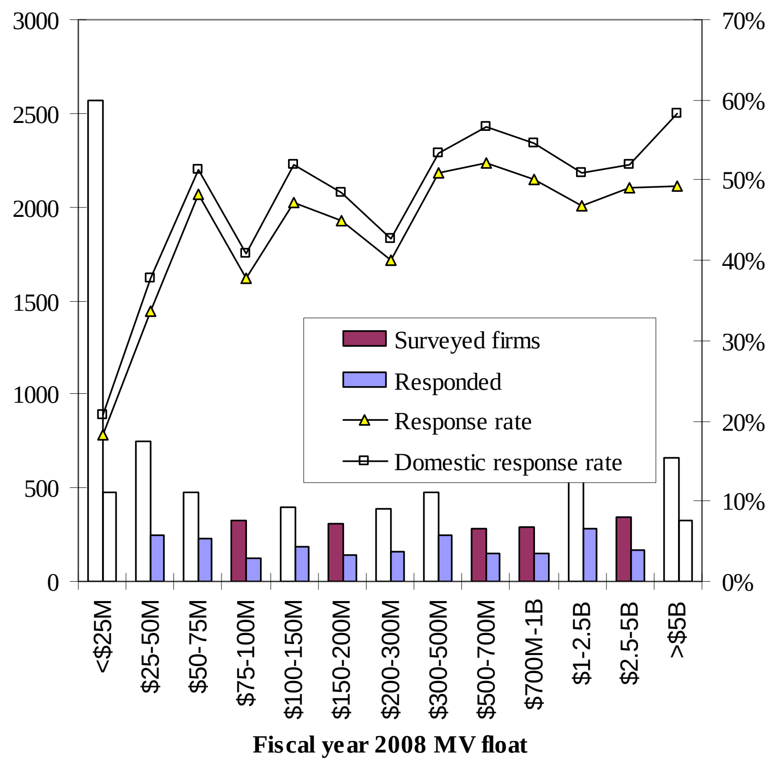
Collection of responses. The survey was launched on December 4, 2008 and remained open on the SEC Website for two months. At various stages of the survey launch, individuals at the companies on the initial list were sent invitations to participate. Some of these invitations were extended by email and some were extended by paper mail. In the case of paper mail, letters were sent to as many as three officers from each company (to the extent that contact information was available): Chief Executive Officer, Chief Financial Officer, and General Counsel. The invitation letters indicated that the recipients could either directly participate in the survey using the login and password information provided or pass the information on to someone within the same company who they thought would be most knowledgeable to complete the survey. Given that invitations were sent to multiple individuals from the same company, we received multiple responses from 216 of the companies on the initial list. Including these, the Web survey elicited a total of 3,138 responses. In the analysis presented here, we treated each response as a separate company-year observation. To assess the sensitivity of the analysis to this treatment, however, we considered alternative approaches: a) averaging multiple responses at the company level; b) retaining only the highest (or only the lowest) response when multiple responses are available for the same company; and c) removing all companies with multiple responses from the sample. Regardless of the approach adopted, the results were not qualitatively affected. Our subsequent

[38] The number of observations may vary from table to table due to data availability constraints resulting from the use of third-party datasets, which may not cover all companies in our sample.

analysis also verified that the companies that provided multiple responses were not clustered within just one or two size categories.

Letters containing customized login IDs and passwords for the survey were mailed to the executives using contact information from the SEC's EDGAR office and other sources, with corrected addresses from returned envelopes used in subsequent rounds. Emails with the same information and a hyperlink to the survey Website were also sent, again using contact information from the SEC's EDGAR office and also through the NYSE and NASDAQ, which distributed the survey link to clients via email encouraging participation. Notices of the survey were additionally posted by professional associations, on the SEC Website, and mentioned in speeches by SEC staff during this period.

Figure 1 – Number of companies on the initial list, number of responding companies, and survey participation rates: by company size. The following chart displays the number of companies in the initial list of companies, the number of responding companies, and the corresponding response rate for various companies' size categories, based on the public float measured in fiscal year 2008.



Response patterns. We received survey responses from 2,907 of the 8,215 companies in the initial list – a measured survey response rate of 35 percent, which is well above the participation rate of earlier surveys of financial executives.[39] Figure 1 plots the response rate according to a candidate firm's public float as of the end of fiscal year 2008.[40] The participation rate among larger filers is around 50 percent, which indicates a relatively high response rate on questions relating to Section 404(b). The response rate is higher still when considering only domestic companies.

Companies' characteristics, selection bias and response bias analyses. To assess the representativeness of the sample of companies responding to the survey, we analyzed the characteristics of companies responding to the survey *vis-à-vis* those from the initial list that did not participate in the survey. The analysis includes comparisons between respondents and non-respondents for: (i) all companies in the initial list, (ii) those companies that have experience with Section 404(b), and (iii) those companies that have experience with Section 404(a) only. Examples of the characteristics that were analyzed for this purpose include company sales, equity market capitalization, return on assets, sales growth, and dividend yield. Considering all 8,215 companies, those for which at least one survey response was received are significantly different from companies that did not participate in the survey. In the vast majority of cases, the mean differences in company characteristics between respondents and non-respondents are economically large and statistically significant. In particular, non-respondent companies (i) are smaller, in terms of their sales and market capitalization of equity, (ii) experienced poorer performance in the year prior to the survey as measured by net income, cash-flows, return on assets, or by 12-month stock returns, and (iii) have lower financial leverage. Financial companies (i.e., banks or insurance companies) are more heavily represented among respondents, whereas the opposite is true for research and development companies. Moreover, non-respondent companies typically pay lower audit fees, are less likely to have used a Big 4 auditing firm, and, since 2004, are less likely to have reported a Section 404(b) material weakness, more likely to

[39] Survey response rates on Sarbanes-Oxley compliance costs tend to be around 5% or less: U.S. Chamber of Commerce (2007) (3.6%), *supra* note 35; Foley & Lardner (2007) (93 respondents out of approximately 10,000 officers contacted), *supra* note 35; FEI (2008) (5.2%), *supra* note 35. The response rate for the survey in this study is also higher than the typical response rate of surveys of financial executives found in scholarly articles. *See, e.g.*, John Graham et al., *Value Destruction and Financial Reporting Decisions*, 62 Financial Analysts Journal 27 (2006) (10.4%); E. Trahan, & L. Gitman, *Bridging the Theory-Practice Gap in Corporate Finance. A Survey of Chief Financial Officers*, 35 Quarterly Review of Economics & Finance 73 (1995) (12%); John R. Graham & Campbell R. Harvey, *The Theory and Practice of Corporate Finance: Evidence from the Field*, 60 Journal of Financial Economics 187 (2001) (9%); Alon Brav et al., *Payout Policy in the 21st Century*, 77 Journal of Financial Economics 483 (2005) (16%).

[40] Henceforth, all references to market float are measured as of the last day of the month ending six months prior to the referenced fiscal year-end, the date used to determine accelerated filer status.

have reported a restatement and/or experienced a change of auditor, but less likely to have been engaged in a merger or acquisition activity.

Table 1 – Characteristics of companies in the initial list, by whether they participated in the survey. This table presents mean characteristics for companies in the initial list that was administered by the SEC's Office of Economic Analysis. The statistics were generated from a sample of 8,215 companies that met the following conditions: filed a 10-K or equivalent form with the SEC during fiscal years 2006 and 2007 (excluding asset-backed securities), and were actively traded at the time of the survey launch. The leftmost columns report the characteristics of respondents and non-respondents for all 8,215 companies; the center columns and the rightmost columns report the same information on Section 404(a)-only companies and Section 404(b) companies in the target sample (at the time of the survey launch), respectively. A difference in means (between respondents and non-respondents) test statistics is reported in italics. The following measures are winsorized at the 1% and 99% levels: ROA, Cash flow/Assets, Dividend yield, Sales growth, and Prior year return. For variable definitions, see Table 2. The column *Diff.* reports the difference in means for the corresponding characteristic. ***, **, and * indicate rejection of the hypothesis that the difference in means for the corresponding characteristic is equal to zero at 1%, 5%, and 10%, respectively.

	All companies on the initial list (N=8,215)			Section 404(a)-only companies on the initial list (N=3,929)			Section 404(b) companies on the initial list (N=4,286)		
Responded to survey	No	Yes		No	Yes		No	Yes	
	N=5308	N=2907	*Diff.*	N=3051	N=813	*Diff.*	N=2205	N=2081	*Diff.*
Total assets ($ mil)	9,930	10,223	*-293*	95	250	*-155****	21,052	13,860	*7,192**
Sales ($ mil)	2,315	3,334	*-1,019****	43	133	*-90****	4,903	4,502	*401*
Public float ($ mil)	2,742	3,827	*-1,085****	43	80	*-37****	5,594	5,142	*452*
Sales growth	17.9%	16.0%	*1.9%**	13.7%	16.5%	*-2.8%***	19.7%	15.7%	*4.0%****
ROA	-8.1%	-1.2%	*-6.9%****	-23.1%	-10.8%	*-12.3%****	-1.5%	1.1%	*-2.6%****
Cash flow/Total Assets	-5.6%	0.8%	*-6.4%****	-20.0%	-10.0%	*-10.0%****	0.9%	3.4%	*-2.5%****
Dividend yield	1.1%	1.2%	*-0.1%*	0.9%	1.1%	*-0.2%***	1.2%	1.2%	*0.0%*
Prior year return	-5.0%	1.8%	*-6.8%****	-12.2%	-1.3%	*-10.9%****	0.7%	2.7%	*-2.0%*
Leverage	15.8%	17.0%	*-1.2%***	10.9%	11.6%	*-0.7%***	18.1%	18.2%	*-0.1%*
R&D company	42.7%	38.1%	*4.6%****	14.8%	24.7%	*-9.9%****	41.1%	37.4%	*3.7%***
Bank	7.4%	13.7%	*-6.3%****	5.6%	15.5%	*-9.9%****	10.0%	12.9%	*-2.9%****
Insurance Company	2.1%	3.1%	*-0.1%***	0.7%	1.7%	*-1.0%****	4.1%	3.6%	*0.5%*
Total audit fees ($ Thou)	1,299.2	1,987.1	*-687.9****	142.3	216.3	*-74.0****	2,899.8	2,678.8	*2,21.0*
Big 4 auditor	41.2%	61.6%	*-20.4%****	12.4%	16.4%	*-4.0%****	81.0%	79.3%	*1.7%*
Material weakness 404(a)	23.1%	21.7%	*1.4%*	23.9%	18.9%	*5.0%****	22.6%	22.9%	*-0.3%*
Material weakness 404(b)	9.3%	16.4%	*-7.1%****	-	-		22.3%	22.9%	*-0.6%*
First time 404(b) complier	7.6%	7.2%	*0.4%*	-	-		17.2%	9.6%	*7.6%****
Restatement	5.7%	3.1%	*2.6%****	7.3%	4.9%	*2.4%***	3.6%	2.4%	*1.2%***
Auditor change	5.4%	3.5%	*1.9%****	7.1%	5.9%	*1.2%*	3.1%	2.5%	*0.6%*
Acquisition made	12.1%	20.9%	*-8.8%****	2.9%	5.4%	*-2.5%****	25.2%	27.1%	*-1.9%*

Table 2 – Definition of companies' characteristics. The following table provides the definitions for the variables presented in Table 1,

Variable	**Definition**
Total assets	The total dollar value of the company's assets during the fiscal year as reported by Compustat.
Sales	The total dollar value of the company's sales during the fiscal year as reported by Compustat.
Public float	The market value of the company's public float reported by Thomson Financial's Datastream six months prior to the fiscal year-end – the day used to assess accelerated filer status.
Sales growth	Current year sales less prior year sales scaled by prior year sales.
ROA	Net income divided by total assets reported in the same fiscal year.
Cash flow/Total Assets	Operating income less interest expense, income tax, and dividends scaled by total assets.
Dividend yield	Total dollar value of dividends issued during the year scaled by total assets.
Prior year return	The company's annual return in the calendar year prior to the fiscal year
Leverage	Long-term debt scaled by total assets as reported by Compustat.
R&D company	Company reported by Compustat as having nonzero research and development expenditures during the year.
Bank	Indicator variable equal to one for companies defined by the Fama and French (1997) 49 industry classification equal to 45, and zero otherwise.
Insurance Company	Indicator variable equal to one for companies defined by the Fama and French (1997) 49 industry classification equal to 46, and zero otherwise.
Total audit fees	The total audit fees the company paid to its independent auditor during the fiscal year as reported by Audit Analytics.
Big 4 auditor	Indicator variable equal to one if the company's independent auditor is one of the Big 4 auditors (i.e., Ernst & Young, PricewaterhouseCoopers, Deloitte & Touche, and KPMG).
Material weakness Section 404(a)/(b)	Indicator variable equal to one if management's assessment (a) or the auditor attestation (b) reported a material weakness in ICFR during the fiscal year as reported by Audit Analytics.
First time Section 404(b) complier	Indicator variable equal to one if the company filed the auditor attestation report of ICFR during the fiscal year as reported by Audit Analytics.
Restatement	Indicator variable equal to one if a company restated any of the financials during the calendar year as reported through an amended filing or 8-K disclosure. Data from Audit Analytics.
Auditor change	Indicator variable equal to one when the company's auditor listed in Audit Analytics changes from the prior year, and zero otherwise.
Acquisition made	Indicator variable equal to one if a company made at least one acquisition of another public company, subsidiary, or private company as reported by Thomson Financial SDC Platinum database. Acquisitions are defined as any completed control change with a reported deal value and where the acquirer owned less than 50% of the target prior to the announcement and 100% after.

Many of these differences, however, disappear or are largely attenuated when the comparison is restricted to companies with Section 404(b) compliance experience. Thus, at least among these companies, the characteristics of respondents and non-respondents are similar. This is important because many survey questions pertain only to Section 404(b) companies. The voluntary nature of the survey thus appears not to have introduced bias into the response statistics on the Section 404(b) companies.[41]

Table 1 reports details of these comparisons for the various samples of respondents and non-respondents while Table 2 provides definitions for each characteristic analyzed. In order to avoid the possibility of outliers driving the mean results in Table 1, we set the most extreme observations of some variables equal to the less extreme values of those variables; specifically, we set the extreme values of return-on-assets, cash flow as a fraction of assets, dividend yield, and prior year's returns at the 1st- and 99th-percentile levels of those variables.[42]

To further examine the differences between respondent and non-respondent companies, we analyzed the response rate across industries. Table 3 reports the number of companies on the initial list and the corresponding participation rate by industry for (i) all companies and (ii) only Section 404(b) companies. The industry definition is based on Fama-French's conversion of 4-digit Standard Industry Classification codes into 49 industry categories.[43] The table shows wide variation in the survey participation rates across industries, between 70 percent and 18 percent. It also appears, however, that survey respondents represent a wide variety of industries and do not cluster within just a few industries whether the response rate is measured relative to all companies on the initial list, or just the Section 404(b) companies on the list.

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[41] To be sure, the proportion of first-time Section 404(b) compliers is larger among non-respondents than respondents (see Table 1). To the extent that the incentives to participate in the survey are a function of first-time compliance costs, it is possible that inferences from the analysis concerning first-time Section 404(b) compliers is biased in a direction that depends on the relation between the decision to participate and the related compliance costs. The lower response rate among first-time Section 404(b) compliers may plausibly be due to the difficulty on our part of reaching out to these companies relative to larger and, thus, 'seasoned' Section 404(b) companies—a factor independent of first-time compliance cost. Indeed, we conducted an additional outreach after the launch to encourage first-time Section 404(b) compliers to participate in the survey.

[42] This is a common practice, known as "winsorizing."

[43] E. F. Fama & K. R. French, *Industry Costs of Equity*, 43 Journal of Financial Economics 153 (1997).

Table 3 – Survey response rates by industry. This table presents the number of companies on the initial list and the corresponding survey participation rate (percentage) by industry, based on the Fama-French 49-industry classification. *All companies* refers to all companies on the initial list, *Section 404(b) companies only* refers to the subset of companies that complied with Section 404(b) as of their last completed fiscal year at the time of the survey.

		All companies		Section 404(b) companies only	
	Industry of respondent company	N	% responded	N	% responded
26	Defense	10	70%	7	57%
24	Aircraft	28	64%	16	81%
5	Tobacco Products	7	57%	6	67%
25	Shipbuilding, Railroad Equipment	14	57%	10	80%
20	Fabricated Products	16	56%	9	67%
29	Coal	19	53%	15	67%
45	Banking	790	50%	490	55%
33	Personal Services	60	48%	43	60%
38	Measuring and Control Equipment	110	48%	65	48%
31	Utilities	155	46%	125	52%
43	Retail	235	46%	178	52%
40	Shipping Containers	11	45%	9	56%
28	Non-Metallic and Industrial Metal Mining	54	44%	39	46%
46	Insurance	202	44%	166	45%
16	Textiles	16	44%	10	60%
23	Automobiles and Trucks	76	43%	56	45%
48	Financial Trading	314	41%	261	46%
37	Electronic Equipment	355	40%	243	44%
41	Transportation	190	38%	132	45%
35	Computer Hardware	127	37%	67	58%
36	Computer Software	420	37%	251	43%
17	Construction Materials	104	37%	54	43%
19	Steel Works Etc	63	37%	44	41%
12	Medical Equipment	259	36%	111	57%
42	Wholesale	212	36%	102	57%
14	Chemicals	171	36%	85	59%
39	Paper Business Supplies	54	35%	41	39%
44	Restaurants, Hotels, Motels	100	35%	55	47%
34	Business Services	453	35%	207	46%
10	Apparel	90	34%	44	52%
22	Electrical Equipment	153	33%	66	48%
47	Real Estate	65	32%	33	42%
2	Food Products	155	32%	53	60%
30	Petroleum and Natural Gas	389	31%	210	46%
13	Pharmaceutical Products	568	30%	289	44%
8	Printing and Publishing	69	30%	33	52%
18	Construction	135	30%	50	44%
4	Beer & Liquor	21	29%	11	36%
9	Consumer Goods	147	29%	50	56%
15	Rubber and Plastic Products	70	29%	18	39%
11	Healthcare	245	27%	70	47%
32	Telecomm communications	274	26%	164	33%
21	Machinery	397	26%	124	48%
7	Entertainment	176	22%	53	45%
1	Agriculture	33	21%	9	44%
3	Candy & Soda	35	20%	12	33%
6	Recreation	332	18%	37	59%
27	Precious Metals	197	18%	44	45%
49	Other	39	36%	19	58%
	All industries	8,215	35%	4,286	48%

We conducted further analysis to confirm the representativeness of the response data. This occurred through a series of tests using the initial list of 8,215 companies that could have participated in the survey. We tested for differences between respondents and non-respondents, and also for differences between companies that responded voluntarily, without any reminder phone call, and a stratified sample of 500 companies that were selected at random for a follow-up call. The companies that received follow-up calls were 23 percent more likely to respond than those that did not receive a call. Yet the characteristics of the two groups of companies are quite similar, as are their survey responses. This is what we would expect to find in the absence of self-selection bias. In Tables 4 through 6, we present comparisons between the characteristics of the survey participants (and their responses to selected survey questions), according to whether the participant responded voluntarily without any follow-up phone call or was among those 500 companies that received such a follow-up phone call. The analysis is broken out by strata (i.e., subsamples) based on company size, for $50-75 million companies (Table 4), $75-100 million companies (Table 5), and $100-700 million companies (Table 6).[44] For each of these tables, Panel A reports the comparison of company characteristics by whether they are in the follow-up group, while Panel B compares selected key variables (compiled based on survey responses).

Consistent with the random nature of the selection process within each relevant size category, most of the characteristics are not significantly different across the two groups of companies (i.e., those selected for follow-up and those not selected). This is consistent with the absence of self-selection bias. These findings hold for each of the three size groups.

[44] The comparison of respondent and non-respondent companies is reported in three parts, by size of company, to parallel the presentation of response statistics in the later sections of this report, which also occurs by size of company. An exception arises in the delineation of the smallest size category. While some of our statistical findings on the smallest companies refer to companies with public float of less than $75 million, the sample of 500 companies was selected at random by a stratified sampling process, with strata defined by public float levels ranging between $50 million and $100 million and between $100 million and $700 million. The use of these size thresholds in the tables reflects this selection process.

Table 4 – Comparison of responding companies by whether they were randomly selected for a follow-up phone call: for companies with 2006 public float between $50 million and $75 million. This table presents summary statistics (*Mean, Median, and Number of Observations*) for companies' characteristics by whether they were the subject of a phone call follow-up effort for companies with public float in 2006 between $50 and $75 million. Panel A reports firm characteristics; Panel B reports selected response variables. Variables' definitions are contained in Table 2. The column *Diff.* reports the difference in means for the corresponding characteristic. ***, **, and * indicate rejection of the hypothesis that the difference in means for the corresponding characteristic is equal to zero at 1%, 5%, and 10%, respectively.

	Not selected for follow up			Selected for follow up			
	Mean	Median	N	Mean	Median	N	*Diff.*
Panel A: Company characteristics							
Total assets ($ mil)	275.0	129.6	79	275.1	112.6	102	*-0.1*
Sales ($ mil)	110.4	53.9	79	129.0	50.7	102	*-18.7*
Sales growth	0.115	0.090	66	0.153	0.103	86	*-0.038*
ROA	-0.105	0.007	69	-0.090	0.006	93	*-0.015*
Cash flow/Total Assets	-0.065	0.015	68	-0.060	0.014	90	*-0.005*
Dividend Yield	0.011	0	68	0.006	0	90	*0.005*
Prior year return	-0.037	-0.130	78	-0.149	-0.195	97	*0.112*
Leverage	0.105	0.060	68	0.093	0.030	92	*0.012*
R&D Company	0.222	0	81	0.423	0	104	*-0.201****
Bank	0.272	0	81	0.221	0	104	*0.050*
Insurance Company	0.025	0	81	0.019	0	104	*0.005*
Total audit fees ($ thou)	419.4	284.0	81	375.2	249.4	104	*44.2*
Big 4 auditor	0.346	0	81	0.346	0	104	*0.000*
Material weakness 404(a)	0.148	0	81	0.279	0	104	*-0.131***
Material weakness 404(b)	0.111	0	81	0.163	0	104	*-0.052*
First time Section 404(b) complier	0.173	0	81	0.144	0	104	*0.029*
Restatement	0.037	0	81	0.048	0	104	*-0.011*
Auditor Change	0.037	0	81	0.048	0	104	*-0.011*
Acquisition	0.123	0	81	0.135	0	104	*-0.011*
Panel B: Survey response characteristics							
Total audit fees ($ thou)	401.4	245.0	76	408.5	259.5	102	*-7.1*
404 costs ($ thou)	488.9	358.4	60	554.7	315.1	79	*-65.8*
Direct Benefit Index	2.033	2	61	1.613	2	93	*0.420*
Indirect Benefit Index	0.087	0	46	-0.046	0	65	*0.133*

Table 5 – Comparison of responding companies by whether they were randomly selected for a follow-up phone call: for companies with 2006 public float between $75 million and $100 million. This table presents summary statistics (*Mean, Median, and Number of Observations*) for companies' characteristics by whether they were the subject of a phone call follow-up effort for companies with public float in 2006 between $75 and $100 million. Panel A reports firm characteristics; Panel B reports selected response variables. Variables' definitions are contained in Table 2. The column *Diff.* reports the difference in means for the corresponding characteristic. ***, **, and * indicate rejection of the hypothesis that the difference in means for the corresponding characteristic is equal to zero at 1%, 5%, and 10%, respectively.

	Not selected for follow up			Selected for follow up			
	Mean	Median	N	Mean	Median	N	*Diff.*
Panel A: Company characteristics							
Total assets ($ mil)	328.8	170.8	69	525.4	243.3	91	*-196.6*
Sales ($ mil)	221.5	79.8	69	530.7	59.7	91	*-309.2*
Sales growth	0.233	0.136	65	0.175	0.101	80	*0.059*
ROA	-0.032	0.013	66	-0.045	0.008	81	*0.012*
Cash flow/Total Assets	-0.014	0.035	65	-0.053	0.015	82	*0.038*
Dividend Yield	0.015	0	65	0.009	0.000	78	*0.006*
Prior year return	0.036	-0.023	68	-0.120	-0.163	93	*0.157**
Leverage	0.138	0.062	66	0.101	0.053	83	*0.036*
R&D Company	0.377	0	69	0.379	0	95	*-0.002*
Bank	0.188	0	69	0.263	0	95	*-0.075*
Insurance Company	0.014	0	69	0.011	0	95	*0.004*
Total audit fees ($ thou)	550.7	337.5	69	445.0	305.5	95	*105.7*
Big 4 auditor	0.493	0	69	0.432	0	95	*0.061*
Material weakness 404(a)	0.246	0	69	0.189	0	95	*0.057*
Material weakness 404(b)	0.217	0	69	0.147	0	95	*0.070*
First time Section 404(b) complier	0.130	0	69	0.095	0	95	*0.036*
Restatement	0.058	0	69	0.063	0	95	*-0.005*
Auditor Change	0.043	0	69	0.053	0	95	*-0.009*
Acquisition	0.043	0	69	0.116	0	95	*-0.072**
Panel B: Survey response characteristics							
Total audit fees ($ thou)	567.7	358	64	478.6	330	93	*89.1*
404 costs ($ thou)	678.0	395	40	657.1	415.1	64	*20.9*
Direct Benefit Index	1.982	2	56	2.076	2	79	*-0.094*
Indirect Benefit Index	0.561	0	41	0.038	0	52	*0.523*

Table 6 – Comparison of responding companies by whether they were randomly selected for a follow-up phone call: for companies with 2006 public float between $100 million and $700 million. This table presents summary statistics (*Mean, Median, and Number of Observations*) for companies' characteristics by whether they were the subject of a phone call follow-up effort for companies with public float in 2006 between $100 and $700 million. Panel A reports firm characteristics; Panel B reports selected response variables. Variables' definitions are contained in Table 2. The column *Diff.* reports the difference in means for the corresponding characteristic. ***, **, and * indicate rejection of the hypothesis that the difference in means for the corresponding characteristic is equal to zero at 1%, 5%, and 10%, respectively.

	Not selected for follow up			Selected for follow up			
	Mean	Median	N	Mean	Median	N	*Diff.*
Panel A: Company characteristics							
Total assets ($ mil)	1010.4	501.2	719	986.6	527.8	125	*23.8*
Sales ($ mil)	547.4	219.0	719	549.0	248.4	125	*-1.6*
Sales growth	0.161	0.096	674	0.113	0.075	117	*0.048**
ROA	-0.019	0.017	685	-0.015	0.027	119	*-0.004*
Cash flow/Total Assets	0.007	0.036	668	0.018	0.044	112	*-0.011*
Dividend Yield	0.011	0	666	0.010	0	118	*0.001*
Prior year return	-0.064	-0.133	717	-0.086	-0.154	125	*0.022*
Leverage	0.160	0.067	692	0.175	0.068	119	*-0.015*
R&D Company	0.361	0	726	0.352	0	125	*0.009*
Bank	0.175	0	726	0.152	0	125	*0.023*
Insurance Company	0.029	0	726	0.032	0	125	*-0.003*
Total audit fees ($ thou)	980.7	683.0	726	952.8	689.5	125	*28.0*
Big 4 auditor	0.686	1	726	0.664	1	125	*0.022*
Material weakness 404(a)	0.293	0	726	0.272	0	125	*0.021*
Material weakness 404(b)	0.284	0	726	0.256	0	125	*0.028*
First time Section 404(b) complier	0.047	0	726	0.032	0	125	*0.015*
Restatement	0.023	0	726	0.048	0	125	*-0.025*
Auditor Change	0.036	0	726	0.048	0	125	*-0.012*
Acquisition	0.208	0	726	0.200	0	125	*0.008*
Panel B: Survey response characteristics							
Total audit fees ($ thou)	934.2	650.0	706	953.1	752.5	122	*-18.9*
404 costs ($ thou)	1,036.2	692.9	444	1,035.8	855.5	73	*-0.4*
Direct Benefit Index	2.402	2	645	2.343	2	108	*0.059*
Indirect Benefit Index	0.340	0	467	0.398	0	83	*-0.057*

Finally, we conducted a comparison of the survey responses to questions about audit fees with audit fees reported by Audit Analytics, a data aggregator that collects this information from SEC filings. The objective was to determine whether survey responses about audit fees were consistent with audit fee data contained in public reports as reported by Audit Analytics.[45] If survey participants are biased in their responses, then this is one question where we can quantify the bias. Table 7 presents the results of this analysis for all companies as well as three separate subsamples based on companies' public float.[46] The table reports summary statistics for audit fees from survey responses and Audit Analytics, both for the most recently completed fiscal year (at the time of the survey) and the prior fiscal year. Overall, on average, respondents provided estimates of audit fees that are lower than what is reported by Audit Analytics. This is consistent with the disparity between the relatively broad definition of audit fees that applies in SEC filings from which Audit Analytics collects data and the comparatively narrow definition of audit fees provided in the survey questionnaire.[47] Moreover, the differences are significant among the medium ($75-700 million) and larger (>$700 million) companies only, precisely where the broad definition of audit fees adopted for the purpose of SEC's filings is most likely to lead to a discrepancy relative to the narrower definition in the survey.

[45] Audit Analytics' definition of "audit fees" is consistent with SEC rules that require registrants to report as "audit fees" the aggregate fees billed for professional services rendered by the principal accountant for the audit of the annual financial statements and review of financial statements included in the registrant's Form 10-Q or 10-QSB or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements. *See* SEC Release No. 33-8183, available at http://www.sec.gov/rules/final/33-8183.htm.

[46] The table excludes 25 observations where the survey response is more than five times greater than what Audit Analytics reports. These observations were also excluded from the remaining analysis.

[47] In asking for "total audit fees," the Web survey asked for the total fees the company paid its independent auditor for both the audit of the financial statements and the audit of ICFR (if applicable), which excludes any fees paid for services that are normally provided in connection with statutory and regulatory filings.

Table 7 – Reported audit fees of respondent companies, compared to audit fee information from Audit Analytics. This table reports summary statistics for total audit fees paid in the 'current' and 'prior' fiscal year as reported in the survey and by Audit Analytics. The table excludes 25 observations where the survey response is more than five times greater than what Audit Analytics reports. There are 2,842 (2,836) observations where both a survey response and an Audit Analytics comparison value for the same prior (current) year are available. The column *Diff.* reports the difference in means for the corresponding characteristic. ***, **, and * indicate rejection of the hypothesis that the difference in means for the corresponding characteristic is equal to zero at 1%, 5%, and 10%, respectively.

		Prior fiscal year			Current fiscal year		
		Survey response	Audit Analytics	*Diff.*	Survey Response	Audit Analytics	*Diff.*
All respondents	mean	1,773,072	1,956,610	*-183,538****	1,764,313	1,975,708	*-211,395****
	median	600,000	640,000	*-40,000*	625,018	661,750	*-36,732*
	N	2,842	2,842		2,836	2,836	
< $75 Million	mean	262,068	269,420	*-7,352*	277,937	275,043	*2,894*
	median	120,500	129,900	*-9,400*	142,748	150,000	*-7,252*
	N	914	914		928	928	
$75-700 Million	mean	885,552	915,436	*-29,884***	871,545	920,241	*-48,696****
	median	600,000	620,938	*-20,938***	622,800	660,000	*-37,200***
	N	1,002	1,002		987	987	
>$700 Million	mean	4,224,856	4,748,562	*-523,706****	4,218,730	4,820,402	*-601,672****
	median	1,976,358	2,177,500	*-201,142****	1,999,129	2,290,900	*-291,771****
	N	926	926		921	921	

IV. Evidence on Issuers' Experience with Section 404 Compliance: Analysis of Web Survey Data

In this section we report responses to questions concerning Section 404 compliance costs, benefits, and related activities. To assess how these costs, benefits, and activities due to Section 404 compliance vary around the 2007 reforms, the analysis partitions survey responses according to the fiscal year relative to the reforms. We classify observations in three groups: observations based on experiences in the last year before the 2007 reforms ("Pre"), observations based on experiences in the first year following the 2007 reforms ("Post"), and observations based on expectations for the fiscal year in progress at the time of the survey ("Next"). Comparisons between the first two categories allow an evaluation of whether companies' experiences have been different, post-reform versus pre-reform. The third category allows us to evaluate whether companies expect their future experiences to be different, e.g., whether the costs for the fiscal year in process are expected to be lower than in the first year following the 2007 reforms.

In addition, to separate the effects of Section 404(a) compliance from those of Section 404(b), when appropriate the analysis distinguishes between Section 404(b) companies and Section 404(a)-only companies. Finally, because the Section 404 experience of non-accelerated filers is of particular interest, and company size may be an important determinant of the perceived economic consequences of Section 404, the analysis partitions companies based on their public float in the relevant fiscal year. With few exceptions—instances where a different threshold is appropriate in order to conduct a meaningful statistical analysis—the typical convention adopted in this study is to distinguish companies according to whether their public float is less than $75 million, between $75 and $700 million, or greater than $700 million in the relevant fiscal year.[48]

a. The Cost of Complying with Section 404

Since the initial implementation of Section 404 in 2004, much of the debate has centered on the costs borne by public companies to comply with its requirements. One of the difficulties with assessing the incremental costs from the implementation of Section 404, however, is that companies tend not to track or disclose these costs separately from the traditional expense items such as administrative expenses or audit fees once they start complying. In response to the widespread interest in information about companies' experiences with Section 404 compliance,

[48] When the focus is on companies complying with Section 404(b) for the first time, we restrict the analysis on companies with public float between $50 and $150 million. Indeed, because filers are not required to start complying with Section 404(b) until public float reaches $75 million, in order to obtain a meaningful sample of first-time 'smaller' complying companies, we adopt this alternative definition.

several industry associations and private organizations conducted surveys to assess the related costs.[49] These studies, however, are open primarily or exclusively to the members of the associations/organizations sponsoring them and typically result in low participation rates.[50] Academic studies also have provided some insights into the incremental costs of Section 404 compliance. These studies typically analyze larger and more representative samples of filers, thus avoiding the potential drawback of industry-specific surveys. Nonetheless, they have limited ability to isolate the incremental costs of Section 404 compliance from changes in administrative and audit costs that may be due to factors unrelated to Section 404. In this respect, given the current disclosure rules, the survey method can provide a perspective on companies' experience with Section 404 compliance not available otherwise.[51]

Since the Commission's survey was open to all publicly traded companies on a voluntary basis, there is no inherent bias from selecting among specific industries or trade associations. Moreover, the participation rate was substantially higher than that of any other previous survey conducted to assess companies' experience with Section 404 compliance. As a result, the cost estimates presented in this study reflect the experience of a substantially greater portion of the population of publicly traded companies and, thus, may be better suited to characterize the aggregate effects of the implementation of Section 404. Moreover, the questionnaire design allows the analysis to identify and isolate the various cost components of Section 404 compliance.

This section presents findings from analyses of responses to questions about the costs of compliance with Section 404 requirements. Tables 8-10 report summary statistics for the components of compliance costs including (i) fees for the independent audit of ICFR under Section 404(b), (ii) fees paid to outside vendors to help comply with Section 404 that are unrelated to the audit fees, (iii) the number of internal staff hours spent on Section 404 compliance, and (iv) any remaining non-labor expenses such as software, hardware, and travel related to Section 404 compliance. A rate of $121 per hour was used to derive an estimate of the dollar costs of internal labor.[52] Because the tables report both internal labor hours and costs, it is possible to determine how the labor costs are affected by changes in the hourly rate.[53]

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[49] *See supra* note 35

[50] *See supra* note 39.

[51] The study by Krishnan, Rama, and Zhang (2008), *supra* note 36, analyzes a sample of 266 companies that voluntarily disclosed detailed cost components of Section 404 compliance in their annual 10-K filings, between January 1, 2003 to September 30, 2005.

[52] This rate is consistent with the rate quoted as of September 2008 for a junior accountant cited in a report on salaries prepared by the Securities Industry and Financial Markets Association (SIFMA), to

The tables also report estimates of total compliance costs derived as the sum of the various components. These latter estimates, however, should be interpreted with care, because deriving total cost figures required additional assumptions that can affect the results. First, because it typically represents a substantial portion of the Section 404 total compliance costs, the computation of total costs is restricted to companies for which the internal labor cost component is explicitly available. That is, if the survey participant responded “not sure” or “not applicable” when asked to provide an estimate of internal labor hours or costs, then the corresponding observation is not used in the analysis of total costs. For similar reasons, in the subsample of Section 404(b) companies, the computation of total costs is restricted to companies for which the respondent explicitly provided an estimate of the portion of the fee due to auditor attestation of ICFR. That is, if the respondent from a Section 404(b) company responded “not sure” or “not applicable” when asked to provide an estimate of the share of audit fees due to Section 404(b), then the corresponding observation is not used in the analysis of total costs. The total cost estimate is thus based on figures provided directly by the respondents for these two largest cost items.

Second, to avoid dropping observations when calculating the total cost of compliance, when “not applicable” or “not sure” responses were provided for non-labor and outside vendor costs, we filled the missing observations relying on two separate approaches. First, when the respondent indicated one of these two items to be “not applicable,” we set the corresponding cost component to equal zero. This is sensible insofar as the response itself implies lack of materiality to the computation of cost. To the extent that this assumption understates the actual costs, the resulting total cost estimate may be downward biased. Most of the “not applicable” values, however, are for the non-labor cost item, which represents a relatively small portion of the total costs when it is provided. Second, for cases in which the respondent indicated to be “not sure” about one of these two items, following a commonly used practice in survey research,[54] we filled the corresponding cost component with the mean for that item conditional on the corresponding company’s size,

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which the Commission frequently refers in its rulemakings. *See* SIFMA Management and Professional Salaries Data – Sept. 2008. *See infra* note 53.

[53] We also performed a similar analysis assuming an hourly rate of $50 for internal labor cost instead, to be consistent with prior surveys of Section 404 compliance. For example, the FEI surveys have used a $50 hourly rate assumption. *See* Exhibit A from FEI (2005), FEI (2006), FEI (2007), FEI (2008), *supra* note 35. In choosing an hourly rate for internal labor, we relied on the rate quoted for a junior accountant by the Securities Industry and Financial Markets Association (SIFMA) as of September of 2008. *See also* text accompanying notes 12-13.

[54] *See, e.g.*, Donald B. Rubin, *Multiple Imputation for Nonresponse in Surveys* (2004) (for a discussion on imputation methods using normal linear regression models).

measured as value of assets.[55] Using this treatment method results in mean cost estimates that are approximately 10% lower than would arise by excluding observations with "not applicable" and "not sure."

Table 8 reports summary statistics for the components of compliance costs by whether the respondents' company complies with Section 404(b) and Section 404 (a) or Section 404 (a) only. For Section 404(b) companies, the largest cost component is reportedly *internal labor*, which falls by 12 percent from a mean of $1,532,521 prior to the 2007 reforms, to $1,346,855 the year after the reforms. The expected costs for the next fiscal year are lower still: $1,216,721. Median internal labor costs show a similar pattern, though the figures are a lot smaller.[56] The median internal labor cost falls by 10 percent from $484,000 prior to the 2007 reforms, to $435,600 the year after the reforms, and is projected to decline to $411,400 during the fiscal year in progress. The differences across medians are statistically significant.[57]

The next largest cost component for Section 404(b) companies is the *fees paid for the independent audit of ICFR*. These fees are calculated by multiplying the companies' total audit fees by the portion of the fees ascribed to the auditors' attestation required under Section 404(b), as reported by respondents. Total mean audit fees fall in consecutive fiscal years, starting from

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[55] Missing data must be treated in order to allow for aggregate analysis. But no treatment method is perfect—each has its own shortcoming. A commonly used approach is to fill missing observations with sample means for missing items. We controlled for the company's size (i.e., value of assets) when filling missing items due to a "not sure" response because most of the analysis presented is conditional on companies' characteristics (i.e., market value of equity float, Section 404 compliance status or experience) that are naturally correlated with size. In particular, "not sure" responses for non-labor and outside vendor costs were filled with the predicted value from the following Tobit regression model:

$$Cost_{it} = \alpha + \beta * Assets_{it} + \gamma * Assets_{it}^2 + \varepsilon_{it},$$

where $Cost_{it}$ is the cost item for fiscal year t explicitly provided by respondent of company i, $Assets_{it}$ is the value of company i's assets in fiscal year t, α, β, and γ are the parameters of the model, and ε_{it} is the model's error. Under our method, the underlying assumption is that the missing responses would, if observed, have been similar to the non-missing responses obtained from companies in the same size class. We also recognize that the estimated values for the missing data points will display a reduced variance and, thus, may inflate the reported test statistics. Nonetheless, we performed the analysis following two alternative approaches—dropping all observations with missing values or assigning the missing values as zeroes—and obtained qualitatively similar results.

[56] Most tables report the Wilcoxon significance of the rank-sum test. Though this test is commonly interpreted as testing for differences in medians, in fact, it is a test for the probability of drawing larger values from one population versus the other. The null hypothesis is that the two samples are drawn the same population, and therefore that their distributions are equal. The alternative hypothesis is that one sample is drawn from a population that is (stochastically) greater. Therefore, it is possible for two samples to have identical medians and yet for the test statistic to reject the null hypothesis that the two samples are drawn the same population. *See, e.g.,*Table 10.

[57] The internal cost estimates reflect an assumption of $121/hour. Changing this dollar figure does not alter the findings on percentage changes or statistical significance.

$2,501,855 in the year prior to the 2007 reforms, to $2,328,062 the year after, and to $2,158,145 expected for the fiscal year in progress. However, neither of the yearly differences is statistically significant.

The Web survey also asked the respondents to estimate the portion of audit fees attributed to the independent audit of ICFR for each year. As Table 8 shows, the mean responses for this value also decrease steadily: 38.3 percent, 35.2 percent, and 32.5 percent. There is no regulatory requirement for companies to report this information, and it is not audited. Hence, in studying the response data, we recognize that survey evidence reflects only the respondents' estimates and perceptions regarding the portion of the audit fee that is attributable to the Section 404(b) requirement. Nevertheless, the evidence from the survey is largely consistent with the evidence in Dey & Sullivan (2009), in which the estimated Section 404 audit premium is 32 percent, although obtained using a different method and data.[58] We use the reported responses for our estimation purposes. Multiplying total audit fees by percent allocated to the independent audit of ICFR to get total Section 404(b) audit fees yields economically and statistically significant differences across years. The typical cost of the independent audit of ICFR decreases 21 percent from a mean of $820,864 prior to the 2007 reforms to $652,095 after, and are expected to be $583,753 in the fiscal year in progress. The corresponding median audit cost decreases 13 percent from $357,700 to $311,121, and is projected to decline to $275,000 in the coming fiscal year.

The next largest component of the total Section 404 cost is *outside vendor costs*, which, like the fees for the audit of ICFR, fall in consecutive years: $437,787 on average prior to the 2007 reforms, $311,323 after, and $222,463 expected for the fiscal year in progress. These differences are economically and statistically significant. Finally, although they represent the smallest portion of the average total costs, *non-labor costs* also fall by a statistically significant amount in consecutive years: $161,563 on average prior to the 2007 reforms, $137,702 after, and $126,335 expected for the fiscal year in progress.

The results in Panel A of Table 8 are consistent with the notion that following the 2007 reforms there is an economically and statistically significant decrease in various cost components of Section 404 compliance. Correspondingly, the average total cost is significantly lower in the fiscal year following the 2007 reforms, by approximately $536,000, representing an almost 19 percent reduction of the average total costs relative to the pre-reforms year total of $2,865,708. Furthermore, the average total cost for Section 404(b) companies is expected to drop even lower in the year in progress at the time of the survey to $2,030,060, reflecting a further reduction of

[58] Dey & Sullivan (2009), *supra* note 32, at 23. *But see* FEI (2008), *supra* note 35, at 11 (reporting a similar estimate, at 23.4% on average and 27% for companies between $75 million and $700 million).

approximately 13 percent. Overall, this analysis provides some *prima facie* evidence that the 2007 reforms may have produced some of their desired effect, by improving the efficiency of companies' compliance with Section 404 requirements. The evidence in Table 8, however, should be interpreted with at least two caveats in mind, which warrant caution against drawing any causal relation between the passage of the reforms and the apparent differences in costs over time. First, it should be noted that Section 404 compliance (dollar) costs are likely to be directly related to a company's size. If observations in the "post-2007" and the "next fiscal year" samples include a larger proportion of smaller companies, then part of the decline may be attributed to a change in sample composition, independent of the 2007 reforms. Second, to the extent that the passage of time corresponds with the acquisition of important compliance experience that allows companies to become more efficient in meeting Section 404 requirements, this too could explain the documented trend in compliance costs.

Panel B of Table 8 reports Section 404 compliance costs for Section 404(a)-only companies. The average financial statement audit fee is lower following the reforms and the difference in means is statistically significant when comparing post- versus pre-reform. The median audit fee, however, does not vary over time. Thus, there is no robust evidence of changes in audit fees around the reforms for Section 404(a)-only companies, which is unsurprising since there is no audit component of Section 404(a). The evidence for the other components of the compliance cost and, thus, for the total cost is qualitatively similar—while differences in medians are significant, the means do not exhibit significant differences. Contrary to what the evidence in Panel A suggests for Section 404(b) companies, it does not appear that the 2007 reforms are associated with any significant change in Section 404 compliance costs for Section 404(a)-only companies.

Table 8 – Total Section 404 costs by component and year relative to 2007 reforms. This table reports summary statistics for the total Section 404 compliance costs and the various cost components reported in the survey. The total compliance cost is calculated as the sum of the respondent company's portion of total audit fees spent on completing the independent audit of management assessment report (*Section 404(b) audit costs*), *internal labor costs* (calculated as $121/hour times reported *internal labor hours*), *outside vendor costs*, and *non-labor costs*. Panel A (Panel B) is restricted to companies recognized by Audit Analytics as complying with Section 404(b) (Section 404(a) only) in the relevant fiscal year. The unit of observation is firm-year. *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. In cases where companies 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 companies 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 last two columns report differences in means and medians. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

Table 8 Panel A: Section 404(b) companies

		Pre	Post	Next	*Post-Pre*	*Next-Post*
A. 404(b) audit	Mean	820,864	652,095	583,753	- 168,769***	- 68,341.6
Costs	Median	357,500	311,121	275,000	-46,379***	-36,121***
	N	1,331	1,494	1,423		
-- Total audit	Mean	2,501,855	2,328,062	2,158,145	- 173,793	- 169,917
	Median	1,000,000	985,250	950,000	-14,750	-35,250
	N	1,892	2,069	1,996		
-- 404(b)	Mean	38.3%	35.2%	32.5%	-3.1%***	-2.7%***
proportion of total	Median	38.6%	34.6%	31.0%	-4.0***	-3.6***
audit	N	1,331	1,494	1,423		
B. Outside vendor	Mean	437,787	311,323	222,463	- 126,463***	- 88,860***
costs	Median	100,000	90,000	55,500	-10,000***	-34,500***
	N	1,892	2,058	1,983		
C. Internal labor	Mean	1,532,521	1,346,855	1,216,721	- 185,666	- 130,134
costs	Median	484,000	435,600	411,400	-48,400*	-24,200*
	N	1,596	1,759	1,698		
-- Internal labor	Mean	12,665	11,131	10,056	- 1,534	- 1,076
hours	Median	4,000	3,600	3,400	-400*	-200*
	N	1,596	1,759	1,698		
D. Non-labor	Mean	161,563	137,702	126,335	- 23,862**	- 11,367
costs	Median	40,000	30,000	28,063	-10,000**	-1,937*
	N	1,884	2,034	1,954		
Total 404 costs	Mean	2,865,708	2,329,618	2,030,060	- 536,091***	- 299,558**
(A+B+C+D)	Median	1,192,997	1,037,740	904,553	-149,642***	-129,688***
	N	1,165	1,311	1,244		

Table 8 – Total Section 404 costs by component and year relative to 2007 reforms. (cont'd)

Table 8 Panel B: Section 404(a)-only companies						
		Pre	Post	Next	*Post-Pre*	*Next-Post*
A. Total audit	Mean	285,212	226,915	216,171	-58,297**	-10,745
	Med	112,000	115,000	120,000	3,000	5,000
	N	938	760	756		
B. Outside vendor costs	Mean	95,782	98,149	82,185	2,367	-15,964
	Med	0	30,000	30,000	30,000***	0
	N	910	727	716		
C. Internal labor costs	Mean	257,535	205,019	195,783	-52,516	-9,236
	Med	48,400	60,500	54,000	12,100**	-6,500
	N	534	595	613		
-- Internal labor hours	Mean	2,128	1,694	1,618	-434	-76
	Med	400	500	446	100**	-54
	N	534	595	613		
D. Non-labor costs	Mean	35,413	36,126	36,687	713	561
	Med	0	5,000	5,000	5,000***	0
	N	895	689	680		
Total 404 costs (B+C+D)	Mean	425,080	335,768	308,735	-89,311	-27,033
	Med	110,900	162,000	139,950	51,100***	-22,050
	N	526	565	575		

As discussed earlier, the results in Panel A of Table 8 mask potentially significant variation in the size of the companies in the pre- and post-2007 reform samples, which in turn could explain the reported differences around the 2007 reforms. To accommodate the possibility that the arrival of new, smaller companies in the sample of Section 404(b) companies may be driving the previous results, Table 9 reports a similar analysis of the cost components of Section 404(b) companies, partitioned based on their public float in the relevant fiscal year. Although companies with a public float below $75 million—as of the end of the second fiscal quarter—do not have a duty to comply with Section 404(b), Table 9 reports that a number of companies do so. Since our public float numbers are obtained from a third-party source, we cross-referenced these figures against what the companies self-report on the cover of their 10-K. While some observations were found to be misclassified due to a reporting error from our third-party source, in fact the vast majority of companies in this group are either voluntary Section 404(b) compliers or have been required to comply in the past as accelerated filers and must continue to do so because their float has not dropped below $50 million.

The evidence in Table 9 is generally consistent with Table 8 and the cost estimates across various subsamples are consistent with those reported in other surveys.[59] Specifically, there seems

[59] These estimates are consistent—though not comparable—with those provided by the FEI surveys. They are not directly comparable because we use a different hourly rate for internal labor ($121) than the FEI does ($50). Nevertheless, were we to rescale these cost estimates using the same assumption as the FEI, the results would be virtually identical. For example, we can calculate the average internal labor hours

to be a general downward trend in Section 404 compliance costs that is independent of firm size, and the differences in costs between pre- and post-2007 reform years are most substantial and more often significant for Section 404(b)-related audit fees and outside vendor costs. However, while medium (between \$75 and \$700 million) and large (>\$700 million) companies appear to have *realized* as well as *projected* substantial decreases in compliance costs following the reforms, the differences are mostly only *projected* for the small companies (<\$75 million). 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 differences in costs across time are 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.

among companies with public float above \$75 million by dividing the internal labor costs by \$121 and averaging the figures across Panel B and Panel C. The result is 10,854 hours, compared to 11,100 hours reported in FEI (2008), Exhibit B, *supra* note 35. Similar calculations reveal that the total Section 404 cost estimates would also be comparable under the same assumption.

Table 9 – 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 companies reported by Audit Analytics as complying with Section 404(b) in the relevant fiscal year. Panel A (B, C) is restricted to companies with public float under $75 million (between $75 million and $700 million, above $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. *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. In cases where companies 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 companies 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 last two columns report differences in means and medians. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

		Pre	Post	Next	*Post-Pre*	*Next-Post*
Panel A: Public float < 75M						
A. 404(b) audit	Mean	310,613	259,004	171,784	*-51,609*	*-87,220***
	Med	200,000	157,500	116,750	*-42,500*	*-40,750****
	N	63	99	162		
B. Outside vendor	Mean	194,429	144,093	98,555	*-50,336*	*-45,538***
	Med	98,000	57,500	50,000	*-40,500***	*-7,500*
	N	76	120	205		
C. Internal labor	Mean	327,145	317,846	283,698	*-9,300*	*-34,147*
	Med	121,000	145,200	121,000	*24,200*	*-24,200*
	N	61	98	167		
D. Non labor	Mean	55,873	40,882	41,745	*-14,991*	*863*
	Med	12,500	10,000	5,000	*-2,500*	*-5,000*
	N	76	117	200		
Total Section 404 (A+B+C+D)	Mean	769,266	690,219	581,176	*-79,047*	*-109,043*
	Med	579,277	439,460	365,900	*-139,817*	*-73,560*
	N	50	83	134		
Panel B: Public float 75-700M						
A. 404(b) audit	Mean	349,589	280,969	269,752	*-68,620****	*-11,218*
	Med	227,220	201,000	193,750	*-26,220****	*-7,250*
	N	668	729	656		
B. Outside vendor	Mean	216,066	167,032	134,691	*-49,035****	*-32,341****
	Med	92,500	70,000	50,000	*-22,500****	*-20,000****
	N	938	971	902		
C. Internal labor	Mean	507,730	489,321	489,302	*-18,408*	*-19*
	Med	302,500	254,100	242,000	*-48,400*	*-12,100*
	N	801	835	780		
D. Non labor	Mean	89,759	79,620	79,348	*-10,139**	*-272***
	Med	25,000	20,000	20,000	*-5,000*	*0*
	N	932	956	885		
Total Section 404 (A+B+C+D)	Mean	1,093,225	1,011,404	934,924	*-81,820*	*-76,480*
	Med	780,728	696,164	629,256	*-84,564***	*-66,908*
	N	587	632	572		

Table 9 – cont'd

Panel C: Public float >700M						
A. 404(b) audit	Mean	1,400,443	1,127,325	1,045,150	*-273,118***	*-82,176*
	Med	675,500	600,000	547,080	*-75,500***	*-52,920*
	N	595	659	598		
B. Outside vendor	Mean	695,522	479,833	343,888	*-215,690****	*-135,944****
	Med	195,740	123,000	90,000	*-72,740****	*-33,000****
	N	871	959	869		
C. Internal labor	Mean	2,765,204	2,350,656	2,193,364	*-414,548*	*-157,292*
	Med	968,000	847,000	847,000	*-121,000***	*0*
	N	728	820	746		
D. Non labor	Mean	248,771	208,307	194,585	*-40,464***	*-13,722*
	Med	100,000	62,500	60,000	*-37,500**	*-2,500*
	N	869	954	863		
Total Section 404 (A+B+C+D)	Mean	5,041,707	3,986,121	3,585,743	*-1055,586***	*-400,377*
	Med	2,446,750	1,993,800	1,790,000	*-452,950****	*-203,800***
	N	524	591	533		

In addition to questions about the resources spent on various components in the process of complying with Section 404, respondents were asked to provide an estimate of the portion of those costs (outside vendors, internal labor, or audit fees) they would attribute to the distinct requirements of the rules under Section 404(b) as opposed to those under Section 404(a). This question was not asked for non-labor costs. Table 10 below reports the sample means and medians of such allocations by fiscal year relative to the 2007 reforms and companies' public float. These results are useful because they provide insights into the relative incremental costs of complying with Section 404(b) as compared to the costs of complying with Section 404(a) only.[60]

Overall, the typical share of the total audit fees allocated to Section 404(b) compliance ranges from 30 percent to 43 percent of the total compliance costs and is inversely related to the company's size. Regardless of size, however, this share is significantly lower post-2007 reforms relative to before, and is projected by respondents to be lower still in the next fiscal year. Thus, the evidence is consistent with the notion that the audit fee premium due to Section 404(b) compliance has decreased around the 2007 reforms and is expected to continue decreasing.

The evidence on the share of outside vendor costs and internal labor costs allocated to Section 404(b) compliance is less homogeneous across the three size groups. The mean share of outside vendor costs that respondents attribute to Section 404(b) compliance varies between 16 percent and 36 percent and, once again, this share is negatively related to the company's public

[60] Nevertheless, these results should be interpreted with care. As with the portion of audit fees attributable to the independent audit of ICFR, it is not always clear to what extent respondents are capable of dividing these component costs into fees attributable to Section 404(a) and Section 404(b).

float. Furthermore, although smaller companies reportedly allocate higher shares of outside vendor costs to Section 404(b) compliance, both the mean and median realized or expected shares of these costs are significantly lower following the 2007 reforms. Meanwhile, these same differences among the medium and large companies are less substantial economically and, for the most part, not statistically significant. Combined with the evidence from Table 9, it appears that small companies spent, or expect to spend, less for outside vendors and a decreasing share of these costs were, or are expected to be, allocated to Section 404(b) compliance following the 2007 reforms. In contrast, although medium and large companies also spent or expect to spend less for outside vendors, for these companies the share allocated to Section 404(b) compliance is, or is projected to be, fairly constant.

Finally, similar to the other two cost components, the mean share of internal labor costs attributed to Section 404(b) compliance appears to be inversely related to size, varying between 24 percent and 40 percent, with a similar result for the median. Except for the expectations of smaller companies, however, it does not appear that the share of internal labor costs allocated to Section 404(b) compliance is significantly different following the 2007 reforms. Hence, again combined with the analysis in Table 9, the evidence suggests that neither the total amount of internal labor resources devoted to Section 404 compliance nor the share of these resources allocated to Section 404(b) compliance have changed, or are expected to change, following the 2007 reforms.

Table 10 – 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 company size and year relative to the 2007 reforms. Panel A (B, C) is restricted to companies with public float under $75 million (between $75 million and $700 million, above $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. Panel D includes all companies. *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. In cases where companies 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 companies 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 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
Panel A: < 75M									
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
Post-Pre	*-2.4*	*-2.0*		*-9.1**	*-20.0***		*-3.2*	*-5.0*	
Next-Post	*-8.0****	*-5.5****		*-3.4*	*-20.0*		*-5.4*	*-5.0*	
Next-Pre	*-10.4****	*-7.5****		*-12.5****	*-40.0****		*-8.6***	*-10.0***	
Panel B: 75-700M									
Pre	40.2	40.0	668	29.5	20.0	571	32.1	25.0	648
Post	37.2	35.0	729	27.8	20.0	622	32.3	25.0	689
Next	34.2	33.0	656	26.8	10.0	604	33.1	25.0	648
Post-Pre	*-3.0****	*-5.0****		*-1.8*	*0.0*		*0.2*	*0.0*	
Next-Post	*-3.0****	*-2.0****		*-0.9*	*-10.0**		*0.8*	*0.0*	
Next-Pre	*-6.0****	*-7.0****		*-2.7*	*-10.0****		*1.0*	*0.0*	
Panel C: >700M									
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*	
Panel D: All companies									
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	1420
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*	

This analysis highlights the potential importance of controlling for the compliance history of Section 404 companies when assessing cost trends around the 2007 reforms. Indeed, we inquire whether experience in Section 404 compliance alone can explain the reduction in costs documented in Tables 8 and 9. Table 11 addresses this by reporting total Section 404 compliance costs for companies sorted according to their public float and the number of years of compliance experience with Section 404(b).

When comparing the medium and small companies with no prior compliance experience between prior to and after the 2007 reforms, there are no significant differences in mean total costs. Conversely, both the mean and median total cost of compliance is significantly smaller following the 2007 reforms for large companies with no prior compliance experience. Thus, to the extent that the 2007 reforms are associated with a decrease in first-time compliance costs, this is limited to the large companies. When focusing on companies with more than one year of compliance experience, it appears that the total costs for the small and medium companies are lower following the 2007 reforms, but significantly so only among companies complying for the second time with Section 404(b).

Table 11 – Total cost of compliance with Section 404 by years of experience with Section 404(b) relative to the 2007 reforms. This table reports summary statistics for the total cost of compliance with Section 404 by the number of years of experience a company has complying with Section 404(b) and by year relative to the 2007 reforms. *Total Cost of compliance* is defined as the sum of 404(b) audit fees, total vendor costs, total internal labor costs, or total non-labor costs. Panel A (B, C) is restricted to companies with public float between $50-150 million (between $150-700 million, above $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. Panel D includes all companies. *Pre* includes firm-fiscal year observations pre-dating November 15, 2007, while *Post* includes all completed firm-fiscal year observations post-dating November 15, 2007. In cases where companies 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 companies 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 column labeled *Mean* (*Median*) *Post-Pre* reports differences in means (medians). ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

	Pre			Post			*Difference*	
							Mean	*Median*
	N	Mean	Median	N	Mean	Median	*Post - Pre*	*Post - Pre*
Panel A: 50-150 M								
1 yr	50	755,150	652,160	62	759,882	562,724	*4,732*	*-89,436*
2 yrs	43	1,079,084	885,200	42	537,199	390,400	*-541,885****	*-494,800****
3+ yrs	121	774,105	492,600	147	785,278	505,300	*11,173*	*12,700*
Panel B: 150-700 M								
1 yr	42	1,356,497	1,045,850	63	1,461,056	816,112	*104,559*	*-229,738*
2 yrs	45	1,262,569	973,500	44	881,527	740,950	*-381,042***	*-232,550**
3+ yrs	325	1,168,319	806,950	333	1,082,814	734,250	*-85,505*	*-72,700*
Panel C: >700 M								
1 yr	64	10,809,176	4,986,246	30	4,266,537	2,666,038	*-6,542,639****	*-2,320,208***
2 yrs	21	2,793,990	1,256,400	68	6,419,480	3,131,897	*3,625,490****	*1,875,497**
3+ yrs	439	4,308,413	2,216,650	493	3,633,421	1,875,815	*-674,992**	*-340,835***
Panel D: All								
1 yr	157	5,010,237	1,353,000	161	1,676,140	812,126	*-3,334,097****	*-540,874****
2 yrs	113	1,450,637	971,500	157	3,173,967	1,059,000	*1,723,330****	*87,500*
3+ yrs	895	2,668,180	1,225,253	993	2,302,072	1,068,000	*-366,108**	*-157,253***

A number of prior studies report that smaller companies pay higher compliance costs as a fraction of their assets.[61] Consistent with this evidence, commenters to the Commission's rulemaking have asserted that the costs of compliance with Section 404 are likely to be "disproportionately higher for smaller public companies than larger ones, and that the auditor's fee represents a large percentage of those costs."[62] In order to explore the extent to which these concerns are borne out in the data, this part of the analysis focuses on the total costs of compliance with Section 404 expressed as a fraction of the reporting company's assets.[63] Table 12 reports the mean of scaled compliance costs for the smaller (between $50 and $150 million), medium (between $150 and $700 million), and larger (greater than $700 million) companies, segmented in four groups based on the number of years of experience complying with Section 404(b) – 1 year, 2 years, 3 years, and 4 or more years.

Consistent with the notion that Section 404 places a disproportionally larger burden on smaller companies, the evidence in Table 12 shows that for Section 404(b) companies the total cost of compliance as a fraction of assets decreases as company size increases. On average, small companies report spending an amount equivalent to 0.79 percent of their total assets to comply with Section 404 in their first year of compliance. In contrast, while large companies spend more in absolute terms, they spend substantially less as a proportion of their assets in their first year of compliance—0.14 percent, on average. For all size categories, scaled compliance costs decrease with the number of years of Section 404(b) compliance experience, and more so for the smaller companies. This is consistent with the presence of start-up costs that weigh proportionally more on smaller companies. The evidence suggests that the start-up costs are absorbed by the third year of compliance. In particular, companies reach a steady state and, although significant differences

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[61] *See, e.g.*, U.S. Government Accountability Office, report to the Committee on Small Business and Entrepreneurship, *U.S. Senate: Sarbanes Oxley Act—Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies* (April 2006), available at http://www.gao.gov/new.items/d06361.pdf (finding that smaller companies have incurred disproportionately higher audit costs in implementing the Act); Foley & Lardner (2006), *supra* note 35; Bengt R. Holmstrom & Steven N. Kaplan, "The State of U.S. Corporate Governance: What's Right and What's Wrong?" (unpublished working paper, 2003), available at http://ssrn.com/abstract=441100 ("Because some of the additional costs of complying with SOX are fixed rather than variable, the effects will be more negative for smaller companies than for larger ones").

[62] *See, e.g.*, "Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers," SEC Release No. 33-8934 (June 26, 2008), available at http://www.sec.gov/rules/final/2008/33-8934.pdf (citing letters of American Electronics Association, International Association of Small Broker-Dealers and Advisers, Small Business Entrepreneurship Council, and the Silicon Valley Leadership Group).

[63] We conducted an analogous analysis using company revenues, and obtained similar results.

remain across the three size groups, they are nonetheless smaller than those observed in the early years of Section 404(b) compliance.

The persistent differences in scaled costs across size are consistent with the presence of recurring fixed costs; larger companies continue to spend proportionally less than smaller companies on Section 404 compliance. Hence, the contention that Section 404 compliance places a disproportionally larger burden on smaller companies appears to be borne out in the data when measured as a proportion of a company's assets. However, a significant portion of the costs in early years of compliance appear to be due to non-recurring fixed costs, suggesting that this burden to smaller companies is attenuated over time. Furthermore, a similar analysis (untabulated) for audit fees unrelated to Section 404 compliance produces roughly similar results—in other words, with sufficient experience, the differences in Section 404(b) compliance costs scaled by assets across companies of different size are roughly similar to differences in non-404 audit fees scaled by assets. Thus, the patterns in Section 404 scaled costs across size categories reflect the typically disproportionally higher cost of being a public company for smaller companies.

Table 12 – Total Section 404 compliance costs 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 company's total assets, measured at the end of the relevant fiscal year. In this table, companies 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. 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 column labeled *(2)-(1)* [*(3)-(2)*, *(3)-(1)*] and the row labeled *2yrs - 1yr* [*3yrs - 2yrs*, *4yrs - 3yrs*, *5+yrs - 4yrs*] report differences in means between the corresponding subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

		Public Float					
	stats	(1) 50 to 150M	(2) 150 to 700M	(3) >700M	*(2)-(1)*	*(3)-(2)*	*(3)-(1)*
1 year	mean	0.79	0.61	0.14	*-0.18**	*-0.47****	*-0.65****
	N	97	101	92			
2 years	mean	0.58	0.39	0.11	*-0.18***	*-0.28****	*-0.47****
	N	71	84	82			
3 years	mean	0.55	0.33	0.11	*-0.23****	*-0.21****	*-0.44****
	N	144	349	453			
4+ years	mean	0.59	0.27	0.08	*-0.31****	*-0.19****	*-0.50****
	N	83	254	416			
2yrs - 1yr		*-0.21**	*-0.21****	*-0.03*			
3yrs - 2yrs		*-0.02*	*-0.07*	*-0.00*			
4+yrs - 3yrs		*0.03*	*-0.05*	*-0.03****			

The evidence in Table 12 is consistent with the idea that experience with Section 404 compliance may explain at least some of the differences in compliance costs around the 2007 reforms documented in earlier tables. As a final check on isolating the effect of compliance experience from that of the 2007 reforms, we performed a more detailed analysis of first-time compliers around the passage of the reform. In principle, a comparison of first-time compliance costs prior and subsequent to the reforms should allow for an analysis that is not affected by a company's experience with Section 404. Furthermore, the trends in first-time compliance costs around the 2007 reforms are of particular interest since non-accelerated filers were not yet required to comply with Section 404(b), a result of several deadline extensions of the original mandate over recent years.

Table 13 reports mean and median Section 404 compliance costs pre- and post-2007 reforms for companies who first complied with that first-time Section 404(b) companies and whose public float is between $50 and $150 million in the relevant fiscal year. Consistent with the evidence in Table 11, the mean (median) total cost of first-time compliers in the year following the 2007 reforms is not significantly different from that in the year prior. Turning to the component costs, first-time compliers reportedly pay significantly lower Section 404(b)-related audit fees following the reforms, both mean and median, consistent with the general trend documented in earlier tables (see, for example, Tables 8 and 9). Outside vendor costs are also lower, whereas average internal labor costs and non-labor costs are higher following the reforms, but these differences are not statistically significant at conventional confidence levels. There is thus some evidence of a shifting of resources across cost components for first-time compliers, from audit-related and outside vendor costs to internal labor and non-labor costs. The overall net effect is, however, not significantly different from zero—a result that may be partly due to the small sample size.

Table 13 – Costs of compliance with Section 404 relative to 2007 reforms for first-time Section 404(b) compliers with public float between $50 million and $150 million. This table reports the mean and median costs of compliance with Section 404 for companies complying with Section 404(b) for the first-time in the relevant fiscal year as reported by Audit Analytics. *Pre* includes firm-fiscal year observations pre-dating November 15, 2007, while *Post* includes all completed firm-fiscal year observations post-dating November 15, 2007. 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 columns labeled *Mean* (*Median*) *Post-Pre* reports differences in means (medians). ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

	Mean			Median			N	
	Pre	Post	*Post-Pre*	Pre	Post	*Post-Pre*	Pre	Post
A. 404(b) audit	228,400	160,915	*-67,485**	150,000	118,173	*-31,827**	60	72
B. Outside vendor	230,329	170,857	*-59,473*	172,000	120,000	*-52,000*	67	75
C. Internal labor	298,449	355,979	*57,529*	180,000	181,500	*1,500*	55	66
-- Labor hours	2,467	2,942	*475*	1,488	1,500	*12*	55	66
D. Non-labor	30,916	41,995	*11,079*	12,500	15,000	*2,500*	67	74
Total Section 404 costs	755,150	759,882	*4,732*	652,160	562,724	*-89,436*	50	62

b. The Benefits of Complying with Section 404

Section 404 rulemaking was intended to enhance the quality of reporting and increase investor confidence.[64] We identified a list of twelve potential areas in the survey for respondents to assess. The list included questions about the effects of Section 404 compliance on either the company's financial reporting process, labeled as *direct effects*, or the company's experiences in dealing with investors and other market participants, labeled as *indirect effects*. The respondents were then permitted to indicate the extent to which they regarded these dimensions to have been affected at their company as a result of Section 404 compliance. The possible responses were: "had little or no impact"; "had a positive impact"; or "had a negative impact," which were coded numerically as 0, +1, and -1, respectively. "Not sure" and "not applicable" were also possible responses. The results are reported in Table 14 in Panels A (*Direct Effects*) and B (*Indirect Effects*), based on public float in fiscal year 2008.[65]

Overall, as shown in Panel A, respondents ascribe some positive direct effects to Section 404 compliance, such as improved quality of the internal control structure, improved confidence by the audit committee's in the company's ICFR, improved quality of the company's financial reporting, and improved ability of the company to prevent and detect fraud. However, a non-trivial proportion of the respondents report some negative direct effects from Section 404 compliance, such as reduced timeliness of the company's financial statement audit.[66] Furthermore, regardless of the effect under consideration, it is uniformly the case that the respondents' perceptions about the direct consequences of Section 404 compliance become significantly more positive (or less negative) as the size of the respondent's company increases. Finally, the evidence also shows that Section 404(b) compliant companies are typically more inclined to ascribe positive effects to Section 404 compliance compared to filers complying with Section 404(a) only. This latter finding is not due to the correlation between company size and

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[64] *See supra* Part II for the Commission's expectations on the benefits of Section 404.

[65] As in the cost analysis, we recognize that the responses to survey questions about benefits depend on the information, expertise and other circumstances of the individual respondent. Evidence of correlation between the private incentive of the respondent and the company's compliance category, not presented in this report, could point toward alternative interpretations of the data beyond what is provided here.

[66] The findings on benefits are largely consistent with the findings from other Web surveys, and the figures are also largely commensurate. For example, 50% of the respondents to FEI (2008), *supra* note 35, reported that financial reports are more accurate; 56% reported that financial reports are more reliable; 45% reported that Section 404 helped prevent or detect fraud; and 69% reported that investors and other external parties are more confident in their financial reports. The FEI Web surveys also report that while financial executives increasingly acknowledge the benefits of Section 404, such as improved financial reporting, many continue to believe the costs outweigh the benefits and question the overall effectiveness of compliance.

Section 404(b) compliance status. In fact, smaller Section 404(b) companies tend to regard the effects of Section 404 more favorably than smaller Section 404(a)-only companies. For large filers, Section 404(b) compliance status has no effect, on average.

When providing an assessment of the *indirect effects* of Section 404 compliance (Panel B), the views of respondents are less favorable. The majority of respondents perceive no effect on their company's ability to raise capital, investors' confidence in the company, the liquidity of the company's common stock, or the company's overall value. Furthermore, approximately one-third of respondents report that Section 404 compliance reduces the efficiency of the company's operations, compared to one in five recognizing improvements instead. Consistent with the evidence in the previous panel, however, Panel B shows that the respondents' perceptions of the indirect effects of Section 404 is again positively correlated with the size and Section 404(b) compliance status of the company.

The respondents are more positive when assessing their confidence in the financial reports of other Section 404-compliant companies. Nearly 40 percent of respondents claim to be more confident in the financial reports of other 404 compliant companies, as opposed to only about one in four that find compliance to have improved investors' confidence in their own company' reports. This seeming discrepancy between the respondents' assessment on two facets of the same effect of Section 404 compliance is consistent with at least two plausible explanations. First, it is possible the discrepancy reveals a reluctance to recognize the beneficial consequences of Section 404 requirements for one's own company (i.e., a bias in the representation of one's perception) because this may imply that pre-Section 404 reports were less than fully reliable. Second, it is also possible that, due to asymmetric information, the respondents' perception of the effect of Section 404 on outsiders' confidence is naturally biased. Indeed, the availability of insider information may provide a more accurate and precise view of the true quality of the reporting process, in turn introducing a bias in the respondent's perception of the effect of Section 404 on outsiders' confidence (i.e., a bias in one's perception). Both arguments 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.

The evidence in Table 14 shows that survey participants are inclined to recognize positive (favorable) direct effects from Section 404 compliance, but they do not typically perceive these improvements to have significant bearing on the companies' interaction with capital market participants. The common element in Panels A and B, however, is that the participants' typical perception varies significantly with the size and Section 404(b) compliance status of the company. Specifically, participants from larger companies and from Section 404(b) companies—

compared to the respondents from their counterparts—tend to provide a relatively more favorable assessment of the effects of Section 404 compliance.

Table 14 – Perceived direct and indirect effects of compliance with Section 404 by company size and Section 404(b) compliance status. Survey participants could indicate the effect they perceive Section 404 compliance to have had on twelve dimensions. The available responses included: "positive impact" (+1), "little or no impact" (0), "negative impact" (-1), "not applicable," and "not sure." The columns under the heading *Negative/Little or none/Positive (%)* report the percent of responses among the first three alternatives only and the corresponding mean response. Column 4 (5) reports mean responses for companies complying with Section 404(a) only (404(b) also). Panel A presents the responses for six characteristics that we label "Direct Effects" from Section 404 compliance (i.e., related directly to the financial reporting process). Panel B presents the responses for six characteristics that we label "Indirect Effects" from Section 404 compliance (i.e., related to how compliance affects the company's interactions with outsiders). The public float for each company is measured as of 2008. The row labeled *(2)-(1)* (*(3)-(2)*, *(3)-(1)*) and the column labeled *(5)-(4)* report difference in means across the corresponding subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

			Negative/Little or none/Positive (%)						
Panel A: Direct effects		N	-1	0	1	*Mean*	(4) Mean 404(a) only	(5) Mean 404(b)	*(5)-(4)*
The quality of your company's internal control structure	< 75M (1)	831	1.80	41.60	56.60	*0.548****	0.52***	0.72***	*0.19****
	75-700M (2)	1107	0.40	23.60	76.10	*0.757****	0.65***	0.77***	*0.12***
	>700M (3)	1041	0.80	16.20	83.00	*0.822****	0.80***	0.82***	*0.02*
	All companies	2979	0.90	26.00	73.00	*0.721****	0.54***	0.79***	*0.25****
	(2)-(1)					*0.209****			
	(3)-(2)					*0.065****			
	(3)-(1)					*0.275****			
The audit committee's confidence in the company's ICFR	< 75M (1)	747	2.50	46.60	50.90	*0.483****	0.45***	0.69***	*0.23****
	75-700M (2)	1057	0.70	24.40	74.90	*0.743****	0.62***	0.75***	*0.13***
	>700M (3)	990	0.60	17.20	82.20	*0.816****	0.78***	0.82***	*0.04*
	All companies	2794	1.10	27.80	71.10	*0.699****	0.47***	0.78***	*0.30****
	(2)-(1)					*0.259****			
	(3)-(2)					*0.073****			
	(3)-(1)					*0.333****			
The quality of your company's financial reporting	< 75M (1)	817	3.30	63.60	33.00	*0.297****	0.28***	0.43***	*0.15****
	75-700M (2)	1096	0.50	47.40	52.20	*0.517****	0.43***	0.52***	*0.09*
	>700M (3)	1023	0.70	42.40	56.90	*0.562****	0.60***	0.56***	*-0.04*
	All companies	2936	1.30	50.20	48.50	*0.472****	0.30***	0.54***	*0.24*
	(2)-(1)					*0.220****			
	(3)-(2)					*0.045****			
	(3)-(1)					*0.265****			
Your company's ability to prevent and detect fraud	< 75M (1)	811	1.80	61.20	37.00	*0.351****	0.34***	0.47***	*0.13****
	75-700M (2)	1071	0.70	50.20	49.00	*0.483****	0.57***	0.47***	*-0.10*
	>700M (3)	1001	0.40	45.10	54.50	*0.541****	0.70***	0.54***	*-0.16*
	All companies	2883	0.90	51.50	47.60	*0.466****	0.36***	0.50***	*0.14****
	(2)-(1)					*0.131****			
	(3)-(2)					*0.059***			
	(3)-(1)					*0.190****			
The efficiency of your company's financial reporting process	< 75M (1)	823	31.50	46.40	22.10	*-0.094****	-0.11***	0.02	*0.13**
	75-700M (2)	1093	29.00	40.00	31.00	*0.02*	0.01	0.02	*0.00*
	>700M (3)	1008	23.40	42.90	33.70	*0.103****	-0.10	0.10***	*0.20*
	All companies	2924	27.80	42.80	29.40	*0.017*	-0.10***	0.06***	*0.15****
	(2)-(1)					*0.114****			
	(3)-(2)					*0.083***			
	(3)-(1)					*0.197****			

		N	-1	0	1	Mean	(4) Mean 404(a) only	(5) Mean 404(b)	(5)-(4)
Timeliness of your company's financial statement audit	< 75M (1)	805	34.30	57.60	8.10	*-0.262****	-0.27***	-0.20***	*0.07*
	75-700M (2)	1077	35.20	50.80	14.00	*-0.212****	-0.18**	-0.22***	*-0.03*
	>700M (3)	1002	21.90	60.50	17.70	*-0.042***	-0.11	-0.04**	*0.07*
	All companies	2884	30.30	56.10	13.60	*-0.167****	-0.27***	-0.13***	*0.13****
	(2)-(1)					*0.050**			
	(3)-(2)					*0.170****			
	(3)-(1)					*0.220****			

Panel B: Indirect effects		N	Negative/Little or none/Positive -1	0	1	*Mean*	(4) Mean 404(a) only	(5) Mean 404(b)	*(5)-(4)*
Your company's ability to raise capital	< 75M (1)	653	8.10	86.10	5.80	*-0.023*$^{+}$	-0.04**	0.06*	*0.10***
	75-700M (2)	848	3.30	88.10	8.60	*0.053****	0.02	0.06***	*0.04*
	>700M (3)	802	2.00	86.40	11.60	*0.096****	-0.17	0.10***	*0.26**
	All companies	2303	4.20	86.90	8.90	*0.046***	-0.03**	0.08***	*0.11****
	(2)-(1)					*0.076****			
	(3)-(2)					*0.043****			
	(3)-(1)					*0.119****			
Investor confidence in your company	< 75M (1)	673	4.20	84.20	11.60	*0.074****	0.06***	0.15***	*0.09***
	75-700M (2)	893	1.50	74.20	24.30	*0.228****	0.21***	0.23***	*0.02*
	>700M (3)	833	1.00	65.40	33.60	*0.327****	0.29	0.33***	*0.04*
	All companies	2399	2.00	74.00	24.00	*0.219****	0.08***	0.27***	*0.19****
	(2)-(1)					*0.154****			
	(3)-(2)					*0.098****			
	(3)-(1)					*0.252****			
Efficiency of your company's operation	< 75M (1)	809	36.30	45.90	17.80	*-0.185****	-0.20***	-0.08	*0.12**
	75-700M (2)	1076	35.00	43.80	21.20	*-0.138****	-0.14	-0.14***	*0.00*
	>700M (3)	995	27.40	50.20	22.40	*-0.050***	-0.20	-0.05**	*0.15*
	All companies	2880	32.80	46.60	20.70	*-0.121****	-0.19***	-0.09***	*0.10****
	(2)-(1)					*0.047*			
	(3)-(2)					*0.088****			
	(3)-(1)					*0.135****			
Liquidity of your company's common stock	< 75M (1)	710	8.60	90.30	1.10	*-0.075****	-0.08***	-0.06**	*0.02*
	75-700M (2)	874	4.80	91.80	3.40	*-0.014*	-0.04	-0.01	*0.02*
	>700M (3)	800	2.10	91.10	6.80	*0.046****	0.00	0.05***	*0.05*
	All companies	2384	5.00	91.10	3.90	*-0.012*	-0.07***	0.01*	*0.08****
	(2)-(1)					*0.061****			
	(3)-(2)					*0.060****			
	(3)-(1)					*0.121****			
Your company's overall value	< 75M (1)	736	18.60	74.30	7.10	*-0.115****	-0.14***	0.00	*0.14****
	75-700M (2)	937	12.10	73.40	14.50	*0.025*$^{+}$	0.08	0.02	*-0.06*
	>700M (3)	869	6.20	72.50	21.30	*0.151****	0.00	0.15***	*0.14*
	All companies	2542	12.00	73.40	14.70	*0.027**	-0.11***	0.08***	*0.19****
	(2)-(1)					*0.140****			
	(3)-(2)					*0.126****			
	(3)-(1)					*0.266****			
Your confidence in the reports of other Section 404 Companies	< 75M (1)	765	4.20	68.00	27.80	*0.237****	0.21***	0.45***	*0.24****
	75-700M (2)	1040	0.90	58.50	40.70	*0.398****	0.34***	0.40***	*0.06*
	>700M (3)	960	0.60	51.50	47.90	*0.473****	0.56**	0.47***	*-0.08*
	All companies	2765	1.70	58.70	39.60	*0.379****	0.22***	0.44***	*0.21****
	(2)-(1)					*0.161****			
	(3)-(2)					*0.075*****			
	(3)-(1)					*0.236****			

The previous discussion highlights that a non-trivial proportion of respondents recognize at least some benefits. Although this evidence is important, it does not permit conclusions to be drawn about whether the recognized benefits justify the costs of complying with Section 404 requirements. In an optional section of the survey, respondents were asked to assess the perceived benefits of Section 404 compliance relative to its costs, i.e., the perceived *net* benefits of compliance, both prior and after the 2007 reforms. The results are reported in Table 15 partitioned according to public float and Section 404 compliance status (i.e., Section 404(b) companies vs. Section 404(a)-only companies). The response provided could vary between -3 and +3, where: -3 referred to "costs far outweigh the benefits"; 0 referred to "costs equal benefits"; and +3 referred to "benefits far outweigh the costs."

The average perceived net benefits are uniformly and significantly negative, other than for a few large companies in the fiscal years following the 2007 reforms. Overall, companies that chose to complete this optional section of the survey typically view the costs of Section 404 compliance as outweighing the resulting benefits. Moreover, independent of the fiscal year considered, the perceived net benefits are significantly higher for larger companies. Finally, independent of the fiscal year considered, Section 404(b) companies typically perceive higher net benefits from Section 404 compliance. This latter finding is not due to the correlation between company size and Section 404(b) compliance status. Rather, the analysis shows that, controlling for size *and* compliance status, the incremental net benefit attributed to Section 404(b) compliance is mostly due to the perception of the smaller, rather than larger filers. That is, while small Section 404(b) companies tend to view more favorably the cost-benefit trade-off of Section 404 than do small Section 404(a)-only companies, there are no significant differences by compliance status among larger filers.

The evidence in Table 15 is largely consistent with the findings on the costs and benefits reported in previous tables. Specifically, first, the perceived net benefits of Section 404 compliance increase significantly with the size of the respondent's company, becoming less negative as the public float increases. This is consistent with the finding that Section 404 costs, scaled by the company's assets, decrease significantly as company size increases, on the one hand, and that the perceived benefits of Section 404 compliance increase significantly with company size, on the other. Second, the average perceived net benefits of Section 404 compliance in the first fiscal year following the 2007 reforms is higher relative to the prior year. This holds across all size groups, significantly so for medium and large companies. Moreover, net benefits are expected to be higher still in the fiscal year in progress at the time of the survey relative to the first post-reform year, suggesting a gradual, steady improvement in the implementation of Section

404. This is consistent with the earlier evidence that Section 404 compliance costs are significantly lower following the 2007 reforms and expected to be lower still during the fiscal year in progress at the time of the survey. Finally, the finding that Section 404(b) companies recognize higher net benefits is consistent with the analysis presented in Table 14, which shows that the responses of participants from these companies tend to be more optimistic about the effects of Section 404 compliance than those of respondents from Section 404(a)-only filers.

It should be noted that a portion of the responses to the optional section of the survey where participants provided their assessment of the cost-benefit trade-off was the result of a follow-up effort ("follow-up sample"). In particular, phone calls were made to individuals that had indicated at the end of the survey their willingness to be contacted and had not completed the optional sections. Hence, the participants in the follow-up sample received an additional "treatment" (i.e., the phone call) to elicit their responses to this section of the survey.[67] Nonetheless, untabulated results show that the inference based on this subsample alone is qualitatively similar to the inference based on the whole set of responses. That is, the respondents' assessment of the cost-benefit trade-off is largely negative, with some exceptions for large accelerated filers. It improves as the size of the respondent's company increases, and it has improved following the 2007 reforms and is expected to improve further during the fiscal year in progress. This is important to highlight because it suggests that our qualitative conclusions are not affected by the additional bias that may result from the respondents' decision to participate in the optional section of the survey.

Although our main conclusions are not affected, a comparison of the typical responses in the follow-up sample to those of participants who voluntarily completed the optional sections when they first completed the survey ("initial sample") reveals some interesting and significant differences. In particular, independent of company size, compliance status, and/or reference fiscal year, the respondents' typical assessment of the cost-benefit trade-off in the initial sample is significantly lower than the one in the follow-up sample. This is consistent with the notion that respondents in the initial sample may have had a stronger incentive to complete the optional section of the survey due to a negative experience with Section 404 compliance. Indeed, this conjecture is supported when we compare responses to the costs and benefits questions across the two samples: controlling for size, compliance status, and fiscal year of reference, the respondents in the initial sample tend to provide significantly higher compliance costs estimates and more

[67] This effort was arguably successful in that it generated an additional set of 532 follow-up responses, compared to 474 initial responses, suggesting that the additional treatment did indeed affect respondents' incentives to participate in the optional section of the survey.

pessimistic assessment of the benefits of compliance. Therefore, the additional analysis suggests that, although the direction of the results is likely not affected by the optional nature of this section of the survey, the evidence in Table 15 may provide an overly negative representation of the cost-benefit trade-off as perceived by the typical target of the survey.

Table 15 – Perceived net benefits by size, year, and Section 404(b) compliance status– (Optional Survey Section). In the optional section of the survey, participants compared the costs and benefits of complying with Section 404 requirements. The available responses could vary between -3 and +3, where: -3 referred to "costs far outweigh the benefits"; 0 referred to "costs equal benefits"; and +3 referred to "benefits far outweigh the costs." The table reports the percent of responses among these alternatives as well as the "not applicable," and the corresponding mean responses, by companies' public float in the relevant year. Public float is downloaded from DataStream and measured as of six months prior to the relevant fiscal year end. Panel A (B, C) reports summary statistics for pre-2007 reforms (post-2007 reforms, in progress) fiscal year. *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. In cases where companies 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 companies are not double-counted in any panel. The row labeled *Post - Pre* [*Next – Post*, *(5)-(4)*] and the column labeled *(2)-(1)* [*(3)-(2)*] report differences in means across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

		(1) <75M	(2) 75-700M	(3) >700M	All	*(2) - (1)*	*(3) - (2)*
Panel A: Pre-2007 reform							
Costs far outweigh the benefits	-3	31.9	22.8	16.8	23.4		
	-2	11	22.4	22.9	19.3		
	-1	10.3	21.2	27.7	20.2		
	0	4.8	15.9	16.5	12.9		
	1	2.3	6.7	9.8	6.5		
	2	0.3	3.1	3.9	2.6		
Benefits far outweigh the costs	3	0.6	1	1.1	0.9		
	N/A	38.7	7	1.4	14.2		
	Mean	*-2.011****	*-1.274****	*-1.042****	*-1.337****	*0.737****	*0.231***
	N	310	416	358	1084		
(4) 404(a) only	Mean	-2.16***	-1.70***	-1	-2.06***		
(5) 404(b)	Mean	-1.11***	-1.24***	-1.04***	-1.14***		
(5) – (4)		*1.05****	*0.462**	*-0.043*	*0.917****		
Panel B: Post-2007 reform							
Costs far outweigh the benefits	-3	47.1	16.7	10.2	23.1		
	-2	16.9	20.1	13.6	17		
	-1	15	20.6	19.9	18.8		
	0	10.5	23.8	26.4	20.9		
	1	3.8	11.5	19.4	12.1		
	2	1.9	4.4	8.1	5		
Benefits far outweigh the costs	3	1	2.5	1.8	1.8		
	N/A	3.8	0.2	0.5	1.4		
	Mean	*-1.868****	*-0.835****	*-0.368****	*-0.959****	*1.033****	*0.467****
	N	314	407	382	1103		
(4) 404(a) only	Mean	-2.01***	-1.15***	0.75*	-1.90***		
(5) 404(b)	Mean	-1.02***	-0.81***	-0.38***	-0.63***		
(5) – (4)		*1.00****	*0.34*	*-1.13*	*1.27****		
Panel C: Next year							
Costs far outweigh the benefits	-3	40.8	14.2	8.6	21.3		
	-2	18.6	18.2	10.8	15.9		
	-1	13.8	16.1	17.2	15.7		
	0	12.7	22.1	25	19.9		
	1	7.2	17.1	21.8	15.3		
	2	3.4	7.9	13.4	8.2		
Benefits far outweigh the costs	3	1.6	3.9	3.2	2.9		
	N/A	1.9	0.5	0	0.8		
	Mean	*-1.576****	*-0.505****	*-0.06*	*-0.712****	*1.070****	*0.443****
	N	377	380	372	1129		
(4) 404(a) only	Mean	-1.78***	-1.00**	0.4	-1.70***		
(5) 404(b)	Mean	-0.88***	-0.49***	-0.06	-0.35***		
(5) – (4)		*0.89****	*0.51*	*-0.46*	*1.35****		

All	*Post - Pre*	*0.143*	*0.439****	*0.674****	*0.378****
	Next - Post	*0.292****	*0.330****	*0.307****	*0.247****
404(a) only	*Post - Pre*	*0.15*	*0.55*	*1.75*	*0.16*
	Next - Post	*0.24**	*0.15*	*-0.35*	*0.2*
404(b)	*Post - Pre*	*0.08*	*0.42****	*0.66****	*0.51****
	Next - Post	*0.14*	*0.33****	*0.31****	*0.28****

Given that many respondents perceive that compliance costs to outweigh the benefits, we inquire whether companies are taking steps to avoid subjecting themselves to Section 404 requirements. Numerous academic studies have examined Section 404's impact on the competitiveness of U.S. capital markets and, specifically, whether the costs of complying with its requirements lead companies to go private or delist.[68] To measure the extent to which such concerns affect companies' decisions to list on U.S. exchanges, respondents were asked to assess the impact that Section 404 requirements have had on their company's decision to remain listed on U.S. exchanges.

Figures 2 and 3 summarize responses to questions on whether companies considered going private or delisting subsequent to the passage of the Act. As shown in Figure 2, approximately 44 percent of respondents from U.S. companies indicated that Section 404 requirements prompted their companies to seriously or at least somewhat consider going private. This result is largely driven by respondents from smaller companies, 70 percent of whom report their companies considered going private as a result of Section 404 requirements. Among foreign companies, 26 percent of respondents report their company to have seriously considered delisting, while 25 percent report to have considered this option less seriously. Similar to the evidence for domestic companies, this primarily reflects the responses of smaller foreign companies. The evidence in Figure 3 implies that respondents from small companies more frequently reported that their companies had considered delisting than did respondents from larger companies.

[68] *See, e.g.*, Carl R. Chen & Nancy Mohan, *The Impact of the Sarbanes-Oxley Act on Companies Going Private*, 19 Research. in Accounting Regulation 119 (2006); Christian Leuz, *Was the Sarbanes-Oxley Act of 2002 Really This Costly? A Discussion of Evidence from Event Returns and Going-Private Decisions*, 44 Journal of Accounting & Economics 146 (2007); Kate Litvak, *The Effect of the Sarbanes-Oxley Act on Non-U.S. Companies Cross-Listed in the U.S.*, 13 Journal of Corporate Finance 195 (2007); Jiseph D. Piotroski & Suraj Srinivasan, *Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings*, 46 Journal of Accounting Research 383 (2008); Craig G. Doidge et al., "Has New York Become Less Competitive in Global Markets? Evaluating Foreign Listing Choices over Time" (2008), unpublished working paper, available at http://ssrn.com/abstract=982193; Jefferson Duarte et al., "Foreign Listings, U.S. Equity Markets, and the Impact of the Sarbanes-Oxley Act" (2009), unpublished working paper, available at http://ssrn.com/abstract=1062641; Ehud Kamar et al., "Sarbanes-Oxley's Effects on Small Companies: What is the Evidence?" (June 2007), unpublished working paper, available at http://ssrn.com/abstract=993198; Christian Leuz et al., "Why Do Companies Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations" (2008), unpublished working paper, available at http://ssrn.com/abstract=592421; Luigi Zingales, "Is the U.S. Capital Market Losing Its Competitive Edge?" (2006), unpublished working paper, available at http://research.chicagogsb.edu/igm/research/papers/1LZingalescompetitiveness.pdf; Ellen Engel et al., "The Sarbanes-Oxley Act and Companies' Going-Private Decisions" (2004), unpublished working paper, available at http://ssrn.com/abstract=546626; Robert P. Bartlett, "Going Private But Staying Public: Reexamining the Effect of Sarbanes-Oxley on Companies' Going-Private Decisions" (2008), unpublished working paper, available at http://ssrn.com/abstract=1088830.

Figure 2
Has Section 404 motivated your company to consider going private?

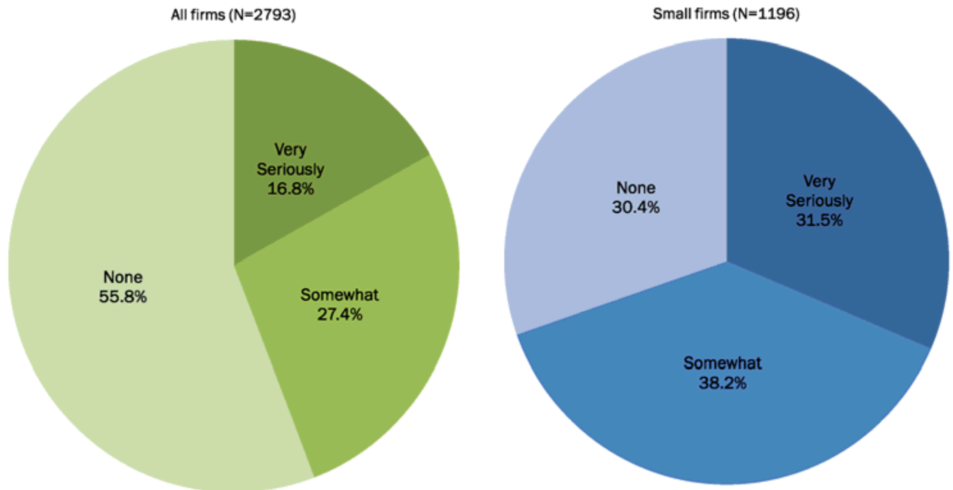
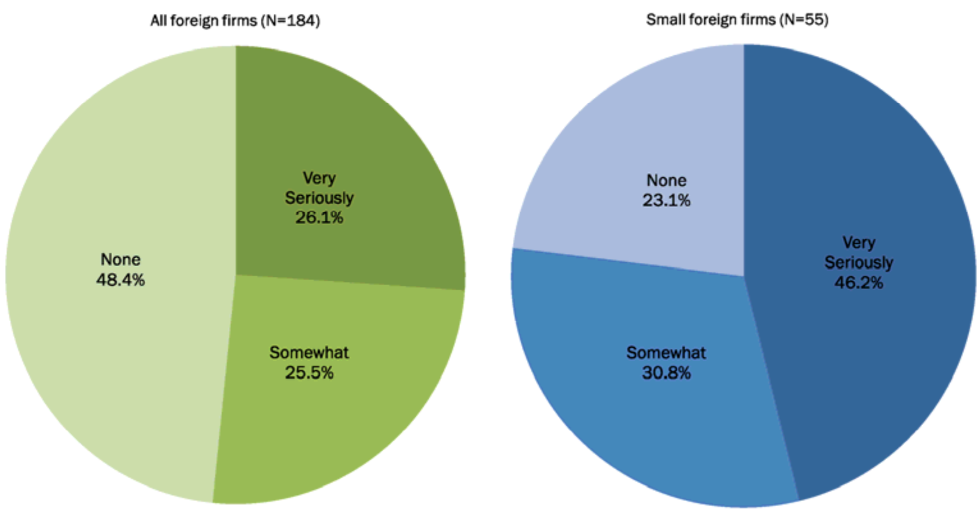


Figure 3
Has Section 404 motivated your company to consider delisting from U.S. exchanges?



c. *The Effects of Management Guidance and Auditing Standard No. 5 on Section 404 Compliance Procedures*

To assess the impact of regulatory reforms introduced by the SEC's Management Guidance and the impact of the PCAOB's AS5 issued in the summer of 2007, respondents were asked direct questions about how the reforms affected the activities entailed by compliance with Section 404 requirements.[69] This section presents the evidence based on management characterization of the impact of these reforms.

Table 16 reports the percent of respondents relying on the SEC's Management Guidance of 2007 and, among these, the percent of respondents that found the Management Guidance useful in complying with Section 404 requirements. The corresponding statistics are reported for the whole sample of available responses as well as for the three groups of companies based on their public float.

Overall, 88 percent of the respondents report that their company relied on the SEC's Management Guidance of 2007 and, among these, 94 percent report to have found the Guidance useful in complying with Section 404 requirements. Thus, approximately 83 percent (i.e., 88 percent times 94 percent) of respondents to this optional section of the survey report having relied on the Guidance and found it useful, suggesting that the SEC's efforts to clarify Section 404 compliance requirements may have found a receptive audience. Although these fractions are high regardless of the company's size, it appears that large companies tended to rely on the Guidance and found it useful more frequently than did medium or small companies.

[69] Because these questions appeared as "optional" at the end of the survey, not all participants responded to them.

Table 16 – The use of Management Guidance – (Optional Survey Section). Survey participants characterized their experience using the SEC's Management Guidance of 2007 in an optional section of the survey. This table reports the percent of participants answering "Yes" to questions about a company's reliance on the Guidance and whether this was found to be useful. Companies are segmented based on the market value of their public float, measured as of 2008. The row labeled *(2) – (1)* [*(3) – (2), (3) – (1)*] reports differences in the proportion of participants answering "Yes" across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

		N	Yes
Have you relied on the SEC's Management Guidance issued in 2007?	< 75M (1)	242	82%
	75 - 700M (2)	363	87%
	>700M (3)	365	92%
	All companies	970	88%
	(2) - (1)		*5%*
	(3) - (2)		*5%*****
	(3) - (1)		*10.1%******
Have you found the SEC's Management Guidance useful?	< 75M (1)	199	91%
	75 - 700M (2)	317	94%
	>700M (3)	336	96%
	All companies	852	94%
	(2) - (1)		*3%*
	(3) - (2)		*2%*
	(3) - (1)		*5%*****

Prior analysis shows the 2007 reforms correspond to a reduction in the costs of complying with Section 404. Nonetheless, as noted earlier, the mere passage of time and the consequent learning process companies undergo as they gain experience in complying with Section 404 could also explain this decline. To help separate these effects, respondents were asked to provide an explicit assessment of the impact they perceive the SEC's Management Guidance and/or PCAOB's Auditing Standard No. 5 to have had on the costs of complying with Section 404 requirements. The response provided could vary between -1 and +1, where: -1 referred to "costs decreased"; 0 referred to "little or no impact"; and +1 referred to "costs increased." Table 17 summarizes the responses for Section 404(b) companies.

On average, companies perceive the 2007 reforms to have helped reduce the cost of complying with Section 404, both when the reforms are considered in isolation as well as when they are considered in combination (i.e., AS5 and Management Guidance together). Although this result holds true independent of company size, it appears that respondents from large companies ascribe a larger impact to the reforms, consistent with the evidence in the previous table about companies' reliance on the SEC's Management Guidance. Moreover, the evidence is consistent with the earlier analysis of the costs of Section 404 compliance, which shows that the typical costs tend to be lower following the 2007 reforms and that these differences in costs are more substantial and significant among larger companies.

Table 17 – 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 SEC's Management Guidance and PCAOB's AS5 of 2007 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) companies and reports summary statistics for the participants' responses to questions about the isolated and combined impact of the reforms on compliance costs. Companies are segmented based on the market value of their public float, measured as of 2008. The column labeled *Mean* reports the mean response in the relevant sample. The row labeled *(2) – (1)* [*(3) – (2)*, *(3) – (1)*] reports differences in mean responses across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

			decrease/none/increase			
		N	-1	0	1	*Mean*
Impact of Management Guidance on total cost of compliance	< 75M (1)	40	47.5%	50.0%	2.5%	*-0.450****
	75-700M (2)	376	30.3%	65.7%	4.0%	*-0.263****
	>700M (3)	364	45.3%	53.3%	1.4%	*-0.440****
	(2) - (1)					*0.187***
	(3) - (2)					*-0.176***
	(3) - (1)					*0.010*
Impact of Auditing Standard No. 5 on total cost of compliance	< 75M (1)	41	48.8%	46.3%	4.9%	*-0.439****
	75-700M (2)	382	47.9%	46.9%	5.2%	*-0.427****
	>700M (3)	373	66.5%	31.4%	2.1%	*-0.643****
	(2) - (1)					*0.012*
	(3) - (2)					*-0.217****
	(3) - (1)					*-0.204***
Combined impact of Management Guidance and AS5 on total compliance cost	< 75M (1)	40	55.0%	40.0%	5.0%	*-0.500****
	75-700M (2)	382	48.2%	46.9%	5.0%	*-0.432****
	>700M (3)	357	69.2%	29.4%	1.4%	*-0.677****
	(2) - (1)					*0.068*
	(3) - (2)					*-0.245****
	(3) - (1)					*-0.177**

One of the objectives of the PCAOB's Auditing Standard No. 5 is to reduce the amount of time it takes to complete the independent audit of ICFR, which would presumably affect the audit fees paid by Section 404(b) companies.[70] Respondents rated the impact of AS5 on the amount of time it takes to complete the independent audit of ICFR, and the response provided could vary between -3 and +3, where: -3 referred to "a large decrease"; 0 referred to "no impact"; and +3 referred to "a large increase."[71] Table 18 reports summary statistics for the respondents' perceptions of the impact of AS5 on this dimension of Section 404 compliance, both in the first year following the 2007 reforms and in the fiscal year in progress at the time of the survey.

At least to some extent, AS5 is perceived to have achieved its intended objectives with respect to the amount of time it takes to complete the independent audit of ICFR in the first year following the 2007 reforms and is expected to have a similar impact in the fiscal year in progress at the time of the survey. Approximately 60 percent of all respondents believe (or expect) AS5 to reduce the time necessary to complete the auditor attestation requirement under Section 404(b). Consistent with the earlier analysis, the evidence in Table 18 also suggests that there are differences in the perceived impact of AS5 across companies of different size. Specifically, large companies typically perceive the impact of AS5 in the year following the reform to be greater than that perceived by either small or medium companies. Thus, although AS5 is perceived to have produced one of its desired effects, it appears that greater benefits from this reform accrue to larger companies, which is also consistent with the evidence discussed earlier on the changes in audit fees imputed to Section 404(b) compliance.

[70] *See* SEC Order 2007 *supra* note 23, at 18.

[71] When asked this question, respondents were explicitly instructed to use as a benchmark the amount of time they thought it would have taken to complete the independent audit of ICFR. Hence, even companies that comply with Section 404(b) for the first time in the first year following the 2007 reforms could provide an assessment of the impact of AS5.

Table 18 – Impact of AS5 on the amount of time it takes to complete the independent audit of ICFR. Participants from Section 404(b) companies characterized the impact of PCAOB's AS5 of 2007 on the time it takes to complete the independent audit of ICFR under the rules of Section 404(b). The response could vary between *-3* and *+3*, where: *-3* referred to "large decrease," *-2* referred to "moderate decrease," *-1* referred to "small decrease," *0* referred to "no impact," *+1* referred to "small increase," *+2* referred to "moderate increase," *+3* referred to "large increase." Alternatively the response could be "not sure" or "not applicable." This table reports summary statistics for the participants' response to this question when companies are segmented based on the market value of their public float in the relevant fiscal year. *Post-2007 reforms* refers to the first fiscal year after the 2007 reforms; *Expected* refers to the fiscal year in progress at the time of the survey. Public float is downloaded from DataStream and measured as of six months prior to the relevant fiscal year end. The row labeled *Mean* reports the mean response in the relevant sample. The column labeled *(2) – (1)* [*(3) – (2)*, *(3) – (1)*] reports differences in mean responses across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

		(1) <75M	(2) 75-700M	(3) >700M	All	*(2) – (1)*	*(3) - (2)*	*(3) - (1)*
Post-2007 reforms								
Large decrease	-3	3.92	1.84	3.80	2.90			
	-2	20.59	19.24	25.98	22.59			
	-1	23.53	35.03	41.27	37.48			
No Impact	0	29.41	27.68	21.97	24.99			
	1	3.92	4.32	2.57	3.45			
	2	8.82	7.03	3.08	5.20			
Large increase	3	3.92	4.22	0.72	2.50			
	N/A	5.88	0.65	0.62	0.90			
	Mean	*-0.46****	*-0.48****	*-0.94****	*-0.71****	*-0.02*	*-0.46****	*-0.48****
	N	102	925	974	1,983			
Expected								
Large decrease	-3	4.55	1.56	2.69	2.37			
	-2	14.65	19.38	18.39	18.46			
	-1	24.24	37.53	41.51	38.06			
No Impact	0	27.27	30.29	31.83	30.70			
	1	6.06	3.23	2.15	3.01			
	2	8.59	5.57	2.47	4.44			
Large increase	3	3.03	1.34	0.65	1.18			
	N/A	11.62	1.11	0.32	1.78			
	Mean	*-0.39****	*-0.63****	*-0.78****	*-0.68****	*-0.24***	*-0.14****	*-0.38****
	N	102	925	974	1,983			

Table 19 reports respondents' perceptions of the impact of AS5 on the amount of time it takes to complete the independent audit of ICFR based on the number of years of experience with Section 404(b) compliance. The evidence indicates that companies which have prior Section 404(b) compliance experience perceive a greater beneficial impact of AS5 on the amount of time it takes to complete the independent audit of ICFR; that is, respondents from companies with prior experience perceive AS5 to reduce the time it takes to complete the auditor attestation more than respondents from the sample of first-time compliers. In particular, for companies complying for the first time in the fiscal year following the 2007 reforms, the typical perception is that AS5 has had no immediate impact, although the reform is expected to help reduce the amount of time necessary to complete the independent audit of ICFR during the fiscal year in progress at the time of the survey. In contrast, for companies with multiple years of experience, the typical perception is that AS5 helps reduce the time necessary to complete the independent audit of ICFR. The differences in the perceived impact of AS5 across groups of companies with prior versus no experience are statistically significant at conventional confidence levels, whereas the average perceived impact of AS5 is not statistically significantly different across companies with 2 and 3+ years of experience.

There are at least two possible interpretations of the evidence. First, it is possible that Section 404(b) compliance experience complements the reforms introduced by AS5 and, thus, *actually* enhances the impact of AS5. For instance, it may be that AS5 has no significant impact on the start-up costs that are required of first-time compliers, while reducing the effort necessary to comply with Section 404(b) past the first year. Alternatively, companies that have no prior experience with Section 404(b) compliance may have a biased assessment of the impact of AS5 because they lack a benchmark against which to evaluate the effect of the reform (i.e., what the first-time audit would have required absent AS5). The evidence for the fiscal year in progress at the time of the survey supports the former explanation. Although companies that complied for the first time with Section 404(b) in the fiscal year following the 2007 reforms perceived AS5 to have no immediate impact, they also typically report that AS5 is expected to reduce the amount of time necessary for auditor attestation in the fiscal year in progress at the time of the survey. Therefore, although AS5 is perceived to have little or no impact on auditor attestation for first-time compliers, the responses indicate that, independent of a company's prior experience, the reform is perceived to affect the process underlying recurring audits of ICFR allowing auditors to complete their work in a shorter amount of time.

Table 19 – Impact of AS5 on the amount of time it takes to complete the independent audit of ICFR by years of experience with Section 404(b). Participants from companies that are Section 404(b) companies characterized the impact of PCAOB's AS5 of 2007 on the time it takes to complete the independent audit of ICFR under the rules of Section 404(b). The response could vary between *-3* and *+3*, where: *-3* referred to "large decrease," *-2* referred to "moderate decrease," *-1* referred to "small decrease," *0* referred to "no impact," *+1* referred to "small increase," *+2* referred to "moderate increase," *+3* referred to "large increase." Alternatively the response could be "not sure" or "not applicable." This table reports the participants' mean response to this question when companies are segmented based on the number of years of compliance experience with Section 404(b) in the first fiscal year following the 2007 reforms, as reported by Audit Analytics (e.g. *1 yr* includes companies complying with Section 404(b) for the first time in the first fiscal year following the 2007 reforms; 2 *yrs* includes companies complying with Section 404(b) for the second time in the first fiscal year following the 2007 reforms; etc.). *Post-2007 reforms* refers to the first fiscal year after the 2007 reforms; *Expected* refers to the fiscal year in progress at the time of the survey. *Mean* is the mean response in the relevant sample. The column labeled *2yrs-1yr* [*3+yrs-2yrs*] reports differences in mean responses across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

		Number of years complying with Section 404(b) in the first fiscal year Post-2007 reforms				
		1 yr	2 yrs	3+ yrs	*2yrs-1yr*	*3+yrs-2yrs*
Post-2007 reforms	Mean	0.05	-0.81***	-0.77***	*-0.86****	*0.04*
	N	175	211	1,604		
Expected	Mean	-0.39***	-0.67***	-0.71***	*-0.27***	*-0.04*
	N	176	207	1617		

Table 20 considers the allocation of effort in support of the respondents' assessment of ICFR. The SEC's Management Guidance of 2007, by providing a top-down, risk-based approach to complying with Section 404(a), was intended to lead companies to a more efficient allocation of resources. Specifically, the Commission's intent was that "management should bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides a reasonable basis for its annual assessment of whether IFCR is effective."[72] The Commission intended management to promote efficiency first by "allowing management to focus on the controls that are needed to adequately address the risk of a material misstatement of its financial statements"[73] and, second, by "allowing management to align the nature and extent of its evaluation procedures [such as evidence gathering, documentation effort, and testing the controls] to those areas of financial reporting that pose the highest risks to reliable financial reporting."[74]

[72] Management Guidance, *supra* note 22, at 35,325.

[73] *Id.* at 35,324.

[74] *Id.* at 35,325.

In its Management Guidance, the SEC predicted several trends in the manner in which management would subsequently conduct its evaluation of ICFR. It predicted that management's effort to identify financial reporting risks and controls would decrease after the first year of compliance because "subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls."[75] The SEC also indicated that "in each subsequent year, the documentation of risks and controls will only need to be updated from the prior year(s), not recreated anew."[76] Consequently, if Management Guidance has been successfully implemented, we should observe management gradually reducing the effort spent identifying financial reporting risks and controls and documenting these controls. However, because Management Guidance stressed a risk-based approach to testing and evaluating the effectiveness of these controls (i.e., more extensive testing in the highest risk area), there is no *a priori* prediction on whether management's effort on these components would increase or decrease.

In an optional section of the survey, respondents described the activities in which their companies engage as they comply with the requirements of Section 404(a). Specifically, respondents were asked to represent the effort devoted to each activity as a fraction of the total effort required to comply with the requirements of Section 404(a). That is, the sum of all activities should add up to one. Respondents were presented with a menu of choices we compiled based on prior surveys and industry studies as well as the interviews conducted in the pre-testing stage of the survey. Table 20 reports summary statistics on the fraction of effort (in percentage terms) that respondents assign to various tasks required to support management's assessment of ICFR, before and after the 2007 reforms. For sake of brevity, the table only presents tasks that received an average effort allocation of 10 percent or higher in the whole sample of respondents.[77]

Overall, the evidence in Table 20 shows statistically significant differences across companies of different size with respect to how effort was allocated to various tasks prior to the 2007 reforms. Specifically, small companies prior to the 2007 reforms allocated a smaller fraction of their effort, relative to medium and large companies, to "Testing the operational effectiveness

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[75] *Id.*

[76] *Id.*

[77] As a result the following categories are excluded from the table: evaluating deficiencies to determine material weaknesses (receiving an average allocation between 4.9% and 5.4%); changes to IT systems (receiving an average allocation between 4.2% and 4.5%); developing related disclosures on SEC filings (receiving an average allocation between 3% and 3.1%); and other (receiving an average allocation of less than 1%).

of controls” and a higher fraction to other tasks such as “Documenting controls identified to address risks,” “Identifying risks to your company's financial reporting,” and “Identifying controls that address identified risks.” Following the 2007 reforms there is a convergence toward a more homogenous allocation of effort to various tasks across companies of different size. For instance, while companies allocate or expect to allocate a larger fraction of their effort to “Testing the operational effectiveness of controls” across all size groups, the average realized or expected increase in effort allocation to this task among smaller companies is notably higher, from 18.7 percent prior to the 2007 reforms to 29.7 percent anticipated for the coming fiscal year. For this same task, large (medium) companies reported a 35.2 percent (31.1 percent) allocation prior to the 2007 reforms, and the anticipation of a 38.9 percent (36.5 percent) allocation in the coming fiscal year. A similar trend toward a more homogenous allocation of effort is observed or anticipated for the following tasks: “Evaluating effectiveness of controls,” “Identifying risks to your company's financial reporting,” and “Identifying controls that address identified risks.” The increased uniformity of practices across companies of different size following the 2007 reforms is consistent with the notion that the SEC’s Management Guidance may have helped clarify the requirements of Section 404(a), thereby helping companies refocus their efforts on the tasks that are of greater importance with regard to compliance with those requirements.

Table 20 – Allocation of effort in support of management's assessment of ICFR – (Optional Survey Section). In an optional section of the survey, participants provided an allocation (in percentage terms) of the effort expended in support of management's assessment of ICFR in compliance with Section 404(a) requirements. The allocation among the following list of tasks was required to sum to 100%: *Changes to IT systems*, *Developing related disclosures on SEC filings*, *Documenting controls identified to address risks*, *Evaluating deficiencies to determine material weaknesses*, *Evaluating effectiveness of controls*, *Identifying controls that address identified risks*, *Identifying risks to your company's financial reporting*, *Testing the operational effectiveness of controls*, *Other*. This table reports the participants' mean allocation when companies are segmented based on their public float in the relevant fiscal year. The table presents activities that receive a mean allocation of 10% or higher only. *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. In cases where companies 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 companies are not double-counted in any panel. The row labeled *Post-Pre* [*Next-Post*] and the column labeled *(2)-(1)* [*(3)-(2)*, *(3)-(1)*] report differences in means across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

Average percent allocation:		(1) <75M	(2) 75-700M	(3) >700M	*(2)-(1)*	*(3)-(2)*	*(3)-(1)*
Testing the operational effectiveness of controls	Pre	18.7%	31.1%	35.2%	*12.4%***	*4.2%*	*16.5%*
	Post	23.4%	35.3%	36.5%	*11.9%***	*1.2%*	*13.1%****
	Next	29.7%	36.5%	38.9%	*6.7%*	*2.5%*	*9.2%***
	Post-Pre	*4.7%**	*4.2%***	*1.3%*			
	Next-Post	*6.3%****	*1.2%*	*2.4%*			
Documenting controls identified to address risks	Pre	20.5%	16.3%	15.1%	*-4.2%*	*-1.2%*	*-5.5%*
	Post	20.6%	14.3%	12.6%	*-6.3%***	*-1.7%*	*-8.0%*
	Next	15.9%	12.0%	11.1%	*-3.9%*	*-0.8%*	*-4.7%**
	Post-Pre	*0.0%*	*-2.1%***	*-2.5%***			
	Next-Post	*-4.7%****	*-2.3%****	*-1.4%**			
Evaluating effectiveness of controls	Pre	10.9%	13.7%	16.1%	*2.8%*	*2.4%*	*5.2%*
	Post	12.8%	15.3%	18.3%	*2.5%*	*3.1%*	*5.5%*
	Next	15.0%	16.6%	17.8%	*1.6%*	*1.3%*	*2.9%*
	Post-Pre	*1.9%*	*1.6%*+	*2.2%*			
	Next-Post	*2.2%***	*1.3%*	*-0.5%*			
Identifying risks to your company's financial reporting	Pre	16.7%	11.4%	10.5%	*-5.3%*	*-0.9%*	*-6.2%*
	Post	11.1%	10.5%	9.6%	*-0.6%*	*0.0%*	*-0.6%*
	Next	9.7%	9.9%	9.5%	*0.2%*	*-0.4%*	*-0.2%*
	Post-Pre	*-5.7%***	*-0.9%*	*-0.9%*			
	Next-Post	*-1.4%*	*-0.6%*	*-0.1%*			
Identifying controls that address identified risks	Pre	14.7%	12.2%	10.1%	*-2.6%*	*-2.0%*	*-4.6%*
	Post	13.1%	10.6%	9.5%	*-2.5%*	*-1.1%*	*-3.6%*
	Next	10.1%	10.1%	9.0%	*-0.1%*	*-1.1%*	*-1.2%*
	Post-Pre	*-1.6%*	*-1.6%***	*-0.6%*			
	Next-Post	*-3.0%***	*-0.5%*	*-0.5%*			
Number responded	Pre	77	208	176			
	Post	120	223	182			
	Next	170	214	185			

Since the previous evidence is based on a set of questions focusing on how Section 404(a) compliance effort is allocated to various tasks and activities in a relative sense (i.e., in proportion to other tasks and activities), it does not provide insight into how various aspects of Section 404(a) compliance have changed around the 2007 reforms in an absolute sense. This was addressed in an optional section of the survey, where respondents indicated whether and in which direction various aspects of Section 404(a) compliance have changed or are anticipated to change. The responses could vary between -1 and +1, where: -1 referred to “a decrease”; 0 referred to “little or no change”; and +1 referred to “an increase.” Table 21 reports the results. Panel A summarizes the responses about the changes experienced from the year prior to the year after the 2007 reforms, while Panel B presents responses about the anticipated changes during the fiscal year in progress at the time of the survey. The results in Panels A and B are fairly similar, for both the whole sample and within each subsample based on companies’ public float. The only difference is that the anticipated changes in Panel B are uniformly smaller in an absolute sense than the experienced changes summarized in Panel A. This is consistent with the notion that there is a gradual adjustment in companies’ compliance practices following the 2007 reforms, but the changes are also more pronounced immediately following those reforms. For sake of brevity, the following discussion focuses only on the evidence in Panel A. Similar inferences apply to the results in Panel B, although the average magnitude of the changes is smaller.

The evidence in Panel A of Table 21 indicates that for the whole sample, the average change in the effort devoted to each compliance activity is not uniformly positive or negative. In particular, respondents report a statistically significant increase in the following aspects of Section 404(a) compliance: “Level of documentation,” “Use of management's interaction with controls as evidence,” “Reliance on evidence gained from self-assessments,” “Reliance on evidence from direct testing,” and “Overall scope.” Conversely, on average, there is a statistically significant reduction in the “Number of risks subject to testing” and “Number of controls tested.” The summary statistics in Panel A reveal statistically significant differences for nearly every aspect of Section 404(a) compliance across companies of different size. First and most notably, for the group of companies with public float below $75 million, respondents report a statistically significant increase in all activities pertaining to Section 404(a) compliance, on average. Second, the typical answers by large and medium companies imply significantly smaller changes than those reported by the small companies for almost all the items in the list provided. These findings are perhaps unsurprising given that many of the smaller companies complied with Section 404(a) for the first time in the year after the passage of the reforms and, thus, would have naturally experienced the largest increase in the effort and time required to comply with Section 404(a). Third, although for many aspects of Section 404(a) compliance, medium and large companies report having experienced changes in the same direction, there are some notable differences across these two groups of companies. In particular, while both groups of companies on average experience a decrease in the "Number of risks subject to testing," "Number of controls tested," and "reporting and discussions of deficiencies/material weaknesses," larger companies experience significantly larger decreases in these aspects of Section 404(a) compliance. Moreover, while, on average, medium companies experience a significant increase in "Reliance on evidence from direct testing," large companies report no significant change in this dimension; and while, on average, large companies experience a significant reduction in the "Overall scope" of Section 404(a) compliance, medium companies report no significant change.

The evidence in Tables 20 and 21 supports the notion that management's procedures for evaluating ICFR are changing in a manner advised by the SEC's Management Guidance. The fact that the number of risks identified and controls tested is decreasing is consistent with SEC guidance that not every risk and control need be tested, but only those that cause the highest risks and those whose testing would adequately address the risks of financial misstatement. Moreover, consistent with the stress placed by the SEC's Management Guidance on the importance of leveraging management's own experience and judgment in designing the evaluation procedures, there is a general increase in the activities that allow for management's discretion. Finally, the notable convergence in the standards applied in performing the evaluation of ICFR is consistent with the idea that the reforms helped dissipate uncertainty about the compliance process.

Table 21 – Changes in activities associated with management's evaluation of ICFR – (Optional Survey Section). In an optional section of the survey, participants characterized the changes in various aspects of Section 404(a) compliance around the 2007 reforms. The responses could vary between *-1* and *+1*, where: *-1* referred to "a decrease," *0* referred to "little or no change," *+1* referred to "an increase." Alternatively, the responses could be "not sure" or "not applicable." Companies are segmented based on the market value of their public float measured in the relevant fiscal year. Public float is downloaded from DataStream and measured as of six months prior to the fiscal year end. The table reports summary statistics for the participants' responses. Panel A (B) is restricted to the participants' responses for changes (anticipated to be) realized during the first fiscal year following the 2007 reforms (fiscal year in progress at the time of the survey). The column labeled *Mean* reports the mean response in the relevant sample. The column labeled *(2) – (1)* [*(3) – (2), (3) – (1)*] reports differences in mean responses across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

Panel A – Realized changes from year prior to the year after the 2007 reforms.

	All Respondents													
		Percent				**(1) <75 M**		**(2) 75-700 M**		**(3) >700 M**		**(2) - (1)**	**(3) - (2)**	**(3) - (1)**
Pre to Post	**N**	**-1**	**0**	**1**	**Mean**	**N**	**Mean**	**N**	**Mean**	**N**	**Mean**			
Number of risks subject to testing	856	31%	51%	18%	-0.13***	182	0.28***	341	-0.17***	333	-0.31***	-0.45***	-0.15***	-0.59***
Number of locations for which you gathered evidence	776	15%	67%	18%	0.03	151	0.25***	313	0.00	312	-0.05	-0.25***	-0.05	-0.30***
Level of documentation	856	13%	61%	26%	0.13***	187	0.53***	340	0.06**	329	-0.04	-0.46***	-0.11**	-0.57***
Number of controls tested	860	49%	32%	19%	-0.31***	185	0.26***	342	-0.35***	333	-0.58***	-0.61***	-0.23***	
Nature, timing, and extent of evidence gathered	861	20%	57%	23%	0.03	186	0.49***	343	0.01	332	-0.20***	-0.49***		
Use of management's interaction with controls as evidence	813	3%	64%	34%	0.31***	179	0.51***	324	0.27***	310	0.23***	-0.25***		
Reliance on evidence gained from self-assessments	745	3%	66%	31%	0.27***	174	0.44***	285	0.24**	286	0.21***	-0.21***		
Reliance on evidence from direct testing	838	10%	63%	27%	0.17***	181	0.48***	331	0.14***	326	0.02	-0.34***		
Reporting and discussions of deficiencies/material weaknesses	802	18%	65%	17%	-0.01	170	0.38***	319	-0.09***	313	-0.15***	-0.47***		
Overall scope	865	21%	54%	26%	0.05**	188	0.51***	344	0.00	333	-0.17***	-0.51***		-0.67***

Panel B – Anticipated (future) changes during the fiscal year in progress at the time of the survey.

	All Respondents					(1) <75 M		(2) 75-700 M		(3) >700 M		(2) - (1)	(3) - (2)	(3) - (1)
		Percent												
Post to Next	**N**	**-1**	**0**	**1**	**Mean**	**N**	**Mean**	**N**	**Mean**	**N**	**Mean**			
Number of risks subject to testing	922	22%	67%	11%	-0.11***	223	0.06*	357	-0.15***	342	-0.18***	-0.21***	-0.03	-0.24***
Number of locations for which you gathered evidence	847	13%	74%	14%	0.01	192	0.15***	330	-0.02	325	-0.04	-0.17***	-0.02	-0.19***
Level of documentation	927	12%	73%	15%	0.04**	228	0.26***	358	0.03	341	-0.10***	-0.24***	-0.13***	-0.37***
Number of controls tested	928	32%	55%	12%	-0.20***	226	0.09**	359	-0.23***	343	-0.36***	-0.33***	-0.12**	-0.45***
Nature, timing, and extent of evidence gathered	925	14%	73%	13%	-0.01	227	0.19***	358	-0.02	340	-0.13***	-0.21***	-0.11***	-0.32***
Use of management's interaction with controls as evidence	885	3%	74%	23%	0.20***	220	0.29***	341	0.18***	324	0.15***	-0.11***	-0.03	-0.14***
Reliance on evidence gained from self-assessments	826	4%	77%	19%	0.16***	214	0.19***	307	0.13***	305	0.16***	-0.05	0.03	-0.02
Reliance on evidence from direct testing	905	8%	75%	17%	0.10***	222	0.20***	347	0.11***	336	0.01	-0.09*	-0.10***	-0.19***
Reporting and discussions of deficiencies/material weaknesses	873	15%	75%	10%	-0.05***	214	0.07*	338	-0.07**	321	-0.12***	-0.14***	-0.05	-0.18***
Overall scope	924	15%	68%	17%	0.02	227	0.24***	356	0.01	341	-0.12***	-0.23***	-0.12***	-0.36***

The analysis in Table 22 considers the extent to which auditors rely on management's assessment of ICFR. An important objective of the 2007 reforms introduced by the SEC and the PCAOB was to direct companies complying with Section 404(b) to structure management's assessment of ICFR, i.e., Section 404(a) compliance, so that the independent audit required under Section 404(b) could (and would) more heavily rely on the effort exerted by management.[78] Presumably, this change in the compliance process eliminates unnecessary duplication of efforts and, thus, reduces the total costs of complying with Section 404, mainly by reducing the audit fees due to Section 404(b) compliance.[79] In an optional section of the survey, respondents were asked to provide an assessment of the extent to which their companies structured their evaluation of ICFR with the intent of allowing the independent auditor to rely on the company's internal work. The response provided could vary between 1 and 3, where: 1 refers to "Not at all"; 2 refers to "moderately"; and 3 refers to "A great deal." Table 22 reports summary statistics for the responses to this optional section of the survey for the year prior and the year following the 2007 reforms, as well as the year in progress at the time of the survey and is restricted to Section 404(b) companies.

The evidence shows that, following the 2007 reforms, companies on average reported devoting significantly greater effort to structuring the compliance process for Section 404(a) to facilitate the work of the independent auditor and, thus, make the compliance process for Section 404(b) more efficient. It does not appear that companies typically expect further changes in the Section 404 compliance process in this regard during the fiscal year in progress at the time of survey. This evidence is consistent with the notion that the 2007 reforms have produced the desired effect of allowing companies to internalize larger shares of the tasks and costs resulting from Section 404 compliance.

[78] *See* SEC Order 2007, *supra* note 12, at 4.

[79] *See id.* at 4 & 17-18.

Table 22 – Allowing independent auditors to rely on management assessment's of ICFR – (Optional Survey Section). In an optional section of the survey, participants characterized the degree to which their company structured its evaluation of ICFR with the intent of allowing the independent auditor to rely on its work. The response could vary between *1* and *3*, where: *1* referred to "Not at all," *2* referred to "Moderately," *3* referred to "A great deal." Alternatively, the response could be "not sure" or "not applicable." Companies are segmented based on the market value of their public float measured in the relevant fiscal year. Public float is downloaded from DataStream and measured as of six months prior to the fiscal year end. The table reports summary statistics for the participants' response. *Pre-2007 reforms* includes firm-fiscal year observations pre-dating November 15, 2007; *Post-2007 reforms* includes all completed firm-fiscal year observations post-dating November 15, 2007; and *Next Year* includes all firm observations referring to the fiscal years in progress at the time of the survey. In cases where companies 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 companies are not double-counted in any panel. The row labeled *Mean* reports the mean response in the relevant sample. The row labeled *Post – Pre* [*Next – Post*] and the column labeled *(2)-(1)* [*(3)-(2)*, *(3)-(1)*] report differences in means across the relevant subsamples. ***, **, and * indicate significance at 1%, 5%, and 10% levels, respectively.

	(1) <75M	(2) 75-700M	(3) >700M	All	*(2) - (1)*	*(3) - (2)*	*(3) - (1)*
Pre-2007 reforms							
Not at all	9.5%	13.9%	11.4%	12.5%			
Moderately	42.9%	37.4%	38.1%	37.9%			
A Great Deal	47.6%	48.6%	50.5%	49.6%			
Mean	*2.38*	*2.35*	*2.39*	*2.37*	*-0.03*	*0.04*	*0.01*
N	21	294	315	631			
Post-2007 reforms							
Not at all	3.2%	6.4%	8.2%	7.1%			
Moderately	25.8%	34.7%	31.8%	33.1%			
A Great Deal	71.0%	58.9%	60.1%	59.8%			
Mean	*2.68*	*2.53*	*2.52*	*2.53*	*-0.15*	*-0.01*	*-0.16*
N	31	314	343	692			
Next year							
Not at all	9.0%	6.8%	7.4%	7.2%			
Moderately	32.8%	29.0%	24.6%	27.4%			
A Great Deal	58.2%	64.2%	68.0%	65.3%			
Mean	*2.49*	*2.57*	*2.61*	*2.58*	*0.08*	*0.03*	*0.11*
N	67	310	337	718			
Post-Pre	*0.30**	*0.18****	*0.13***	*0.16****			
Next-Post	*-0.18*	*0.05*	*0.09**	*0.05*			

V. Outsiders' Perspective on the Effects of Section 404: Discussion of In-Depth Interviews with External Users of Financial Statements and Independent Auditors

a. Objective, Broad Scope, and Subjects of the In-Depth Interviews

Section 404 requirements were intended to *directly* improve the quality of the information produced by companies' financial reports. Investors—not management—are the intended primary beneficiaries of Section 404. If compliance with Section 404 leads to improvements in financial reporting quality that are valued by users of financial statements from outside the corporation, this could reduce the cost of capital. If the resulting benefits outweigh the cost of compliance, the improvements in financial reporting quality could ultimately enhance value—for instance, by allowing filers to access capital markets at more convenient terms or by improving the depth (i.e., liquidity) of securities markets.

As discussed in Section IV.b, the evidence from the Web survey indicates that, to a large extent, companies experience direct beneficial effects of complying with Section 404 requirements, supporting the notion that Section 404's implementation has typically been effective in that regard. Nonetheless, the evidence suggests that survey participants do not perceive the direct improvements in the reporting process to affect the companies' dealings with capital market participants. For instance, respondents recognize virtually no effect from Section 404 implementation on companies' cost of capital or the ease with which they access capital markets. As previously discussed, however, the evidence on the indirect effects of Section 404 may be biased if the respondents' perceptions or their representations of those perceptions are biased. While a determination of the source and extent of these biases is beyond the scope of this study, it is important that the analysis identifies the benefits of compliance with Section 404. To obtain a broader and more complete assessment of the effects of Section 404 on capital market participants, the staff of the SEC's Office of the Chief Accountant ("OCA") conducted in-depth interviews with individuals representing a variety of external users of financial statements.

Under the rules of Section 404(b), companies are required to undergo and disclose the results of an annual independent audit of ICFR. One of the objectives of this study is to evaluate whether the auditor attestation requirement among Section 404(b) companies is being implemented in a manner that may be cost-effective for smaller reporting companies, which were not required to comply with this requirement to date. Therefore, recognizing that compliance with Section 404(b) requires the involvement and efforts of agents outside the corporation (i.e., independent auditors), following the previous logic, we determined that it would be valuable to complement the analysis of public companies' survey responses with an assessment of the views of independent auditors about Section 404's compliance process and how the latter may have been affected by the SEC's and PCAOB's 2007 reforms.

To allow this supplemental analysis, the OCA staff conducted in-depth phone interviews with external users of financial statements as well as independent auditors.[80] In particular, various organizations were contacted to assist in the identification and solicitation of interview participants. Based on the willingness of the parties invited to participate in the interview, a sample of 30 individuals representing investors and other external financial statement users was selected. Following is the list of users of financial statements interviewed and a broad description of the scope of the interviews:

- *Investors* – Eight individuals from five investors were interviewed to assess whether and how information on ICFR is used in making investment decisions. The interviews focused on the impact of the Section 404 reporting requirements on the decision to add or liquidate securities of the respective companies to/from their investment portfolios. These individuals were primarily employees of institutional investors representing both fixed-income and equity investors and covered a range of strategies, industries, and company sizes (although none invested in non-accelerated filers).
- *Lenders* – Five individuals from two corporate lenders were interviewed to gain insights to assess whether, and how, information on ICFR is used in performing credit analyses and in making lending decisions. These individuals span a wide range of experience, industry focus, and client sizes.
- *Securities Analysts* – Fifteen individuals from six companies providing securities analysis were interviewed in order to assess whether, and how, information on ICFR affects their recommendations. These individuals held a variety of responsibilities, including fixed-income and equity, buy-side and sell-side, domestic and international, and different industries. Although the size of companies covered varied, none covered non-accelerated filers.[81]
- *Credit Rating Agencies* – Two individuals from one credit rating agency were interviewed to assess whether and how information on ICFR is used in their credit rating analyses, including how it impacts rating decisions.

[80] In this section of the report, the expression "external users of financial statements" collectively refers to the groups of investors, lenders, analysts, and credit rating agencies interviewed by the OCA staff.

[81] This is not too surprising, given the analysts' limited coverage of small publicly traded companies.

Finally, OCA staff selected twelve audit firms to interview focusing on the auditors' perspectives concerning the impact of the 2007 reforms on the independent audit of ICFR, as well as the auditors' perceptions about management's assessment of ICFR. The twelve firms selected for interviews included firms of various sizes that provide their services to both accelerated and non-accelerated filers.

It should be noted at the outset that the interviews are not intended to support a statistical analysis and, as such, the interview findings are not statistically comparable with the evidence from the Web survey. Nevertheless, the financial statement end-users' ("users") views on several aspects of Section 404 compliance were fairly homogeneous, suggesting a shared perception of Section 404 implementation. What emerges from the interviews is largely consistent with the survey evidence.

b. Interviews with External Users of Financial Statements

All the interviews with external users of financial statements were structured to cover the following areas and, in all cases, the interviews prompted the users to assess whether the perceived effects of Section 404 compliance depend on the size of the complying company:

- *Use of information provided by internal control disclosures* – This initial portion of each interview was designed to gather information about the user's experience with internal control disclosures required by the Act – specifically, by eliciting a description of the user's use of officer certification and ICFR disclosures required by Sections 302, 404, and 906 of the Sarbanes-Oxley Act.
- *Benefits* – Each interview was designed to gather an assessment of any benefits realized by the user from the company's compliance with the Section 404 requirements. This portion of the interview was structured in two parts:
  - *Questions concerning Management's Assessment – specifically Section 404(a)*: This portion focused on the benefits realized solely from the requirement that management provide an assessment of the effectiveness of ICFR.
  - *Questions concerning the Independent Audit of ICFR – specifically Section 404(b)*: This portion focused on the incremental benefits realized from the requirement for an auditor to express an opinion on the effectiveness of ICFR.

- *Changes since initial Section 404 implementation* – This portion explored the effects of the availability of ICFR disclosures on the users' decision-making processes and whether these have changed since the initial implementation of Section 404.

- *Costs* – Although users generally would not be expected to have direct insight into companies' costs of compliance, they were solicited to provide their perceptions about the costs of complying with Section 404 requirements.[82]

External users of financial statements depend on financial reports that are of high quality and reliable to effectively fulfill their job responsibilities. Although the users' backgrounds vary widely, overall, they expressed a general support for measures that enhance the reliability of financial reporting and, thus, improve capital market conditions, asserting that the requirements of Section 404 are consistent with these objectives.

Before providing a more detailed discussion of the interviews, it is useful to describe the users' typical frame of reference to help interpret their views. First, as part of their daily responsibilities as a group, the users' primary focus seemed to be on larger companies (i.e., large accelerated filers and accelerated filers). Second, given their focus on large companies and because these companies tend to have complied with both Sections 404(a) and 404(b) since the initial implementation of these requirements, the vast majority of users expressed difficulty in separating the impact of Section 404(a) from that of Section 404(b) compliance. Nonetheless, some participants suggested the auditors' attestation to be a crucial part of Section 404 requirements given the auditors' expertise and independence in the evaluation of ICFR. Third, consistent with the declining number of accelerated filers reporting ineffective ICFR since the initial implementation of Section 404, the users typically indicated that they have come to expect all companies they track to have effective ICFR. Given this expectation, as well as the nature of the disclosures when no material weaknesses are disclosed, users generally reported spending minimal time reviewing the disclosures when they reveal companies to have effective ICFR. The majority of users, however, indicated that the requirement to evaluate ICFR has significantly impacted their confidence in companies' financial reports. Fourth, users generally indicated that their use of ICFR disclosures has not changed since the initial implementation of Section 404. That is, although ICFR disclosures were examined more intently during the initial years of Section 404 implementation because of a lack of familiarity with its requirements, the users generally asserted that the impact of the information that these disclosures provide has not

[82] For instance, participants were asked about whether the compliance costs are an appropriate use of resources, and their perceptions of how the costs compare to the realized benefits.

changed, including after the 2007 reforms. Finally, the users generally indicated that they could not provide direct insights into the cost of Section 404 compliance. With these caveats in mind, the remaining portion of this section summarizes and discusses the users' views on the dimensions described earlier.

Many user interviews indicated that the Section 404 compliance produces benefits that are inherently hard to quantify. One of the most commonly cited reasons for this difficulty is that Section 404 implementation is not the only change and improvement to financial reporting in recent years. Most notably, the Act introduced other reforms aimed at improving the quality of financial reports—this includes Section 301 of the Act, which requires audit committee members to be independent. In discussing the benefits recognized by the users, however, four observations tended to be recurrent:

1. Users generally perceive compliance with both Section 404(a) and Section 404(b) to have a positive impact on their confidence in companies' financial reports.
2. Users generally perceive ICFR disclosures, especially those concerning material weaknesses to be beneficial.
3. Users generally do not believe that the benefits of Section 404 compliance vary with the size of the company.
4. Users generally do not believe that the realized benefits of Section 404 have changed since its initial implementation.

1) Confidence in Financial Reports

Most users asserted that the separate annual evaluations of the effectiveness of ICFR by both management and auditors increase their level of confidence in the quality and reliability of companies' financial reports for a number of reasons.[83] The users typically believe that Section 404 compliance causes management to devote more resources to having a disciplined financial reporting process. Specifically, the users generally believe the requirements of Section 404 cause management to: a) better understand financial reporting risks; b) put in place appropriate controls to address financial reporting risks; and c) address internal control deficiencies in a more timely fashion (than might be the case absent the disclosure requirements). While some users believe

[83] The terms "few," "some," "many," or "a majority of/generally/in general" are used throughout to indicate approximately 0-10 percent, 10-30 percent, 30-50 percent, or more than 50 percent, respectively, of participants in the interviews for the specified group.

that Section 404 requirements improve management's ability to identify and address areas that pose risks related to fraud, most participants did not perceive these requirements to have significantly improved the company's ability to prevent or detect fraud.[84]

2) Internal Control Disclosures

The typical view among users is that disclosures of material weaknesses pursuant to Section 404 have an impact on the user's decision-making process. With regard to this aspect, the users generally view Section 404 requirements as being particularly beneficial because, when ICFR is effective, the associated disclosures provide evidence of potential financial reporting problems in a standardized way that is simple to analyze and, when ICFR is ineffective, the associated disclosures allow users easily to identify evidence of potential financial reporting problems. Moreover, some users find disclosures of material weaknesses to be helpful in highlighting areas of potential risk and, when combined with the discussion of planned remediation, to provide a useful perspective on the impact the weaknesses could have on the reliability of a company's financial reporting.

Nonetheless, there appears to be notable heterogeneity in how, and the extent, to which disclosures of material weaknesses affect financial statement users' decision-making processes. Some consider the existence of a material weakness to be a sufficiently serious risk factor to make it a binary (pass/fail) input into the decision-making process.[85] A majority of users interviewed, however, described evaluating material weaknesses based on their severity and find their effect on the decision-making process to depend on those considerations. On the one hand, users in this second group typically perceive material weaknesses that are narrow in scope and related to a single area of financial reporting as less severe, because these weaknesses are anticipated to be corrected within a year. On the other hand, the same users indicated that material weaknesses that are more pervasive, related to a company's key metrics, and/or related to a company's "tone at the top" are generally viewed as more severe. These users stated that the more severe weaknesses are likely to negatively affect their decision-making because they are expected to take multiple years to remediate.

Regardless of how each individual user uses Section 404 disclosures, there is a consensus that material weaknesses represent "red flags" in that management either is not receiving the

[84] In obtaining answers to this question, we did not explore the basis for the interviewees' conclusions relating to fraud detection ability.

[85] For instance, some users in the investor group indicated they might exclude companies with ineffective ICFR from potential investments due to the resulting lack of confidence in those companies' financial reports.

information needed to effectively manage and report on its business or is receiving information that is not sufficiently reliable. Consistent with this observation, users report monitoring subsequent filings for evidence of progress in remedying the previously reported material weakness(es) for companies with ineffective ICFR in which the user has a continued interest. In fact, many users indicated that a company's remediation activity and disclosure is often even more important for their decision-making than the initial disclosure of a material weakness.

A few users expressed a desire for a more detailed disclosure than the current "pass/fail" ICFR model provides, indicating that this would allow external users to better differentiate among companies based on the quality of their controls.[86] Along these lines, some characterized disclosures of material weaknesses as often being too broad, making it difficult to evaluate the nature of the disclosed weaknesses without further discussions with management, which is not always feasible.[87] A majority underscored that Section 404 disclosures often do not occur at an early enough date and that the existence of material weaknesses is already known at the time of the disclosure because companies tend to report them through other communications, such as earnings calls and restatement announcements.

3) Company Size

Many users did not perceive the benefits of Section 404 compliance to vary with the size of the reporting company—which could mean that as external users they find Section 404 reports equally valuable regardless of the size of the company.[88] Rather, many indicated that these benefits depend on a company's complexity and industry affiliation. Those that find a company's complexity to be an important factor highlighted that they perceive the risk of material misstatements to be directly dependent on it, but also that the amount of resources devoted to the financial reporting process by complex companies may be higher, regardless of Section 404 requirements. With respect to a company's industry affiliation, many users view the reporting process of companies that operate in certain industries as inherently more opaque and subject to

[86] However, no specific recommendations were provided on how a practical disclosure system that would accomplish this level of detail could be developed.

[87] Many of the participants indicated that once a material weakness is identified, they rely on their interaction with management to obtain a more complete understanding of the nature of the material weakness and management's planned remediation activities. However, their access to management and further information from management varied.

[88] Some users, however, perceive that their benefit from compliance by smaller companies with Section 404 is insufficient to justify the requirements. Their reasoning was that financial reporting is, typically, less complex for small companies and senior management has intimate familiarity with the company's financial reporting. According to these users, the officer certifications required by Sections 302 and 906 of the Act may provide an appropriate level of comfort to users.

risk of misreporting. Some of these users stated that Section 404 requirements are more important in higher risk and/or less transparent industries. Generally, however, the users agreed that variations in compliance requirements based on complexity and/or industry affiliation would likely be impractical.

4) Changes in Benefits over Time

While most users indicated that the benefits they perceive from Section 404 compliance have generally not changed substantially over time, few expressed the opinion that these benefits have decreased since the initial implementation. Users in this latter group stated that a "fresh look benefit" occurred upon initial implementation of the Act when more attention was placed on controls and ICFR improved. Now, they believe, the "fresh look benefit" only applies to situations such as IPOs and major business combinations that implement the requirements of Section 404 for the first time. Nevertheless, the same users indicated that they believe Section 404 requirements should be retained.

In addition to responding to specific questions about the perceived benefits of Section 404 compliance, users provided their views on a variety of other matters pertaining to internal control requirements. The main topics covered include:

1. Whether the costs resulting from Section 404 compliance are an appropriate use of a company's resources;
2. Whether Section 404 requirements are preventing companies from entering the U.S. capital markets;
3. The role of the independent audit of ICFR.

1) Use of Resources

Notwithstanding their limited direct knowledge about the actual costs of Section 404 compliance, many users perceive these costs to be an appropriate use of a company's resources. The general sentiment among users is that financial statements must be of high quality and in compliance with generally accepted accounting principles and that companies need effective ICFR to ensure this is the case. Furthermore, users typically do not perceive Section 404 compliance costs to be significant when compared to the costs of a financial reporting failure. This general sentiment notwithstanding, some users indicated that the improvements resulting from Section 404 compliance may not justify the associated costs, especially for the smaller companies. These users suggested that Section 404 requirements may impose a disproportionate burden on smaller public companies, as does most financial regulation. They also observed that while having effective ICFR is important, the compliance requirements should not cause management to divert its attention from other important areas of their business. However, these participants did not waver from their belief that strong ICFR is equally important for companies of all sizes.

2) Effect on U.S. Capital Markets

Although not a unanimous sentiment, users generally do not appear to believe that the Section 404 requirements discourage companies from entering the U.S. capital markets. Instead, users in this group highlighted other factors that may be causing this trend, including: the growth of non-U.S. markets, litigation risk, taxes, currency, government incentives, and culture. These users generally believe that the blame on Section 404 requirements is a result of companies' frustrations and are not well founded.

3) Independent Audit of ICFR

Although a few users stated otherwise, the general consensus was that the auditor's report on ICFR required under Section 404(b) provides an incremental benefit beyond the management's report required under Section 404(a). Many perceive the audit requirement to provide necessary discipline to the reporting process. Among these users, some highlighted that auditors' involvement benefits investors and users because auditors provide professional expertise in evaluating internal controls and risk their professional reputations by signing audit opinions, both of which are perceived to positively affect the quality of the auditor's assessment of ICFR compared to that of management.[89] Among the users that did not ascribe incremental benefits to Section 404(b) compliance, the typical view was that the traditional financial statement audit provides them with a greater level of confidence than the auditor's assessment of ICFR.

c. Interviews with Auditors[90]

The interviews with auditors focused on:

- Some aspects of the cost of Section 404 compliance;

[89] These users expressed the view that auditors tend to have a greater breadth of experience in the assessment of internal controls than management because they serve multiple clients.

[90] Throughout this section, the term "auditors" refers to audit engagement partners.

- Changes in the process underlying management's assessment and auditor's attestation of ICFR;
- The impact and usefulness of Management Guidance and AS5 on audits of ICFR.

Most of the interviewed auditors indicated that the process of compliance with Section 404 has become more efficient and less costly since the initial implementation of the requirements in 2004. The primary reasons cited for the improvement included:

- Reduction in the level of effort necessary to satisfy the documentation requirements;
- Improved communications between auditors and management;
- Increased use of professional judgment in scoping and testing;
- More focus on higher risk areas;
- Streamlining of audits subsequent to the first-time effort required by Section 404 compliance.

The most common explanation provided by the auditors relates to a reduction in the level of effort to document the issuer's internal controls. The majority of auditors indicated that the documentation and understanding of ICFR is established during the first year of Section 404 compliance, whereas the process in subsequent years is more streamlined because both management and the auditor can focus on documenting changes relative to the prior year.

Moreover, auditors generally indicated that coordination between management and auditors has improved and that management is more commonly using judgment in completing the assessment required under Section 404(a) to focus on areas of higher risk. In this sense, the perspective provided by auditors during the interviews was generally consistent with the survey evidence presented earlier as well as the intended objective of Management Guidance. Some auditors indicated that they perceive management to have taken greater ownership of the process of Section 404 compliance through less reliance on outside consultants and a better understanding of the objective, enabling greater focus on areas of higher risks. Moreover, some auditors indicated that management's assessment is becoming more integrated with the business and is no longer perceived by management as solely a compliance exercise. Nonetheless, the auditors expressed mixed views regarding their reliance on the work of others. For example, while most reported an increased reliance on management's work over time, some auditors perceive that they cannot rely heavily on management's work because it is not performed by objective personnel.

Focusing on the process of Section 404(b) compliance, auditors generally reported experiencing: a reduction in the number of controls tested; an increased reliance on entity-level controls; and, in certain cases, a reduction in the number of locations and accounts that are tested. There were mixed responses, however, when auditors were asked to indicate the portion of the audit of ICFR that requires the most effort. Some suggested that most time is spent on testing controls, whereas others indicated documentation, including process documentation, or assessing risks requires the most effort. Finally, most auditors indicated that the audit of ICFR has become more efficient because it is now integrated with the traditional audit of financial statements. However, a few disagreed with this view, especially those auditors servicing smaller companies, indicated that such integration is difficult.

The auditors' view about the greater integration of the auditing processes is in some sense in contrast with what the survey evidence suggests with respect to respondent companies' ability to identify the portion of audit fees attributable to Section 404(b) compliance. Indeed, most of the interviewed auditors expressed the view that audit companies do not provide information to companies to distinguish the fees due to the financial statement audit from fees due to the audit of ICFR. In fact, some auditors suggested that they could not estimate the audit fees related solely to the audit of ICFR, given that the latter has been integrated into the financial statement audit. Most of them asserted that they could determine the portion of audit fees related to testing internal controls separately from the portion associated with detailed tests of transactions, but they could not isolate the portion of the fees associated with testing internal controls that is incremental to what would be necessary for a traditional audit of the financial statement.[91]

Finally, the auditors participating in the interviews had an opportunity to express their views on the effects that they perceive the 2007 reforms to have had on the process of Section 404 compliance. Some of them find the 2007 reforms to be helpful, contributing to increased efficiency. However, most auditors had difficulty quantifying the portion of this trend that could be directly ascribed to the 2007 reforms and some suggested that experience with Section 404 compliance is the most significant factor in explaining the increase in efficiency of the evaluations and audits of ICFR. In contrast, some auditors suggested that the 2007 reforms did not have a statistically significant impact, because elements of those reforms had already been incorporated in the ICFR evaluation process before the guidance was issued. Among these, however, some found 2007 reforms to be helpful to the extent that they removed any uncertainty.

[91] When audit engagement partners were asked why they believed companies were comfortable with providing such estimates, some indicated that issuers continue to have a perception of the allocation of the total audit fees based on those that were quoted during the initial implementation of the ICFR audit requirement.

In specific regard to AS5, some auditors stated that the new auditing standard effectively incorporated and/or clarified guidance related to the top-down approach, provided a greater ability to rely on the work of others, and removed certain prescriptive requirements. Furthermore, many auditors indicated that a first-time audit of ICFR under AS5 is notably more efficient than a similar audit under AS2. Several auditors also noted that management incorporates AS5 in conducting the assessment of ICFR required under Section 404(a), so as to maximize the auditor's ability to rely on management's work.

VI. Conclusion

This report presents findings from analysis of new data, obtained through a Web survey and in-depth interviews. To examine whether Section 404 is being implemented in a manner that will be more cost-effective for smaller reporting companies, the economic analysis of the Web survey evidence and the presentation of findings from in-depth interviews considered a range of questions – the magnitude of Section 404 compliance costs, determinants of compliance costs, the change in the cost before versus after the Commission's 2007 reforms, and the extent to which executives in reporting companies recognize benefits from Section 404 compliance.

The analysis of the survey data reveals that compliance costs vary with company size (increasing with size), compliance history (decreasing with increased compliance experience), and compliance regime (lower after the 2007 reforms). Although larger companies incur higher compliance costs, smaller companies incur higher scaled costs (i.e., relative to their assets), on average. This finding is consistent with the idea that annual Section 404 compliance involves a fixed cost that is unrelated to the size of the reporting company (i.e. not scalable). Nevertheless, across all categories, compliance costs tend to decrease steadily after the first-year of compliance—implying that Section 404 compliance entails start-up costs that dissipate over time. In addition, the estimated incremental cost of Section 404(b) compliance is similar to the cost of Section 404(a) compliance. Based on our analysis, the largest cost component of Section 404 compliance is internal labor costs, whether a company complies with Section 404(b) or Section 404(a)-only. Then, for Section 404(b) companies, audit fee is the next largest cost component, followed by outside vendor costs and non-labor costs.

The evidence is consistent with the notion that the Commission's 2007 reforms have had the intended effect of reducing compliance costs. The Web survey results reveal not only a decreasing trend in compliance costs but also changes in the evaluation procedures for ICFR. Comparing the compliance cost reported for the first fiscal year after the reforms with the one reported for the fiscal year prior the reforms reveals that total costs have tended to decline in the relevant subgroups of companies. Although the Commission is primarily interested in the experience of smaller businesses that have yet to comply with Section 404(b), the greatest dollar savings due to the 2007 reforms have come from larger companies that comply with this section of the Act—owing to the fact that their compliance costs were already larger. Among the first-time Section 404(b) compliers in the years around the reform, the total compliance cost has decreased, although not significantly, and the Commission's 2007 reforms appear to have had the largest impact on companies that have at least one year of prior compliance experience. This is consistent with the Commission's objective of reducing *de novo* efforts in identifying risks and attendant controls each year following the first year of compliance. It also appears that the benefits of these reforms may not have fully accrued, as companies expect further decreases in compliance costs in the fiscal year in progress at the time of the survey.

The Web survey also included questions about the benefits of Section 404 compliance. Company insiders were found to recognize benefits of compliance, mainly in the area of the quality of ICFR and the audit committee's confidence in the quality of ICFR. Company insiders were more likely to report *direct* benefits of compliance with Section 404 rules (e.g., better ICFR and or higher quality of financial reporting), rather than *indirect* benefits of compliance (e.g., investor confidence and the ability to raise capital). Larger companies tend to regard Section 404 compliance more favorably than smaller companies in almost every respect, and the answers to questions about Management Guidance and benefits of Section 404 compliance tend to be related to company size. Nevertheless, a majority felt that the costs of compliance outweighed the benefits. This was especially true among smaller companies.

Regarding the evidence on Management Guidance, nearly all respondents who answered questions about this aspect of the 2007 reforms indicated that they made use of the Management Guidance and most said they found it to be useful.

This report also presents the general findings of in-depth phone interviews of external users and auditors of financial statements, conducted by the Office of the Chief Accountant. The results of the interviews were generally consistent with the findings of the Web survey, although these parties were less knowledgeable about the costs of complying with Section 404. External users tended to put a heavy premium on having high quality financial statements that are in compliance with generally accepted accounting principles, and these users felt that companies need effective ICFR to ensure this is the case.

In sum, the evidence from the survey response data shows that the cost of Section 404 compliance decreased following the Commission's reforms introduced in 2007 and is expected to decrease further based on respondents' estimates for the fiscal year in progress at the time of the survey. Moreover, the survey participants perceive the reforms to have been a significant catalyst for these changes. This evidence may prove useful in understanding the effects of the 2007 reforms as well as guiding any subsequent regulatory efforts.

Appendix A. SEC's Regulatory History of Section 404 from 2003 to 2008[92]

SEC Release No.	Date	Action	Title
33-8238	June 5, 2003	Final Rule	Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports
33-8392	Feb. 24, 2004	Final Rule	Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports
33-8545	Mar. 2, 2005	Final Rule	Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers; Extension of compliance dates
33-8618	Sep. 22, 2005	Final Rule	Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Companies that Are Not Accelerated Filers
34-54122	Jul. 11, 2006	Concept Release	Concept Release Concerning Management's Reports on Internal Control over Financial Reporting
33-8730A	Aug. 9, 2006	Final Rule	Internal Control over Financial Reporting in Exchange Act Periodic Reports of Foreign Private Issuers That Are Accelerated Filers
33-8760	Dec. 15, 2006	Final Rule	Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers and Newly Public Companies
33-8809	Jun. 20, 2007	Final Rule	Amendments to Rules Regarding Management's Report on Internal Control over Financial reporting
33-8810	Jun. 20, 2007	Interpretive Release	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
34-56152	Jul. 27, 2007	SEC Order	Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments
33-8934	Jun. 26, 2008	Final Rule	Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers

[92] This table does not include any proposing releases.

Appendix B. Section 404 Web Survey Questionnaire

SECTION A: Screening Questions– (Programmer – DO NOT SHOW)

Background Information
In order to solicit feedback that is most relevant to your experiences with Section 404 of the Sarbanes-Oxley Act, the next series of questions will ask for general background information about your company, such as its filing status and fiscal year.

A-1 What is your current title? *Please select all that apply.*

1	Chief Executive Officer
2	Chief Financial Officer
3	Chief Accounting Officer
4	Chief Operating Officer
5	Chief Compliance Officer
6	Chief Risk Officer
7	Controller
8	Vice President Finance
9	General Counsel
10	Audit Committee Member
11	Other: please specify

A-2 Including your current position and all previous positions, for approximately how many years have you been employed with this company?

1	One year or less	CONTINUE TO NEXT
2	Two years	CONTINUE TO NEXT
3	Three or four years	CONTINUE TO NEXT
4	Five or more years	CONTINUE TO NEXT
5	Not Sure	CONTINUE TO NEXT

A-3 What is the ticker symbol for your company's common stock?

1	Ticker Symbol: ________	CONTINUE TO NEXT
2	Not available or unsure	CONTINUE TO NEXT
3	I prefer not to provide this information	CONTINUE TO NEXT

A-4 In what year did your company *first* file an annual report, such as a 10-K or 20-F, with the SEC?

1	Before Calendar Year 2007	CONTINUE TO A-5
2	During Calendar Year 2007	GO TO FINISH FOR NEWLY-PUBLIC COMPANIES BELOW
3	During Calendar Year 2008	GO TO FINISH FOR NEWLY-PUBLIC COMPANIES BELOW

FINISH FOR NEW PUBLIC COMPANIES

Thank you very much for agreeing to participate in this important survey. However, the questions asked will be relevant only for companies that have completed an assessment of the effectiveness of internal control over financial reporting and included that assessment in an annual report filed with the SEC. We hope that you will participate in future surveys.

ASK ALL

Throughout this survey, ICFR will refer to "internal control over financial reporting."

A-5 Are you one of the persons in your company who is knowledgeable about any of the following:

- Your company's evaluation of ICFR (internal control over financial reporting), including the manner in which your company designed its evaluation process,

- The independent audit of your company's ICFR and the manner in which your independent auditor conducted its audit, or

- Your company's experience in complying with Section 404 of the Sarbanes-Oxley Act, including costs and benefits of compliance?

1	Yes	SKIP TO SECTION B
2	No	ASK A-6 AND FINISH

ASK ONLY IF No (Code 2) in A-5

A-6 If you would be comfortable doing so, we would appreciate it very much if you would assist us in extending an invitation to participate in this survey to the person (or persons) in your company who is (or are) most knowledgeable about your company's experience in complying with Section 404 of the Sarbanes-Oxley Act by providing the following information:

Person	Name	Email	Telephone
#1			
#2			
#3			

O Cannot give name (ASK QUESTION BELOW)

FINISH

(IF NAME GIVEN): Thank you very much for providing us with the names of additional persons within your company who we can contact. We will be contacting them shortly to invite them to participate in this survey.

(IF NAME NOT GIVEN): Thank you very much for your time. We appreciate your help.

SECTION B: FISCAL YEAR AND FILING STATUS -- (Programmer – DO NOT SHOW)

ASK ALL FILERS

B-1 What is the end date for the fiscal year in which you last filed a Form 10-K or 20-F? Please indicate Month, Day, and Year. (For example, if your company's fiscal year ends on December 31, 2007, and it filed its form 10-K in February 2008, you would choose December 31, 2007).

January	1	2007	*Programming Instruction: Use the answer to this question to establish the most recent fiscal year. The prior year is the year before the most recent fiscal year.*
February	2	2008	
March	3		
April	4		
May	5		
June	6		
July	7		
August	8		
September	9		
October	10		
November	11		
December	12		
	13		
	14		
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	22		
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	24		
	25		
	26		
	27		
	28		
	29		
	30		
	31		
Not Sure	Not Sure	Not Sure	

ASK ALL FILERS

B-2 Please indicate the fiscal years for which your company had an independent audit of the effectiveness of its ICFR (internal control over financial reporting)? (For example, some companies have been required to have an independent audit of ICFR since fiscal year ending in 2004). (Please check Fiscal Year ending in [INSERT FY AFTER MOST RECENT FY] even if you haven't yet filed a financial statement for that year, but will be *required* to include an independent audit of ICFR). *Please select all that apply.*

	Fiscal Year ending in 2004	Fiscal Year ending in 2005	Fiscal Year ending in 2006	Fiscal Year ending in 2007	Fiscal Year ending in 2008
Yes	1	1	1	1	1
No	2	2	2	2	2
Not Sure	3	3	3	3	3

Programming Logic: For B-2 please ask until Fiscal Year ending in (N+1) where N is the year chosen in B-1. Those who responded as 2007 should only be asked until 2008; those who responded as 2008 should be asked until 2009.

ASK THOSE WHO DID NOT FILE IN FY 2004 – 2008. SHOW ONLY YEARS NOT CHOSEN IN B-2

B-3 Did you voluntarily have an independent audit of your company's ICFR in any of the following years? *Please select all that apply.*

	Fiscal Year ending in 2004	Fiscal Year ending in 2005	Fiscal Year ending in 2006	Fiscal Year ending in 2007	Fiscal Year ending in 2008
Yes	1	1	1	1	1
No	2	2	2	2	2
Not Sure	3	3	3	3	3

Programming Logic: Let N be the year selected from B-1. If Fiscal Year ending in Year N-1 is checked Yes (1) in B-2, then "Tenured Accelerated Filers"; else if Fiscal Year ending in Year N is checked Yes, then "New Accelerated Filers"; else "Non-Accelerated Filers."

ASK ALL FILERS

B-4 Is your company a foreign private issuer? (Generally, a company that is organized under the laws of any foreign country and that has more than 50% of its voting securities directly or indirectly held by residents outside the United States is a foreign private issuer).

1	Yes	CLASSIFY AS FOREIGN
2	No	
3	Not Sure	

SECTION C: QUESTIONS FOR FOREIGN FILERS -- (Programmer – DO NOT SHOW)

ASK ONLY FOREIGN FILERS (CODE 1 IN B-4)

C-1 Do your home country's rules and/or regulations require your company to report on its ICFR?

1	Yes
2	No
3	Not Sure

ASK ONLY FOREIGN FILERS (CODE 1 IN B-4)

C-2 How much overlap is there related to reporting on the effectiveness of ICFR between the requirements of your home country and those of the United States?

1	Requirements are about the same
2	Great deal of overlap
3	Moderate amount of overlap
4	Small amount of overlap
5	No overlap or almost no overlap
9	Not sure

SECTION D: AUDIT FEES -- (Programmer – DO NOT SHOW)

Total Audit Fees

This next section of the survey is about the *total* fees your company paid its independent auditor for *both* the audit of the financial statements and the audit of ICFR (if applicable), as well as factors that may have caused those fees to change from year to year. You should *exclude* from your total audit fees any fees paid for *non-audit services* (such as tax compliance services or audit services that are not related to filings of your company's financial statements with the SEC, such as fees to audit an employee benefit plan).We would like you to think about the approximate total audit fees your company paid in fiscal year ending in (INSERT PRIOR FY) and in fiscal year ending in (INSERT MOST RECENT FY), and the approximate total audit fees you EXPECT to pay in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR).

D-1 What is the approximate total amount of fees paid to your independent auditor for the audit of the financial statements and the audit of ICFR in fiscal year ending in (INSERT PRIOR FISCAL YEAR) and in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)? What do you EXPECT to be charged in fiscal year ending in (INSERT FY AFTER MOST RECENT FY) for the audit of the financial statements and the audit of ICFR (if applicable)?

(PLEASE USE -1 FOR CANNOT ESTIMATE).

Approximate Fees Paid in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	*Approximate Fees Paid in Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)*	*Approximate Fees EXPECTED to be Paid in Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR)*
$ __________________	$ __________________	$ __________________
O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)

IF RESPONDENT CANNOT GIVE A NUMBER UNAIDED, ASK FOR EACH RELEVANT YEAR:

D-2 Please use the following list to let us know approximately the total amount of fees paid to your independent auditor related to the audit of the financial statements and the audit of ICFR in (INSERT PRIOR FISCAL YEAR)?

Approximate Fees Paid in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)		
1	Less than $25,000	Continue with Next Question
2	$25,000 to $49,999	Continue with Next Question
3	$50,000 to $99,999	Continue with Next Question
4	$100,000 to $249,999	Continue with Next Question
5	$250,000 to $499,999	Continue with Next Question
6	$500,000 to $999,999	Continue with Next Question
7	$1,000,000 to $1,999,999	Continue with Next Question
8	$2,000,000 to $3,999,999	Continue with Next Question
9	$4,000,000 to $4,999,999	Continue with Next Question
10	$5,000,000 to $7,499,999	Continue with Next Question
11	$7,500,000 to $9,999,999	Continue with Next Question
12	$10,000,000 and more	Continue with Next Question
13	Cannot estimate	SKIP TO D-7
14	Not Applicable	SKIP TO D-7

D-3 Compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR), did the total amount of fees paid to your independent auditor increase or decrease in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), or did it remain the same?

1	Increased	CONTINUE WITH NEXT QUESTION
2	Decreased	CONTINUE WITH NEXT QUESTION
3	Remained the Same	SKIP TO D-5
4	Not Sure	SKIP TO D-5
5	Not Applicable	SKIP TO D-5

D-4 What was the approximate percent (INSERT “increase” or “decrease”) in the total amount of fees paid to your independent auditor in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR)?

Approximate Percent (INSERT “Increase” OR “Decrease”) in Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)
$ ________________
O Cannot estimate

D-5 Compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), do you EXPECT the total amount of fees paid to your independent auditor to increase or decrease in fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), or will it remain the same?

1	Expect to Increase	CONTINUE WITH NEXT QUESTION
2	Expect to Decrease	CONTINUE WITH NEXT QUESTION
3	Expect to Remain the Same	SKIP TO D-7
4	Not Sure	SKIP TO D-7
5	Not Applicable	SKIP TO D-7

D-6 What is the EXPECTED percent (INSERT "increase" or "decrease") in the total amount of fees paid to your independent auditor in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)?

Approximate Percent (INSERT "Increase" OR "Decrease") in Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)
$ ___________________
O Cannot estimate

D-7 In the last question, you told us what your total fees were in the past few years. Now we would like to know if any of the following had an impact on your total fees in fiscal year ending in (INSERT PRIOR FISCAL YEAR). Please indicate whether any of the following events or factors occurred in fiscal year ending in (INSERT PRIOR FISCAL YEAR) and if so, how they affected the total audit fees (relative to what the total audit fees would have been without such events or factors).

	DO NOT ROTATE	Not Applicable	Caused HIGHER Fees	LITTLE OR NO IMPACT	Caused LOWER fees	Not Sure
	In Fiscal Year ending in (INSERT CURRENT FISCAL YEAR)					
A	Material Acquisition or Divestiture	O	O	O	O	O
B	Restatement of the company's prior financial statements	O	O	O	O	O
C	Change in reliance by your independent auditor on the work of others (e.g., management, internal audit).	O	O	O	O	O
D	Adoption of new accounting and auditing pronouncements (separate from Auditing Standard No. 5)	O	O	O	O	O
E	Change of auditor	O	O	O	O	O
F	Change in the number of hours the auditor needed to conduct the audit	O	O	O	O	O
G	Change in auditor bill rates	O	O	O	O	O
H	Other material events: Please specify	O	O	O	O	O

D-8 Now we would like to know if any of the following had an impact on your total fees in fiscal year ending in (INSERT CURRENT FISCAL YEAR). Please indicate whether any of the following events or factors occurred in fiscal year ending in (INSERT PRIOR FISCAL YEAR) and if so, how they affected the total audit fees (relative to what the total audit fees would have been without such events or factors).

	DO NOT ROTATE	Not Applicable	Caused HIGHER Fees	LITTLE OR NO IMPACT	Caused LOWER fees	Not Sure
	In Fiscal Year ending in (INSERT CURRENT FISCAL YEAR)					
A	Material Acquisition or Divestiture	O	O	O	O	O
B	Restatement of the company's prior financial statements	O	O	O	O	O
C	Change in reliance by your independent auditor on the work of others (e.g. management, internal audit).	O	O	O	O	O
D	Adoption of new accounting and auditing pronouncements (separate from Auditing Standard No. 5)	O	O	O	O	O
E	Change of auditor	O	O	O	O	O
F	Change in the number of hours the auditor needed to conduct the audit	O	O	O	O	O
G	Change in auditor bill rates	O	O	O	O	O
H	Other material events: Please specify	O	O	O	O	O

D-9 Now we would like to know if you EXPECT any of the following to have an impact on your total fees in fiscal year ending in (INSERT FISCAL YEAR AFTER CURRENT FISCAL YEAR). Please indicate whether the following events or factors are expected to occur in fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR) and if so, how they are expected to affect the total audit fees (relative to what the total audit fees would be without such events or factors).

	DO NOT ROTATE	Not Applicable	Caused HIGHER Fees	LITTLE OR NO IMPACT	Caused LOWER fees	Not Sure
	In Fiscal Year ending in (INSERT CURRENT FISCAL YEAR)					
A	Material Acquisition or Divestiture	O	O	O	O	O
B	Restatement of the company's prior financial statements	O	O	O	O	O
C	Change in reliance by your independent auditor on the work of others (e.g. management, internal audit).	O	O	O	O	O
D	Adoption of new accounting and auditing pronouncements (separate from Auditing Standard No. 5)	O	O	O	O	O
E	Change of auditor	O	O	O	O	O
F	Change in the number of hours the auditor needed to conduct the audit	O	O	O	O	O
G	Change in auditor bill rates	O	O	O	O	O
H	Other material events: Please specify	O	O	O	O	O

Section E: ICFR Audit Fee Intro -- (Programmer – DO NOT SHOW)

Fees for Independent Audit of ICFR
In this next section, we will ask questions about the costs of compliance that are associated with the *independent audit of ICFR*, which can be measured as dollar fees or time spent. In answering these questions, you should exclude from consideration the costs of the traditional financial statement audit. Again, we would like you to think about the approximate amount of fees your company paid in fiscal year ending in (INSERT PRIOR FY) and in fiscal year ending in (INSERT MOST RECENT FY), and the approximate amount you EXPECT to pay in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR).

E-1 Thinking about what you paid in fiscal year ending in (INSERT PRIOR FISCAL YEAR), in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), and what you EXPECT to pay in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR), what approximate percent of the total amount you paid to your independent auditor was or will be spent on the *independent audit of ICFR*? Please indicate if you are not able to estimate.
(PLEASE USE -1 FOR CANNOT ESTIMATE; USE -2 FOR NOT APPLICABLE).

	Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)	Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR
Insert Percent	____%	______%	______%
Cannot Estimate	O	O	O
Not Applicable	O	O	O

SECTION F: Audit background and perception -- (Programmer – DO NOT SHOW)

ASK ONLY OF TENURED ACCELERATED FILERS

F-1 How much of an impact did the following factors have on the amount of *time spent by your independent auditor* for the independent audit of the company's ICFR in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) as compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR)?

	ROTATE SERIES	Not Applicable	Caused a DECREASE in Time Spent	LITTLE OR NO IMPACT	Caused an INCREASE in Time Spent	Not Sure
	Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR) compared to Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)					
A	Change in the number of accounts and processes selected for audit	O	O	O	O	O
B	Change in the number of areas for which the independent auditor conducted walk-throughs	O	O	O	O	O
C	Change in the number of controls selected and/or the nature, timing, and extent of control testing by the auditor	O	O	O	O	O
D	Change in the number of company locations selected for audit	O	O	O	O	O
E	Change in the degree of the auditor's reliance on the work of others (e.g. management, internal audit,)	O	O	O	O	O
F	Other: please specify	O	O	O	O	O

ASK ONLY OF TENURED ACCELERATED FILERS AND NEW ACCELERATED FILERS

F-3 Now we would like to know if you EXPECT any of the following to have an impact in fiscal year ending in (INSERT FISCAL YEAR AFTER CURRENT FISCAL YEAR). How much of an impact do you EXPECT the following factors to have on the amount of *time spent by your independent auditor* for the independent audit of the company's ICFR in fiscal year ending in (INSERT FISCAL YEAR AFTER CURRENT FISCAL YEAR) as compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)?

	ROTATE SERIES	Not Applicabl e	EXPECT a DECREASE in Time Spent	LITTLE OR NO IMPACT	EXPECT an INCREASE in Time Spent	Not Sure
	Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR) compared to Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)					
A	Change in the number of accounts and processes selected for audit	O	O	O	O	O
B	Change in the number of areas for which the independent auditor conducted walk-throughs	O	O	O	O	O
C	Change in the number of controls selected and/or the nature, timing, and extent of control testing by the auditor	O	O	O	O	O
D	Change in the number of company locations selected for audit	O	O	O	O	O
E	Change in the degree of the auditor's reliance on the work of others (e.g., management, internal audit, others)	O	O	O	O	O
F	Other: please specify	O	O	O	O	O

ASK ALL TENURED AND NEW ACCELERATED FILERS

F-4 What is your perception about the impact that Auditing Standard No. 5 has had on the amount of time it takes to complete the independent audit of ICFR in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)?

Decrease in Time			NO IMPACT on Time Spent	Increase in Time			Not Sure	Not Applicable
Large	Moderate	Small		Small	Moderate	Large		
O	O	O	O	O	O	O	O	O

F-5 What impact do you EXPECT Auditing Standard No. 5 to have on the amount of time it takes to complete the independent audit of ICFR in fiscal year ending in (INSERT FISCAL YEAR AFTER THE MOST RECENT FISCAL YEAR)?

Decrease in Time			No Impact on Time Spent	Increase in Time			Not Sure	Not Applicable
Large	Moderate	Small		Small	Moderate	Large		
O	O	O	O	O	O	O	O	O

SECTION G: NON-LABOR COSTS -- (Programmer – DO NOT SHOW)

Non-Labor Costs

The next set of questions pertains to any software, hardware, travel, or any other NON-LABOR expenditures you have had to make so that your company can be in compliance with Section 404.

Again, we would like you to think about the approximate amount your company paid in **fiscal year ending in** (INSERT PRIOR FISCAL YEAR) and in **fiscal year ending in** (INSERT MOST RECENT FISCAL YEAR), and the approximate amount you EXPECT to pay in **fiscal year ending in** (INSERT YEAR AFTER MOST RECENT FISCAL YEAR).

G-1 Approximately how much money did you spend on software, hardware, travel, or any other NON-LABOR expenditures to help you comply with Section 404 in fiscal year ending in (INSERT PRIOR FY) and in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) that you would not have spent in the absence of Section 404 requirements? What do you EXPECT to pay in fiscal year ending in (INSERT FY AFTER MOST RECENT FY)?

(PLEASE USE -1 FOR CANNOT ESTIMATE; USE -2 FOR NOT APPLICABLE).

Approximate Dollars Spent in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	*Approximate Dollars Spent in Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)*	*Approximate Dollars EXPECTED to Spend in Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR)*
$ __________________	$ __________________	$ __________________
O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)
O Not applicable	O Not applicable	O Not applicable

IF RESPONDENT CANNOT GIVE A NUMBER UNAIDED, ASK FOR EACH RELEVANT YEAR:

G-2 Please use the following list to tell us approximately how much money you spent on software, hardware, travel, or any other NON-LABOR expenditures to help you comply with Section 404 in fiscal year ending in (INSERT PRIOR FY)?

Approximate Dollars Spent in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)		
1	Less than $25,000	Continue with Next Question
2	$25,000 to $49,999	Continue with Next Question
3	$50,000 to $99,999	Continue with Next Question
4	$100,000 to $249,999	Continue with Next Question
5	$250,000 to $499,999	Continue with Next Question
6	$500,000 to $999,999	Continue with Next Question
7	$1,000,000 to $1,999,999	Continue with Next Question
8	$2,000,000 to $3,999,999	Continue with Next Question
9	$4,000,000 to $4,999,999	Continue with Next Question
10	$5,000,000 to $7,499,999	Continue with Next Question
11	$7,500,000 to $9,999,999	Continue with Next Question
12	$10,000,000 and more	Continue with Next Question
13	Cannot estimate	SKIP TO SECTION H
14	Not Applicable	SKIP TO SECTION H

G-3 Compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR), did the money you spent on software, hardware, travel, or any other NON-LABOR expenditures increase or decrease in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), or did it remain the same?

1	Increased	CONTINUE WITH NEXT QUESTION
2	Decreased	CONTINUE WITH NEXT QUESTION
3	Remained the Same	SKIP TO G-5
4	Not Sure	SKIP TO G-5
5	Not Applicable	SKIP TO G-5

G-4 What was the approximate percent (INSERT “increase” or “decrease”) in money you spent on software, hardware, travel, or any other NON-LABOR expenditures in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR)?

Approximate Percent (INSERT Increase” OR “Decrease”) in Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)
% _________________
O Cannot estimate

G-5 Compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), do you EXPECT the money you will spend on software, hardware, travel, or any other NON-LABOR expenditures to increase or decrease in fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), or do you expect it to remain the same?

1	Expect to Increase	CONTINUE WITH NEXT QUESTION
2	Expect to Decrease	CONTINUE WITH NEXT QUESTION
3	Expect to Remain the Same	SKIP TO Section H
4	Not Sure	SKIP TO Section H
5	Not Applicable	SKIP TO Section H

G-6 What is the EXPECTED percent (INSERT “increase” or “decrease”) in the money you EXPECT to spend on software, hardware, travel, or any other NON-LABOR expenditures in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT MOST RECEDNT FISCAL YEAR)?

Approximate Percent (INSERT “Increase” OR “Decrease”) in Fiscal Year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR)
% _________________
O Cannot estimate

SECTION H: CONSULTANT COSTS -- (Programmer – DO NOT SHOW)

ASK ALL

Outside Vendor Costs
Many companies hire outside vendors to assist management in its evaluation of ICFR. These may include SOX 404 consultants or IT consultants or any other providers of goods and services that were obtained *specifically* to support the company's 404 compliance. In this survey, "outside vendors" do not include your company's independent auditor. The next series of questions seeks information about your company's use of such resources. Again, we would like you to think about the approximate amount your company paid in **fiscal year ending in** (INSERT PRIOR FISCAL YEAR), and in **fiscal year ending in** (INSERT MOST RECENT FISCAL YEAR), and the approximate amount you EXPECT to pay in **fiscal year ending in** (INSERT YEAR AFTER MOST RECENT FISCAL YEAR).

H-1 Approximately what were the fees your company paid to consultants and vendors specifically to help you comply with Section 404 in fiscal year ending in (INSERT PRIOR FY) and in fiscal year ending in (INSERT MOST RECENT FY)? (DO NOT INCLUDE ANY FEES PAID ASSOCIATED WITH THE INDEPENDENT AUDITOR). What are the fees you EXPECT to pay in fiscal year ending in (INSERT FY AFTER MOST RECENT FY)?

(DO NOT INCLUDE ANY FEES CHARGED BY THE INDEPENDENT AUDITOR).
(PLEASE USE -1 FOR CANNOT ESTIMATE; USE -2 FOR DID NOT USE A CONSULTANT OR VENDOR).

Approximate Fees Paid in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	*Approximate Fees Paid in Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)*	*Approximate Fees EXPECTED to be Paid in Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR)*
$ _________________	$ _________________	$ _________________
O Did not Use a Consultant or Vendor in this Year	O Did not Use a Consultant or Vendor in this Year	O Did not Use a Consultant or Vendor in this Year
O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)

Programming Logic: For each "cannot estimate", ask the range question (H-2) with each relevant year. If all three years are (point estimates or Did not use a Consultant), then skip H-3 to H-6; else if MOST RECENT FISCAL YEAR is "Did not use", then skip H-3 to H-6; else if MOST RECENT FISCAL YEAR is a point estimate and PRIOR YEAR is (either point estimate or Did not use), then skip H-3 and H-4; else if FY AFTER MOST RECENT FY is (either point estimate or Did not use) and MOST RECENT FY is (either point estimate or Did not use), then skip H-5 and H-6.
IF DID NOT USE IN ANY YEAR, SKIP TO SECTION J

IF RESPONDENT CANNOT GIVE A NUMBER UNAIDED, ASK:

H-2 Please use the following list to let us know the approximate fees paid to consultants and vendors specifically to help your company comply with Section 404 in fiscal year ending in (INSERT PRIOR FISCAL YEAR)?

Approximate Dollars Spent in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)		
1	Less than $25,000	Continue with Next Question
2	$25,000 to $49,999	Continue with Next Question
3	$50,000 to $99,999	Continue with Next Question
4	$100,000 to $249,999	Continue with Next Question
5	$250,000 to $499,999	Continue with Next Question
6	$500,000 to $999,999	Continue with Next Question
7	$1,000,000 to $1,999,999	Continue with Next Question
8	$2,000,000 to $3,999,999	Continue with Next Question
9	$4,000,000 to $4,999,999	Continue with Next Question
10	$5,000,000 to $7,499,999	Continue with Next Question
11	$7,500,000 to $9,999,999	Continue with Next Question
12	$10,000,000 and more	Continue with Next Question
13	Cannot estimate	SKIP TO H-7
14	Not Applicable	SKIP TO H-7

H-3 Compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR), did the fees paid to consultants and vendors increase or decrease in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), or did it remain the same?

1	Increased	CONTINUE WITH NEXT QUESTION
2	Decreased	CONTINUE WITH NEXT QUESTION
3	Remained the Same	SKIP TO H-5
4	Not Sure	SKIP TO H-5
5	Not Applicable	SKIP TO H-5

H-4 What was the approximate percent (INSERT "increase" or "decrease") in the total dollar amount of fees paid to consultants and vendors in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR)?

Approximate Percent (INSERT "Increase" OR "Decrease") in (INSERT MOST RECENT FISCAL YEAR)
$ __________________
O Cannot estimate

H-5 Compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), do you EXPECT the total dollar amount of fees paid to consultants and vendors to increase or decrease in fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), or will it remain the same?

1	Expect to Increase	CONTINUE WITH NEXT QUESTION
2	Expect to Decrease	CONTINUE WITH NEXT QUESTION
3	Expect to Remain the Same	SKIP TO H-7
4	Not Sure	SKIP TO H-7
5	Not Applicable	SKIP TO H-7

H-6 What is the EXPECTED percent (INSERT “increase” or “decrease”) in the total dollar amount of fees paid to consultants and vendors in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)?

Approximate Percent (INSERT “Increase” OR “Decrease”) in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR)
$ _________________
O Cannot estimate

H-7 Now thinking of those same fees paid to consultants and vendors, please indicate approximately what PERCENT of these fees were spent complying with Section 404a (management’s assessment), and approximately what percent of these fees were spent complying with Section 404b (independent audit of ICFR) in fiscal year ending in (INSERT PRIOR FISCAL YEAR) and in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)? How much do you EXPECT to spend in fiscal year ending in (FY AFTER THE MOST RECENT FISCAL YEAR)?

	Fees Paid		Fees EXPECTED to be Paid
	Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)	Fiscal Year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR)
Insert Percent Spent on Management Assessment of ICFR (404a)	____%	______%	______%
Insert Percent Spent on Independent Audit of ICFR (404b)	____%	______%	______%
TOTAL (SHOULD ADD TO 100%			
Cannot Estimate			

SECTION I: CONSULTANT ACTIVITIES AND PERCEPTION -- (Programmer – DO NOT SHOW) ASK ALL FILERS THAT USED A CONSULTANT IN H-1

ASK ONLY THOSE YEARS FOR WHICH THEY INDICATED USAGE OF A CONSULTANT IN H-1.

I-1 For each of the activities below, we would like to know the contribution of consultants and vendors to your effort in preparing for the management assessment of ICFR. During fiscal year ending in (INSERT PRIOR FISCAL YEAR), to what degree did your company rely on the services of consultants or vendors in each of the following activities relating to 404 compliance and the management assessment of ICFR?

	ROTATE SERIES	Did NOT Rely on Consultants/ Vendors	Relied on Consultants/ Vendors MODERATELY	Relied on Consultants/ Vendors A GREATLY	Not Sure
	In Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)				
A	Identifying risks to your company's financial reporting	O	O	O	O
B	Identifying controls that address identified risks	O	O	O	O
C	Documenting controls identified to address risks	O	O	O	O
D	Gathering evidence related to (i.e. testing) the operational effectiveness of controls	O	O	O	O
E	Evaluating the effectiveness of controls	O	O	O	O
F	Evaluating deficiencies identified to determine if they were significant deficiencies or material weaknesses	O	O	O	O
G	Developing disclosures on SEC filings related to management's assessment	O	O	O	O
H	Helping you prepare for an independent audit of ICFR	O	O	O	O
I	Any other tasks: please specify	O	O	O	O

I-2 During fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), to what degree did your company rely on the services of consultants or vendors in each of the following activities relating to 404 compliance and the management assessment of ICFR?

	ROTATE SERIES	Did NOT Rely On Consultants/ Vendors	Relied on Consultants/ Vendors Moderately	Relied on Consultants/ Vendors a Great Deal	Not Sure
	In Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)				
A	Identifying risks to your company's financial reporting	O	O	O	O
B	Identifying controls that address identified risks	O	O	O	O
C	Documenting controls identified to address risks	O	O	O	O
D	Gathering evidence related to (i.e. testing) the operational effectiveness of controls	O	O	O	O
E	Evaluating the effectiveness of controls	O	O	O	O
F	Evaluating deficiencies identified to determine if they were significant deficiencies or material weaknesses	O	O	O	O
G	Developing disclosures on SEC filings related to management's assessment	O	O	O	O
H	Helping you prepare for an independent audit of ICFR	O	O	O	O
I	Any other tasks: please specify	O	O	O	O

I-3 During fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), to what degree do you EXPECT your company will rely on the services of consultants or vendors in each of the following activities relating to 404 compliance and the management assessment of ICFR?

	ROTATE SERIES	Did NOT Rely on Consultants/ Vendors	Relied on Consultants/ Vendors MODERATELY	Relied on Consultants/ Vendors A GREAT DEAL	Not Sure
	In Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR)				
A	Identifying risks to your company's financial reporting	O	O	O	O
B	Identifying controls that address identified risks	O	O	O	O
C	Documenting controls identified to address risks	O	O	O	O
D	Gathering evidence related to (i.e. testing) the operational effectiveness of controls	O	O	O	O
E	Evaluating the effectiveness of controls	O	O	O	O
F	Evaluating deficiencies identified to determine if they were significant deficiencies or material weaknesses	O	O	O	O
G	Developing disclosures on SEC filings related to management's assessment	O	O	O	O
H	Helping you prepare for an independent audit of ICFR	O	O	O	O
I	Any other tasks: please specify	O	O	O	O

SECTION J: INTERNAL LABOR COSTS -- (Programmer – DO NOT SHOW)

Internal Staff Hours

The next series of questions will focus on your company's internal employee effort required to comply with Section 404. This includes only the effort that is required specifically to support your company's 404 compliance. Again, we would like you to think about the approximate amount of effort your company expended in **fiscal year ending in** (INSERT PRIOR FY) and in **fiscal year ending in** (INSERT MOST RECENT FY), and the approximate amount effort you EXPECT to incur in **fiscal year ending in** (INSERT YEAR AFTER MOST RECENT FISCAL YEAR).

J-1 What was the approximate number of total internal staff hours you spent on 404 compliance in fiscal year ending in (INSERT PRIOR FISCAL YEAR) and in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)? This should include any hours spent on activities specifically required to prepare for the management assessment or independent audit of ICFR that would not have occurred without the 404 requirements. How many total internal staff hours do you EXPECT to spend in fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FY).

(PLEASE USE -1 FOR CANNOT ESTIMATE; USE -2 FOR DID NOT USE ANY INTERNAL STAFF HOURS).

Approximate Internal Staff Hours Spent in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	*Approximate Internal Staff Hours Spent in Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)*	*Approximate Internal Staff Hours EXPECTED to Spend in Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR)*
_________________	_________________	_________________
O Did not Use any Internal Staff Hours this Year	O Did not Use any Internal Staff Hours this Year	O Did not Use any Internal Staff Hours this Year
O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)	O Cannot estimate (ASK QUESTION BELOW)

Programming Logic: If all three years are (either point estimates or "Did not use", then skip J-3 to J-6; else if MOST RECENT FY is "Did not use", then skip J-3 to J-6; else if MOST RECENT FY is a point estimate and PRIOR YEAR is (either point estimate or "Did not use"), then Skip J-3 and J-4; else if FY AFTER MOST RECENT FY is (either point estimate or "Did not use") and MOST RECENT FY is (either point estimate or "Did not use"), then skip J-5 and J-6. If did not use in any year, skip to Section K.

IF RESPONDENT CANNOT GIVE A NUMBER UNAIDED, ASK FOR EACH RELEVANT YEAR:

J-2 Please use the following list to let us know approximately how many internal staff hours you spent on 404 compliance in fiscal year ending in (INSERT PRIOR FISCAL YEAR). This should include any hours spent on activities specifically required to prepare for the management assessment or independent audit of ICFR, which would not have occurred without the 404 requirements. (To help you estimate, a full-time employee would be approximately 2000 hours)

Approximate Internal Staff Hours Spent in Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	
1	Less than 100
2	100 to 499
3	500 to 999
4	1,000 to 1,999
5	2,000 to 4,999
6	5,000 to 9,999
7	10,000 to 24,999
8	25,000 to 49,999
9	50,000 to 74,999
10	75,000 to 99,999
11	100,000 to 149,999
12	150,000 to 199,999
13	200,000 or more
14	Cannot estimate

J-3 Compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR), did the number of internal staff hours you spent on 404 compliance increase or decrease in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), or did they remain the same? Again, this should include hours spent on activities specifically required to prepare for the management assessment or independent audit of ICFR, which would not have occurred without the 404 requirements.

1	Increased	CONTINUE WITH NEXT QUESTION
2	Decreased	CONTINUE WITH NEXT QUESTION
3	Remained the Same	SKIP TO J-7
4	Not Sure	SKIP TO J-7
5	Not Applicable	SKIP TO J-7

J-4 What was the approximate percent (INSERT “increase” or “decrease”) in the internal staff hours you spent on 404 compliance in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT PRIOR FISCAL YEAR)?

Approximate Percent (INSERT “Increase” OR “Decrease”) in (INSERT MOST RECENT FISCAL YEAR)
$ ________________
O Cannot estimate

J-5 Compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), do you EXPECT the internal staff hours you will spend on 404 compliance in fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR) to (INSERT “increase” or “decrease”), or will they remain the same?

1	Expect to Increase	CONTINUE WITH NEXT QUESTION
2	Expect to Decrease	CONTINUE WITH NEXT QUESTION
3	Expect to Remain the Same	SKIP TO J-7
4	Not Sure	SKIP TO J-7
5	Not Applicable	SKIP TO J-7

J-6 What is the EXPECTED percent (INSERT “increase” or “decrease”) in the internal staff hours you will spend on 404 compliance in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR) compared to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR)?

Approximate Percent (INSERT “Increase” OR “Decrease”) in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR)
$ __________________
O Cannot estimate

J-7 Now thinking of those same hours, please indicate approximately what PERCENT of these hours were spent complying with Section 404a (management’s assessment), and approximately what percent of these hours were spent complying with Section 404b (independent audit of ICFR) in fiscal year ending in (PRIOR FISCAL YEAR) and in fiscal year ending in (MOST RECENT FISCAL YEAR). What PERCENT of these hours do you EXPECT to spend on each section in fiscal year ending in (FY AFTER MOST RECENT FY)? If you cannot provide an approximate estimate, please indicate “cannot estimate” below.

	Hours Spent		Hours EXPECT to Spend
	Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)	Fiscal Year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR)
Insert Percent Spent on Management Assessment of ICFR (404a)	____%	______%	______%
Insert Percent Spent on Independent Audit of ICFR (404b)	____%	______%	______%
TOTAL (SHOULD ADD TO 100%			
Cannot Estimate	O	O	O
Not Applicable	O	O	O

SECTION K: OTHER EFFECTS OF SECTION 404 -- (Programmer – DO NOT SHOW)

Other Effects of Section 404
We are interested in understanding the general impact that complying with Section 404 has had on your company and its participation in the capital markets.

ASK ALL FILERS

K-1 To the best of your knowledge, what impact has complying with Section 404 of the Sarbanes-Oxley Act had on the following?

	RANDOMIZE ORDER	NEGATIVE IMPACT	LITTLE OR NO IMPACT	POSITIVE IMPACT	Not Sure	Not Applicable
A	The quality of your company's internal control structure	O	O	O	O	O
B	The audit committee's confidence in the company's ICFR	O	O	O	O	O
C	The quality of your company's financial reporting	O	O	O	O	O
D	Your company's ability to prevent and detect fraud	O	O	O	O	O
E	Your company's ability to raise capital	O	O	O	O	O
F	Investor confidence in your company	O	O	O	O	O
G	Efficiency of your company's operation	O	O	O	O	O
H	The efficiency of your company's financial reporting process	O	O	O	O	O
I	Timeliness of your company's financial statement audit	O	O	O	O	O
J	Liquidity of your company's common stock	O	O	O	O	O
K	Your company's overall firm value	O	O	O	O	O
L	Your confidence in the financial reports of other 404-compliant companies	O	O	O	O	O

ASK ALL FILERS

K-2 Have the requirements to comply with Section 404 motivated your company to consider going private?

1	Yes, very seriously
2	Yes, somewhat
3	No
9	Not sure

All Foreign Filers

K-3 Have the requirements to comply with Section 404 motivated your company to consider delisting from U.S. exchanges?

1	Yes, very seriously
2	Yes, somewhat
3	No
9	Not sure

K-4 To the best of your knowledge, what is the impact that complying with Section 404 requirements might have on companies in your home country's jurisdiction that are not subject to Section 404?

Negative Impact on Firm Value			No Impact on Firm Value	Positive Impact on Firm Value			Not Sure	Not Applicable
Large	Moderate	Small		Small	Moderate	Large		
O	O	O	O	O	O	O	O	O

ASK THOSE WHO SAY YES IN EITHER K-2 OR K-3

K-5 Have the costs that motivated your company to consider going private, deregistering or delisting gone away entirely or become smaller over time?

1	Yes, gone away entirely
2	Yes, become smaller over time
3	They have remained the same
4	No, they have increased
9	Not sure

SECTION L: FINAL QUESTIONS – (Programmer – DO NOT SHOW)

ASK ALL FILERS

Additional Information

L-1 In which of the following surveys regarding Section 404 of the Sarbanes-Oxley Act, if any, have you participated*? Please select all that apply.* *RANDOMIZE*

0	Have not participated in any prior surveys about this topic
1	Financial Executives International (FEI)
2	Charles River Associates International (CRAI)
3	Foley and Lardner (attorneys)
4	Deloitte and Touche LLP
5	Greater Boston Chamber of Commerce
6	Independent Community Bankers of America
7	NASDAQ
8	KPMG LLP
9	Lord & Benoit
10	AMR Research
11	U.S. Chamber of Commerce
12	Institute of Management Accounts
13	American Electronics Association
14	Other: please specify
15	Not Sure

ASK ALL FILERS

Thank you very much for participating in this survey. This concludes the main body of our survey.

L-2 If you have a few additional minutes, please let us know if you would like to share some additional thoughts on the topics listed below. Finally, if you would like to receive an executive summary of the results, you can click on the follow-up section and provide us with contact information. This will also allow us to contact you again if we have a few points of clarification about the answers that you gave.

Topic	Estimated Time to Complete	Yes	No
Management assessment experience	7 Minutes	1	2
Cost-Benefits of Sarbanes-Oxley	2 Minutes	1	2
Open-Ended Questions Where you can write anything you want	5 Minutes	1	2
Follow-up (where you can register to get an executive summary of the report the SEC will prepare on costs and benefits that will feature results from this survey).	1 Minute	1	2

NEXT GO TO EACH OF THE SELECTED (“YES”) TOPICS

SECTION M: MANAGEMENT GUIDANCE DIAGNOSTICS - (Programmer – DO NOT SHOW)

Management Guidance Diagnostics

In this section, we are looking for greater detail on your experience with the management assessment of ICFR, and with the SEC's guidance on how management can prepare for the assessment of ICFR. This information will help us analyze the nature of any improvement in implementation of the Section 404 rules that has occurred and determine what, if any, adjustments might be warranted.

M-1	Have you relied on the management guidance that the SEC issued in June 2007?
1	Yes
2	No

Programming Logic: If yes, ask the next question; if no, skip the next question.

M-2	Have you found the management guidance useful?
1	Yes
2	No

M-3 Please consider all of your company's effort in support of management's assessment of ICFR for fiscal year ending in (INSERT PRIOR FISCAL YEAR) and in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR). Approximately what percentage (in terms of costs) of that effort was related to the following tasks? Thinking of (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), approximately what percentage (in terms of costs) of that effort do you EXPECT to be related to the following tasks?

(PLEASE MAKE SURE THE PERCENTAGES ADD UP TO 100%)

		Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)	Fiscal Year ending in (INSERT FY AFTER MOST RECENT FY)
1	Identifying risks to your company's financial reporting			
2	Identifying controls that address identified risks			
3	Documenting controls identified to address risks			
4	Gathering evidence related to (i.e. testing) the operational effectiveness of controls			
5	Evaluating the effectiveness of controls			
6	Evaluating deficiencies identified to determine if they were material weaknesses			
7	Making changes in IT systems to conduct management's assessment			
8	Developing disclosures on SEC filings related to management's assessment			
9	Any other tasks: please specify			
	TOTAL	100%	100%	100%
	CLICK HERE IF CANNOT ESTIMATE FOR THIS YEAR			
	CLICK HERE IF NOT APPLICABLE FOR THIS YEAR			

M-4 How have the following activities associated with management's evaluation of ICFR changed in fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) from fiscal year ending in (INSERT THE PRIOR YEAR)?

	ROTATE A-I. J SHOULD ALWAYS COME LAST	Not Applicable	DECREASE	LITTLE OR NO CHANGE	INCREASE	Not Sure
	Think of the change from fiscal year ending in (INSERT MOST RECENT FISCAL YEAR) to fiscal year ending in (INSERT PRIOR FISCAL YEAR)					
A	The number of risks subject to testing	O	O	O	O	O
B	The number of locations for which your company gathered evidence to support your company's assessment	O	O	O	O	O
C	The level of documentation maintained in support of its assessment	O	O	O	O	O
D	The number of controls for which your company gathered evidence (i.e. tested) to support your company's assessment	O	0	0	0	0
E	The evidence (nature, extent, timing) gathered as part of your assessment	O	O	O	O	O
F	Use of management's interaction with its controls as evidence to support its assessment	O	O	O	O	O
G	Management's reliance on evidence gained from self-assessments (i.e. evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities).	O	O	O	O	O
H	Management's reliance on evidence from direct testing (i.e. tests ordinarily performed on a periodic basis by individuals who are not responsible for the controls operation)	O	0	0	0	0
I	The reporting and discussion of significant deficiencies and material weaknesses to the audit committee	O	O	O	O	O
J	The overall scope of your company's evaluation process	O	O	O	O	0

M-5 How do you EXPECT the following activities associated with management's evaluation of ICFR to change in fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR) from fiscal year ending in (INSERT MOST RECENT FY)?

	ROTATE A-I. J SHOULD ALWAYS COME LAST	Not Applicable	DECREASE	LITTLE OR NO CHANGE	INCREASE	Not Sure
	Think of the EXPECTED change from fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR) to fiscal year ending in (INSERT MOST RECENT FISCAL YEAR).					
A	The number of risks subject to testing	O	O	O	O	O
B	The number of locations for which your company gathered evidence to support your company's assessment	O	O	O	O	O
C	The level of documentation maintained in support of its assessment	O	O	O	O	O
D	The number of controls for which your company gathered evidence (i.e. tested) to support your company's assessment	O	0	0	0	0
E	The evidence (nature, extent, timing) gathered as part of your assessment	O	O	O	O	O
F	Use of management's interaction with its controls as evidence to support its assessment	O	O	O	O	O
\` \` G	Management's reliance on evidence gained from self-assessments (i.e. evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities).	O	O	O	O	O
H	Management's reliance on evidence from direct testing (i.e. tests ordinarily performed on a periodic basis by individuals who are not responsible for the controls operation)	O	0	0	0	0
I	The reporting and discussion of significant deficiencies and material weaknesses to the audit committee	O	O	O	O	O
J	The overall scope of your company's evaluation process	O	O	O	O	0

ASK ALL TENURED AND NEW ACCELERATED FILERS ONLY

M-6 For fiscal year ending in (INSERT PRIOR FISCAL YEAR), how much responsibility did each of the following have for gathering evidence to support your company's management assessment of ICFR?

	DO NOT ROTATE	NO Responsibility	MODERATE Responsibility	A GREAT DEAL of Responsibility	Not Sure	Not Applicable
	In Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)					
A	Employees who are part of an internal audit function	O	O	O	O	O
B	Employees who are not internal auditors	O	O	O	O	O
C	Outside vendors who are NOT on your company's payroll	O	O	O	O	O
D	Other: Please specify	O	O	O	O	O

ASK ALL

M-7 For fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), how much responsibility did each of the following have for gathering evidence to support your company's management assessment of ICFR?

	DO NOT ROTATE	NO Responsibility	MODERATE Responsibility	A GREAT DEAL of Responsibility	Not Sure	Not Applicable
	In Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)					
A	Employees who are part of an internal audit function	O	O	O	O	O
B	Employees who are not internal auditors	O	O	O	O	O
C	Outside vendors who are NOT on your company's payroll	O	O	O	O	O
D	Other: Please specify	O	O	O	O	O

ASK ALL FILERS

M-8 For fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), how much responsibility is each of the following EXPECTED to have for gathering evidence to support your company's management assessment of ICFR?

	DO NOT ROTATE	NO Responsibility	MODERATE Responsibility	A GREAT DEAL of Responsibility	Not Sure	Not Applicable
	In Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)					
A	Employees who are part of an internal audit function	O	O	O	O	O
B	Employees who are not internal auditors	O	O	O	O	O
C	Outside vendors who are NOT on your company's payroll	O	O	O	O	O
D	Other: Please specify	O	O	O	O	O

These next questions ask about whether your company's evaluation process was modified to improve coordination with your independent auditor.
ASK NON-ACCELERATED FILERS

M-9 During fiscal year ending in (INSERT PRIOR FISCAL YEAR), to what degree did your company structure its evaluation of ICFR with the intent of allowing the independent auditor to rely on the company's work?

		NOT AT ALL	MODERATELY	A GREAT DEAL	Not Sure	Not Applicable
	Degree to which your company structured its evaluation of ICFR with the intent of allowing the independent auditor to rely on it	O	O	O	O	O

M-10 During fiscal year ending in (INSERT MOST RECENT FISCAL YEAR), to what degree did your company structure its evaluation of ICFR with the intent of allowing the independent auditor to rely on the company's work?

		NOT AT ALL	MODERATELY	A GREAT DEAL	Not Sure	Not Applicable
	Degree to which your company structured its evaluation of ICFR with the intent of allowing the independent auditor to rely on it	O	O	O	O	O

ASK ALL TENURED ACCELERATED FILERS

M-11 During fiscal year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), to what degree do you EXPECT that your company will structure its evaluation of ICFR with the intent of allowing the independent auditor could rely on the company's work?

		NOT AT ALL	MODERATELY	A GREAT DEAL	Not Sure	Not Applicable
	Degree to which your company structured its evaluation of ICFR with the intent of allowing the independent auditor to rely on it	O	O	O	O	O

SECTION N:– Cost Benefits -- (Programmer – DO NOT SHOW)

ASK ALL FILERS

Costs and Benefits of Section 404

N-1 How responsive has the SEC been to concerns about the costs of complying with Section 404 of the Sarbanes-Oxley Act? Please use a 7-point scale, where 1 means not at all responsive and 7 means very responsive.

		Not at All Responsive Very Responsive							Not Sure	Not Applicable
		1	2	3	4	5	6	7		
	SEC's Responsiveness	O	O	O	O	O	O	O	O	O

ASK TENURED ACCELERATED FILERS AND NON-ACCELERATED FILERS

N-2 From the perspective of your company, how have the benefits of complying with Section 404 compare with the costs of complying? Please use a 7-point scale, where 1 means the costs far outweighed the benefits and 7 means the benefits far outweighed the costs, and answer for fiscal year ending in (INSERT FIRST FISCAL YEAR WAS REQUIRED TO FILE A REPORT), fiscal year ending in (INSERT PRIOR FISCAL YEAR) and fiscal year ending in (INSERT MOST RECENT FISCALY YEAR). In fiscal year (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR), how do you EXPECT the benefits of complying with Section 404 to compare with the costs of complying? Please use a 7-point scale, where 1 means the costs far outweighed the benefits and 7 means the benefits far outweighed the costs.

		Costs Far Outweighed the Benefits Benefits Far Outweighed the Costs							Not Sure	Not Applicable
A	In Fiscal Year ending in (INSERT FIRST FISCAL YEAR WAS REQUIRED TO FILE A REPORT)	1	2	3	4	5	6	7		
B	In Fiscal Year ending in (INSERT PRIOR FISCAL YEAR)	O	O	O	O	O	O	O	O	O
C	In Fiscal Year ending in (INSERT MOST RECENT FISCAL YEAR)	O	O	O	O	O	O	O	O	O
D	In Fiscal Year ending in (INSERT FISCAL YEAR AFTER MOST RECENT FISCAL YEAR)	O	O	O	O	O	O	O	O	O

PROGRAMMING LOGIC: For Row A, insert the First Fiscal Year for which the report was filed which can be gleaned by Question B-2. At any rate, all respondents should however be asked about three years (PRIOR FISCAL YEAR, MOST RECENT FY, and FY AFTER MOST RECENT FY).

N-3 Given your experience, how did the SEC's issuance of interpretive guidance for management and the PCAOB's issuance of Auditing Standard No. 5 affect your costs of complying with Section 404?

	DO NOT ROTATE	Not Applicable	DECREASED YOUR COSTS	LITTLE OR NO IMPACT on Costs	INCREASED YOUR COSTS	Not Sure
A	Impact of Interpretive Guidance for Management	O	O	O	O	O
B	Impact of Auditing Standard No. 5	O	O	O	O	O
C	Combined Impact of Guidance for Management and Auditing Standard No. 5	O	O	O	O	O

ASK ALL FILERS

SECTION O: – Open-Ended Questions -- (Programmer – DO NOT SHOW)

Additional Comments

O-1 In what other ways – if any - has compliance with Section 404 of Sarbanes-Oxley benefited your company and its investors? *Please type your response here.*

O-2 In what other ways – if any - has compliance with Section 404 of Sarbanes-Oxley been costly or created difficulties for your company and its investors? *Please type your response here.*

ASK ALL FILERS

O-3 Please provide any additional information or suggestions for actions that the SEC might take to help increase the benefits or reduce the costs of compliance with Section 404 of the Sarbanes Oxley Act. *Please type your response here.*

O-4 Please indicate whether your company has experienced or is EXPECTING to experience any other changes in its management evaluation of ICFR in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR) compared to (INSERT MOST RECENT FISCAL YEAR). *Please type your response here.*

O-5 Please indicate any other changes your company has experienced or is EXPECTING to experience in the independent audit of the company's ICFR in fiscal year ending in (INSERT YEAR AFTER MOST RECENT FISCAL YEAR) compared to (INSERT MOST RECENT FISCAL YEAR). *Please type your response here.*

O-6 If you have any additional information or comments, please feel free to express your views below: *Please type your response here*.

SECTION P: FOLLOW-UP -- (Programmer – DO NOT SHOW)

Contact Information

P-1 May we contact you again if we have additional questions or would like to clarify your response? This would not require a significant amount of time on your part – if we needed clarification on something, it probably would take no more than 5 minutes.

1	Yes	CONTINUE
2	No	GO TO FINISH

ASK ONLY IF FILER IS WILLING TO BE CONTACTED (CODE 1 IN Q66)

P-2 Please provide your contact information below.
Name
E-mail address
Phone
Mobile Phone

FINISH

Thank you very much for participating in this survey, which will bring real-world evidence to the study of costs and benefits of the Section 404 implementation being undertaken by the economists of the SEC. As a small token of our appreciation for your participation, you will receive an executive summary of the report of that study.