

# **Sarbanes Oxley: Examining the Effectiveness of Section 404**

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## **Sarbanes-Oxley and Section 404 Compliance Regulation**

Beginning in 2001, the American stock market experienced financial distress of cataclysmic proportions as wave after wave of accounting fraud cases were uncovered. According to *The Economist* (2005), investors lost an estimated \$900 billion as a direct result of the 30 largest accounting fraud cases from 1997 to 2004. In response, Congress immediately began drafting legislation that sought to reinvigorate a positive view of corporate America and deter firms from participating in shoddy and illegal accounting practices (Sweeney, 2005, p. 23). The result was the SEC-regulated Sarbanes-Oxley act of 2002, aimed at strengthening a variety of accounting and internal control standards for all public firms.

Since the implementation of SARBOX, public corporations as well as auditing firms have been under intense pressure to conform to the new regulation standards; the most rigorous of these are defined in section 404, which requires all public firms to strictly test and revise their internal control policies on an annual basis. Although the legislation has been in effect for a short time, the financial community has reacted strongly to the provisions outlined in this section. While the majority of corporate executives report that section 404 has been instrumental in developing more effective internal control standards, there has been a substantial outcry from public firms to revise certain aspects of the document (Sweeney, 2005, p. 23). Thus, as the regulating body of the legislation, it is crucial for the SEC to analyze the successful as well as the ineffective aspects of section 404 in order to generate viable solutions that will make SARBOX more effective. According to Paul Sweeney of *Financial Executive*, section 404 requires firms to take strict steps to enhance their control policies in order to deter fraud. In addition to regularly examining and revising control procedures, firm management must contract

external auditors to assess the quality of these testing programs. As a third regulation, section 404 created the Public Company Accounting Oversight Board (PCAOB) to monitor external auditor performance (Sweeney, 2005, p. 24). This tripartite division of checks and balances seeks to ensure that firms are actively working toward halting fraudulent and inconsistent accounting standards before they create consequences for investors.

#### **Successful Aspects of Section 404**

In its effort to increase auditor liability and curtail accounting irregularities through strengthened internal control systems, section 404 has fostered substantial success. In the context of auditor liability, the Public Company Accounting Oversight Board is granted authority to “levy fines, censure, suspend, and bar from practice both individual accountants and firms” (Kohn & Del Vecchio, 2004, p. 37). Through annual auditor reviews, the PCAOB has been able to place considerable pressure on auditors to conduct strict and thorough investigations of internal controls that uphold section 404 standards; as a result, accounting firms both large and small are shifting their auditing methodology toward complete compliance with section 404 and other generally accepted accounting principles (Kohn & Del Vecchio, 2004, p. 37). The stakes are simply too high for auditors to continue to apply lax accounting methods; ramifications for violating auditing code will now result in damaged credibility and substantially decreased profits for firms providing public accounting services.

One of the most prominent positive effects of section 404 stems from the enthusiasm that many corporate leaders have adopted by utilizing the legislation as a means to venture above and beyond the regulations and jump ahead of the competition. A

2005 Deloitte and Touche roundtable with hundreds of corporate executives revealed that “many firms see [404] as an opportunity to adapt a ‘beyond compliance’ and ‘get it done now’ approach by upgrading information technology, enhancing internal controls, and developing employee compliance training programs to get a competitive advantage” (Filipek, 2005, p. 17). Essentially, section 404 has forced public companies to conduct long overdue maintenance on these control processes, leading to the elimination of duplicate and outdated systems; the upshot is a sizeable boost in accounting efficiency and accuracy that places companies actively pursuing this methodology well beyond the average industry competitor.

According to Dennis Nally (2005, p. 18), PriceWaterHouseCoopers conducted a study of 225 public firms that clearly portrays section 404’s inherent power to strengthen internal controls. The research concluded that 40% of public firms revised at least a quarter of their internal controls within the first year of section 404’s implementation. Furthermore, thousands of internal control deficiencies were detected and there were 26% fewer restatements of SEC filed financials for these firms since 2002 (Nally, 2005, p. 18).

#### **Unsuccessful Aspects of Section 404**

On the opposite end of the spectrum, section 404 has caused intense controversy and debate among those directly affected by the legislation. The first and foremost source of aggravation deals with the initial costs incurred for large cap firms (those with a market capitalization above \$750 million) to facilitate compliance with the regulations. A 2005 Financial Executives International survey concluded that the average large cap firm spent 26,000 hours and \$4.3 million to comply with section 404 alone. This produced cumulative compliance costs of \$7 billion (1% of revenue) for all publicly listed firms each year

(Koehn & Del Vecchio, 2004, p. 39).

Moreover, audit fees for the four largest accounting firms have risen 66%; these costs are passed to public firms, which then inflate prices for goods and services rendered for consumers (Koehn & Del Vecchio, 2004, p. 39). An example of the sharp increase of compliance costs associated with section 404 and SARBOX can be observed in Exhibit 1; this table represents data gleaned from 32 large cap companies in a study by the Foley and Lardner law firm (Koehn & Del Vecchio, 2004, p.38).

Although large cap corporations incurred elevated costs, companies with market capitalizations of under \$750 million have been penalized by a much greater degree. To efficiently comply with the regulations outlined in section 404, a majority of existing information technology processes and software packages had to be upgraded (Volonino, 2004, p. 220). While large firms have more monetary flexibility to facilitate this process, small companies with significantly lower profit margins and liquidity cannot suffer these costs without extensive strain on their bottom lines. In fact, the most significant burden falls on micro-cap firms that maintain a market cap of less than \$120 million; the relatively low revenue generation of these firms leads to compliance costs that consume up to 5% of total annual revenue as opposed to .9% for large cap firms. (Levinsohn, 2006, p. 1).

The financial distress inflicted on small and micro-cap firms resulting from section 404 compliance comes at great cost in the context of a healthy competitive market. According to Alan Levinsohn (2006, p. 1), “the costs of Section 404 compliance make it difficult for smaller companies to compete and grow....Development stage companies with no profit certainly can’t afford the compliance costs.” Consequently, as many of these firms lose their competitive edge, there is a severe drop in market competition that results

in less efficient markets and higher prices for consumers.

A final cause of vexation in section 404 is derived from its often unclear and ambiguous language. The most prominent area of conflict lies in the “auditing standards” section which details the process by which auditors report management’s evaluation of internal controls. The repeated use of vague words such as “reasonable” and “substantial,” in conjunction with a lack of examples of what constitutes weak controls, have caused massive confusion for auditing firms (Seidenberg, 2006, p. 41). Rather than applying time resources toward assisting firms in adhering to section 404 standards, auditors have been forced to spend their time interpreting the provisions of the document (Nally, 2005, p. 18).

### **Conflict Analysis**

To effectively analyze the positive and negative aspects of section 404 and develop a basis for a revision recommendation, it is crucial to explore the issue from a few different angles. In particular, large and small cap corporations are affected by the legislation in different ways; thus, it is necessary to analyze the future impact of section 404 on large and small firms independently.

With a focus on large cap firms, the issue of compliance costs again becomes the primary concern. As noted previously, the cost statistics above refer only to initial expenses; however, evidence regarding future costs associated with section 404 alters the issue entirely. Recent research reveals that a portion of the costs incurred by firms in year one of Sarbanes-Oxley are “one time only” expenses (Levinsohn, 2006, p. 1). Many studies, including a survey conducted by CRA International in December of 2005, report that compliance costs for large corporations will fall by an average of 42% in 2006. This

will result in an average cost reduction from \$7.3 to \$4.3 million (Levinsohn, 2006, p. 1). Alan Levinsohn, editor of *Strategic Finance*, explicitly states the reasoning behind this conclusion:

Auditors are getting more up to speed, are less inclined to excessively scrutinize a company's controls, and are less concerned with being sued. And many people on the front lines are benefiting from efficiencies gleaned from year one: documentation completed, experience earned, and vastly remediated internal controls. All that translates into lower costs.

(Levinsohn, 2006, p. 1)

Essentially, as external auditors perform assessments of a firm's internal control testing procedures, their experience from year one will ensure higher efficiency and, consequently, fewer costs for the auditing project. Furthermore, the rigorous testing and revisions from year one effectively mended a majority of the leading control problems. Thus, with less inefficiency this year, there will be fewer testing procedures to review.

In reviewing the case for small firms, the issue of future compliance costs is more complicated. Due to lower liquidity and tighter revenues, micro-cap firms are expecting no decline in costs (Filipek, 2005, p. 18). Because compliance expenses consume such a high percentage of revenues for small cap companies, the financial repercussions are much more significant; consistently high compliance costs further reduce the ability of small firms to compete effectively against large firms that are characterized by declining expenses. As a final note, the provision of section 404 that requires external auditor review of control testing accounts for roughly 35% of these expenses (Levinsohn, 2006, p. 1).

In reference to auditors and the ambiguity of language in section 404, the outlook is positive. Although section 404 has proven to be confusing to auditors last year, many of

the common discrepancies have been resolved, leading to less confusion for accounting firms in the coming years. “This year, audit firms and companies will test fewer controls and generate less documentation, and outside auditors expect to rely more on the work of others, including internal auditors, which should make the whole process less costly” (Levinsohn, 2006, p. 1).

### **Final Recommendation**

While the adaptation of section 404 into corporate governance policy should prove to be highly beneficial over the long run, the initial compliance transition has shaken up corporate America. Despite concerns from public corporations and auditors about compliance costs and inconsistencies in the auditing standards section, there has been little response from lawmakers. Congress loosely noted that section 404 may be reviewed in late 2007, although no commitment to revise the document has yet been made. Thus, the burden of expediting the process of analysis and revision of section 404 and its policies lies on the SEC.

In this context, there are a few viable solutions that could be implemented to greatly enhance section 404. In regard to large cap firms, it is far too early to make any conclusive revisions that would directly affect corporations in this position. As evidenced above, although costs for year-one compliance were seemingly excessive, various studies suggest that costs should fall substantially in 2006. If these reports are accurate, the expenses associated with section 404 will become more reasonable, especially in relation to the strong benefits of strengthened internal control procedures. Consequently, the cost-benefit ratio for large cap firms should equilibrate. However, if the reports prove to be inaccurate, it may be warranted to revisit the issue and make revisions.

In the case of small cap firms, research clearly indicates that companies in this position are being excessively penalized. Not only do compliance costs consume a higher proportion of revenue, but there is no expected decrease in these expenses in coming years. Therefore, one feasible solution would be to add a provision that eliminates the requirement for small firms to contract external auditors to review their internal control tests. If these expenses are cut, small firms will experience 35% less in compliance costs, but would still be held to the strict internal control revision standards of 404. This sizable decrease in costs would allow small firms to continue to compete practically in the market while still retaining the benefits of better control systems.

As a final suggestion, the language of section 404 needs to be amended and clarified. The accounting standards section should be revised by eliminating vague words and providing clear examples of weak internal controls that auditing firms should focus on. With these simple modifications, the ambiguity that characterizes section 404 could be eradicated with some ease. The upshot would be a more polished piece of legislation that would allow auditors to focus their time and resources on proper compliance instead of wasteful interpretation.

Generally speaking, Sarbanes-Oxley and section 404 have proven to be crucial elements in the process of reestablishing fair and balanced markets in corporate America. Although SARBOX is a step in the right direction, it seems to have been implemented as a damage control policy, and thus was hastily drafted. Now that flaws have emerged in section 404, it is imperative to take action in order to streamline the legislation and increase its value. The above outlined revisions could be implemented with ease and would most certainly help Sarbanes-Oxley more closely achieve its original goals. With that in mind, it is the obligation of the SEC to devote extensive resources toward modifying

section 404 in order to alleviate unnecessary strain on auditors and public firms.

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