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SARBANES-OXLEY AND SMALL BUSINESS: ADDRESSING PROPOSED REGULATORY CHANGES AND THEIR IMPACT ON CAPITAL MARKETS

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

FIRST SESSION

April 18, 2007

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COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP

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FIRST SESSION

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SARBANES-OXLEY AND SMALL BUSINESS: ADDRESSING PROPOSED REGULATORY CHANGES AND THEIR IMPACT ON CAPITAL MARKETS

WEDNESDAY, APRIL 18, 2007

UNITED STATES SENATE,
COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP,
Washington, D.C.

The Committee met, pursuant to notice, at 10:30 a.m., in room 428-A, Russell Senate Office Building, Hon. John F. Kerry, Chairman of the Committee, presiding.

Present: Senators Kerry, Bayh, Pryor, Tester, Snowe, Coleman, Thune, and Corker.

OPENING STATEMENT OF THE HONORABLE JOHN F. KERRY, CHAIRMAN, SENATE COMMITTEE ON SMALL BUSINESS AND ENTREPRENEURSHIP, AND A UNITED STATES SENATOR FROM MASSACHUSETTS

Chairman KERRY. This hearing will come to order. I apologize to everybody for the delay, but we had two votes in the Senate, as I think you know, and we just finished the second one, so people are hustling over here.

I want to thank SEC Chairman Cox, the PCAOB Chairman Olson, and all of our witnesses for taking time out of busy schedules to be here to testify at this hearing, in which we will examine the effects that the Sarbanes-Oxley regulations are having on small business and how we can help small businesses to comply with the law.

Let me say up front that we are all proud that our country boasts the fairest and most transparent and efficient financial marketplace in the world. We have achieved this status by developing a regulatory approach that ensures investors around the world can have confidence in our markets. However, between the years 1998 and 2000, there were 464 financial restatements by public companies. That number was higher than the previous 10 years combined, and too often, those public companies were overstating their income in order to attract investors or hold on to investors.

The trust and confidence of the American people in their financial markets was dangerously eroded by the actions of WorldCom, Enron, Arthur Andersen and others, and the shocking malfeasance by these businesses and accounting firms put a strain on the

growth of our economy, cost investors billions in assets and hurt the integrity of financial markets around the world.

By all accounts, the Sarbanes-Oxley Act has brought back accountability to corporate governance and to auditing and to financial reporting for public companies. The audit of internal controls over financial reporting has produced significant benefits, and public company financial reporting has improved overall. As a result, investor confidence in our capital markets has been restored and our Nation's economic growth continues.

Recent published reports show that accounting restatements on large companies' financial results declined by 20 percent last year. This is important evidence that Sarbanes-Oxley is working. These improvements, however, have not come without some drawbacks and complications. Too many small public companies who have played by the rules are now expected to deal with the time and financial burden required by the Sarbanes-Oxley law. Last year, businesses with less than $75 million in assets saw the number of financial restatements increase by 46 percent. This shows that businesses getting ready to comply with Sarbanes-Oxley are having trouble. I believe that we will all benefit when small businesses are prepared for compliance with Sarbanes-Oxley.

However, according to a recent U.S. Government Accountability Office study requested by Senator Snowe, the cost of compliance and the time needed for small companies to comply with Sarbanes-Oxley regulations has been disproportionately higher than for large public companies. Firms with assets of $1 billion or more spend about 13 cents per $100 in revenue for audit fees, while small businesses are forced to spend more than $1 per $100 in revenue to comply with the same rules.

As we will hear from witnesses on the second panel today, this disproportionate burden faced by small public companies may be a deterrent to other small businesses interested in going public. These small businesses aren't resistant to fair and open financial reporting, but they are hesitant to make this transition because of the burdensome costs involved with compliance.

Small businesses, we all know, are vital participants in capital markets. They play a critical role in future economic growth and high-wage job creation. I have no doubt that small public companies will be able to comply with the Sarbanes-Oxley law just as big business is doing today. All small public companies know it is in their best interest to have regulations in place that provide transparency and accountability. These are the qualities that encourage investor confidence in U.S. markets, giving them access to more investors and increasing the pool of available capital, while keeping their competitors from manipulating the marketplace through faulty accounting.

But, and this is an important but, I think each of us on this Committee, wherever we have gone in the country, when talking to business people, hear anecdotally that there is sort of an overreach or an excessiveness, that we could, perhaps, accomplish the goals of Sarbanes-Oxley perhaps with a little less financial and administrative burden. It is important for us to listen to that, to take it into account, to try to figure out if that is true. I think the real measure of this hearing is whether we can sustain the goals, the

accountability, and the transparency while minimizing the disruptive features and costs so that you maximize your competitive abilities and your growth, and that is the balance we would obviously like to find.

We need to find a way, I think, to help some of these small businesses, the backbone of the American economy, to make this transition and make it effectively and smoothly. To that extent, I am very pleased that the Securities and Exchange Commission and the Public Company Accounting Oversight Board are currently considering final rules and guidance on the implementation of Sarbanes-Oxley that will make it easier for small businesses to comply with the law.

And while I acknowledge that the intent of the rule changes is to make it easier and less burdensome for small businesses to comply, we all know that the devil is always in the details. So I look forward to hearing from Chairmen Cox and Olson on the status of the rulemaking progress and see how those regulations will take into consideration the concerns of the small business community.

As we move forward, there are additional steps that could be taken to assist small businesses, and I want to work with Senator Snowe and others on this Committee to find, hopefully, a common ground on how we could do that.

I recently wrote to the SEC and the PCAOB with Senator Snowe urging the regulators to give small businesses up to an additional year to comply with the pending changes to Sarbanes-Oxley regulations. I believe this added time will help small businesses adapt to the changing regulatory structure and make it easier for those who lack the expertise or the financial resources to be able to comply with the law. I thank Chairman Cox for his previous support in providing small public companies with additional time to comply with Sarbanes-Oxley.

As Chair of the Committee on Small Business and Entrepreneurship, I will continue to closely follow this impact on small firms and very much look forward to working with Senator Snowe and our colleagues to try to help small companies be able to abide by the law while simultaneously allowing them to focus on what they do best, which is creating jobs and growing our economy by participating in the capital markets.

So we look forward to hearing from our witnesses today. Before I introduce them, let me turn—Senator Snowe, I know, is on her way, but let me turn to Senator Coleman. Do you have any opening statement, Senator?

OPENING STATEMENT OF THE HONORABLE NORM COLEMAN, A UNITED STATES SENATOR FROM MINNESOTA

Senator COLEMAN. Just very briefly. I want to thank the Chair for convening this hearing. As I travel around my State and I talk to small businesses, this and health care are the two single most common concerns and complaints.

I would just also take a note of personal pride in that both our witnesses before us, Chairman Cox and Chairman Olson, both have ties to St. Paul, Minnesota, having been born there or lived there, so I know they have the right kind of background to be very sensitive to these concerns and are smart enough to handle the con-

cerns. I look forward to their testimony and the testimony of the other witnesses.

Again, I want to thank the Chair for his leadership on this very critical issue.

Chairman KERRY. Thank you. You are not going to claim there is something in the Mississippi River water, are you?

[Laughter.]

Chairman KERRY. Senator Tester?

OPENING STATEMENT OF THE HONORABLE JON TESTER, A UNITED STATES SENATOR FROM MONTANA

Senator TESTER. I also want to thank the Chairman. I want to thank Chairman Cox and Chairman Olson for being here. It is a delicate balance between regulation and what is appropriate and I look forward to hearing your perspective on Sarbanes-Oxley and how we can make it better. Thank you.

Chairman KERRY. Thank you very much.

Senator Corker?

OPENING STATEMENT OF THE HONORABLE BOB CORKER, A UNITED STATES SENATOR FROM TENNESSEE

Senator CORKER. In the interest of time, I just want to thank you for the hearing and our witnesses and I will associate myself with Mr. Coleman's comments. Thank you.

Chairman KERRY. Thanks a lot, Senator.

Senator Bayh?

Senator BAYH. I have no opening statement.

Chairman KERRY. We welcome Chris Cox, the 28th Chairman of the Securities and Exchange Commission. He was appointed by President Bush in 2005, and prior to his appointment, he spent 17 years in the House of Representatives.

Our second witness is Mark Olson, Chairman of the Public Company Accounting Oversight Board. He served as a member of the Federal Reserve Board of Governors, the Federal Local Market Committee since December of 2001.

Both are highly qualified and we really welcome you here today. Thanks for taking the time to come.

Mr. Cox?

STATEMENT OF THE HONORABLE CHRISTOPHER COX, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you very much, Mr. Chairman, Ranking Member Snowe when she arrives, and members of the Committee for inviting me to testify on behalf of the Securities and Exchange Commission concerning the application of Section 404 of the Sarbanes-Oxley Act to small business.

Mr. Chairman, you asked in your opening statement whether or not the United States can achieve the goals of accountability and transparency that underlie Section 404 of the Sarbanes-Oxley Act while simultaneously minimizing the costs and the disruption, especially for small business. The answer to that, in the view of the Securities and Exchange Commission, and I dare say in the view of the PCAOB, is yes.

Your Committee's charge is a vitally important one concerning costs of Sarbanes-Oxley to small business in particular, and even more generally, given the importance of small business to our economy. For our part, the SEC's charge in the statute includes the promotion of capital formation upon which small businesses, of course, depend. So like you, therefore, we are completely committed to fostering the climate of entrepreneurship that is so essential to growth and the success of smaller public companies.

For a small business, raising private capital often depends upon the future prospective possibility of tapping the public market. So it isn't just that the companies that are already public or ready to go public today are affected by how we implement Sarbanes-Oxley. It is also true that companies of all sizes are similarly affected. Every start-up, every new business idea, every determined woman with a dream or a man striking out on his own needs a flourishing IPO market.

America, as you well know in this Committee, creates far more new businesses than does Europe, absolutely and on a percentage basis, and our capital markets have a far higher percentage of individual owners of securities. So it is essential for the vitality of our economy that we protect both the opportunity for small businesses to raise the capital that they need to innovate and the savings of the individuals, the many individuals, who have invested their money in the securities of smaller companies.

Today, 4 years after the Sarbanes-Oxley Act was signed into law, over 6,000 public companies still aren't required to provide the audited internal control reports that are called for by Section 404 of the Act. As a practical matter, almost every public company with securities registered by the Commission, if it has $75 million or less in public equity, falls into this category. They haven't been required to comply with Section 404, as you noted, Mr. Chairman, because the Commission has been very sensitive to the special concerns of smaller public companies. All other public companies in the United States already have 3 years of reporting on internal controls under their belts.

The Commission has delayed Section 404 compliance for smaller companies because of the disproportionately higher cost that they face, just as you pointed out. Our experience in the first 3 years told us that the way that 404 was being implemented was too expensive for everyone; so imposing that system on the smallest companies would impose unacceptably high costs from the standpoint of the companies' investors, who, after all, pay the bills.

So the Commission and the Public Company Accounting Oversight Board set out to address the unique concerns of small business. We further delayed the implementation of 404 for smaller public companies until Chairman Olson and I, working together with the full Commission and the full Board and our professional staffs, could replace the current inefficient system of Section 404 implementation with a more streamlined approach that focuses on the material risks but that still provides for effective and meaningful internal control audits to protect investors.

The focus of this hearing is on the proper implementation of Section 404. Focusing on the implementation of 404 rather than changing the law is consistent with the SEC's view that the prob-

lems we have seen with 404 to date can be remedied without amending the Sarbanes-Oxley Act. And, despite the unduly high costs of implementing Section 404, I believe that the Act overall, including Section 404, may be fairly credited with correcting the most serious problems that beset our capital markets just a few years ago.

So as the Commission and the PCAOB move forward with our plans to make the application of Section 404 workable for smaller companies, it is important to remember that Congress's focus on internal controls was not a mistake. It was and it remains exactly the right thing to do.

It is also important to keep in mind that the Congress didn't invent the internal control provisions of Sarbanes-Oxley out of thin air. There were clear antecedents for SOX 404 in the Federal Deposit Insurance Corporation Improvement Act, FDICIA, and before that in the Foreign Corrupt Practices Act. Since the internal control requirements in those Acts hadn't resulted in unexpected high costs, it was reasonable for Congress to assume that Section 404 wouldn't be disruptive, either.

In the case of FDICIA, however, the banking regulators hadn't adopted a highly prescriptive standard to implement the statute's internal control provisions. But, following the passage of SOX in 2003, the PCAOB and the SEC adopted a very different Auditing Standard Number 2 to implement Section 404. It was approved for use by auditors starting with internal control attestations in 2004. Following the implementation of AS2, many companies increased the documentation of their controls and formalized the procedures they use to identify, test, and analyze the effectiveness of those controls.

The cost of this exercise far outstripped all expectations, including the formal estimate made by the Securities and Exchange Commission when the reporting requirements of 404 implementation were approved. It is undoubtedly true that some of these higher-than-expected costs reflected long-neglected maintenance of internal control systems, but it is equally true and undeniable that much of the extra cost was and continues to be the result of excessive, duplicative, and misdirected effort.

That concern is one of the reasons that, even now, smaller companies aren't yet required to comply with Section 404. In a moment, Chairman Olson will talk about the particulars of the proposed new auditing standard that the PCAOB is working on to replace AS2. But it isn't just the auditing standard that is being refashioned.

The SEC is simultaneously writing guidance specially directed to the management of companies to give them a truly scalable approach to designing controls that will work for the particular circumstances in which they find themselves, especially for small business. And we are coordinating the two proposals by eliminating from the new auditing standard any language that would create an expectation that the controls would be designed to fit the audit rather than the audit being designed to fit the controls.

It is our intention that the new guidance for management will work together with the PCAOB's proposed auditing standard to clearly delineate the auditor's responsibility for opining on manage-

ment's assessment, on the one hand, and the company's responsibility for the methods and the procedures that it uses in its internal controls evaluation process, on the other hand. In combination, the Commission's proposed guidance and the PCAOB's proposed auditing standard should result in the management of smaller companies being able to use a top-down, risk-based approach to their evaluation of the internal controls. And the new approach to 404 implementation should shift discussions between managements and auditors away from management's evaluation process and toward what matters most to investors, the risk that material misstatements in the company's financials won't be prevented or detected in a timely manner.

By the way, managers and auditors should talk to each other, and not just managements, but audit committees and boards of directors should have a healthy and ongoing dialogue with their auditors about the company's internal controls. There is no auditor independence rule or any other rule or standard that stands in the way of this kind of useful communication.

The comment periods for both the Commission and the PCAOB proposals closed on February 26 of this year. The Commission received 205 comment letters from a broad cross-section of investors, small companies, large companies, accountants, lawyers, regulators, and academics.

In our outreach to small business throughout this process, the SEC has been aided by the exceptional work of our Office of Small Business Policy located within the Division of Corporation Finance. The Office of Small Business Policy and its very able Director Gerry Laporte are focused on making sure that the unique needs of small business are reflected in our rules and in the interpretations and guidance that we provide to the public.

The Office of Small Business Policy also served as the secretariat for the Advisory Committee on Smaller Public Companies, which issued its report to the SEC in April 2006. That report was the first to focus on the problems with Section 404 implementation in a systematic way, and it has informed many of the solutions that we are now implementing.

Of special significance to this Committee is that the comments from the small business community that we received on the proposed new 404 procedures were generally consistent with those that we received from other commentators. Almost three-quarters of the comment letters from small business interests indicated that the SEC's proposed guidance would allow managements to tailor their evaluation to the facts and circumstances of their particular companies and help to focus the 404 process on the areas that are most important to reliable financial reporting.

Sixteen of the 42 comment letters representing small business also emphasized the need to allow sufficient time for smaller companies to consider the final guidance issued, or to be issued, by the Commission and the final auditing standard that we expect will be adopted by the PCAOB before they are required to implement fully Section 404 of Sarbanes-Oxley. We take all these comments that we have received very seriously, and we are working hard to address these concerns.

Very recently, on April 4, Chairman Olson and I held an open meeting to review the general nature of the public comments and the work that remains to be done to address them. At that meeting, the Commission made it clear that we are very pleased with the progress that we and the PCAOB are making in our collaboration, and we focused on four remaining areas where we believe additional work is necessary.

First, we need to better align the proposed PCAOB audit standard and the Commission's proposed guidance.

Second, we need to improve the discussion in the proposed auditing standard of how auditors can scale the audit procedures, which will be of a special benefit for smaller companies.

Third, we need to do further work to ensure that it is crystal clear that auditors should use their professional judgment in determining audit procedures and testing based on their assessment of risk.

And fourth, the auditing standard needs to use broader principles rather than prescriptive rules to describe when auditors may use the work of others. This last will ensure that auditors can rely, for example, upon work obtained from management's risk assessments and monitoring activities when those are found to be competent and objective.

As this Committee is aware, the Commission has carefully phased in application of the 404 reporting requirements. Specifically, smaller companies would file management reports on their internal controls along with their annual report for their first fiscal year ending after December 14, 2007. For calendar year-end companies, this would mean March 2008.

We aim to implement Section 404 just as Congress intended, in the most efficient and effective way to meet our objectives for the investor protection, well-functioning financial markets, and healthy capital formation by companies of all sizes. We won't forget, Mr. Chairman, the failures that led to the passage of the Sarbanes-Oxley Act in the first place, and we won't forget that, for small business to continue to prosper in America, strong investor protection has to go hand-in-hand with healthy capital formation.

The reforms that we are making to the Sarbanes-Oxley 404 process are intended to be of direct benefit to American small businesses and the millions of Americans who work for them, who invest in them, and who benefit from the goods and the services that they provide. We are reorienting 404 to focus on what truly matters to investors and away from expensive and unproductive make-work procedures that waste investors' money and distract attention from what is genuinely material. No longer will the 404 process tolerate procedures performed solely so someone can claim that they considered every conceivable possibility.

Mr. Chairman, these next few weeks are a critical time for small business as we approach the finish line in our work to rationalize 404. We look forward to working with you and all the members of this Committee in the days ahead on these issues as well as on the many other issues that face our Nation's small businesses.

Thank you again for the opportunity to speak on behalf of the Commission, and of course I will be happy to take your questions.

[The prepared statement of SEC Chairman Cox follows:]

TESTIMONY OF CHRISTOPHER COX
CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING REPORTING ON THE INTERNAL CONTROLS OF SMALL BUSINESSES UNDER SECTION 404 OF THE SARBANES-OXLEY ACT OF 2002

BEFORE THE
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
UNITED STATES SENATE

April 18, 2007

Chairman Kerry, Ranking Member Snowe, and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission concerning the application of section 404 of the Sarbanes-Oxley Act to small business.

This committee's charge is a vitally important one, both to the millions of small businesses in America, and to our economy. For our part, the SEC is charged by statute with the promotion of capital formation, upon which our small businesses depend. Like you, we are therefore completely committed to fostering the climate of entrepreneurship that is the key to small business growth, and to the creation of so many jobs and so many goods and services in our country.

For a small business, raising private capital often depends upon the future viability of tapping the public markets. It isn't just the company that is ready to go public today that benefits from a healthy market in publicly traded securities. Every startup, every new business idea, every determined woman with a dream and every man striking out on his own need a flourishing IPO market.

America creates far more new businesses than does Europe. And our capital markets have a far higher percentage of individual owners of securities. So it's essential for the vitality of our economy that we protect both the opportunity for small businesses to raise the capital they need to innovate, and the savings of individual investors that are invested in the securities of public companies.

Today, four years after the Sarbanes-Oxley Act was signed into law, over 6,000 public companies still aren't required to provide the audited internal control reports required by section 404. Generally, every public company with securities registered with the Commission, if it has less than $75 million in public equity, falls into this category. They

have not been required to comply with section 404 because the Commission has been very sensitive to the special concerns of smaller public companies. All other public companies in the United States already have three years of reporting on internal controls behind them.

The Commission has delayed section 404 compliance for smaller companies because of the disproportionately higher costs they face compared to larger companies. Our experience of the first three years told us that the way 404 was being implemented was too expensive for everyone – and imposing that system on the smallest companies would impose unacceptably high costs from the standpoint of the companies' investors, who would have to pay the bills.

So the Commission and the Public Company Accounting Oversight Board (PCAOB) set out to address the unique concerns of small business. We further delayed the implementation of 404 for smaller public companies until Chairman Olson and I, working together with the full Commission and PCAOB, could replace the current inefficient system of 404 implementation with a more streamlined approach that focuses on material risks – but that still provides for effective and meaningful internal control audits to protect investors.

The focus of this hearing is on the proper implementation of section 404. Focusing on the implementation of 404, rather than changing the law, is consistent with the SEC's view that the problems we've seen with 404 to date can be remedied without amending the Sarbanes-Oxley Act. And despite the unduly high costs of implementing section 404 of the Act, I believe that the Act overall – including section 404 – may be fairly credited with correcting the most serious problems that beset our securities markets just a few years ago, and with restoring investor confidence in our markets.

One reason the Congress can be confident that the law you wrote is having the desired effect of improving the integrity of financial reporting is that many of its provisions are being replicated by other nations around the world. That is true even for section 404, albeit not the audit requirement. Variations of the law's internal control reporting requirements are being adopted in Japan, France, China, Canada, and several other countries. Still other nations, including the United Kingdom, have adopted a comply-or-explain approach to managements' assessments of internal controls and auditor reports on those assessments.

So as the Commission and the PCAOB move forward with our plans to make the application of section 404 workable for smaller companies, it is important to remember that Congress's focus on internal controls was not a mistake – it was, and remains, exactly the right thing to do.

It's also important to keep in mind that the Congress didn't invent these internal controls disclosure requirements out of thin air. SOX 404 was not the first effort by Congress to focus public companies on the need for strong internal controls over their financial reporting and accounting.

The very first legislation in this area was enacted in 1977, in response to the discovery that a number of companies had falsified financial records in order to disguise or conceal the source and use of "slush funds." Those slush funds were used to make questionable or illegal payments to foreign officials, and for a number of other illegal purposes. The year before that law was passed, in a report on these cases that the SEC made to the Senate Committee on Banking, Housing and Urban Affairs, we stated that:

> The almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability .... Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments. Such falsification of records has been known to corporate employees and often to top management, but often has been concealed from outside auditors and counsel and outside directors.

So in January 1977, the Commission proposed four rules to address the issues covered in that report to Congress.

Two of the Commission's four proposals eventually resulted in the accounting and internal control provisions of the Foreign Corrupt Practices Act. Among other things, these two provisions require each public company to make and keep books, records, and accounts which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the company. In addition, the company must maintain a system of internal accounting controls to provide reasonable assurances that transactions are recorded as necessary for the preparation of financial statements according to generally accepted accounting principles.

The remaining two proposals were adopted as rules by the Commission. One prohibits anyone from falsifying corporate books and records. The other prohibits officers and directors from lying to auditors.

Following adoption of the Foreign Corrupt Practices Act in 1977, various private sector commissions and task forces recommended that companies and their auditors issue public reports on their level of compliance with the internal control provisions of the new law. And some companies voluntarily issued management reports about their system of internal controls. Some of those reports, typically from larger companies, also expressed views regarding the effectiveness of the company's system of internal controls.

On two occasions, in 1979 and again in 1988, the SEC proposed rules that would have required reports from both management and the auditors on a company's internal control system. Although those proposals weren't adopted, the Commission encouraged private sector initiatives to review the need for this kind of disclosure.

Meanwhile, both through additional legislation and continued private sector efforts, the concept of an internal controls review was given sharper definition. In 1988, Congress

amended the Foreign Corrupt Practices Act to define "reasonable assurances" to clarify that the standard does not require an unrealistic degree of exactitude or precision. Then in 1991, in response to a financial institution crisis following many savings and loan association failures, Congress enacted the Federal Deposit Insurance Corporation Improvement Act—FDICIA. That Act includes an internal control provision that is nearly identical to Section 404. And in 1992, the Committee of Sponsoring Organizations, or COSO, funded the publication of a framework for companies to use in developing internal control systems. COSO emphasized that internal controls should include the processes designed by a company to test whether its financial reporting objectives are being met. Organizations in other countries, as well as academics and professional associations, also helped in the 1990s to define and explain what is meant by an effective system of internal controls over financial reporting.

With all of this as background, it wasn't surprising that five years ago, when Congress was again faced with the problem of egregious financial reporting and governance failures, one of the solutions at hand was to revisit the rigor of internal controls. In section 404 of Sarbanes-Oxley, Congress mandated that managements disclose their own conclusions about the effectiveness of their internal controls. And section 404 enhanced the credibility of that disclosure by also requiring that auditors attest to and report on the assessment made by management. The clear antecedents for this provision were FDICIA and the Foreign Corrupt Practices Act. Since the internal control requirements in those Acts had not resulted in unacceptably high costs, it was reasonable for Congress to assume that section 404 would not be disruptive, either. In the case of FDICIA, of course, the banking regulators did not adopt a prescriptive standard to implement the statute's internal control section.

In order to meet the requirements in section 404 of Sarbanes-Oxley, however, in 2003 the PCAOB adopted its very different Auditing Standard Number 2 under section 404. The SEC approved it for use by auditors starting with 2004 internal control attestations.

Following the implementation of AS 2, many companies increased the documentation of their controls, and formalized the procedures they use to identify, test, and analyze the effectiveness of those controls. The cost of this exercise far outstripped all expectations – including the formal estimate made by the SEC when the reporting requirements for 404 implementation were approved. It's undoubtedly true that some of these higher-than-expected costs reflected long-neglected maintenance of internal control systems. But it is also undeniable that much of the extra cost was, and continues to be, attributable to excessive, duplicative, or misdirected efforts.

The Commission is determined to see to it that all waste of investors' money is eliminated from reporting under section 404. We and the PCAOB are working to re-focus 404 on the statutory purpose of informing investors about weaknesses in a company's internal controls that are truly material and really matter. The information conveyed to investors about the nature of those weaknesses has to be helpful to them in making investment decisions.

It was, of course, never intended that the 404 process should become inflexible, burdensome, and wasteful. Following the Commission's adoption of rules to implement section 404 in May 2003, we indicated that the methods used to evaluate the effectiveness of internal controls would, and should, vary from company to company. Early on, the SEC recognized that the approach taken by a Fortune 500 company wouldn't be right for a small company. The operating and financial environments in a small business are very different from those in large companies. That concern was one of the reasons that, even now, smaller companies are not yet required to comply with section 404.

But in 2004, when Auditing Standard No. 2 went into effect, it laid out in too-elaborate detail what an audit of internal control over financial reporting should look like. And because AS 2 contained language that created auditor expectations for the way management would conduct its evaluation process, AS 2 became the de facto guidance for management's evaluations and assessments. The resulting lack of flexibility for companies to design the internal controls best suited to their circumstances is one of the fundamental flaws in AS 2 that we are now working to address.

In a moment, Chairman Olson will talk about the particulars of the proposed new auditing standard the PCAOB is working on to replace AS 2. But it isn't just the auditing standard that is being refashioned. The SEC is simultaneously writing guidance specially directed to the company's management, to give them a truly scalable approach to designing controls that will work in their particular circumstances – especially for smaller companies. And we are coordinating the two proposals by eliminating from the new auditing standard any language that would create an expectation that the controls would be designed to fit the audit, rather than the audit being designed to fit the controls.

The proposed standard, and the Commission's proposed management guidance, would also make clear that auditors are not opining on the methods or on the procedures management uses to evaluate its internal controls. Rather, they are opining on the effectiveness of the internal control structure and procedures.

During the first few years of SOX implementation, we've learned a great deal from both the companies and the auditors who have had to implement section 404. We've listened at roundtables, studied comment letters, and paid close attention to the hearings and studies conducted by this Committee and the rest of the Congress. We have benefited from a great many academic and private sector studies. Almost all of them have concluded that the cost of compliance with section 404 has thus far exceeded the benefits that we've achieved.

In July 2006, the Commission issued a concept release covering potential reforms of section 404 implementation, and in reply we received over 150 comment letters. Many suggested specific areas that we should cover in our guidance and the type of guidance that would be most helpful.

After considering those comments carefully, last December the Commission formally proposed the new interpretive guidance I just mentioned to assist managements in developing a process for evaluating their internal controls over financial reporting.

An overarching objective of the Commission's proposed guidance is to allow managements to focus on the areas that present the greatest risk of material misstatements in the financials. This is what the law has always intended we be focused on. It's also what investors care about. It is, in short, what's important for achieving reliable financial reporting.

The guidance we proposed allows each company to exercise significant judgment in designing an evaluation that is tailored to its individual circumstances. Unlike external auditors, management in a smaller company tends to work with its internal controls on a daily basis. They have a great deal of knowledge about how their firm operates. Our new guidance would allow management to make use of that knowledge.

Our proposed guidance also recognizes that those companies that are already complying with section 404 have invested considerable resources in the design and implementation of their processes. The Commission's proposed guidance should not disrupt or require any changes to those companies' processes. At the same time, we believe that not only small businesses but companies of all sizes will benefit from our proposed new guidance. We also expect that, over time, even some larger companies may choose to adjust their 404 evaluations in response to the guidance.

When the Commission proposed its guidance, we also made clear that it provides one, but not the only, way to comply with the 404 requirement for an annual assessment of internal controls. We've made it clear that management can follow other reasonable approaches, too. For those managements that do follow the basic approach described in our guidance, we've proposed a rule that gives them the comfort of knowing that by doing so they have satisfied their obligation to evaluate their internal controls.

It is our intention that the proposed auditing standard and our proposed guidance for management will work together to clearly delineate the auditor's responsibility for opining on management's assessment, on the one hand, and the company's responsibility for the methods and procedures it uses in its internal controls evaluation process, on the other hand. In combination, the Commission's proposed guidance and the PCAOB's proposed auditing standard should result in management using a top-down, risked-based approach to its evaluation of internal controls. And they should shift discussions between managers and auditors away from management's evaluation process to what matters most to investors – the risk that material misstatements in the company's financials won't be prevented or detected in a timely manner.

By the way – managers and auditors *should* talk. And not just managements, but audit committees should have a healthy and ongoing dialogue with their auditors about the company's internal controls. There is no auditor independence rule, or any other rule or standard, that stands in the way of this kind of useful communication.

The comment periods for both the Commission and the PCAOB proposals closed on the same day – February 26 of this year. The Commission received 205 comment letters from a broad cross-section of investors, small companies and large companies, accountants, lawyers, regulators, and academics. About 70% of the respondents to the Commission's proposed guidance also provided comments to the PCAOB on its proposed auditing standards. The percentage that commented to both of us would have been higher, except that we received 48 letters from a class at the University of Wisconsin, who apparently found writing to the SEC a more appealing assignment than commenting to the PCAOB.

In our outreach to small business throughout this process, the SEC has been aided by the exceptional work of our Office of Small Business Policy in the Division of Corporation Finance. The Office of Small Business Policy is focused on making sure that the unique needs of small business are reflected in our rules, and in the interpretations and guidance we provide to the public. The Office of Small Business Policy served as the secretariat for the Commission's Advisory Committee on Smaller Public Companies, which issued its report to the Commission in April 2006. That report was the first to focus on the problems with section 404 implementation in a systematic way, and it has informed many of the solutions that we are now preparing to put into effect.

While the Commission hasn't yet made any final decisions based on the comments we've received, there are a few recurring themes in the letters that stand out.

First, there is overall support in the comment letters for the principles-based nature of the Commission's management guidance. Many commenters believe that this will encourage a healthy use of judgment and common sense in formulating the procedures companies use to evaluate whether material weaknesses exist in their internal control systems.

A significant number of commenters, however, are concerned that the principles-based guidance from the Commission may not be well-aligned with the more prescriptive auditing standards proposed by the PCAOB.

These commenters expressed concerns that having a more detailed auditing standard could drive managements to perform procedures or create documents during their evaluation process that would be unnecessary under the Commission's guidance. They believe managements may feel compelled to perform this unnecessary work, or to create documents solely so the auditors will have them during the subsequent audit process. Essentially, the commenters are concerned that having a more prescriptive auditing standard will needlessly drive up costs, especially for smaller companies. It would mean that the company and its investors either have to pay the auditor to do additional testing and documentation that wasn't required by the SEC's guidance, or the company will have to do that otherwise unnecessary work itself, so that it can be relied upon by the auditors.

Several suggestions were made in the comment letters about how to better align the Commission and PCAOB documents. Many of the comments focused on the need to

insure that after all of this effort we do not simply end up with, once again, an auditing standard that drives a significant amount of management's work. In particular, commenters suggested that the PCAOB allow auditors to use more professional judgment in determining the necessary amount of testing and documentation. In other words, they suggested making the audit standard less prescriptive by removing requirements that could lead to unnecessary documentation and testing.

Several commentators also noted that differences in certain definitions and terms in the proposals could be sources of confusion. These discrepancies between the SEC and PCAOB definitions of the same terms, they said, could also lead to over-documentation and over-testing. As a result, they asked that the Commission and the PCAOB more closely align our terminology.

Of special significance to this Committee is that the comments from the small business community generally were consistent with those received from other commenters. Almost three-fourths of the comment letters from small business interests (31 of 42) indicated that our proposed guidance would allow managements to tailor their evaluations to the facts and circumstances of their particular companies and focus on the areas that are most important to reliable financial reporting. Many of these commenters also noted the need to better align the Commission and PCAOB documents and to reduce the prescriptive nature of the PCAOB document, and suggested additional areas to be covered in the Commission's guidance.

Sixteen of the 42 comment letters representing the small business community also emphasized the need to allow sufficient time for smaller companies to consider the final guidance issued by the Commission, and the final revisions to the auditing standard adopted by the PCAOB, before they're required to implement the 404 reporting requirements.

We take all of the comments we've received seriously, and we're working hard to address these concerns.

Very recently, on April 4th, the Commission held an open meeting to review the general nature of the public comments and the work that remains to be done to address them. Chairman Olson and Jeff Steinhoff, the Managing Director for Financial Management and Assurance at the Government Accountability Office, also participated in that meeting. At the meeting, the Commission made it clear we're very pleased with the progress that we and the PCAOB are making in our collaboration, and we focused on just four remaining areas where we believe additional work is necessary:

- First, we need to better align the proposed PCAOB audit standard and the Commission's proposed guidance, as I just described.

- Second, we need to improve the discussion in the proposed auditing standard of how auditors can scale the audit procedures, which will be a particular benefit for smaller companies.

- Third, we need to do further work to insure it's crystal clear that auditors should use their professional judgment in determining audit procedures and testing based on their assessment of risk.

- And fourth, the auditing standard needs to use broader principles rather than prescriptive rules to describe when auditors may use the work of others. This last will ensure that auditors can rely, for example, upon work obtained from management's risk assessments and monitoring activities when those are found to be competent and objective.

In addition, in furtherance of the integrated audit that is contemplated by section 404, the Commission directed our staff to work with the PCAOB to ensure that there is better integration of the financial statement audit (which itself includes an assessment of internal controls) with the internal control audit required by the PCAOB.

We're pedal-to-the-metal on finishing this work, and we won't require smaller public companies to have a section 404 audit until the new guidance and the new auditing standard are available to them with plenty of time to prepare. As this Committee is aware, the Commission has carefully phased in application of the 404 reporting requirements. We have continued to defer 404 compliance for small companies. The result of our determination to phase in 404 for smaller companies is that we've had the opportunity to field test the requirements first. Now, we're using what we've learned to lessen the burden not only for smaller companies that will eventually comply with the requirements, but for companies presently subject to the requirements as well.

The rules the Commission adopted in December 2006 will permit smaller public companies – those with $75 million or less of public float – to postpone their first 404 audit until the first fiscal year ending after December 14, 2008. For calendar year end companies, this would mean March 2009.

In the meantime, those smaller companies can begin to get ready for full SOX 404 compliance by undertaking the less burdensome part of 404 beginning with their SEC reports the year after next. Specifically, smaller companies would file management reports on their internal controls along with their annual report for their first fiscal year ending after December 14, 2007. For calendar year end companies, this would mean March 2008.

One of the suggestions that has been made is that, even though as things now stand smaller companies won't be required to come into full compliance with SOX 404 until March 2009, the Commission should provide for a further extension of an additional year. If we were to do that, the first 404 audit reports wouldn't be filed until three years from now, beginning in March 2010.

In the Commission's release last December, when we issued the latest rules on the timing of these requirements, we stated that if we have not issued additional guidance for

management on how to complete its assessment of internal controls in time to be of sufficient assistance in connection with annual reports for 2007, we will consider whether we should further postpone the requirement. That remains true today.

We also stated that we would consider further postponing the requirement of eventual 404(b) compliance after considering the PCAOB's anticipated revisions to the auditing standard – and that remains true as well.

But that's not Plan A. As I described, we're working diligently to provide both guidance for managements and a new auditing standard in time for companies and their auditors to use them in connection with annual reports to be filed in 2008. In the next few weeks, we intend to finish our work on management's guidance, and to coordinate those efforts with what should be a new AS 5 adopted by the PCAOB. We aim to implement section 404 just as Congress intended: in the most efficient and effective way to meet our objectives of investor protection, well-functioning financial markets, and healthy capital formation by companies of all sizes. We won't forget the failures that led to the passage of the Sarbanes-Oxley Act in the first place. And we won't forget that for small business to continue to prosper in America, both strong investor protection and healthy capital formation must go hand in hand.

The reforms we're making to the SOX 404 process are intended to be of direct benefit to America's small businesses – and the millions of Americans who work for them, invest in them, and benefit from all that they provide to our economy. We're re-orienting 404 to focus on what truly matters to investors – and away from expensive and unproductive make-work procedures that waste investors' money and distract attention from what's genuinely material. No longer will the 404 process tolerate procedures performed solely so someone can claim they considered every conceivable possibility.

Mr. Chairman, these next few weeks are a critical time for small business as we approach the finish line in our work to rationalize 404. We look forward to working with you in the days ahead on these issues, as well as on the other important issues facing our nation's small businesses. Thank you again for the opportunity to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

Chairman KERRY. Thank you very much, Mr. Cox.
Mr. Olson?

STATEMENT OF THE HONORABLE MARK W. OLSON, CHAIRMAN, PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

Mr. OLSON. Thank you very much, Chairman Kerry, and members of the Committee, for inviting us to be here. It is a privilege to be here with Chairman Cox. We have had the opportunity to work on this important issue and I have been pleased at the amount of time that he has accorded this issue in order that we can achieve, as you appropriately pointed out, the retention of transparency in the U.S. capital markets while at the same time making the cost consistent with the incremental benefit.

We look at our charge as the overseer of the accounting profession with a very significant small business focus. First of all, from the standpoint that, as you know, every accounting firm, auditing firm, that either audits or wishes to audit a company that is publicly traded must register with us. There are over 1,700 firms around the world that have registered with us, and of that number,

just under 1,000 of them are domestic and they come from all over the country. As a matter of fact, of that number, we have—let me see, there are, regrettably, zero from South Dakota, but 21 from Tennessee, 10 from Minnesota, 31 from Massachusetts, 1 from Montana, 11 from Indiana, and 2 from Arkansas. So as you can see, they do cover all of America and most of them are very small.

Of the number, only a handful, about 125, audit more than five publicly-traded companies. The foundation of the statute is that if you choose to access the capital markets, there is an expectation for the level of internal controls that you are expected to have, and the external auditor is expected to opine on that. This is not an unreasonable expectation for accessing the U.S. capital markets and it is perfectly consistent, I think, with what you said earlier about maintaining the transparency of the markets while at the same time maintaining confidence in the markets. Senator Tester called it a delicate balance and we believe that is exactly the case.

With respect to small businesses and small firms, unquestionably, the factors of scale alone will mean that the burden will fall disproportionately to the smaller firms if it is not addressed. I think your 13 cents per hundred for the large businesses and a dollar per hundred for the small businesses is probably pretty accurate in terms of cost if we do not pay specific attention to them. I would like to focus on the manner in which we have done that so far and then talk about some of the things that we can continue to do in the future.

First of all, we have had small business audit forums around the country for the last several years. We have had 19 forums in 14 cities, and those forums have helped the small firms learn how they can do audits in the post-Sarbanes-Oxley environment. We have had 1,400 auditors attend, and in many cases, we have also had representatives of audit committees attend.

The manner in which we do the supervision, or oversight, of the small firms is very different from the larger firms. In many of the cases, we do not need to be intrusive to the point that we need to be on site. Much of it can be off-site. The manner in which we do the inspections is consistent with the level of involvement that they have with publicly-traded companies.

We are in the process now, and I think that this is very key, of developing guidance for auditors of small public companies. The guidance we are developing is through the volunteer efforts of 12 practitioners from 12 firms around the country who are looking at the scalability of the small audits and trying to make sure that we can define, in a very specific way, how they can be scalable and, cost effective for the smaller public companies. That is due to be made public later this year.

Chairman Cox talked about some of the goals for a revised Standard AS2, which will be replaced by what we expect will be AS5. We will help address that as well.

AS5 will be focused on controls that really matter. It will be written in understandable language as opposed to audit-speak, and we think that this will help in the manner in which audit committees or CFOs work on the engagement with the external auditor. Ultimately, working with the SEC, I am very confident that we will get the words right.

But as you suggested, the devil is in the details. Implementation is really key; that is going to involve PCAOB and the SEC with our respective guidance that we are putting out. Very importantly, it will involve the firms themselves. The issue is for the firms to recognize that there is an expectation for a certain level of internal controls that hopefully will be respected and appreciated.

Very importantly, the auditing firms need to be involved. They need to be involved in the sense that they need to scale the manner in which they are making the audits more efficient. Just today, Mr. Chairman and members of the Committee, we issued what we call a 4010 Report where we have summarized some of what we noticed in the efficiencies of the audits as they were done in 2006, and we pointed out in a very specific way how the efficiency has been improved and pointed out ways that it can be even more improved.

As Chairman Cox said, this is at least the third time, I think, that the Congress has mandated an expectation that there will be a requirement for internal controls over financial reporting, FDICIA was the next-to-the-last and the Foreign Corrupt Practices Act was the first.

One final point I would like to make gets to the U.S. competitiveness issue. In the relatively brief period of time that the PCAOB has been functioning, we have noticed that in almost all the developed countries of the world there has been a PCAOB-like organization started. As capital markets improve around the world, we are also finding around the world that there is a need for a government-mandated entity that would focus on oversight over the accounting and auditing professions.

Next month, we will be holding a workshop here in the United States for our peers around the country. It can be a learning experience for all of us. Interestingly, there are people from 44 different countries who represent organizations like the PCAOB who are coming here to participate in the workshop.

Mr. Chairman, that concludes my statement. We have a formal statement that we have submitted for the record. I would be happy at this point to answer any questions.

[The prepared statement of PCAOB Chairman Olson follows:]

Testimony Concerning
The Sarbanes-Oxley Act of 2002
and Its Impact on Small Businesses

PCAOB
Public Company Accounting Oversight Board

Mark W. Olson
Chairman
Public Company Accounting Oversight Board

Before the
Committee on Small Business
And Entrepreneurship

United States Senate

April 18, 2007

Chairman Kerry, Ranking Member Snowe, and Members of the Committee:

I am pleased to appear on behalf of the Public Company Accounting Oversight Board ("PCAOB" or the "Board") to speak about the impact of the Sarbanes-Oxley Act of 2002 (the "Act") on small business, and, in particular, the PCAOB's oversight of small audit firms. I am also pleased to join Chairman Cox before you today. The PCAOB works closely with the Securities and Exchange Commission ("SEC") to achieve our shared goal of protecting the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements.

I. Introduction and Background

This Committee's focus on small business and entrepreneurship and the Committee's particular focus today on the impact of the Act are both appropriate and very timely. The PCAOB, along with our colleagues at the SEC, are in the final stages of replacing Audit Standard 2, which I will later describe in greater detail. A priority concern that triggered our current efforts is the desire to assure that the audit standard mandated by the Act can be conducted in a manner consistent with the size and complexity of America's small publicly traded companies.

Mr. Chairman and Committee members, we see two important dimensions to the PCAOB focus on small business. First, of the 1,000 plus domestic audit firms that have registered with the PCAOB, the overwhelming majority are small firms. While our experience in examining these firms varies to some extent, we are reassured to

discover that many very small firms provide audits of consistently high standard for their clients, many of whom are small businesses.

The second dimension of our small business focus is our recognition that these small businesses constitute the largest segment of entities impacted by our audit standards, and we need to be cognizant of their needs as we develop the standards.

With more than half of all American households invested in U.S. public companies,[1/] the discoveries of financial reporting and auditing improprieties at numerous public companies earlier this decade sweiled in 2002 to a national crisis in confidence in the integrity and reliability of public companies' financial statements. Widespread investor risk aversion across markets adversely affected innovation and the economy more broadly.[2/] This led to a predictably strong response on the part of the investing public, as well as boards of directors at public companies, the accounting profession, regulators, and Congress. There was an increased recognition of the need to bolster internal controls over financial reporting and bring an enhanced focus to corporate governance. Congress reacted by passing the Act, which among other things

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1/ Due to the expansion of defined contribution plans and other incentives, nearly 57 million U.S. households own stocks directly or through mutual funds, according to a study by the Investment Company Institute and the Securities Industry Association. See *Equity Ownership in America: 2005* (November 2005), *available at* http://www.ici.org/pdf/rpt_05_equity_owners.pdf.

2/ By all measures, the forward risk premium for the S&P 500 swelled in October 2002 to nearly double the historical mean. The forward risk premium reflects the additional risk that investors perceive exists in the stock market, as compared to the bond market. See Monthly Earnings Report, Lehman Brothers, at p. 72 (April 7, 2004). The effect of this risk aversion was not limited to U.S. markets. For example, in 2002 it led to the collapse of Germany's Neuer Markt, a young stock market designed to provide capital opportunities for small European companies and thus to compete with U.S. markets for shares of new "dotcoms" and other technology companies. See Benoit, B., Skorecki, A., and Stafford, P., "Deutsche Borse to Close Neuer Markt Next Year," Financial Times (September 27, 2002).

established the PCAOB to replace the audit profession's self-regulatory model with an independent oversight system.

The PCAOB's mandate is to oversee the auditors of public companies, in order to protect the interests of the investing public in the preparation of informative, accurate and independent audit reports on public company financial statements. The PCAOB does not set accounting standards or regulate disclosures by public companies; rather, its role is to enhance the quality of the audits of those companies. Simply put, the PCAOB's job is to improve the quality and reliability of public company audits, so that investors can have more confidence in audited financial statements. High quality financial disclosure by public companies is a cornerstone of U.S. capital markets and is necessary for the continued growth and competitiveness of the U.S. economy.

With that brief history as context, I would like to devote my time today to describing the PCAOB's programs, with a particular focus on the PCAOB's approach to small audit firms. In addition, I will describe the PCAOB's efforts, together with the SEC, to implement the provisions of the Act related to internal control, again with a particular focus on preparations for small companies and their auditors to implement those provisions, according to the timetable established by the SEC.

II. The PCAOB's Auditor Oversight Programs Foster a Dialogue with Small Audit Firms to Help Them to Improve Their Audits and Compete in the Market to Provide Public Company Audit Services.

Subject to the oversight authority of the SEC, the Board is responsible for --

- Registering audit firms that prepare audit reports for U.S. public companies;

- Establishing, by rule, auditing and related professional practice standards relating to the preparation of audit reports for U.S. public companies;
- Conducting inspections of registered firms;
- Conducting investigations of, and imposing appropriate sanctions where justified upon, registered firms and associated persons of such firms.

I will focus my remarks today on the PCAOB's oversight and interaction with small firms in particular.

A. More Than 1,700 Accounting Firms Have Registered with the PCAOB.

Early concerns that independent oversight might deter firms, particularly smaller firms, from continuing to audit public companies have not been borne out. On the contrary, since the PCAOB opened its doors in January 2003, it has registered more than 1,700 accounting firms that audit, or wish to audit, U.S. public companies. Of these firms, about 1,000 are U.S. firms. The firms vary dramatically in size. Some are multi-office regional firms with several, and sometimes a great number of, partners and professional staff, and others are sole practitioners with no professional staff. Only about 125 of these firms had more than five public company clients at the time they registered. In addition, more than 450 of these firms registered even though they were not the auditor of record for a public company at the time they registered.[3/]

[3/] Importantly, the PCAOB's rules related to registration were designed with care not to impose unnecessary impediments for small firms. Thus, while a registering firm must demonstrate that the Board's approval of its application is consistent with the Board's responsibilities under the Act to protect the interests of investors and to further the public interest in the preparation of informative, accurate, and independent audit reports, firms need not have a current public company audit client in order to register.

The PCAOB has observed that the market is improving for small audit firms registered to audit U.S. public companies. While the Big Four firms audit most public companies, they have reduced their public company audit client base over the past few years. At the same time, the next four and even smaller firms have increased the number of public companies that they audit.[4/] Indeed, within the last year, two registered firms have grown their audit practices to such an extent that they now issue audit reports for more than 100 public companies, which triggers the requirement under the Act and the Board's rules that the Board conduct annual inspections of those firms.

Smaller firms are likely to continue to seize opportunities to expand their businesses by taking on new clients appropriate to the size and sophistication of the firms' practices. At the same time, for their business growth to reach its full potential, the firms must understand and know what is expected of them within the Sarbanes-Oxley and PCAOB framework. For smaller firms, the adjustment to that framework can give rise to issues and questions different from those for the larger firms.

B. The PCAOB Uses Outreach to Small Firms and the Small Business Community to Provide Information About PCAOB Activities and Seek Insight on Small Business Concerns and Challenges.

The PCAOB has established an ambitious outreach effort directed toward small registered firms and their audit clients to address their unique issues and questions. These one- and two-day discussion sessions, called Forums on Auditing in the Small

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[4/] See Yellow Card Trend Alert, Glass, Lewis & Co., at 1 (Feb. 15, 2005). According to this study by Glass, Lewis & Co., in 2004, Big Four firms reduced their public company audit clients by 400, the next four firms added overall, net, 117 public company audit clients, and all other accounting firms had a net gain in public company audit clients of 217.

Business Environment, follow an in-depth curriculum on PCAOB activities and developments. They have provided an avenue for small registered firms and small public companies to obtain a better understanding of the workings of the PCAOB, and they have fostered a robust dialogue that has given the PCAOB valuable insights to apply in its programs. In addition, I believe the Forums have better equipped firms with information to address the challenges of the new regulatory environment.

To date, the PCAOB has held 19 Forums in 14 metropolitan areas across the country. Nearly 2,000 people involved in the small business community have attended the Forums, including about 1,400 auditors from smaller public accounting firms. Based on positive feedback from participants, the PCAOB intends to continue to hold Forums to further the PCAOB's dialogue with such firms and companies.

C. The PCAOB's Supervisory Inspection Program Helps Small Firms Focus on Audit Quality Necessary to Compete in the Market to Provide Public Company Audit Services.

While the Forums reach small firm auditors in a group environment, PCAOB inspections foster an even deeper, one-on-one dialogue between the PCAOB and small registered firms. Under the Act and the Board's rules, firms that audit the financial statements of 100 or fewer public companies are subject to inspection at least once every three years. The PCAOB has taken a supervisory approach toward implementing its inspection program. In these inspections, the PCAOB has observed first-hand how some small firms distinguish themselves professionally and competitively by performing high-quality audits. In other cases, PCAOB inspections identify areas in which firms

should do better. For those firms that strive to improve the quality of their audits and their ability to compete for public company audit clients, the supervisory dialogue throughout the inspection process helps them to do so.

While the PCAOB's inspection program is the core of its supervision of registered firms, these inspections take place largely outside the public view. This is because the Act mandates a significant degree of confidentiality relating to inspection information. One particular provision relates to any portion of a PCAOB inspection report that describes criticisms of the firm's system of quality control. Under the Act, a firm has one year to show that it has satisfactorily addressed those criticisms, and if it does so those criticisms remain nonpublic. This remediation mechanism reflects Congress's policy decision to use the possibility of public disclosure as an incentive to firms to address systemic problems.[5/] It has proven to be a key tool to motivate firms to do better. When the PCAOB identifies problems, firms typically take those criticisms seriously and make substantial changes within a year.

Under the Board's supervisory approach, it is able to use its inspection process to address most of the individual, or isolated, auditing problems identified, without the need to invoke its disciplinary authority to enforce applicable laws and standards. For

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[5/] In order to give the public an understanding of how this incentive works, last year the Board described its experiences in monitoring firms' efforts to address problems identified in the first year of inspections. *See* PCAOB Release No. 104-2006-078, Observations on the Initial Implementation of the Process for Addressing Quality Control Criticisms within 12 Months After an Inspection Report, March 21, 2006, available at http://www.pcaobus.org/Inspections/ Public_Reports/2003/2006-03-21_Release_104-2006-078.pdf; *see also* PCAOB Release No. 104-2006-077, The Process for Board Determinations Regarding Firms' Efforts to Address Quality Control Criticisms in Inspection Reports, March 21, 2006, available at http://www.pcaobus.org/Inspections/2006-03-21_Release_104-2006-077.pdf.

example, when an individual audit is not up-to-grade, inspectors discuss with the firm precisely what the deficiency is. Sometimes this means a firm will perform additional audit procedures to shore up a weak audit. When the problem relates to an individual auditor, a firm may provide additional training to or supervision of the person involved or take other action the firm determines is appropriate. Thus, the PCAOB inspection process has been able to prompt and facilitate firms' achievement of significant real-time improvements, often even before an inspection is concluded.

D. The PCAOB Develops Auditing and Related Professional Practice Standards with the Needs and Challenges of Small Firms in Mind.

The Act directs the Board to establish certain standards for use by auditors of public companies. Those include standards for auditing and related attestation work, standards for quality controls, ethics standards, and independence standards. In order to ease firms' transition to independent oversight, early in the Board's first year of operation, in 2003, the Board adopted as interim standards certain auditing and related professional practice standards that had been developed and adopted by the auditing profession prior to the establishment of the PCAOB. These are standards with which audit firms large and small were already familiar, as they existed on April 16, 2003.[6/]

[6/] In summary, these are: Generally Accepted Auditing Standards (or, "GAAS") as previously established by the American Institute of CPAs ("AICPA"); Attestation Standards and related interpretations and Statements of Position as previously adopted by the AICPA; the AICPA's Statements on Quality Control Standards and certain AICPA SEC Practice Section membership requirements; certain provisions of the AICPA's Code of Professional Conduct on integrity and objectivity, and the standards and interpretations of the Independence Standards Board.

Since adopting this body of pre-existing standards, the Board has adopted four new standards[7/] as well as new ethics and independence rules relating to tax services and contingent fees. To develop new standards and rules, the Board uses a standards-setting process that provides for public input at a variety of stages. In particular, three times a year the Board holds a public meeting with its Standing Advisory Group.[8/] The advisory group's 31 members are drawn from a cross-section of the nation's companies – small and large – as well as auditors from small and large accounting firms, investors and their advisors, academics, and others. These individuals share their informed opinions on how the Board, consistent with its mandate, can improve the quality of audits, including by advising on best practices and emerging issues. Many of the advisory group's discussions have focused on matters related to small business and the audits of small registered firms. On occasion, they have also included dedicated panels of small firm auditors who can offer their insights on best practices and their experiences with the unique challenges the small business community faces.[9/]

7/ Specifically, the Board's Auditing Standard No. 1 relates to references in auditors' reports to the standards of the PCAOB; Auditing Standard No. 2 relates to audits of internal control over financial reporting; Auditing Standard No. 3 relates to audit documentation, and Audit Standard No. 4 relates to auditors' reporting on whether a previously reported material weakness continues to exist. They are available on the Board's Web site at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/index.aspx, along with the Board's new ethics and independence rules.

8/ The Board convened its Standing Advisory Group pursuant to Section 103(a)(4) of the Act. The Group consists of experts in auditing and financial reporting, including individuals with experience at institutional investors, accounting firms, and public companies.

9/ The Board also participates as an observer of other agencies' initiatives to examine issues germane to the small business community, including the SEC's Advisory Committee on Smaller Public Companies, the Committee of Sponsoring Organization's Task Force on Guidance for Smaller Public Companies, and the Financial Accounting Standards Board's Small Business Advisory Committee.

In addition to seeking the views of its advisory group members and other interested persons, the Board seeks public comment on proposed new standards and rules, makes those comments publicly available on its Web site, and considers them before adopting final standards or rules. Board standards are also subject to SEC review, and they do not go into effect unless they are approved by the SEC.[10/]

III. The PCAOB's Role in Implementing the Act's Internal Control Requirements

I would like to devote the remainder of my time today to the PCAOB's role in implementing, through its auditing standards, the provisions of the Act related to internal control over financial reporting. In particular, Section 404 of the Act requires public companies annually to provide investors an assessment of their internal control over financial reporting, accompanied by an auditor's attestation on the same subject.

A. The Act's Internal Control Reporting and Auditing Requirements

The term "internal control over financial reporting" refers to a company's system of checks and processes designed to protect corporate assets, keep accurate records of those assets as well as its financial transactions and events, and prepare accurate periodic financial statements. Investors can have much more confidence in the reliability of a company's financial statements if management demonstrates that it maintains adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets, and the safeguarding of company assets. Indeed, research

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10/ In most cases, applicable securities laws and rules provide for the SEC to publish PCAOB rules and standards for public comment as part of the SEC's consideration and approval process.

shows that disclosures about the reliability of internal control have a significant effect on companies' cost of capital.[11/]

Companies have been required to have internal control over their accounting since Congress enacted the Foreign Corrupt Practices Act in 1977. There is no doubt, however, that the Sarbanes-Oxley Act's requirement for annual assessments, and auditor attestations to those assessments, took corporate responsibilities for internal control over financial reporting to an entirely different level.

As directed by Section 404(a) of the Act, in June 2003 the SEC established rules describing companies' required assessments. In March 2004, the PCAOB implemented Sections 103, requiring an auditing standard on internal control, and 404(b) of the Act by establishing a new auditing standard – Auditing Standard No. 2 – to provide for an audit of internal control over financial reporting integrated with the audit of the financial statements themselves. The SEC approved Auditing Standard No. 2 in June 2004.[12/] For large, established companies – which the SEC calls accelerated filers – the initial

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11/ See Ashbaugh-Skaife, Collins, Kinney and LaFond, The Effect of Internal Control Deficiencies on Firm Risk and Cost of Equity Capital (April 2006, updated February 2007). Specifically, the researchers found that when companies report they have corrected a previously reported material weakness in internal control, their cost of capital goes down on average 1.5 percent. Conversely, when companies report material weaknesses in audited financial reports after they had previously reported in unaudited statements that internal control was effective, their cost of capital goes up on average almost 1 percent (93 basis points).

12/ See SEC Release No. 34-49884, Order Approving Proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (June 17, 2004).

assessments and attestations were required by SEC regulations to be included in their annual Form 10-K filings for fiscal years ending after November 14, 2004.[13/]

The SEC has delayed implementation for smaller companies, i.e., the non-accelerated filers. Such companies have until they file financial statements for a fiscal year ending on or after December 15, 2007, to file their first management assessments of internal control. In addition, the SEC will not require such companies to file audit reports on such assessments until they file financial statements for a fiscal year ending on or after December 15, 2008.[14/]

B. Although the Act's Internal Control Reporting Requirements are Not Yet Applicable to Small Companies, the PCAOB Has Used Its Experience Monitoring Large and Mid-Cap Company Implementation to Revise Its Auditing Standard and Develop Tailored Guidance with Small Companies In Mind.

Notwithstanding this delay, there is considerable concern among small public companies about implementing the Act's internal control reporting requirements. For its part, the PCAOB has monitored implementation by companies that are subject to the requirements, among other things with a view toward easing implementation challenges

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13/ Accelerated filers (and large accelerated filers) generally include companies with an aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer (referred to as "public float") of $ 75 million or more, as of the last business day of the issuer's most recently completed second fiscal quarter. See SEC Exchange Act Rule 12b-2, 17 C.F.R. 240.12b-2; see also SEC Release 33-8644, Revisions to Accelerated Filer Definition and Accelerated Deadlines for Filing Period Reports (December 21, 2005) (amending definition of "accelerated filer" to distinguish between "accelerated filers" and "large accelerated filers," which have a public float of $700 million or more). According to the SEC, approximately 44% of domestic companies filing periodic reports are non-accelerated filers. See SEC Release No. 33-8760, Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers and Newly Public Companies (December 15, 2006), at 11.

14/ See SEC Release No. 33-8760, Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-accelerated Filers and Newly Public Companies (December 15, 2006).

smaller companies may face. To this end, based on that experience, the PCAOB recently proposed a revision of its auditing standard on internal control and is developing specialized guidance and training for auditors of small companies.

1. The PCAOB Has Monitored Auditors' Implementation of Auditing Standard No. 2 and, as Needed, Provided Guidance.

In the nearly three years since the SEC's rule on management assessments of internal control and the Board's related auditing standard went into effect for accelerated filers, the Board has closely monitored the challenges that those companies and their auditors have faced. As appropriate, the PCAOB has provided additional guidance to facilitate implementation. In this regard, the Board's staff has issued five sets of interpretive guidance that answer 55 frequently asked technical questions on the implementation of Auditing Standard No. 2.[15/] In addition, on May 16, 2005, the Board issued a policy statement describing ways auditors can make their internal control audits as effective and efficient as possible.[16/]

The PCAOB has also used its inspections of larger firms to monitor firms' implementation of the Board's auditing standard on internal control. To this end, the PCAOB issued a report on its inspections and other monitoring, on November 30, 2005.

15/ These questions and answers are available at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx.

16/ See PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2 (May 16, 2005).

That report describes best practices and provides additional guidance on how auditors can make their work more efficient.[17]

The PCAOB's monitoring has also included participating, along with the SEC, in two roundtable discussions with representatives of public companies, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies, including the Government Accountability Office's April 2006 report to this Committee on Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, and the Final Report of the SEC's Advisory Committee on Smaller Public Companies issued the same month.[18]

2. *The Board Has Proposed a Revision of Its Standard, to Promote Efficiency and Eliminate Unnecessary Procedures.*

The Board is determined to make internal control audits as cost-effective as possible for companies that are required by the SEC's rules to obtain an audit report on internal control. Therefore, based on its experience monitoring implementation, on

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[17] See PCAOB Release No. 2005-023, Report on the Initial Implementation of Auditing Standard No. 2 (November 30, 2005), available at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf. Importantly, in the first of those reports, issued after the first year of implementation, the Board found that many auditors faced tight deadlines, staffing and other resource constraints, and significant training needs. Moreover, their clients faced similar hurdles that were, in many cases, exacerbated by having to make up for deferred maintenance on internal control systems that had not kept up with the company's growth and development.

[18] See GAO, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies (April 2006, GAO-06-361); Final Report of the Advisory Committee on Smaller Public Companies (April 23, 2006), available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

December 19, 2006, the Board proposed a revision of its auditing standard on internal control, along with related amendments and rules.[19/] Among other things, the proposed standard includes explicit guidance on scaling audits to reflect the attributes of smaller, less complex companies. In addition, the proposal is designed to –

- **Focus the audit on the matters most important to internal control** by, among other things, directing the auditor's testing to the most important controls; emphasizing the importance of risk assessment; revising the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness; and clarifying the role of materiality, including interim materiality, in the audit;

- **Eliminate unnecessary procedures** by, among other things, removing the requirement to evaluate management's process; permitting consideration of knowledge obtained during previous audits; refocusing the multi-location testing requirements on risk rather than coverage; removing barriers to using the work of others; and recalibrating the walkthrough requirement;

- **Simplify the requirements** by, among other things, reducing detail and specificity; better reflecting the sequential flow of an audit of internal control; and improving readability.

The Board has received thoughtful public comment on the proposal and, after considering those comments, expects to finalize a new standard in the near future.

3. The Board Plans Guidance for Auditors of Small Companies.

Based on the experience of small companies and auditors who have been – and are currently going – through the process of evaluating internal control, the Board is also working with practitioners to develop tailored implementation guidance for audits small public companies. This guidance should emphasize the scalability of internal

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19/ At the same time, the SEC has proposed guidance that can be used by management in making the assessment required by Section 404(a) of the Act. See SEC Release No. 33-8762, Management's Report on Internal Control Over Financial Reporting (December 20, 2006).

control audits at a practical level, by providing auditors with examples of how the internal control audit process can and should be scaled to fit the relative sizes of small companies, from those that are on the cusp of accelerated filer status to those that have merely a handful of employees. The PCAOB is targeting publication of this guidance later this year, after the proposed revised standard is finalized.

Finally, the Board is exploring various means of facilitating training for auditors of smaller public companies on auditing internal control. With constructive, practical guidance, the Board hopes that small companies and their investors will be able to reap the benefits of internal control reporting without unnecessary costs.

IV. Conclusion

The PCAOB works hard to achieve the objectives Congress set for it in the Act. The oversight program it has in place is reducing the risk of financial reporting failures and renewing confidence in the financial reports of public companies and, ultimately, in the U.S. securities markets. The Board continues to assess its oversight programs, however, and in doing so it takes into account the effect on, and perspective of, the small business community. As I have described, the Board has and will continue to make appropriate adjustments to assure that it achieves the objectives of the Act in the most effective and efficient manner possible. In particular, the Board is committed to ensuring that its standard on internal control lays the foundation for efficient audits that are cost-effective for small business and maintain the benefits intended by the Act.

Thank you. I will be pleased to answer any questions.

Chairman KERRY. Thank you very much, Mr. Olson.

That was very helpful, both testimonies, and we appreciate them very much.

Senator Snowe is now here. Senator, do you want to wait and sort of gather for a minute——

OPENING STATEMENT OF THE HONORABLE OLYMPIA J. SNOWE, A UNITED STATES SENATOR FROM MAINE

Senator SNOWE. Thank you, Mr. Chairman. I appreciate it and I am going to dispense with my opening statement, but I want to thank you for holding this hearing today because this is a critical issue that has an enormous impact on small public companies.

I want to welcome Commissioner Cox, with whom I have had the privilege of serving in the U.S. House of Representatives. I am delighted that he is continuing his record of standing public service to the SEC. To Chairman Olson, thank you for your contributions and charting a new course as Chair of the Public Company Accounting Oversight Board, so we thank you very much.

These are critical issues and I will get into it in my questioning. We obviously have to address the challenge of harmonizing the regulations and the direction from both the SEC and from the Board itself. That is one of the issues that I have heard from the small business community in my State and across this country. It is creating a lot of confusion and the impact of the cost compliance is becoming exorbitant for many small public companies that otherwise should be channeling their resources in the direction of job creation and innovation rather than paying the unnecessary expenses associated with regulatory compliance. I have introduced a bill to address the impact of the regulations on small public companies, as well, because I think that these carts should be assessed along the way.

But we will get into that in the questions and I thank you both for being here and the other witnesses, as well. Thank you, Mr. Chairman.

[The prepared statement of Senator Snowe follows:]

Senator Olympia J. Snowe
Senate Committee on Small Business and Entrepreneurship
Hearing on "Sarbanes-Oxley and Small Business: Addressing Proposed Regulatory Changes and their Impact on Capital Markets"
April 18, 2007

Opening Statement

Good morning. Thank you Senator Kerry for holding this critical hearing to analyze the proposed regulatory changes for small businesses and their impact on capital markets. Our nation's small stock companies are the cornerstone of our entrepreneurial economy, and it is essential that we carefully address the regulatory barriers that impede their growth. This hearing is also timely as the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) are finalizing rules that will mandate how small public companies must comply with the Sarbanes-Oxley Act's internal control requirements.

I want to welcome all of our witnesses, and express our deep gratitude to them for participating this morning. I especially want to recognize and commend Commissioner Cox's tremendous efforts. On a personal note, let me just say how much I, along with many others, appreciated then-Congressman Cox as an esteemed colleague in the U.S. House of Representatives. I am pleased that he is continuing his record of public at the SEC.

I also want to thank Chairman Olson for being here today. In the short 10 months he has served, Chairman Olson has worked diligently to include small companies in the regulatory formulation process by holding field tests, inspections, and carefully considering small companies' comment letters.

Commissioner Cox, since beginning your tenure you have demonstrated concern for small companies. You established the Advisory Committee on Smaller Public Companies, and have worked with the PCOAB to hold public meetings on this issue – where, I understand, many passionate small business

owners spoke their minds! I also want to thank the SEC for taking the time recently to answer the questions posed by a small company from Presque Isle, Maine, about the proposed rule changes. Chairman Cox, I want to thank you for encouraging your staff to be accessible to these companies and I look forward to our continued collaboration on this issue.

I believe that the Sarbanes-Oxley Act was essential in restoring investor confidence after accounting fraud and massive company deceptions shook the public's trust in U.S. markets. The horrendous debacle of corporate greed from companies like Enron and Worldcom forced not only thousands of employees to lose their jobs, but also wiped out the life savings of many retirees. Now, as we refine Sarbanes-Oxley's regulations, we must carefully preserve investor protections and ensure company transparency and accountability.

In my home state of Maine, small publicly-traded companies are indispensable to the strength and renewal of our economy. However, the fact is these small stock companies are struggling with the cost of Sarbanes-Oxley compliance, regardless of their industry. Whether it's a utility company, a dairy pharmaceutical company that makes large animal vaccines, or a community bank that fears being smothered by the combined weight of Sarbanes-Oxley and banking regulations, it is crucial that Maine's home grown companies focus their energies on developing new products, entering new markets, and creating jobs – not on compliance.

Regulations disproportionately affect small businesses and significantly hinder their competitiveness. In 2004, Senator Enzi and I jointly requested that the Government Accountability Office study the effects of the Act on small public companies' access to capital. As this chart demonstrates, the study found that the costs for complying with Sarbanes-Oxley were nine times greater for smaller companies than for large stock companies. We must reduce the burden imposed by Sarbanes-Oxley so that our small stocks in Maine, and nationally, continue to be some of the world's fastest growing and most innovative companies.

Commissioner Cox and Chairman Olson, I have been a measured advocate for refining and "right-sizing" Sarbanes-Oxley regulatory requirements for small businesses. However, for these reforms to work, it is absolutely paramount for our nation's small businesses that the SEC and the PCAOB harmonize its final rules. Currently, many small businesses are concerned that while the SEC's pending guidance is too vague -- and conversely that the PCAOB's requirements are too specific. It is imperative that the two organizations' final requirements do not create conflicting standards which lead to confusion, waste, and additional, unnecessary expenses for small companies in order to achieve regulatory compliance.

Additionally, I believe small companies will require time to understand and implement the final guidance that is scheduled to be issued by the SEC and PCAOB in June. I urge the SEC to extend small public companies' compliance date by up to one year after final rules are published.

Frankly, the impact of the SEC's and PCAOB's forthcoming final rules on small companies must be thoroughly considered and evaluated. In an effort to facilitate that process, I plan to introduce the Small Business Regulatory Review Act. Before issuing final guidance, my bill would mandate the SEC to assess the cost of its rules under the Regulatory Flexibility Act, and publish a small business compliance guide to help small companies implement these new rules. It would also require the GAO to subsequently investigate how these requirements are impacting small public companies.

These review measures will help to assure that small stock companies do not suffer from additional unintended consequences which harm their ability to compete, innovate, and grow.

I'd like to again thank our witnesses for their attendance. I look forward to your testimony.

Chairman KERRY. Thank you very much, Senator Snowe.

We will try to proceed as quickly as we can, maybe 5-minute rounds to start with and if we need more time, I am happy to open it up to do that.

I want to start. I appreciate the testimony of both of you, and it is helpful. As a starting principle, an awful lot of small businesses that we meet with say to us, "Senator, I am not a big corporation. I don't have the same money. I can't afford all of this. I am just starting up. I don't have as much working capital. These guys can afford all of these accountants," et cetera. You have set a principle here, which I think is important for us to air as a threshold principle with which we are dealing, which is essentially: If you want to get into the marketplace, if you decide to go public, there is a standard of behavior that you have to adhere to.

Is it fair to say that has to be without regard to cost and therefore, you are loath to draw a distinction between the big companies and the small companies, so everybody in the marketplace is the same? Is that a fair statement?

Mr. OLSON. The audit itself, Mr. Chairman, should be very idiosyncratic and it should be based on the size and complexity of the individual firm. We have heard examples of relatively small companies that have, for instance, a very high degree of complexity if they are doing a lot of derivative activities. We have also heard of simple companies that are accelerated filers. In other words, they have passed the threshold of being very large, but in fact, they are a very uncomplicated company. And so the audit itself ought to reflect that complexity——

Chairman KERRY. And you are saying it doesn't today?

Mr. OLSON. No, it can and increasingly can. It was the initial expectation that it could, but that is exactly what we are trying to do in the rewriting of the AS5. We are in a very specific way describing how it can be more risk-focused and how it can be designed for the particular complexity and size of the company involved.

Chairman KERRY. I see. So in the end, there will be a variation, but the variation will not be defined by the per se size of the company. It will be defined by sort of what the company is engaged in and what kind of activities it is involved in. Is it fair to say that the discretionary audit standard is going to be applied?

I say discretionary because in reading Chairman Cox's four areas, the four areas that you say—or the four remaining areas where we believe additional work is necessary are not inconsequential areas. The one in particular that leapt out at me was that we need to do further work to ensure it is crystal clear that auditors should use their professional judgment in determining auditor procedures and testing based on their assessment of risk. That seems to sort of restore or put back in place a fairly large measure of discretion. I assume that is the purpose of it.

Mr. OLSON. That is the purpose of it. What the starting point——

Chairman KERRY. Is there a danger in that, where you go back to where we were?

Mr. OLSON. The starting point is the management itself defining its critical controls, and then the auditor would come in and attest to management's assertions as to the adequacy of those controls.

What PCAOB does is provide the standard that the external auditor would come in to do in order to make that determination.

What we have now, and they have to be looked at in combination, is the management guidance provided by the SEC which anticipates that the management will have a very clear hands-on understanding of which controls are key. In addition, PCAOB has defined a standard as to how you could do the audit but with an emphasis on how you can identify the key controls and not simply make a recitation of all the controls.

Chairman KERRY. So what happens, Mr. Chairman, if the auditor and the management disagree on what either risk is?

Mr. OLSON. That could well happen, and that is a negotiated process in a sense. But also, what the external auditor is doing is applying the standard——

Chairman KERRY. Why is it a negotiated process? I mean, pre-Sarbanes-Oxley, that was also a negotiated process, correct?

Mr. OLSON. Yes.

Chairman KERRY. But what we discovered——

Mr. OLSON. Well, negotiated in the sense that there could be agreement—the focus was on the extent to which the control was a key control and the extent to which they were following appropriate audit standards.

Mr. COX. I would also jump in, if I may, and point out the obvious, which is that, pre-Sarbanes-Oxley, there was no Sarbanes-Oxley Section 404 audit of internal controls.

Chairman KERRY. Correct. There were just the standards of the industry and the sort of——

Mr. COX. Well, there was a financial statement audit.

Chairman KERRY. Correct. Understood. So the assumption is that given 404 and its requirements and the level of scrutiny that both of you will argue here, not to mention the risk in the marketplace of adverse reporting, you believe that this standard you are looking for here of professional judgment and testing and assessment of risk is the balance? That is effectively what you are looking for now?

Mr. COX. That is correct, Mr. Chairman.

Chairman KERRY. And you think that balance can, in fact, reduce costs?

Mr. COX. The entire purpose of using judgment is to achieve the idiosyncratic audit that Chairman Olson is talking about. If an auditor cannot use his or her judgment, if there is a "check the box" mentality, then there is absolutely no way to avoid doing things that everyone knows are wasteful.

Chairman KERRY. What is the check against an overly friendly relationship building in the assessment process?

Mr. COX. Well, obviously, we have a great deal of emphasis placed on the independence of the auditor to begin with. Second, there is still ample direction for both the auditor in auditing what management has done and for management itself in terms of what it is that they are trying to achieve with this whole exercise. It is supposed to be focused on things that can affect the financial statements, and what we are trying to wring out is any make-work that has nothing to do with something that might be material to the financial statements.

Chairman KERRY. So it is your judgment that there has been that kind of make-work in the process to date?

Mr. COX. That is the testimony that we have had from a number of commentors at our roundtables, in the report of the Advisory Committee on Smaller Public Companies, in the letters that we have received as recently as our latest round of proposals from both the PCAOB and the SEC. I think everyone is focused on the fact that investors are doubly injured when their money is wasted on things that don't matter, because not only is that money misspent, but it is also a distraction to the auditors and for the financial statement integrity away from what truly is material.

Chairman KERRY. Did you find in the process that there was a distinction between the make-work requirements with respect to small business and what happens in large business?

Mr. COX. Not necessarily, although I think it is felt more acutely by smaller businesses for the reason that you described, that proportionately, those costs fall heavier on smaller businesses.

Chairman KERRY. In the fourth paragraph of the items that you think need more work, you talked about how the auditing standard needs to use broader principles rather than prescriptive rules. Can you sort of fill that out a little bit for us?

Mr. COX. Yes. I think that that is a cognate of the point we were just discussing. The hope is that we can avoid waste and inefficiency in the audit, and both the PCAOB—in its inspection process, which in part is focused on efficiency—and the SEC—in our provision of guidance to management want to be sure that that aim is achieved. By coming at this in a principles-based way, we hold people accountable for what truly matters.

In Enron, which gave rise to a great deal of this, there was famously adherence to a lot of technical rules, but when you stepped away from examination of the bark on the trees and recognized the forest, there was a massive fraud underway. A principles-based system holds people accountable even if they have technically complied with all of the small particular requirements, even if they have with a check-the-box mentality said, "I complied with these technical rules." We want to be sure that we have that kind of safeguard built into the system.

Chairman KERRY. A final question. On the consumer side, they have also weighed in with you. You have received a lot of letters from everybody on both sides. But they have suggested that the Commission is more concerned with reducing cost to business than with ensuring that the audit is effective. Can you speak to that?

Mr. COX. Our No. 1 concern is investor protection. We want to make sure that we have financial statements upon which investors can rely, and we want to make sure that the investors' money is being appropriately spent to achieve that objective. As I mentioned a moment ago, if the investors' money is being wasted on things that don't affect the reliability of the financial statements or their integrity, then they are being doubly injured because all resources are scarce, including the auditors' time. And, if the auditors are chasing things down rabbit holes that don't matter, they are probably missing other things that are truly important.

Chairman KERRY. Thank you, Mr. Chairman.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

Mr. Olson, in the conference report of the Sarbanes-Oxley Act when it passed, it indicated that internal controls should not be the subject of a separate audit. I just would like to have clarification from both of you on how you interpret the intent of Congress. Obviously, we want to create an important balance here. There is a public interest at stake. At the same time, I don't want to stifle competitiveness and inhibit job creation and job growth and innovation. In the conference report, in referring to the internal control evaluation reporting, it indicated that any such attestation shall not be the subject of a separate engagement.

Mr. OLSON. Senator, a couple of points on that. There was some confusion, I think, or there was some disagreement as to whether or not an audit could be done on management's assertions and then a separate audit done on the controls themselves, and that is one of the issues that we addressed in AS5. We determined that it was not necessary to do two audits but, in fact, if you were to focus on just the controls themselves, you did not have to have a separate audit done on the management assertions. And so that has been addressed in AS5.

Furthermore, I think that the previous guidance, under which the FDICIA 112 audits had been done, the question was raised that you could focus on either one or the other but you could do it with a single audit.

Also, I think it is important to know that what we are trying to do now is to look—if you can combine the audit of internal controls and the financial audit themselves, there are a lot of efficiencies to be gained in that. So we have tried to address that question.

Senator SNOWE. Are you in agreement on the fusion of those two audits, I mean, on the accounting standards side?

Mr. COX. Senator Snowe, as you may recall, I served on the House-Senate Conference Committee on Sarbanes-Oxley, and I think you are exactly right in reading the plain language that you just quoted. And second, inferring the intent of Congress here, it was clearly contemplated in Section 404 that we would have an integrated audit, and for many of the good reasons that Chairman Olson just specified. So the Commission has directed our staff to work closely with the PCAOB staff as we finish up this work to ensure that there is the best possible integration of the financial statement audit, which itself includes an assessment of internal controls, and the internal control audit that is required by the PCAOB.

Senator SNOWE. In the hearings, in the meetings that you conducted around the country, have you had a chance to get a response from small public companies with respect to this integrated approach at this point? Small companies won't be able to review the new requirements until June when these guidelines are issued?

Mr. COX. We have indeed received many comment letters in the formal comment process on both the proposed audit standard, and the SEC's proposed management guidance and those comments are generally the same coming from smaller companies as from larger companies. They think that, in this respect, we are moving in the right direction.

Senator SNOWE. I know I have heard from some of the smaller public companies in Maine, and I want to thank you again, Chairman Cox, for you and your staff being responsive to a number of the questions that they have asked of the SEC. But what I have heard is that with the 6-month period in which they would have to conform to those regulations, do you think that that is going to be a sufficient amount of time for them to do so?

Mr. COX. I don't think it would be a sufficient amount of time to comply in full with Section 404. There are two parts to 404. There is what management does without its auditors, and then there is the 404 audit. And in our experience it is that 404(b) requirement, the 404 audit, that is the basis of most of the complaints, most of the stories about distracting non-essential work and instinct for the capillary instead of instinct for the jugular that we are trying to fix. And so we have postponed for a further year the requirement that smaller public companies would have to apply with that 404 audit piece.

Senator SNOWE. I see. So on that piece, you are deferring for another year?

Mr. COX. Another year.

Senator SNOWE. I see. OK. Now——

Mr. COX. That would be March 2009 for a calendar year-end company.

Senator SNOWE. I know one of the other issues that has been raised by the small business community is that the SEC and the PCAOB should harmonize their rules, because on one hand, the SEC's guidelines have been too vague. On the other hand, the Board's have been too specific. Do you think you have been able to fuse the rules sufficiently so that there is clarity in that regard and provide specific guidance? There is a tremendous burden that is placed on these small public companies that obviously face the costs disproportionately than larger companies. Senator Enzi and I requested a Government Accountability Office study back in 2004 that basically asserted that fact. I think it was $1.14 it cost small companies for every dollar required for compliance. This was nine times greater than it was for large companies to comply with the regulations.

Mr. OLSON. Senator, the operative word that you use is in "harmony" and I think that that is exactly what we are trying to achieve, harmony in this respect. The management guidance that would come from the SEC is the guidance to management that has the hands-on familiarity, and in our case, what we are doing is adopting a standard that the auditing firm would use. The management guidance should help in one very important respect: With that management guidance, our auditing standards should no longer be the de facto standard against which management would adopt its standards.

I think that, in addition to being highly prescriptive in the original AS2, there was an overabundance of caution, and the auditing world, the PCAOB, probably the SEC, and even audit committees, I think, were absolutely over-prescriptive. They wanted to make sure there were no mistakes made. Well, we have now lived with Sarbanes-Oxley and we have learned better how we can make it much more efficient and effective and I think we will move toward

achieving that. The harmonization between the SEC and the PCAOB is exactly what we are trying to achieve.

Senator SNOWE [presiding]. That is important and I appreciate that. Thank you.

Senator Tester?

Senator TESTER. A question for Chairman Olson, and Chairman Cox, if you wish. First of all, I want to thank the Board for flexibility on Sarbanes-Oxley. I guess my question is going to revolve around what is going on in other countries. What happens when we have got a situation where you have got investor protection versus capital formation in other countries? Is there a Sarbanes-Oxley out there for other markets? Of course, there will be a follow-up on this.

Mr. OLSON. Senator, there is indeed, and I think that is one, for me at least, of the more interesting components of the environment that we are dealing with. It is following the growth in capital markets around the world.

If you look at the markets that are growing the fastest right now, they are in places like India, developed Asia, even a resurgence in Japan. You see a significant building of capital markets in Europe, for example, in Eastern Europe, and London has been—has not always been, but in recent years has become a very attractive market. So as you see the capital markets grow and you see more and more investors in those countries investing in those capital markets, logically and not surprisingly, what you see is a focus on the quality of the audits being conducted. As a result, that is why we see PCAOB-like entities around the world.

I just came from a meeting not long ago where I met with my counterparts from around the world, all of whom are grappling essentially with this same issue, the appropriate way to monitor and inspect the auditing profession while at the same time not unduly interfering with a cost burden.

Senator TESTER. So how do they deal with—are they more onerous or less or similar? With Sarbanes-Oxley, are we putting our businesses in this country at a competitive disadvantage? I guess that is ultimately the question.

Mr. OLSON. Let me describe the differences, because you have hit on a very important point and the differences are really important. What Sarbanes-Oxley did in establishing the PCAOB is that it required an independence of the PCAOB separate from the accounting profession. So, for example, we do not get funding from the accounting profession. Our funding comes directly from corporate America, from publicly-traded companies.

In many other countries that have established an organization like ours, they don't have the same resources we do. They are not in all cases able to fund the kind of a staff that we have to do our inspections, and sometimes they don't have the same degree of independence. Bulgaria and Romania do not have the same resources that we do, for example, but they have had somewhat that same focus.

Senator TESTER. From an investor protection standpoint, where do we rate in the worldwide economy?

Mr. OLSON. We are not participating in a race to the bottom, and I think that is the most important point. We are maintaining con-

fidence in the standards we have in the United States while still being an attractive marketplace. If you look at the impact of Sarbanes-Oxley, you can actually track the fact that there has been a reduced cost of capital for firms that have gotten a clean bill of health on their ICFR audit. I don't know where we rank. I wouldn't put a number on it, but I think that confidence in the U.S. markets has been restored.

If you look at the growth of IPOs, we have not grown as fast as some, but there has been an increase in the number of U.S. IPOs every year since 2003. We have an increased number of foreign companies that are issuing stock either as joint issuance or issuing in the United States. I think that that bodes well for the confidence in our markets.

Senator TESTER. Thank you, Madam Chairman. Thank you, Chairman Olson.

Chairman KERRY [presiding]. Thank you. Senator Coleman?

Senator COLEMAN. Thank you, Mr. Chairman. Again, I want to thank you. I do have a more extended opening statement that I would like entered into the record.

Chairman KERRY. Without objection, it will be placed in the record.

Senator COLEMAN. Thank you.

[The prepared statement of Senator Coleman follows:]

Committee on Small Business and Entrepreneurship

April 18, 2007

Senator Coleman
Opening Statement

Thank you Chairman Kerry for holding this important hearing.

Before I address the focus of this hearing, I would like to acknowledge the strong Minnesota presence of the witnesses before the committee today.

Mark Olson is a life long Minnesotan who has led a distinguished public service career which has included serving as member of the Federal Reserve Board. We welcome you to today's hearing.

The current SEC chairman also began his life in Minnesota before leaving for the sunny climes of southern California where he eventually became a successful Member of Congress. I'm sure though that Chairman Cox would agree, that while you can leave behind the cold weather, the warmth of the Minnesota people stays in your heart forever.

I would also like to acknowledge a third witness: Rich Wasielewski, who comes here from Wazayta, Minnesota, where he is CFO of Nortech Systems, a small and successful electronic manufacturing services company.

It gives me great pride to see the state of Minnesota so well represented. Welcome all.

Mr. Chairman, the issue before us today has been of great concern to me. This is one of the top issues I hear about from small businesses. As a member of this committee and a former Mayor, I am very troubled at the compliance burden of Sarbanes-Oxley on small businesses. Our economy is powered by small businesses. Our future job growth depends on small businesses. Our future economic prosperity and competitiveness depends on the ability of our small businesses to innovate and grow into industry leaders – to become the next Medtronic or the next Target – two great Minnesota companies. In order for small businesses to do so they need to be able to continue to access U.S. capital markets as opposed to being effectively

shut-out of these markets due to the high cost of Sarbanes-Oxley which are leading companies to go or stay private. More broadly speaking, I would add that our future competitiveness also depends on making sure that U.S. is a welcome home for capital.

Ultimately trust is the capital market's currency. The Enron and the WorldCom scandals badly devalued this currency at great cost to our capital markets, honest businesses, investors and the economy as a whole. As a result of the corporate scandals, the bond of trust forged over decades between the investing public and the capital markets was unraveling in an electronic trading second.

While Sarbanes-Oxley has helped in some measure to restore the investing public's confidence in our capital markets it has done so at a great price. As Rich Wasielewski and others will share with the Committee, the compliance burden of Sarbanes-Oxley is too great. This burden is not just a bottom-line issue, but a jobs and a competitiveness issue. The signs are clear, from the disproportionate compliance cost faced by small businesses to the increase in the number of small businesses going private as reported by a GAO report last year.

Businesses should not have to make the trade-off between hiring a new worker and/or purchasing new equipment and putting in place internal controls and hiring auditors to ensure compliance with Sarbanes-Oxley. Ultimately such a trade-off is not healthy for our increasingly global

economy. A better approach is to have small businesses report trusted and verifiable numbers -- but in a way that enables to do what they do best – grow jobs and the economy.

Despite the best efforts of the SEC and PCAOB, it is clear that both have struggled to achieve the difficult balance of protecting investors while not burdening businesses with crushing compliance costs.

That said, I recognize the difficulty in achieving this balance and commend the SEC and the PCAOB for their efforts to reach out to the small business community and develop new rules late last year intended to reduce the compliance burden. It is my hope that both will continue to

work with the small business community on this very important issue.

Thank you Mr. Chairman. I look forward to hearing from our witnesses.

Senator COLEMAN. I really appreciate the efforts and the sensitivity of both of the Chairmen here who understand the importance of us being competitive and small business being able to prosper. Clearly, some progress is being made even at this stage. We will have another witness here, a small business person from Minnesota, Rich Wasielewski, and my belief is he will talk about some of the competitive disadvantages that American business faces because of some of the burdens of Sarbanes-Oxley. So clearly, I think we are still in search of a more perfect balance.

Chairman Olson, you raise the issue about harmonization. Or you made the comment about harmonization. I am sure you are both aware that on February 21, 2007, the SBA Office of Advocacy sent letters to both of you relating to the proposed internal control on auditing standard rules. That letter raised, at least from what I saw, significant concerns about the differences, about this effort at harmonization. I think it went on to say that despite the working relationship, it was clear to me that the rules that you are proposing don't fully comport. For example, according to the comment letter, to quote, "the SEC guidance seeks to provide flexibility and scalability to small public companies and therefore does not prescribe a particular methodology of identification of risk and controls. In contrast, the PCAOB's revised accounting standard is very prescriptive and contains detailed bullet points on how auditors must evaluate management's internal control reporting process." In the end, the letter finally stated that "small business representatives have stated that by the use of the PCAOB's revised auditing standard as their de facto guidance, they are afraid that following the SEC's vague and flexible management guidance results in a negative audit by an auditor using the more detailed and prescriptive revised auditing standard."

My question, then, is with these concerns in mind, can you talk a little bit more about harmonization? Can you more specifically address this issue so that we don't have businesses acting in fear and have a sense that they are dealing with the concerns of both of you?

Mr. OLSON. I would be happy to lead off on that one, Senator. To go back to when we first issued AS2, that was a well thought-through, carefully crafted standard that gave a lot of specific guidance as to what auditors might do in auditing the internal controls of financial reporting. Because of the abundance of caution that I mentioned, many of those specific examples, then, were determined to either be mandatory or presumptively mandatory. Some of the wording and some of the language in there perhaps suggested a great deal more procedures be done than were necessary. The term "make work" was used before. I don't associate with that term. I don't think it was make work. I think it was just the fact that people were wearing a belt and a pair of suspenders in terms of identifying the number of controls for which they wanted documentation and they wanted to test them.

And then, immediately following that, in two separate instances, the PCAOB had issued either questions and answers or additional guidance as to how you could make the audit more scalable and less costly and less intrusive. And yet what we discovered was that the auditing firms were still going back to the original standard.

They weren't fully incorporating the subsequent guidance. That is why instead of amending AS2, we are replacing AS2. I think that will address the de facto standard issue. Also, the SEC is providing its new management guidance relatively simultaneously.

Senator COLEMAN. And my concern, and I turn to Chairman Cox, is that this guidance is not either conflicting or confusing but, in fact, is harmonization. What I am looking for, I just want to be assured—I want you to assure this Committee that when you finally get the kind of rules out there that they are not going to create confusion, that they are not going to be in conflict, and that the differences will be resolved. Chairman Cox?

Mr. COX. Senator, there are two areas of the four that I mentioned that we are now focused on in the remaining weeks as we tie up the loose ends on this major project that relate to what you are describing. One is harmonizing definitions, and that, as you can imagine, is vitally important. We don't want to use the same terms in different ways as part of the same process, so we are strongly committed to getting that right.

The second area where harmonization is important and where we are focused, and I believe this goes directly to the comment that you are relating to us, is that, to the extent that the SEC's management guidance is more principles-based than the current version of the PCAOB proposed audit standard, we are trying to get further in harmony there, as well. Because if one is check-the-box and the other is principles-based, and I don't mean to use that characterization because I don't think that that is where we are at all, I think we are really down to the short strokes here. But just to use that as two extremes, if one were check-the-box and the other were principles-based, then you would almost certainly have a very serious problem of the check-the-box approach being the de facto standard. That is what happened last time around, and that is the very problem we are trying to fix.

Senator TESTER. Thank you. I just again hope that you work together on this so that those differences are resolved. Thank you, Mr. Chairman.

Chairman KERRY. Thanks, Senator. I appreciate it.

Senator Bayh?

Senator BAYH. Thank you, Mr. Chairman. Gentlemen, thank you for your service and your time today.

Mr. Olson, I would like to start with you. The chart that is up behind us here about the differences in the cost of compliance, is there any evidence that as we have gone through this cycle now a couple of times the disparity is shrinking sort of as people get their feet under them, even in the absence of any additional action by you and the—I see you are looking at the chart. It just visualizes what has been orally said about the added cost of compliance for small business.

[The referenced chart was not available at press time.]

Mr. OLSON. The bar on the left indicates small companies, $75 million and over, and Sarbanes-Oxley does not yet apply to them. I am assuming that what is shown is an estimate. Section 404 does not yet apply to them. So I would think that it would not fully take into consideration——

Senator BAYH. Well, let me ask, then, for companies above the bar where it goes into place——

Mr. OLSON. Yes.

Senator BAYH [continuing]. As the auditors and the companies begin to go through this process, are natural efficiencies due to familiarity beginning to take place anyway?

Mr. OLSON. Very much so, and I think a couple of things——

Senator BAYH. Is that just anecdotal or is there any analysis that quantifies that?

Mr. OLSON. Let me tell you why it is difficult to come up with a real careful quantification. If the external auditor is auditing both—in other words, doing a consolidated audit of financials and internal controls, it is tough to break out which of the costs are for the internal controls as opposed to the financial audit. Anecdotally, what we are hearing is that firms that have accelerated filers have their methodology in place, and have their approach to the controls. In fact, I very recently heard an example of an accelerated filer that used the occasion of Sarbanes-Oxley to catch up on some of the internal controls that already needed attention; they used this as an opportunity.

What I think we are hearing increasingly from the accelerated filers, and I hear this again and again and again, that they are a better company today because of Sarbanes-Oxley, but that the incremental cost still exceeds the incremental value and that is what we are trying to bring into line. We still have a ways to go. I wouldn't claim that we have achieved all of that at this point.

Senator BAYH. So some progress, but progress yet to make?

Mr. OLSON. I think that is a fair statement.

Senator BAYH. Chairman Cox, for you, one of the things I have been interested in since the beginning of this whole thing, and I know you were there at the inception, as well, I would be interested to know if anybody in your shop has any data about sort of the aggregate cost of compliance across the economy versus the aggregate amount of fraud that we have been preventing or that had been taking place because of this. One of the things that has been on my mind, it would be ironic if in the name of protecting the shareholders we actually were imposing more costs on the shareholders than the harm we were preventing. Is there any data out there about this?

Mr. COX. It is a mismatch because there is much harder data on what we spend to prevent fraud and much softer data on the fraud that doesn't occur. Economists make a real and heroic effort to measure the latter, but as you might imagine——

Senator BAYH. How about the fraud we were actually catching?

Mr. COX [continuing]. Measuring what didn't happen is very, very difficult.

Senator BAYH. Pre-Sarbanes-Oxley, there is some data on the amount of fraud that was actually detected——

Mr. COX. Well, we do know—our economists will now probably want to restrain me because I am going to——

Senator BAYH. You need a one-armed economist.

[Laughter.]

Mr. COX. I am going to practice amateur economics here, but if one is willing to do reasonably rough justice about this, it is a fact

that our markets are healthy now. They were not before. They were stressed. They were in great difficulty. Investor confidence was shaken. There were significant problems that were uncovered. We are, at least right now, at a time when we do not have problems of that magnitude coming to the fore. We at the SEC look for them every day.

Senator BAYH. Well, how about the hard data that we do have on the additional costs of compliance? Are there figures out there on that?

Mr. COX. Yes, of course.

Senator BAYH. What would those be?

Mr. COX. Now, you mentioned specifically that you are looking for a figure in aggregate for the whole country?

Senator BAYH. I think you know what I am driving at, the appropriate additional cost to promote transparency. I am just trying to do a cost-benefit analysis of what we are spending and the benefit we are deriving from that.

Mr. COX. What I would like to do, we have, of course, an Office of Economic Analysis and it is staffed by top-flight professionals at the SEC. What I would like to do is get you the very best data that we have on this rather than trying to wing it. But I assure you, having looked at this very carefully, that the numbers are going to be much more reliable on the cost side than they are on the benefits side.

Still, I want to go back to a question Senator Tester put a moment ago. I think that the fact that so much of the world, and Chairman Olson mentioned this in his response, is emulating Sarbanes-Oxley, and there is a lot of competitive marketing going on in other countries, attacking the brand name of Sarbanes-Oxley and so on. But if you take a look at the securities regulations that are being propounded in these other countries, including in the United Kingdom and many of the leading markets in the world, they are emulating the major parts of Sarbanes-Oxley, including internal controls assessments by management. The one respect in which they have not emulated 404 is the audit piece.

But across the board, I think that, if one is talking about Sarbanes-Oxley in general and the recent improvements that are being made to investor protection in the United States of America, the emulation by other countries and around the world tells us, first, we are not putting ourselves at a competitive disadvantage because that is what is going on in these other markets, and second, we probably did something right.

Senator BAYH. Thank you, gentlemen.

Chairman KERRY. Thank you very much, Senator. I appreciate it.

We have one more Senator and then we do have another panel. I don't know, gentlemen, do you have folks here with you who may be able to stay and hear them, because I find sometimes the regulatory folks who come up first would sometimes benefit by hearing what the other folks have to say.

Mr. OLSON. We have people who will stay, yes.

Chairman KERRY. Thanks. That is great.

Senator Corker?

Senator CORKER. Thank you, Mr. Chairman, and I thank both of you for your service.

I want to follow up a little bit on Senator Bayh and Senator Tester's comments. Before I do that, I do want to thank you for working together to try to create some harmony. I think "harmony" is the word that has been used here today, to make sure that companies don't feel bifurcated, if you will, in their efforts to satisfy each of you and end up doing a lot of work that is make-work. I will just add to Norm Coleman's comments, as far as what you hear back in the State of Tennessee from small companies, SOX is a huge issue and one that they continue to be concerned about.

But I want to take it more to the macro level. I know we are talking about small business today, but I know that Senator Bayh was asking more quantitative kinds of questions, and I know it is hard to come up with those and sometimes even ever find out what is a true answer to those questions. If you step back and just look at the macro level in our country and look at the way we are competing with other countries, the tremendous resurgence of private equity here—I know a lot of that is due to the low cost of debt today, but tremendous attribution to the regulations it takes to be in public markets today, we see a tremendous resurgence in London and Europe and other countries.

Could you all just give us some editorial comments as to where you see us as a country relating to public markets over the next 5 or 10 years and just some other editorial comments, because both of you addressed this, as to what we might ought to look at as a country to make ourselves more attractive in those ways.

Mr. COX. Senator, the globalization of markets, which has been a fact of life ever since we have had public companies, for hundreds of years, is accelerating in the time in which we live and markedly so. And so for the Securities and Exchange Commission, focusing on how we work with our fellow regulators around the world has been a very, very big part of my job, and to a certain extent, given the SEC's history, a surprisingly large part.

As you know, the New York Stock Exchange and Euronext have combined. The NASDAQ took a 25 percent stake in the LSE. There are alliances being formed among markets and exchanges around the world. Increasingly, investors have the opportunity, either directly or indirectly, to require foreign securities to subject themselves to the regulation therefore not of the United States but of other countries. You mentioned the phenomenon of very large private pools of capital, including private equity hedge funds and so on, all of these changes. And added to that, the development of large liquidity pools in other countries that are competitive with the United States that didn't formally exist and not to that extent have made the environment a very challenging one for the United States generally and for regulators specifically.

But here is, if we take a snapshot, where we find ourselves. We are the largest, deepest, most liquid market in the world by far. Our exchanges are the largest, deepest, and most liquid by far. We continue to attract the lion's share of the world's investment offerings and there is no other market that comes particularly close to us. We have no birthright to that, and so we have to constantly sharpen our competitive edge.

In my view, one of our comparative advantages is that one puts its, his, or her money into the United States, there is a rule of law

here and a sense of safety and security that is unparalleled and exists nowhere else in the world. We want to maintain that competitive and comparative advantage. We also want to make sure that our regulations, because we have to now work more closely with other regulators, fit this new increasingly global world in which investors are living, and that means not so much that we have to diminish in any way the ultimate level of protection, but rather that in order to achieve constantly that same high level of protection, we have got to keep pace. We have got constantly to change for that reason.

Mr. OLSON. Senator, let me just follow up. First of all, I associate myself with Chairman Cox's remarks. Having come to the PCAOB from another regulator and having been in a highly regulated environment all of my life, there is one fundamental premise that we in the United States have that most of the rest of the world does not have, and it is this: The markets in the United States are presumed to work until such time as there is evidence that there needs to be some intrusion to correct a market irregularity.

If you look at most of the regulatory burden that exists in the United States, almost all of it came out of a specific crisis in the past. All of the agencies that were created—like the Federal Reserve Board, the Comptroller of the Currency, the FTC, the SEC, for example, were designed around addressing specific previous crises.

So, with much of the rest of the world, what you see is not a very permissive, very free market; but rather you instead have entities that are allowed to do only what they are specifically prescribed to do by law.

I think that we continue to have a free and open marketplace and it is only when there are events like an Enron or a WorldCom that create a Sarbanes-Oxley, or a new body of law. I think that what we need to do is to make sure that we have retained respect for the fact that markets do work and that we still do not want to be an environment where individuals, who are investors, cannot have confidence in the markets.

Fifty-percent-plus now of all U.S. households are investors in one way or another. That fact, I think, has been an important consideration for assuring that we have a body of law that addresses consumer concerns at the equity investment level. We can do that in a way that is still cost effective. Things are still out of line, but we are working very hard to bring them back into alignment.

Chairman KERRY. Thanks, Senator, very, very much.

Just one parting question, if I can, as sort of a summary of this. We hear from some venture capital folks around the country that Sarbanes-Oxley is sort of a barrier to start-up here. Is there any evidence of companies actually making a decision to move to Europe or elsewhere as a consequence of these rules? It is a derivative of the question asked earlier by Senator Tester, but it is something that I have heard lately from some very thoughtful and significant D.C. types.

Mr. COX. Senator, I, of course, hear the same thing from the venture capital community, from their formal association and from individuals in the industry, so I think at least in some sense, there is a reality to this. It is the firm conviction of people in that com-

munity that there are serious problems and problems that affect their decision making. Whether or not upon the completion of our work that will remain their opinion is something else. But I think we all know——

Chairman KERRY. But you are consciously, in the four areas you talked about and in your approach to these rules that you are refining, you are consciously taking that into account? Is that part of what you are factoring into this, or not?

Mr. COX. Yes. We are open to the possibility that many might persist in their antipathy towards Sarbanes-Oxley, notwithstanding the reality, and I think the other part of your question might challenge us to provide data and I think the answer to that question might be very different. I would be happy, by the way, to follow up if you would permit with some hard data on that topic——

Chairman KERRY. We would like to follow up——

Mr. COX [continuing]. Because I think we have some.

Chairman KERRY. I will leave the record open for 2 weeks here to deal with the follow-up with you in writing on a couple questions because we are pressed for time now, but I think it would be important to try to determine some of those things, if we can.

We are very, very appreciative. Thank you so much, both of you. Thank you for the work you are doing. You can tell there is a lot of serious interest here on this and we will follow it very closely and we thank you.

Mr. COX. Thank you, Senator.

Mr. OLSON. Thank you.

Chairman KERRY. Could I ask the members of the second panel to come right forward and we will try to continue seriatim here.

First, Tom Venables, the president and chief executive officer of the Benjamin Franklin Bank in Franklin, Massachusetts, and he is testifying on behalf of the American Bankers Association, but I also want to thank Dan Forte and the Massachusetts Bankers for their efforts on behalf of the financial services industry and particularly addressing these concerns.

We also have Joseph Piche, the CEO and founder of Eikos, a high technology company located in Massachusetts.

And third, we will hear from Richard Wasielewski, the vice president and chief financial officer of Nortech Systems in Wayzata, Minnesota, a full-service electronics manufacturer. I might also note, if my memory serves me correctly, Wayzata is a good feeder for hockey players in America.

Mr. Venables, please lead off. Go ahead.

STATEMENT OF THOMAS VENABLES, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BENJAMIN FRANKLIN BANK, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. VENABLES. Thank you. Mr. Chairman, I am pleased to represent the American Bankers Association's views regarding the impact of the Sarbanes-Oxley Act of 2002 on small businesses. Chairman Kerry and Ranking Member Snowe, before I go further, I would like to thank you both on behalf of the ABA for your efforts on this issue and specifically the letter that you wrote requesting an additional extension of the Section 404 compliance date for nonaccelerated filers.

The ABA is very concerned about the huge time and cost burdens experienced in complying with the Act as well as business opportunity costs. The banking industry has significant experience with management reporting on internal controls because of the FDIC Improvement Act of 1991, or FDICIA, which has long required management reports and auditor attestations. Although the Act used FDICIA as its model, the rules followed for FDICIA were rewritten for Section 404 purposes, resulting in excessive work and cost. The burdens of Section 404 are also having an impact on non-registrants as the AICPA and the PCAOB work to make the auditing standards for FDICIA and Sarbanes-Oxley 404 the same.

For illustrative purposes, my own company, the Benjamin Franklin Bank Corp. in Franklin, Massachusetts, a community bank with $913 million in total assets, employing 186 people, incurred costs of approximately $420,000 and over 2,200 internal man hours during 2006 to comply with Section 404. This represents 6 percent of our normalized 2006 earnings.

My experience is not unusual. Most community banks have similar scenarios. This expenditure of time and money has not improved our ability to manage the bank.

Given my experience with Section 404, I would like to raise three areas of concern: The revised and reformed rules, which need to be finalized with utmost speed; the implementation of the rules, which needs to focus on cost reductions; and the application of Section 404, which needs to be delayed for non-accelerated filers to give them time to adjust to the updated rules.

First, the rules related to Section 404 appear to be improving. The SEC and the PCAOB proposals have the potential to reduce the cost of compliance for all filers while retaining the strong investor protections. The proposed guidance and auditing standards need to be finalized, though, with utmost speed.

Another set of rules, those related to shareholder thresholds for SEC registration, must be updated. Under the Securities Exchange Act, companies are required to register if they have total assets exceeding $10 million and 500 or more record shareholders. Because nearly all banks exceed the $10 million threshold, the only criterion of importance is the record shareholder threshold. The shareholder level has remained at the same level since it was first set in 1964. Accordingly, the ABA strongly recommends updating the Exchange Act registration shareholder threshold to between 1,500 and 3,000 record shareholders. The threshold for de-registration should also be brought in line to between 900 and 1,800 record shareholders.

Second, the implementation of the rules need to focus on cost reductions which will only be realized if the auditing firms apply them as intended by the rule makers. The SEC and the PCAOB have achieved the proper balance with their proposals, but monitoring the results will be extremely important in determining the successes of these changes.

Finally, concerning the application of Section 404, non-accelerated filers need a delay of the compliance date. It is imperative that the rules are successfully implemented and tested before requiring non-accelerated filers to comply. It is also necessary to provide non-accelerated filers with adequate notice, a minimum of one

full year in the case of calendar-year companies, in advance of the required compliance. This prevents the smaller companies from wasting valuable resources on and overpaying for unnecessary internal control work.

We are concerned that during the recent Section 404 meeting of the SEC, there was no mention of a specific delay of the compliance date for non-accelerated filers. It is urgent that the SEC provide relief to these small businesses in a timely fashion. Non-accelerated filers are required to produce reports this year on internal controls. In order to comply, they must decide now whether to follow the old rules or follow the recently proposed rules. Placing such a significant time constraint on these smaller companies is unreasonable. The clock is ticking for these non-accelerated filers and the alarms are ringing.

In conclusion, thank you for holding this hearing and allowing us the opportunity to provide our observations to you.

[The prepared statement of Mr. Venables follows:]

Testimony of
Thomas Venables
on behalf of the
American **Bankers** Association
before the
Committee on Small Business and Entrepreneurship
of the
United States Senate

April 18, 2007

Mr. Chairman and members of the Committee, my name is Thomas Venables. I am Chief Executive Officer of Benjamin Franklin Bancorp, Inc. in Franklin, Massachusetts. My community bank has $913 million in total assets, employs 186, and was chartered over 130 years ago. I am pleased to be here today to represent the American Bankers Association (ABA) regarding the Sarbanes-Oxley Act of 2002 (Act) and its impact on small business. ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Before I go any further, we would like to recognize and thank Chairman Kerry and Ranking Member Snowe for their efforts in advocating an extension of the compliance deadline for non-accelerated filers. This hearing is timely because, under the current Securities and Exchange Commission (SEC) rules, 2007 is the first year for which non-accelerated filers will be required to begin complying with the rules of Section 404, which has proven in many ways to be the most troublesome part of the Act.

First, let me say that the ABA fully supports the establishment and use of strong internal controls, which are critical to provide users of financial statements with reasonable assurance about the integrity of financial statements and to provide a foundation for appropriately managing a company's risks. However, we continue to be very concerned about the huge time and cost burdens experienced in complying with the Act, as well as business opportunity costs. The purpose of this testimony is to share those concerns from a community bank perspective and to provide some insights for your consideration.

The banking industry has had a significant amount of experience with management reporting on internal controls and auditor attestations, because the FDIC Improvement Act of 1991 (FDICIA), and the corresponding banking regulations, have required similar reporting for banks with total assets of $500 million or more (recently raised to $1 billion). Since then, banks have been required to produce annual reports on internal controls, and external audit firms have assessed the effectiveness of bank internal controls and have attested to these reports. Bankers, banking regulators, and accounting professionals have spent many hours specifically determining how to achieve such attestations. In fact, the Act used the FDICIA management report and attestation as its model. However, the rules surrounding the FDICIA process were re-written for Section 404 purposes, resulting in excessive work and costs.

By way of background, my own company, Benjamin Franklin Bancorp, achieved full compliance with Section 404 as of December 31, 2006. It may be helpful to share several facts related to our efforts during 2006 in this regard. Our team of officers and employees involved in the Section 404 effort expended 2,214 hours during 2006 at a cost of $180,082. In addition, we incurred an ***increase*** of internal audit costs of $113,080, information technology (IT) audit costs of $48,680, and additional external audit costs of $78,000, for a grand total of $419,842. During this time, we decided not to employ the services of an outside Section 404 "expert," or the costs would have been even higher. ***This expenditure of time and money has not improved our ability to manage the bank.*** The FDICIA controls that we have had in place for years are more than adequate to provide a framework for management to assess and report on the effectiveness of our internal controls. To put the approximately $420,000 of Section 404-related expenditures in perspective, this amount represents 6.1 percent of normalized 2006 earnings! It is not enough to be struggling with an inverted yield curve and tremendous loan and deposit competition in our markets, but to start off the earnings year at 94 percent of potential because of the Section 404 compliance costs – well, this is difficult. Our shareholders were not well served, as the costs outweighed the benefits. My experience is not unusual. In fact, most community banks report significant hits to earnings from these costs.

Given my experience with Section 404, I would like to raise three areas of concern:

- the revised and reformed rules – which need to be finalized with utmost speed;
- the implementation of the rules – which needs to focus on cost reductions; and
- the application of Section 404 – which needs to be delayed for non-accelerated filers to give them the time to adjust to the updated rules.

The Rules Need to be Finalized with Utmost Speed

The rules appear to be improving. The ABA appreciates the significant work the SEC and the Public Company Accounting Oversight Board (PCAOB) have done to provide management guidance and improve the auditing standards. We support the SEC's position that streamlining of this guidance is important for both large and small registrants, as implementation costs have been too high and need to come down.

Chairman Cox and Chairman Olson, particularly, should be commended for their efforts to streamline the Section 404 process to make it more cost-effective. They have focused on the appropriate areas, and the new guidance and auditing standards are clearly headed in the right direction. Their proposals provide efficient guidance and standards for management and auditors that have the potential to reduce costs of compliance for all filers while retaining the strong investor protections and risk focus of Section 404. Those proposals, which reduce the level of prescriptive detail (by shifting from transactions-based to risk-based audits) and eliminate unnecessary duplication of work, will, hopefully, make the Section 404 process more efficient and less costly. Thus, this will be a win-win for investors and the companies in which they invest. ***The proposed guidance from the SEC and proposed auditing standards from the PCAOB need to be finalized with utmost speed.***

Another set of rules, those related to shareholder threshold for SEC registration, must be updated as well. ***Updating the shareholder threshold for SEC registration is a specific action that could appropriately flow from today's hearing as a step that would immediately reduce***

regulatory costs on small businesses consistent with protection of shareholders. I would be remiss to not discuss this with you, the Senate Committee on Small Business and Entrepreneurship. This topic is of utmost importance to small businesses, and, without amending Section 404 itself, it would have an impact on the application of Section 404 by small businesses.

Due to the increasing cost of being a registered public company, a number of small businesses, especially some of our member community banks, have determined that deregistration is in the best interests of their shareholders. Under the implementing regulation of Section 12(g) of the Securities Exchange Act of 1934, Rule 12h-3(b)(1), companies that wish to deregister must either have less than $10 million in assets or less than 300 record shareholders. Because ninety-nine percent of banks exceed the $10 million threshold for registration, the only criterion of importance to our member institutions in the rule is the record shareholder threshold. Thus, it is very difficult for most community banks to deregister without buying back shares from investors to retain fewer than 300 record shareholders. Doing so, however, can have negative consequences for local communities. Besides reducing small bank access to capital, it deprives small communities of one of the last opportunities to invest in a local business. Nevertheless, the high costs of Section 404 compliance drives many bankers to choose this less than best option.

Often banks do not choose to become SEC registrants, but are forced into it because of the organic growth in shareholder ownership. Without marketing their securities, many community banks have seen their shareholder base exceed the 500 mark as successive generations of shareholders distribute their shares amongst their descendents. Recently, these same institutions have seen the cost of compliance with Section 404 and other recent regulatory mandates significantly impact the profitability of the company. Community banks subject to Section 404 are experiencing significant hits to earnings. For small institutions, this amount represents an enormous financial burden.

Although the SEC noted its intention to consider updating this threshold back in 1996, the shareholder level has remained at the same level since it was first set in 1964. At that time, the indicator of a public market was determined to be 500 shareholders. This indicator is now overdue for a revision to account for a more than threefold increase in the American populace investing in exchange-listed companies. In 2007 dollars, after adjusting for inflation, the same market presence today that 500 shareholders would have occupied in 1964 would be six times as large. In other words, it would take approximately 3000 shareholders today to equal the market presence of 500 shareholders in 1964, assuming the average number of shares held by each shareholder and the average price of each share have not changed. ***Accordingly, the ABA recommends updating the Exchange Act registration shareholder threshold to between 1500 and 3000 record shareholders. The threshold for deregistration should similarly be brought in line to between 900 and 1800 record shareholders.***

On a related note, it is our understanding that the SEC's Division of Corporation Finance is considering a notice of proposed rulemaking on the definition of "held of record" found in Section 12(g). Under the current definition, only persons identified in the issuer's records as security holders are considered "held of record." This definition includes shares held in street or nominee name by financial intermediaries such as banks and broker-dealers. Expanding this definition to include "beneficial owners," i.e., equitable owners of the shares, would not only make it difficult to determine the number of shareholders for purposes of the registration requirements, but could significantly affect smaller companies. Under such an approach, many currently unregistered community banks and small companies would be required to register under the Exchange Act and incur all the concomitant costs of being a public company. If the SEC were to take such a step, we

believe that many of our smaller community banks will be forced either to sell up or substantially reduce their shareholder ownership, because they are unable to bear the new regulatory costs.

Implementation of the Rules Needs to Focus on Cost Reductions

Reducing costs and streamlining efforts will only be achieved if the auditing firms have the incentive to make efficiency a priority. Our primary concern with respect to implementation of Section 404 involves the uncertainty as to auditor reactions to the combination of the SEC's final management guidance and the final auditing standards published by the PCAOB. The first year of Section 404 saw exorbitant costs attributable to audit firms' over-testing and evident misinterpretation of the requirements of Section 404 and the PCAOB's auditing standards. Additional costs were incurred internally from hiring consultants and additional compliance employees to establish documentation and internal controls processes – much of which was unnecessary. These costs made severe dents in many companies' profitability without a commensurate return to shareholders.

In May 2005, to address some of the inefficiencies being identified, the PCAOB issued guidance that was similar to some of what is now being proposed for more formal inclusion in their rules. Although there was minor improvement in audit firms' reactions to the May 2005 guidance, it was insufficient. Clearly, time has passed and new audits are underway, which could result in further improvements; however, what is the incentive for audit firms to forgo this additional revenue, even if many clients and shareholders view it as over-auditing?

Efficiencies will only be successful if the auditing firms accept these streamlining efforts. The realization of the goals of these efforts will be measured by: (1) an evaluation by individual filers as to whether the work and costs are reduced; and (2) the reviews of auditing firms by the PCAOB. We believe that the SEC and PCAOB have achieved the proper balance with their proposals, but ***monitoring the results will be extremely important in determining the success of the changes.***

The excessive burdens of Section 404 are also having an impact on small businesses that are not SEC registrants. For example, banks that are over $1 billion in total assets and are not SEC registrants are not required to follow Section 404, but must continue to follow FDICIA. Unfortunately, the auditing firms and the banking regulators are working to make FDICIA management reporting as burdensome as Section 404. Thus, Section 404 has been costly – even to those banking institutions that are not SEC registrants. This process should be stopped until we can better assess the effectiveness and efficiency of the new guidance and standards.

Application Needs to be Delayed for Non-Accelerated Filers

Non-accelerated filers need a delay of the compliance date. We would like to take this opportunity to thank you, Chairman Kerry and Ranking Member Snowe, for your attention to the problem of timing of compliance for non-accelerated filers. Although my institution is a small business, we are an accelerated filer and a delay for non-accelerated filers does not benefit us. However, I know firsthand how draining the Section 404 process was – and continues to be -- on our resources, and it is imperative that the rules are reasonable before requiring other small businesses to comply. We fully agree with your letter to Chairman Cox on the need for an additional delay, and we further believe that the effective date for compliance for non-accelerated

filers should be delayed until such time as the new rules have been successfully implemented and evaluated for effectiveness.

In order to allow sufficient time for non-accelerated filers to implement the guidance in the SEC's proposal and auditors to adjust to using the PCAOB's new auditing standards, it is necessary to provide non-accelerated filers with adequate notice (a minimum of one full year in the case of calendar year companies) – in advance of required compliance – so that they are not expected to invest in outdated processes and have sufficient time to understand and implement any new guidance.

The previous extension granted to non-accelerated filers delayed the financial burdens of Section 404 and the strain on valuable resources until costs could be reduced through experience, additional guidance for management, and improvements in the compliance process. This prevented these smaller companies from wasting valuable resources on unnecessary testing and overpaying consultants and auditors for unnecessary internal control work.

The clock is ticking with respect to non-accelerated filers, and the alarms are ringing. We know that the SEC and PCAOB are working diligently to finalize their rules. We are concerned that at the close of the most recent Section 404 meeting of the SEC there was no mention of a specific delay of the compliance date for non-accelerated filers. ***It is urgent that the SEC provide relief to these small businesses in a timely fashion.*** Non-accelerated filers whose fiscal year coincides with the calendar year are now required to report in their 2007 annual reports on their internal controls over financial reporting. In order to comply properly with this requirement, non-accelerated filer management must decide ***now*** whether to follow the old rules or whether to follow the proposed rules, which are supposed to be completed sometime this summer. Moreover, once the proposals have been issued in final form, both audit firms and registrants must quickly read and understand the final rules, and then apply them. Placing such a significant time constraint on these smaller companies is unreasonable.

Based upon the recent public SEC meeting, there appeared to be agreement between the SEC and PCAOB that the new rules will significantly change the current rules, providing the SEC with sufficient justification to provide the much needed delay. It should be noted that smaller audit firms will also need to develop internal guidance for their auditors to follow *subsequent to* the release of the final rules. In all likelihood, smaller companies will not want to begin their processes without agreement from their auditing firms and there simply is not enough time for small companies to understand and implement the guidance successfully and efficiently to the satisfaction of their external auditors. Ideally, non-accelerated filers should not be required to comply until the rules have been implemented and successfully tested for accelerated filers. This will help ensure that the efforts to improve the Section 404 process are actually working prior to requiring America's small businesses to comply.

In conclusion, the ABA and I appreciate your leadership, Chairman Kerry and Ranking Member Snowe, on the Section 404 issues and the path you are taking toward making it a meaningful and efficient process for small business and investors alike. We are glad this Committee is focusing on these issues that are so important to America's small businesses.

Chairman KERRY. Thank you very much, Mr. Venables. That was very helpful.

Mr. Wasielewski?

STATEMENT OF RICHARD WASIELEWSKI, VICE PRESIDENT AND CHIEF FINANCIAL OFFICER, NORTECH SYSTEMS, INC.

Mr. WASIELEWSKI. Good afternoon. I would like to thank Chairman Kerry, Ranking Member Snowe, and the other Committee members for this opportunity to share our company's experience and insights into the benefits and costs of complying with the Sarbanes-Oxley Act of 2002 and the increased SEC regulations. I am also honored to participate in this hearing with Chairman Cox and Chairman Olson.

My name is Richard Wasielewski and I am the Vice President and Chief Financial Officer for Nortech Systems, Incorporated. To provide some background on Nortech, we are a publicly traded Minnesota corporation organized in 1990. We file annual and quarterly reports, proxy statements, and other documents with the SEC. We are an electronic manufacturing services company with facilities in Minnesota, Wisconsin, Iowa, and Monterrey, Mexico. We have over 1,100 employees who manufacture wire harness and cable assemblies, electric sub-assemblies, and printed circuit board assemblies for a variety of original equipment manufacturers. Approximately 950 of these employees are U.S. employees and 150 are supporting our Monterrey operations. The primary markets we serve are industrial equipment, medical equipment, military/defense, and transportation.

Our 2006 revenue was just over $105 million, with a net profit of $1.3 million, or 1.25 percent. Our industry is highly competitive. We are battling against global competitors with significant greater resources. We have assets totaling $42 million and a current market capitalization of just over $20 million.

Over the last 5 years, our compliance costs have increased almost 2½ times, from $376,000 in 2002 to $933,000 in 2006. We estimate that approximately 50 percent of this increase is the result of the cost incurred from the Sarbanes-Oxley compliance and internal control initiatives while the other 50 percent is cost incurred on expanded SEC and Financial Accounting Standards Board reporting requirements.

Despite these high costs, Nortech's board of directors, CEO, CFO, and officers fully support the goals and objectives of the Sarbanes-Oxley Act of 2002 and believe in the U.S. capital markets. The major benefits to date of this Act is the assurance and continuous confidence our investors have in our company reporting of financial and management performance, along with the additional governance from a stronger internal control of our financial processes. Our internal control policy and procedures are benefiting from a solid structure of clearly defined roles and responsibilities, risk assessment, monitoring, and corrective actions for continued improvement.

However, these benefits come at a significant cost to Nortech from large administrative costs and fees necessary to meet regulations. Our company faces a competitive disadvantage against large public companies with great economies of scale, as well as private

and foreign companies that do not have to comply. Our relatively small finance department spends a disproportionate amount of time on regulatory compliance activities rather than supporting the business and operations.

Every dollar spent on increased regulatory requirements is one dollar less we are able to spend on growth opportunities, capital investment, and our ability to attract new investors to our company. Every hour spent by me and my staff on regulatory requirements is one hour less that can be devoted to overseeing the critical financial performance metrics essential for day-to-day operating decision as well as short- and long-term financial planning.

We know that the SEC and the PCAOB teams are working hard to understand the impacts increased regulations and oversight have on small business companies such as Nortech. We look forward to the new guidance on Section 404 for small companies to help us reduce costs and save time in order to keep us competitive in our global marketplace and provide our shareholders a fair return on their investment.

We support the Committee on Small Business and Entrepreneurship and their request that the implementation date of 404 for small companies be delayed from the current effectivity date. This delay will allow us to continue to build upon our current internal control processes without the time and cost pressures the current deadlines have and also allow us to field test the new guidance for small businesses.

In conclusion, we believe the great opportunity and major benefits of 404 are already in place. Investors' confidence has been restored in U.S. capital markets and improved control processes helping companies like Nortech better manage internal control systems are in place. For the competitive health of smaller U.S. companies like Nortech Systems, it is vital that our future compliance burden be scalable.

Thank you again for the opportunity to participate in today's hearings and for the Committee's interest in this critical issue to Nortech and small businesses.

[The prepared statement of Mr. Wasielewski follows:]

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Sarbanes-Oxley and Small Business: Addressing Proposed Regulatory Changes and their Impact on Capital Markets

Testimony of
Richard Wasielewski, Vice President and CFO
Nortech Systems, Inc.
Before the
U.S. Senate Committee on Small Business & Entrepreneurship
April 18, 2007

Chairman Kerry, Ranking Member Snowe and Committee Members, thank you for the opportunity to share our company's experiences and insights into the benefits and costs of complying with the Sarbanes-Oxley Act of 2002 and increased Security and Exchange Commission (SEC) regulations.

My name is Richard Wasielewski, and I am the Vice President and Chief Financial Officer for Nortech Systems, which is a publicly traded Minnesota Corporation, organized in 1990. We file annual and quarterly reports, proxy statements and other documents with the SEC. We are an electronic manufacturing services company with facilities in Minnesota, Wisconsin, Iowa and Monterrey, Mexico. We have over 1,100 employees who manufacture wire harness and cable assemblies, electronic sub-assemblies, and printed circuit board assemblies for a variety of original equipment manufacturers. The markets we serve are Industrial Equipment, Medical Equipment, Military/Defense and Transportation.

Our 2006 revenue was just over $105 million, with a net profit of $1.3 million or 1.25% of revenue. Our industry is highly competitive – we are battling against global competitors with significantly greater resources. We have assets totaling $42 million with a market capitalization at 2006 fiscal year-end of just over $20 million.

I'd like to begin by stating that Nortech's Board of Directors, CEO and Officers fully support the goals and objectives of the Sarbanes-Oxley Act of 2002. The major benefit of this Act is the assurance and continued confidence our investors have in our company's reporting of our financial performance and management, along with the additional governance from a stronger internal control of our financial processes. Our internal control policy and procedures are also benefiting from a solid structure of clearly defined roles and responsibilities, priority management, risk assessment, monitoring, and corrective actions for continued improvement.

However, these benefits come at a significant cost to Nortech from the large administrative costs and fees necessary to meet the regulations. Our company faces a competitive disadvantage against larger public companies with greater economies of scale to deal with increased compliance costs, as well as private and foreign companies that do not have to comply with Sarbanes-Oxley requirements. In addition, in order to meet the requirements of Sarbanes-Oxley and other internal control initiatives from expanded SEC and Financial Statement Standard Board (FASB) reporting requirements, our relatively small finance department spends a disproportionate amount of time on pure regulatory compliance activities rather than supporting the business and operations.

Over the last five years, our compliance costs have more than doubled, from $376,000 in 2002 to $933,500 in 2006. We estimate that approximately 50% of this increase is a result of costs incurred from our Sarbanes-Oxley compliance and internal control initiatives. The other 50% is costs incurred to meet expanded SEC and FASB reporting requirements. A detailed breakdown of Nortech's total cost of compliance for financial statement audits, SEC filings and internal controls over the past five years is included in the table below.

Nortech Systems, Inc., Historical Costs for Audit & SEC Compliance

	2002	2003	2004	2005	2006
Actual Fees Paid:					
Auditors	$103,500	$131,000	$200,000	$224,000	$266,000
Tax, SEC & GAAP	$ 52,500	$ 90,000	$113,500	$196,000	$134,000
Consulting & Advising					
Sub Total Fees Paid	$ 156,000	$221,000	$313,500	$420,000	$400,000
Estimated In-House Costs:					
Management & Staff	$200,000	$250,000	$300,000	$400,000	$485,000
Expenses	$ 20,000	$ 25,000	$ 30,000	$ 40,000	$ 48,500
Total Compliance Costs	$376,000	$496,000	$643,500	$860,000	$933,500

Another cost of the Sarbanes-Oxley Act has been the increased need for auditors and their services. The increased need to hire auditors for attestation reports for the earlier accelerated filers has resulted in higher compliance costs of our audit, consulting and GAAP advising fees due to the increased demand for resources.

It should be noted that our current compliance costs do not include the cost for the Sabanes-Oxley auditor attestation reports, because they are not required for our Company until the end of 2008. The earlier cost estimates in 2002 and 2003 for our auditor attestation reporting requirements were roughly 25-40% of our financial statement audit cost for a given year. Now that estimate has been increased up to 75-80% of the financial statement audit cost and the cost base is much higher. We estimate our auditor attestation cost to be an additional $200,000 to the above 2006 figure on an ongoing basis once we reach the required audit attestation stage.

In addition, the increasing cost burden of compliance puts us at a significant competitive disadvantage against private and foreign companies, who, as I mentioned previously, do not have to comply with Sarbanes-Oxley requirements. Our competition has more time to focus on the growth and management of their business and less on regulatory requirements. Every dollar spent on increased regulatory requirements is one dollar less we are able to spend on growth opportunities, capital investment and attraction of new investors to our company. Every hour spent by me and my staff on regulatory requirements is one hour less we can devote to overseeing the critical financial performance metrics essential for day-to-day operational decision-making as well as short- and long-term strategic planning.

We know that the SEC and the Public Companies Accounting Oversight Board are working hard to understand the impacts their regulations and oversight are having on small public companies such as

Nortech Systems. We look forward to the new interpretative guidance on Section 404 for small companies to help us reduce costs and save time in order to keep us competitive in the marketplace and provide our shareholders a fair return for their investment.

We support the Committee on Small Business & Entrepreneurship and their request that the implementation date of Section 404 for small companies be delayed up to one additional year from current effective dates. This delay will allow us to continue to build upon our current internal control processes without the time and cost pressures of the current deadlines and requirements for audit attestation.

Thank you again for the opportunity to participate in today's Hearing and for the Committee's interest in this critical issue to Nortech and other small businesses. I look forward to responding to any questions you may have.

Chairman KERRY. Thank you very much, Mr. Wasielewski.
Mr. Piche?

STATEMENT OF JOSEPH PICHE, CHIEF EXECUTIVE OFFICER AND FOUNDER, EIKOS, INC.

Mr. PICHE. Chairman Kerry, Ranking Member Snowe, and members of the Committee, it is an honor to testify this morning regarding the impact of Sarbanes-Oxley on small businesses. My name is Joe Piche and I am the founder and CEO of Eikos, Inc., in Franklin, Massachusetts. We are a small nanotechnology company that makes flexible, transparent, conductive films and coatings, and Eikos last year won the Wall Street Journal's Technical Innovation Award globally for the most innovative material in the world.

We started in 1996 and we have grown to 16 very talented people. In 2006, we had approximately $3.5 million in sales and our products have applications around the world. We have one licensee in Japan. As much of our commercial sales are in Japan and Asia, we contribute in a small way to reduce America's trade deficit.

I am pleased with what my team has accomplished, but we have reached a point where we need to access capital markets in order to expand. We have explored various options and concluded the best venue for raising the required capital for expansion might lie in the public markets. As such, we have explored the options within the United States and concluded that the atmosphere for doing so here is less favorable than utilizing other public markets, such as the AIM in London.

I am not an economist nor an accountant nor an expert in the details regarding issues of the regulation of public companies. I am a chemist by training, and from my perspective as an entrepreneur, the atmosphere for raising capital in the United States has taken a turn for the worse, specifically with regards to going public and the costs associated with compliance for a small public company in the United States.

At Eikos, we believe that some aspects of Sarbanes-Oxley have contributed to the current change in the financial climate in the U.S. capital markets. While Sarbanes-Oxley has had positive impacts, it has made it more difficult for me, a private company, and has dramatically increased our costs of doing business.

Let me say from the outset, I believe Sarbanes-Oxley, for the most part, is very good legislation. Entrepreneurs like me depend

on our capital markets, and our capital markets depend on trust. Sarbanes-Oxley and the PCAOB have helped to restore the trust that corporate accounting scandals have helped to destroy. But over time, it has become clear that some of the secondary impacts of Sarbanes-Oxley have made it more difficult for companies like mine to do business.

Regarding increased costs, as I have mentioned, Eikos needs to raise capital through private equity markets. However, due to increased regulations, the costs for our company to obtain this equity is extraordinarily high. The accounting costs specifically associated with taking a company public are now so large they threaten to wipe out the funding that a company like Eikos would receive in its IPO. So what is the incentive to take the company public when the company will not gain any capital as a result?

The increased cost of accounting has far broader effect on a small company than just the question of whether or not to go public. Sarbanes-Oxley has increased the price of accounting services. I have witnessed a dramatic increase in the costs at Eikos. This cost is small relative to the huge resource expenditure that public companies are now required to make as part of Sarbanes-Oxley. For example, I see other nanotechnology companies that have gone public or are public and they are now spending more per employee on Sarbanes-Oxley compliance than they are spending on health care. This should not be.

With regards to liability, the increased liability imposed by Sarbanes-Oxley makes it simply not worth the risk to serve on the board without good D&O insurance. Before Sarbanes-Oxley, I could buy insurance for approximately $8,000 a year. Immediately after, the price shot up to approximately $40,000 to $50,000, a substantial increase. And it is not the same policy. The deductible went up and the coverage is much less comprehensive.

At Eikos, we offer the best available health insurance. This is something I refuse to compromise because I do not want my employees to ever worry about their health or the health of a family member. But the high cost of D&O insurance forced me to make a decision between maintaining this high standard of health insurance versus maintaining D&O insurance. Hence, I have lost board members because of the lack of our D&O insurance.

Driving investment overseas, it is our transparency and accountability that inspire the global investment community's confidence in American markets, and that attracts investments from around the world to the United States. Sarbanes-Oxley was designed specifically to strengthen the world's confidence in our markets and thus attract even more foreign investment. This was a noble goal and in many ways has succeeded well. But in some ways, it has gone too far. Some of the very requirements of Sarbanes-Oxley that were designed to restore global confidence in the American markets by creating tremendous financial incentives for private companies to go public not in the United States, but in other countries. By increasing the costs of going public in the United States, Sarbanes-Oxley is giving foreign capital markets a competitive advantage over American markets.

Eikos has considered carefully going public on the London AIM exchange. We estimate the cost in the United States to be approxi-

mately $2 million, but only $500,000 to $600,000 on the AIM. We are by no means alone. In foreign markets, the percentage here has increased in the last several years whereas the United States has held relatively stagnant or decreased.

In conclusion, I would like to thank you, Senator Kerry, for your leadership in sponsoring legislation to help make it easier for small businesses to comply with Sarbanes-Oxley. I would also like to thank the members of the Committee for your ongoing commitment to support small businesses like Eikos. America's small businesses are the engines of innovation and employment and they are absolutely essential to our continued competitiveness in this century.

[The prepared statement of Mr. Piche follows:]

Testimony of Joseph Piché
Chief Executive Officer and Founder
Eikos Inc.
Before the Senate Small Business and Entrepreneurship Committee
April 18, 2007

Chairman Kerry, Ranking Member Snowe, and Members of the Committee, it is an honor to be asked to testify this morning regarding the impact of Sarbanes-Oxley on small businesses.

My name is Joseph Piché, and I am the founder and CEO of Eikos, Inc. Eikos is a high performance materials or "nanotechnology" company based in Massachusetts that makes flexible, transparent, conductive films for application to electronic displays, solar cells, touch screens and any other electronic application that might require a transparent and conductive material. I started the company in my basement in 1996, and we have grown to employ 16 very talented people. In 2006 we had approximately $3.5 million in sales, and our products have applications throughout the world. The health of Eikos stands upon its technological know-how and the associated portfolio of intellectual property. As much of our commercial sales are in Japan and Asia, we contribute in a small way to reduce America's trade deficit.

I am proud of what my team and I have done with Eikos, but we have reached a point where we need to access capital markets in order to continue to expand. We have explored various options and concluded that best venue for raising the required capital for expansion might lie in the public markets. As such, we explored the options within the U.S. and concluded that the atmosphere for doing so here was less favorable than utilizing other public markets such as the AIM in London.

I am not an economist, nor an accountant, nor an expert in the details the issues regarding of regulation of public companies, but from my perspective as an entrepreneur, the atmosphere for raising capital in the U.S. has taken a turn for the worse, specifically, with regard to the cost of going public and the costs associated with compliance for a small public company in the U.S.

We at Eikos believe that some aspects of Sarbanes-Oxley have contributed to the current change in the financial climate in the US capital markets. While Sarbanes-Oxley has had many positive impacts, it has made it more difficult for me to take my company public – and it has dramatically increased our cost of doing business even as a private company.

Let me say at the outset that I believe Sarbanes-Oxley is, for the most part, very good legislation. Entrepreneurs like me depend on our capital markets, and our capital markets depend on trust. Sarbanes-Oxley and the Public Companies Accounting Oversight Board have helped to restore the trust that corporate accounting scandals had helped to destroy. But over time, it has become clear that some of the secondary impacts of Sarbanes-Oxley have made it more difficult for companies like mine to do business.

Increased Costs

As I mentioned, Eikos now needs to raise capital through the public equity markets. However, due to the increased regulations of Sarbanes-Oxley, the cost for our company to obtain this equity may be extraordinarily high. The accounting costs specifically associated with taking a company public are now so large that they threaten to wipe out the funding that a company like Eikos would receive in its IPO. What is the incentive to take a company public when the company will not gain any capital as a result?

The increased cost of accounting has far broader effect on small businesses than just the question of whether or not to go public. Sarbanes-Oxley has increased the demand for accounting services, while the accounting industry has consolidated. Due to increased demand upon a reduced supply, with the added burden the accounting firms themselves face due to more conservative business practices, the price for accounting services has increased dramatically. I have witnessed at least a 20 percent increase the cost of accounting services for Eikos.

This cost is small relative to the huge resource expenditure that public companies are now required to make as part of Sarbanes-Oxley. For example, I see other nanotechnology companies that have gone public, and are now spending more per employee on Sarbanes-Oxley compliance than they are spending on health care. This is not in the best interest of the companies or their employees. Eikos would be much more likely to go public, raising necessary capital, if we did not believe that the costs of compliance alone might be larger than the capital raised. Again, I believe that transparent accounting is vital for both private and public companies, but the high cost of accounting for small businesses is hurting their growth.

Liability

Sarbanes-Oxley's liability provisions pose further difficulties for small businesses like mine. In the current business environment, high-quality executives and advisors are increasingly demanding that companies offer Directors' and Officers' (D&O) insurance. The increased liability imposed by Sarbanes-Oxley makes it simply not worth the risk to serve on a board of directors, for example, without the protection of insurance. Before Sarbanes-Oxley, I could buy good D&O insurance for $8,000. After Sarbanes-Oxley, the price shot up to $40,000 – a 500 percent increase. And it is not the same policy: the deductible went up, and the coverage is much less comprehensive.

At Eikos, we offer the best available health insurance. It is something about which I refuse to compromise, because I do not want any of my employees to worry about their health or the health of a family member. But the high cost of D&O insurance is forcing me to make a choice between maintaining this high standard and offering the insurance coverage necessary to attract and retain the best management and directors. It cannot have been the intent of Congress, when it passed Sarbanes-Oxley, to put small businesses like mine in such a dilemma.

Driving Investment Overseas

I cannot emphasize enough how important it is that America have capital markets that lead the world in transparency and accountability. It is our transparency and accountability that inspire the global investment community's confidence in American markets, which attracts investment from around the world to the United States. Sarbanes-Oxley was designed to strengthen the world's confidence in our markets, and thus attract even more foreign investment.

This was a noble goal, and in many ways it has succeeded quite well. But in some ways it has gone too far. Some of the very requirements in Sarbanes-Oxley that were designed to restore global confidence in American markets are creating tremendous financial incentives for private American companies to go public – not in the United States, but in other countries. By increasing the costs of going public in the United States, Sarbanes-Oxley is giving foreign capital markets a competitive advantage over American markets.

Eikos has carefully considered going public on the London AIM stock exchange. We estimate that it would cost Eikos approximately $2 million to go public on a U.S. exchange, but only $500,000 to go public on the AIM. We are by no means alone: IPOs in foreign markets have increased over the last several years, while IPOs in U.S. markets have held stagnant or decreased.

Conclusion

I would like to thank you, Senator Kerry, for your leadership in sponsoring legislation to help make it easier for small businesses to comply with Sarbanes-Oxley. I would also like to thank the Members of this Committee for your ongoing commitment to supporting small businesses like mine. America's small businesses are engines of innovation and employment, and they are absolutely essential to the nation's continued competitiveness in the 21st century's global economy.

Chairman KERRY. Thank you very much, Mr. Piche.

Let me just pick up with you, since you testified last. So what would you do? What is the balance here?

Mr. PICHE. What would I do today? I would use the London AIM because I utilize the concept of Ockham's razor. When you have two different alternatives, I take the simpler and the more cost effective for the company, because as the CEO, it is my duty to do that which provides the most benefit to the stockholders and the employees, many of which are stockholders.

Chairman KERRY. How do you do that and maintain the integrity that everybody has fought for? There are a lot of folks who believe that the London standard, in fact, has no minimum size requirements, no minimum public float, no minimum share value, no government review of company disclosure documents, and so, in effect, they are exempting people from the full code of corporate governance. I mean, the so-called "attraction" is to go back to the Wild West.

Mr. PICHE. I understand what you are saying. I am not an expert in this area. However, as a CEO, I am focused on the growth of the corporation and, therefore, our perspective is we care very much about corporate governance and we are not in a position to make decisions regarding how the law should be changed or modified in any way. However, we would like to run Eikos in a right, good, and proper way. When we talk to the people that come to our company, knocking on our doors as representatives of the AIM, often unsolicited, we——

Chairman KERRY. Is that what is happening? They are coming over here and come to our market because we are——

Mr. PICHE. That is correct, yes. It has happened to us at Eikos, so——

Chairman KERRY. Well, I wish—again, this is the problem you have when you have the order of testimony, and we tend to do this on all our committees here, the regulatory folks first and then they are gone. It would be good to get the interaction, actually. I think in the future, I am going to try to see if we can't set it up that way a little better.

Obviously, the testimony of Chairmen Cox and Olson is that they are moving in Europe to adopt a similar standard here. Now, the AIM actually contradicts that, and in fact, there was a pretty dramatic example recently of a company that placed a convertible loan stock on the market. It knew its financial performance was going to fall short, and when they prepared a news release to that effect, the investment banker advised them to withhold it until after the offering was complete, and they did, and then, of course, the news came out and it lost 75 percent of its value in 2 days and it got a tiny slap on the wrist. I mean, it was like nothing had happened. So again, that is clearly not the standard that we want to go back to.

Mr. PICHE. Correct.

Chairman KERRY. We would like to see people move rapidly to here. I assume we may be losing a few folks who want to go out into that kind of an atmosphere, but I am sure that investors broadly, as they look at the movement of capital and the safety of that capital, are going to ultimately have some problems with that.

Mr. PICHE. Possibly. However, the way we look at it at Eikos, if I may say so——

Chairman KERRY. Yes.

Mr. PICHE [continuing]. Is that our example is if we are going to put an addition on a home and we needed to borrow $250,000 for an addition for new bedrooms for children or such and we have the opportunity to get it from bank one at a certain rate, but we can get it at bank two at half the rate, we will get it at bank two at half the rate, end of discussion. We go in the direction of——

Chairman KERRY. So the bottom line——

Mr. PICHE [continuing]. What is best for the——

Chairman KERRY [continuing]. Will drive it no matter what? Mr. Wasielewski, you are nodding your head in assent there. Do you want to add on?

Mr. WASIELEWSKI. Yes. It gets back to the cost versus the benefit. Is it worth it?

Chairman KERRY. I am struck. You are on a pretty tight profit margin.

Mr. WASIELEWSKI. Yes, we are, and——

Chairman KERRY. With that kind of revenue, that surprised me.

Mr. WASIELEWSKI. We need the different markets to raise capital. We believe in the U.S. markets. It is our next area to raise capital and cash to fund our growth, but we also have to balance that against venture capital and even going private. So we do that on a constant basis and it is reviewed on an annual basis, sometimes more often.

Chairman KERRY. And your net view of Sarbanes-Oxley is—I mean, you seem to support in your testimony the notion of having this kind of accountability, but you have a "but" there, right?

Mr. WASIELEWSKI. Yes, absolutely. It is getting to where it is working—it was encouraging to hear the discussion earlier that they are working towards it, that they are taking our scale into consideration. I am concerned that when these 6,000 other filers hit the marketplace, what it is going to do to the cost again to the accountants and auditors and services that are going to be needed. Is that going to do another bump in our costs that you have on the board? Are they going to go higher? Are they going to be 26 cents and $2? That is a real concern of ours. So they really have to keep that cost-benefit under control.

Chairman KERRY. Mr. Venables, you all heard the testimony of the folks who preceded you. I know I have heard this from bankers previously about the FDIC experience and so forth and that the 404 seems to go beyond that and you felt that it was adequate, and there is every indication that it was adequate, as a matter of fact. Were you satisfied that what they said is going to sufficiently take into account the concerns you all have expressed?

Mr. VENABLES. Only partially, Mr. Chairman. If I can give you a little example from our own company, in 2002 when I became CEO of Benjamin Franklin Bank, the bank had run amuck of some regulatory matters and there was a requirement for a new CEO to come in and I was part of that change. At the time, the bank was $450 million in size. It was not required to be FDICIA registered in any way, but I made the decision as a new CEO that I wanted

to make sure I understood the controls. I wanted to make sure we had a proper framework for risk.

And so we did an early adoption of FDICIA and voluntarily implemented those controls and I had a very powerful management tool out of the FDICIA exercise to enable me to understand exactly how this company was running and what changes needed to be made. We emerged from the excess regulatory oversight almost immediately and enjoy a very, very high rating in all of our areas, especially in our compliance areas.

Now, in 2005, we did an initial public offering. Obviously, we become affected by Sarbanes-Oxley. In 2006, we became an accelerated filer and needed to go through that whole exercise as I outlined. That whole exercise resulted in these tremendous costs as we have outlined, and yet I did not pick up any additional ability to better manage our company. I think that is the big frustration.

When I hear the PCAOB and the SEC talk about reforms, I am greatly encouraged. We think that is definitely heading in the right direction. But there are a couple caveats. The first is the devil will be in the details, and unfortunately, as a new Accounting Standard 5 is being evolved, there are decisions that need to be made today by managements of companies who are non-accelerated filers with respect to how they need to implement these controls and to which standards are they needing to adhere. I think ABA is very troubled by the fact that until those standards are actually in place, it is unfair to set deadlines for compliance and we really feel that there should be a full year after the final rules are generated before smaller companies——

Chairman KERRY. Sure. Well, I see the folks who are here taking some notes on that. I think that is an important thing for us to convey and to have some dialogue with the folks who testified previously.

Senator Snowe and some of my colleagues will draw this out a little more, so let me cede my time here.

Senator SNOWE. Yes. To follow up on that delay, were you suggesting a year delay from——

Mr. VENABLES. We are suggesting a year delay from when the final rules have been put in place and tested. Our concern is that it is changing rapidly. My own experience as a company, I know that the Chairmen feel that implementation sometime in June would be adequate for the controls that are necessary for the year-end financial statements. I assure you they are not. There are two things happening at once.

One, there is a tremendous resource drain, and by that, I mean not only the internal small business staffers who need to put all this in place, but also the outside experts. They all will have this crush of companies that need to comply and the meter runs very high in those types of scenarios.

Secondly, the way the rules work and the proper framework is that you build the framework and then you test. You may find as a result of the test that you have a deficiency. If you find you have a deficiency, then you need to fix that and then retest. Every one of those cycles is a 3-month—is a quarterly cycle, so that if you do have control issues that need addressing, you may not have an opportunity to address them and have them implemented by the time

of your annual statements at the end of the year, and that could have serious repercussions.

Senator SNOWE. I see. So when you are talking about non-accelerated filers, they haven't done any testing on those standards, or audited those standards, because they haven't been put in place?

Mr. VENABLES. That is correct.

Senator SNOWE. So when they were talking about the various dates, March 2009, the date companies need to have the auditors review their company's internal controls, does that apply to non-accelerated filters?

Mr. VENABLES. I think that is what they are addressing, yes.

Senator SNOWE. But that is not sufficient because companies need to furnish their assessment of those controls in March of 2008.

Mr. VENABLES. Senator, if the rules were in effect today, that could very well be sufficient.

Senator SNOWE. OK. So it is just a matter of time, that is the big question.

You mentioned the fact of increasing the number of shareholders—the current is 500 to 1,500 or 3,000. Can you explain how that would benefit community banks, for example?

Mr. VENABLES. Certainly.

Senator SNOWE. What would be the benefit of that?

Mr. VENABLES. It is one of these issues that existed, and then with the advent of Sarbanes-Oxley and all of this talk it became a much more critical issue. Today, the threshold for non-filers is the 500 record shareholders and the $10 million in assets. Well, in banks, we all have more than $10 million in assets, so it is the 500 shareholders. The standard was set in 1964.

Over the course of the years, in these small, rural in many times, banks, there may be generations that are inheriting the stock, and where you might have had one holder, now you have three children and then you might have five grandchildren, and over time, the number of shareholders has crept larger. The statute has not changed at all to keep up with the number of investors.

ABA did some research and determined that, and you can pick any standard, but one that they found was a reasonable approach was let us look at the number of shareholders there are out there in the investing public back in 1964 and let us look at the number today, and if we apply that same rate of growth, the 500 threshold limit of 1964 would be more like the 1,500 to 3,000, depending on how you interpret the data, of today. So it is merely trying to have that change sort of indexed for the fact that there are many more investors and there are small companies that have a tough choice, because if they go over 500, they become registrants. They can't necessarily—there is still an investment opportunity——

Chairman KERRY. It is still small income.

Mr. VENABLES. Yes.

Senator SNOWE. I know that some of the banks that I have heard from in Maine are having to both comply with the banking regulations as well as Sarbanes-Oxley. Is there no way to consolidate any of these requirements?

Mr. VENABLES. Well, I don't think there is a way to consolidate all of it, but I think a lot of the auditing standards can be made

similar so that we are not doing a completely different controls framework by one set of standards and then also maintaining FDICIA. I will tell you in the case of my own company, you may know that the FDICIA standard has now gone to $1 billion. Well, we are a $913 million company and we have decided to continue with FDICIA controls because we can discontinue perhaps this year, but with any growth, we will be facing them again. So we are maintaining two sets of intense risk management frameworks and I don't think that is necessary.

Senator SNOWE. Thank you. Mr. Wasielewski and Mr. Piche, could you tell me, was there anything that you heard from both Chairman Cox and Mr. Olson with respect to the issues that they addressed in harmonizing the audits, any of the issues that made it more positive?

Mr. WASIELEWSKI. Let me take that. The integration audit is really important because that could help us greatly on costs. You are working with the same audit team. I think that comment has probably got the biggest benefit that would be the biggest step that could be taken. The fear is to have a different audit team in there and have to reeducate them just like you do on your financial statements. These folks know our business. They know our processes already. That could be a definite benefit, so that is an encouragement.

Senator SNOWE. And you mentioned scalability. Do you think that it addresses that in that sense, that it avoids the one-size-fits-all?

Mr. WASIELEWSKI. I don't know.

Senator SNOWE. Yes.

Mr. WASIELEWSKI. Based on what he said, I have a feeling that is the tough nut in how they go about trying to get that equal on that slide behind you in the future.

Senator SNOWE. Right.

Mr. WASIELEWSKI. We just get the higher price of audit and auditors and accountants by supply and demand, I think, is the biggest issue that we are going to face.

Senator SNOWE. That is why we need to get an updated assessment of the costs, you know, for every $100 revenue, it is $1.14 in audit costs.

Mr. WASIELEWSKI. Remember, there are only a couple thousand that file today and, 6,000 that haven't filed yet. That work hasn't been done on our side and the impact isn't on theirs either. We have done a lot. We have improved the internal control. We feel it is a lot better. I know our investors do. It is just that it would be nice to field test what they are proposing right now, so we could understand the impact or it might even be more.

Senator SNOWE. Mr. Piche?

Mr. PICHE. Regarding that specific question?

Senator SNOWE. Yes, that is right. Yes. Was there anything that you heard that was more positive that might affect the bottom line?

Mr. PICHE. My concern is that I didn't necessarily hear a clear pathway that I understand, but again, I am not a professional accountant or regulator, I am a chemist by training and an entrepreneur, and my fear is that it sounds slightly more complex, because then there is now another level of making determinations

and definitions as to, well, what should be audited and where do the limits begin and end. So there might be another layer of requirements on top of the ones that already exist.

Senator SNOWE. And in your particular situation, would you wait to see how, this all shakes out in the process?

Mr. PICHE. We cannot.

Senator SNOWE. No, you cannot.

Mr. PICHE. No. I think no small company can. It is a global economy. My competition is everywhere.

Senator SNOWE. Right. It is interesting because the GAO did a study of IPOs in the period between 1999 and 2004 and showed a decrease of IPOs, from 70 percent to 46 percent. So it would be interesting to know exactly where that stands today. I think that is true, because the initial capitalization is extremely important for any small company, small public company. This is a real issue, because you are really the essence of job creation in many ways. When you grow from a small business to a public company, that is where the innovation emerges.

So I think this is something we are going to have to examine. At the same time we must make sure we calibrate the right approach and preserve the public interest in response to what happened with Enron and WorldCom.

Thank you. I appreciate your comments here today. Thank you.

Chairman KERRY. Thank you.

Senator Coleman?

Senator COLEMAN. Thank you, Mr. Chairman. I associate myself with the comments of the Senator from Maine in terms of what we have to do here. Just two quick questions—and by the way, this has been a very good hearing, very helpful. We have talked about or just touched upon various issues—willingness to serve on boards, what kind of direction and leadership are going to be available to small business if folks find it difficult or impossible to serve on boards, and the cost of accounting, and then as the system grows, the pressures of supply and demand is just going to push up the costs. So we haven't capped out costs here. If anything, they are going to rise significantly.

Just two quick questions. Mr. Venables, you made the point about the need for delay perhaps of 1 year for those non-accelerated filers, but the other point, then, I take it, is that it is urgent that that decision be made soon. That has got to be one of the factors. Rather than wait for us in Congress to do something, it is my sense you need to know soon whether there will be delay for that year?

Mr. VENABLES. Certainly, Senator Coleman, and in conjunction with that, as well, the work that you heard PCAOB and the SEC working on together with respect to the new audit standards also needs to be finished as quickly as possible.

Senator COLEMAN. I hope, again, staff is listening. It goes to the Chairman's point about having folks here to hear that.

Mr. Wasielewski, you were actually very positive about some of the changes but talked about cost. I don't know if I heard this. Have you thought about going private? In spite of you being profitable, you have got a really thin line here. You make, what, one point, you spend about as much on auditing as you make in profit.

Mr. WASIELEWSKI. Yes.

Senator COLEMAN. Where are you at on that decision?

Mr. WASIELEWSKI. Well, I think the board and our CEO and I and the officers review it on an ongoing basis. Again, we do believe in the U.S. capital markets and that that is a good place for us to get some cash and invest in our business. So right now, that is the strategy. As these things grow and these things pan out, you know, they are always taken into consideration. It is a dynamic decision point. We do review it, not at every board meeting, but at least one time a year, that particular situation.

Senator COLEMAN. So it gets to that question of balance and at certain points the balance tips over and says, we can't afford to be in this public market. We just have to go private.

Mr. WASIELEWSKI. And again, it is a balance of benefits and cost. I think everybody said that. It is definitely, and I think nobody would disagree that it is definitely weighted now on the costs. The benefits are in place the last 5 years. Our internal controls are better. Most small companies are better. It is the question of how much more better do we have to get and at what cost.

Senator COLEMAN. Mr. Chairman, thank you.

Chairman KERRY. Thank you very much.

Yes, Mr. Venables?

Mr. VENABLES. If I may make one follow-up comment on the cost, we have been concentrating, I think, a lot on the first-year cost, and I do want to share with you an illustration of subsequent costs because I think they are important, as well. In 2005, our bank went public and had an acquisition, so obviously we had substantial audit costs related with those transactions. In 2006, we implemented Sarbanes-Oxley. We had substantially higher audit costs. Our auditors tell us that our budget for 2007 is less than 2006. The second-year costs are lower than the first-year costs, but they are still substantially higher than 2005, the year that we went public and the year that we made an acquisition. So it is embedded as an additional layer that that will go on for earnings.

Senator SNOWE. May I?

Chairman KERRY. Yes.

Senator SNOWE. Do you think that there has been an impetus to shift from public to private companies? I mean, there has been a lot of shift in that respect. Do you think that this has been an impetus for that?

Mr. VENABLES. From my own experience, I can tell you that in the banking industry, there are certainly many banks that have delayed going public for this reason.

Senator SNOWE. Because of the costs and because of the complexity of the regulations?

Mr. VENABLES. Exactly.

Mr. WASIELEWSKI. Let me just add to that. It is not only Sarbanes-Oxley and the internal control, it is all the SEC regulations and compliance stuff that have taken place. Our 10(k) in 2002 was 47 pages long. This year, it is 95 pages plus. It is a substantial amount of work to meet these requirements and we are not even at the Sarbanes-Oxley attestation point yet, so it is not only the internal control.

Senator SNOWE. Thank you.

Chairman KERRY. This is tough stuff. If I could just ask Mr. Piche, speaking generally, to come back to the VC question I asked earlier. Is it, in fact, making it harder to find investors rather than easier? As the argument is made, because there is an assurance of the openness and accountability, do investors feel safer or is it harder?

Mr. PICHE. From the investors' perspective? Well, from the CEO's perspective whose ambition it is to raise money to grow the corporation, from the many CEOs that I know, I think we uniformly believe that it has become more difficult. I was at a meeting of the Nano Business Alliance yesterday and I talked with many CEOs over the course of 2 days in Manhattan. I had the opportunity to be on the floor of the NASDAQ yesterday at the closing as part of that and it was fun. But I hear anecdotal stories often, in taxi lines, from friends of mine that are CEOs of small public companies, and we see the same thing, which is that it is harder to raise funds privately because of it and it is harder to raise funds publicly and the costs associated are substantial.

Chairman KERRY. I am particularly struck by the issue on the banks, and I think that it would be important for the SEC and the PCAOB to look hard at this issue of the FDIC Improvement Act requirements and what the banks are already jumping through and this question of harmonization, because I have heard this from small bankers all over the country. What was it that you said? You said 6 percent—who said 6 percent? Who said 6 percent of your profits are——

Mr. VENABLES. Six percent.

Chairman KERRY [continuing]. And that is above what you were already committed to the FDIC?

Mr. VENABLES. Oh, yes. That was just incremental costs——

Chairman KERRY. That is an incremental cost, an additional 6 percent of profit, on a $406,000——

Mr. VENABLES. Exactly, for the implementation effort.

Chairman KERRY. I think that is something that folks really need to think about hard, especially when there is a pretty strong individual regulatory process already in place, whether there is a harmonization process and whether that is sufficient and, therefore, all that is required. I mean, that is a judgment. You talk about risk assessment and judgment. The risk assessment ought to be made with respect to that standard, whether or not it is adequate for the industry, since it is an industry-wide standard.

I served on the Banking Committee for 10 years and I was there when we did the RTC and went through that horrible period, and I think that since then, we have already responded to the crisis of confidence in the marketplace and there is no evidence at this point, in my judgment, that it is somehow being abused. So again, there is an example potentially—I am saying potentially—of where this double requirement may, in fact, really be a drag on our economy and a drag on business.

So there is a lot to look at here and I want to—I am confident that Senator Snowe wants to join with me, and we will team up to put some thoughts in front of the Chairmen. I think this has been very important and very, very helpful today.

Senator Snowe, do you have any additions?

Senator SNOWE. No. I thank you. I appreciate it, but I think it does underscore the serious challenges and impediments that you face. We just really have to make sure that we reasonably understand the impact and the severity of the burdens of these regulations. On one hand, we have to address the public interest question, and on the other hand, we have to make sure that we develop and encourage job creation through your leadership. These are not mutually exclusive endeavors. I am sure that we can try to get this right, and that is what we will attempt to do through some legislative mechanisms, as well. So I appreciate your thoughtfulness and your comments here today.

Chairman KERRY. Thank you very, very much. Again, thank you very much, all of you. We appreciate it.

We stand adjourned.

[Whereupon, at 12:33 p.m., the Committee was adjourned.]

APPENDIX MATERIAL SUBMITTED

Questions of Senator Kerry for SEC Chairman Christopher Cox Small Business Committee Sarbanes-Oxley Hearing

1. **Extension of Section 404 Deadline for Small Businesses.** I appreciate your prior efforts to provide small businesses with additional time to comply with the Sarbanes-Oxley regulations. I understand and agree with the idea that small public companies need to comply with the law as quickly as possible. But, many in the small business community, including witnesses heard from at the hearing, believe that small public companies will need more time than big businesses to comply with the final changes to the Sarbanes-Oxley rules. Now that the rules have gone final, non-accelerated filers that have not yet had to comply with the law only have six months to implement the controls according to the new regulatory environment. As you know, Senator Snowe and I have asked you to consider providing additional time.

- **Do you expect non-accelerated filers to be able to comply under this timeframe? Please explain your reservation to providing the additional time that small firms have stated that they need.**

ANSWER:

Yes. Since the SEC has deferred compliance for non-accelerated filers four times in an effort to ensure that the burden of compliance did not unduly impact smaller companies, adequate time to prepare should not be an issue. All other public companies in the United States already have three years of reporting on internal controls behind them. Nonetheless, we will continue to monitor the trends in compliance to determine whether a further extension is justified before smaller companies would otherwise have to comply with the audit requirement beginning with the SEC filings in 2009.

The very positive result of our determination to phase in 404 compliance for smaller companies is that we and they have had the opportunity to field test the requirements so that smaller companies have the benefit of learning from the experiences of larger firms.

These experiences have deeply informed the SEC's new Interpretive Guidance and the PCAOB's proposed new auditing standard. It is important to note that the SEC's Interpretative Guidance is optional, providing those choosing to use the guidance a means for complying with section 404, and does not impose any new requirements. The continued phased implementation will allow smaller firms to start complying with section 404(a) of SOX starting in 2008, while the first audit under section 404(b) won't be due until 2009.

The SEC's new guidance is intended to be of significant and direct help to smaller companies. Completing the implementation of Section 404 is important to further

enhancing the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets. The Commission and the PCAOB will continue our ongoing outreach efforts over the coming months to ensure that the changes recently made in the implementation of section 404 live up to our expectations for a more effective and efficient system for all filers.

2. **SEC/Congressional Action to encourage businesses to go public.** In order for our economy to grow, we need more small businesses to become public companies and to create new jobs.

- **Beyond making appropriate changes to the Sarbanes-Oxley regulations, what efforts can the SEC and the Congress take to help more small businesses, especially minority small businesses, become small public companies?**

ANSWER:

We continually review our regulations with a view towards reducing the burdens of being a public company and to remove obstacles to raising capital, consistent with investor protection. For example, on May 23 the Commission approved a package of rule change proposals designed to modernize and streamline capital raising and reporting requirements affecting small business. The small business improvements that the SEC recently proposed include:

- Giving small businesses access to the expedited "shelf" registration process for their own securities offerings, which previously was available only to big companies.

- Cutting paperwork for thousands of small businesses, by allowing them to raise capital in a private offering after filing a simplified Form D online.

- Establishing shortened holding periods for restricted securities, making it easier for small business shareholders to put their securities on the market sooner and hopefully reducing the discount that small businesses must absorb to sell restricted securities.

- Giving issuers the benefit of a new, limited offering exemption from Securities Act registration requirements for offerings and sales of securities to a newly defined category of "qualified purchasers" in which limited advertising would be permitted.

- Eliminating the limit on the number of employees who can receive stock options from their fast-growing private firms, improving the ability of emerging growth companies to attract and retain talent without prematurely triggering the requirements of the Exchange Act.

- Providing a simplified system of disclosure for almost 1,600 additional smaller public companies, an increase of over 45% in the number of small companies that are currently eligible.

Many of these rule proposals address key recommendations made by the Commission's Advisory Committee on Smaller Public Companies. We look forward to further input from the small business community as we receive the public comments on those proposals. We will continue to consider additional recommendations made by the Advisory Committee.

In addition, we regularly engage in outreach to the small business community in other ways. For example, we hold an annual forum that focuses on the capital formation needs of small businesses. A major purpose of this forum is to provide a platform for small companies to highlight improvements needed to the capital-raising process and the related regulatory requirements. In recent years, the forum has included small interactive breakout groups to develop recommendations for government action and, in some cases, legislation. We expect to host another forum this fall.

Finally, while it is outside the regulatory purview of the SEC to address tax policy, it is consistent with our statutory mandate to promote capital formation to observe that the regime for the taxation of gains from investment in securities has a direct and significant impact on smaller companies' cost of capital and thus the ability of small businesses, including minority small businesses, to become public companies. Congress, of course, has plenary authority over such matters.

Senator Olympia J. Snowe
Follow-up Questions
Small Business Committee Hearing
April 18,2007

Question for Chairman Cox

1. 1934 Securities Exchange Act.
How would the SEC benefit from making the Sarbanes-Oxley Act of 2002 part of the 1934 Securities Exchange Act? What is the SEC's opinion of recommendations suggesting that Congress expressly incorporate Sarbanes-Oxley into the Securities Exchange Act?

ANSWER:

There is no particular benefit that would be achieved by making the Sarbanes-Oxley Act of 2002 ("SOX") part of the Securities Exchange Act of 1934 ("Exchange Act"). Indeed, many of the provisions of SOX are already incorporated into the Exchange Act. For example, many of the provisions in Titles II, IV, V, and VI of SOX are drafted as amendments to the Exchange Act. In addition, many of the provisions in Titles VIII, IX and XI of SOX are criminal provisions incorporated into Titles 18 and 28 of the U.S. Code; and some provisions are drafted as amendments to the Employee Retirement Income Security Act of 1974 and the bankruptcy laws. There would appear to be little benefit from making these provisions part of the Exchange Act. Still other provisions of SOX, such as those in Title VII, include study and report requirements that already have been complied with, and including these provisions in the Exchange Act would not appear to have any effect. SOX does include some stand-alone provisions, particularly in Title I, which provides for the establishment and oversight of the Public Company Accounting Oversight Board ("PCAOB"), and in Titles III and IV.

The Commission has extensive rulemaking authority under SOX, similar to that provided under the Exchange Act. Section 3(a) of SOX expressly grants the Commission general rulemaking authority to promulgate rules and regulations in furtherance of the Act. In addition, Section 3(b) of SOX provides that a violation of the Act, a Commission rule under the Act, or a rule of the PCAOB shall be treated as a violation of the Exchange Act, enabling the Commission to exercise its enforcement authority under the Exchange Act with respect to the provisions of SOX.

While we do not recommend incorporating SOX into the Exchange Act, there is one particular legislative change to SOX to make it consistent with the Exchange Act that would be beneficial. SOX does not include an explicit grant of general exemptive authority, while the Exchange Act does. We recommend that Congress grant explicit exemptive authority to the Commission over those provisions of SOX that are not already incorporated into the Exchange Act (and for which SOX currently does not provide *specific* exemptive authority).

2. SEC's Ability to Raise Shareholder Limit.
Does the SEC currently have the authority to raise the shareholder threshold limit, below which companies are exempt from specific SEC requirements, from 500 shareholders to a higher number?

ANSWER:

In connection with directing the staff to advise the Commission on possible amendments to the Commission's rules that relate to the shareholder threshold that triggers registration under Section 12(g) of the Securities Exchange Act of 1934, I also have directed the staff to determine whether we have sufficient authority to undertake that action. We will let you know of any future action that we decide to take to amend these rules, and whether additional authority is needed. In this connection, I have also directed the Commission's Office of Economic Analysis to undertake a review of the Section 12(g) registration standards to determine whether they continue to be the most appropriate means of accomplishing the objectives of Section 12(g).

3. SEC and Arbitration.
Where is the SEC on its shareholder arbitration initiative? If the SEC is serious about this proposal, how will the SEC ensure that future regulations balance shareholder rights against the need to promote efficient capital markets and diminish costly litigation? Are there any other tools the SEC needs from Congress to further promote dynamic and efficient capital markets that protect investors?

ANSWER:

There is no pending rule or proposal before the Commission to allow corporations to mandate arbitration of shareholder claims. Corporations should not be able unilaterally to limit the rights of investors to sue, and I can assure you that the Commission does not plan to advance any proposal that diminishes investor rights. Because shareholders benefit from efficient capital markets and efficient dispute resolution, these goals are mutually reinforcing. The SEC will continue to examine ways to further promote dynamic and efficient capital markets that protect investors, and we believe we have the necessary tools to do so.

4. Backdating of Stock Options.
What is the status of pending investigations and civil actions the SEC has taken against firms and executives alleged to have backdated stock options? What is the estimated timing and the number of future SEC actions on this issue?

ANSWER:

The SEC's Division of Enforcement is currently investigating more than 140 companies for possible fraudulent reporting of stock option grants. The companies under investigation are located across the country, are of various sizes, and span multiple industry sectors. All of the SEC's regional offices are currently involved in these investigations.

Longstanding SEC policy precludes the disclosure of any information about these ongoing investigations; however, enforcement actions have been filed against former executives of Symbol Technologies, Peregrine, Brocade, Comverse Technology, McAfee, Monster Worldwide, TakeTwo Interactive Software, Engineered Support Systems, Apple Inc. and Mercury Interactive. To date, the Commission has brought enforcement cases against 4 issuers and 19 former executives. These cases involved alleged misconduct of chief executive officers, general counsels, chief financial officers, and other accounting and human resources employees. The Department of Justice has also brought parallel criminal actions against 10 of the 18 former executives charged by the Commission.

Below are details of enforcement actions brought by the Commission to date:

SEC v. Michael F. Shanahan, Sr., et al. (Engineered Support Systems): On July 12, 2007, the Commission filed a civil injunctive action against Michael F. Shanahan, Sr. (former ESSI Chairman and CEO) and Michael F. Shanahan, Jr. (former ESSI Comp Committee Member) alleging that they participated in a scheme to grant undisclosed, in-the-money stock options to themselves and other ESSI officers, directors, and employees, from 1997 to 2002. As a result of the backdating, the Commission alleged that ESSI failed to disclose approximately $20 million in unauthorized compensation. The Commission alleged that Shanahan, Sr. personally profited by over $8.9 million from the scheme; Shanahan, Jr. personally profited by approximately $380,000. Both are litigating.

SEC v. Brocade Communications Systems: On May 31, 2007, the Commission filed a settled civil fraud action against Brocade for falsifying its reported income from 1999 through 2004 through the backdating scheme committed by its former CEO and other former executives. The company settled the action by agreeing to an antifraud injunction and payment of a $7 million civil penalty.

SEC v. Mercury Interactive LLC (f/k/a Mercury Interactive Corporation): On May 31, 2007, the Commission filed a civil fraud action against Mercury Interactive and four of its former executives – former Chairman and CEO Amnon Landan, former CFOs Sharlene Abrams and Douglas Smith, and former GC Susan Skaer – alleging a fraudulent scheme from 1997-2005 that included: (a) fraudulent backdating of option grants that understated expenses by at least $258 million; (b) fraudulent disclosures concerning Mercury's "backlog" of sales revenues to manage its reported earnings; (c) fraudulent loans for option exercises by overseas employees to avoid recording expenses; and (d) backdating of option exercises of certain executives. Mercury settled the case by agreeing

to an antifraud injunction and payment of a $28 million penalty. [Mercury was acquired by Hewlett-Packard Company on Nov. 8, 2006, after the alleged misconduct.]

SEC v. Nancy R. Heinen and Fred D. Anderson (Apple): On April 24, 2007, the Commission sued Nancy Heinen, former general counsel of Apple Inc., for participating in the fraudulent backdating of two large option grants to Apple's top officers that caused the company to underreport its expenses by nearly $40 million. The Commission also filed a settled action against former Apple CFO Fred Anderson, alleging that Anderson should have noticed Heinen's efforts to backdate a large executive team grant but failed to take steps to ensure that Apple's financial statements were correct. Anderson agreed to a permanent injunction and payment of approximately $3.5 million in disgorgement and penalties in order to settle the matter against him.

SEC v. Kent H. Roberts (McAfee): On February 28, 2007, the Commission sued Kent Roberts, formerly secretary of the compensation committee of McAfee's board of directors and general counsel, for allegedly falsifying the minutes of a compensation committee meeting, and directing the company to issue a 420,000 share option grant to McAfee's chief executive a day later than the committee had directed. This litigation is ongoing.

SEC v. Myron F. Olesnyckyj (Monster Worldwide): On February 15, 2007, the Commission sued Myron Olesnyckyj, the former general counsel of online search firm Monster Worldwide, for his alleged role in a multi-year scheme to secretly backdate stock options granted to thousands of Monster officers, directors and employees, including grants to him. Olesnyckyi allegedly falsified documents to make it appear as if the company had actually granted options on certain dates, which in reality had been selected after the fact by looking backward for a date on which the stock price was low. On March 27, 2007, Olesnyckyj settled to a permanent antifraud injunction and permanent officer and director bar.

SEC v. Ryan Ashley Brant (TakeTwo Interactive Software): On February 14, 2007, the Commission settled charges that Ryan Brant, the former CEO and chairman of board of directors of TakeTwo Interactive Software, had illegally backdated options. Brandt and others at TakeTwo referred to their granting practices as "pick-a-date" option granting. Brandt agreed to pay over $5.2 million in disgorgement and prejudgment interest and to pay a $1 million penalty, and agreed to a permanent officer and director bar.

SEC v. Steven J. Landmann, SEC v. Gary C. Gerhardt (Engineered Support Systems): On February 6, 2007, the Commission sued Steven Landmann, the former controller of Engineered Support Systems, and Gary Gerhardt, the former CFO, for their alleged roles in a 6-year option backdating scheme which resulted in employees and directors receiving approximately $20 million in unauthorized compensation, $15 million of which was granted to top executives and directors. Landmann agreed to pay over $600,000 in disgorgement and prejudgment interest and a $259,486 penalty, a permanent officer and director bar and agreed to be suspended from appearing or practicing before the Commission as an accountant. The litigation against Mr. Gerhardt is ongoing.

SEC v. Jacob ("Kobi") Alexander, David Kreinberg, and William F. Sorin (Comverse Technology): On August 9, 2006, the Commission sued Kobi Alexander, co-founder, former Chairman and CEO of Comverse, David Kreinberg, former Comverse CFO, and William Sorin, former Comverse General Counsel and a former director, for their alleged roles in a scheme which involved the creation of a slush fund of backdated options granted to fictitious employees. Subsequently, the options were made immediately exercisable, to recruit and retain key personnel. Kreinberg settled and agreed to pay approximately $2.4 million in disgorgement and prejudgment interest, agreed to a permanent officer and director bar, and agreed to be suspended from appearing or practicing before the Commission as an accountant. Sorin settled and agreed to pay over $3 million in civil penalties, disgorgement, and prejudgment interest, agreed to a permanent officer and director bar, and agreed to be suspended from appearing or practicing before the Commission as an attorney.

SEC v. Gregory L. Reyes, et al. (Brocade Communications Systems): On July 20, 2006, the Commission sued former Brocade CEO, Chairman and President Gregory Reyes, and former Brocade VP of Human Resources, Stephanie Jensen, for their alleged roles in an option backdating scheme that involved falsified employment offer letters and compensation committee minutes, to hide the fact that option grants had been awarded to employees before they had actually been hired by the company. Litigation in this matter is ongoing.

SEC v. Peregrine Systems Inc.: On June 30, 2003, the Commission charged Peregrine Systems, Inc. with financial fraud to inflate the company's revenue and stock price during 1999-2001 through various improper practices. As part of the case, the SEC also charged the company with fraudulent options backdating that resulted in Peregrine understating its expenses by approximately $90 million. Peregrine settled the case by agreeing to an antifraud injunction, among other relief.

SEC v. Symbol Technologies, Inc. et al.: On June 3, 2004, the Commission charged Symbol Technologies Inc. and numerous former Symbol employees for engaging in various fraudulent accounting practices and other misconduct from 1998-2003. Among the misconduct alleged, the SEC charged Peregrine and its former General Counsel Leonard Goldner with fraudulently backdating the date of stock option exercises so that senior executives could profit unfairly at the company's expense by falsifying company documents and forms the executives used to report their option exercises to the SEC and the public. The improper accounting associated with the backdated exercises resulted in a cumulative net increase in reported stock option expenses was $229 million. Symbol Technologies settled the matter by agreeing to an antifraud injunction and payment of a $37 million penalty. Goldner settled the matter by consenting to a permanent antifraud injunction, a permanent Officer & Director bar and Rule 102(e) suspension from practice before the Commission as an attorney; the Commission's claims for disgorgement and civil penalties against Goldner were withdrawn in view of Goldner's civil forfeiture payment of $2 million in connection with his guilty plea in a parallel criminal case.

In addition to the above enforcement actions, the SEC has taken many steps to promote clear, full, and fair disclosure about executive compensation, including a requirement for real-time reporting of stock option grants. The revised executive compensation disclosure rules the Commission adopted in July 2006, include a number of provisions that directly or indirectly address backdating of options.

RESPONSES BY SEC CHAIRMAN COX TO QUESTIONS FROM SENATOR SNOWE

Senator Olympia J. Snowe
Follow-up Questions
Small Business Committee Hearing
April 18, 2007

Question for Chairman Cox and Chairman Olson

1. International Competition and Sarbanes-Oxley.
With increasing international competitiveness and the strong rise of foreign markets, how should Sarbanes-Oxley be further reformed to help American small businesses remain competitive in the global marketplace? How can the SEC, and the PCAOB prevent outsourcing in the financial services sector to avoid repeating what happened in the U.S. manufacturing sector?

ANSWER:

Rationalizing the implementation of section 404 of the Sarbanes-Oxley Act is the most important action we can take to help American small businesses remain competitive in the global marketplace. To make sure that the U.S. capital markets remain robust and competitive, the SEC in July 2007 repealed the costly Auditing Standard No. 2, which had made Sarbanes-Oxley compliance so difficult, and replaced it with a completely new standard that is top down, risk-based, materiality focused, and scalable for companies of all sizes.

To prevent U.S. job losses and diminution of global market share in the financial services section, our entire regulatory system needs to be consistently reexamined with a view to the rapidly changing conditions of the global marketplace. This is particularly true with respect to financial reporting. In this connection, I have recently appointed an advisory Committee on Improvements to Financial Reporting which will study the issues relating to financial reporting and recommend improvements that will keep America's financial reporting system as the gold standard for the world. The Commission also recently issued a concept release on whether U.S. companies should be able to file using the International Financial Reporting System as published by the International Accounting Standards Board. Having a set of globally accepted accounting standards will be critical to the rapidly accelerating global integration of the world's capital markets.

2. Manufacturing.
Maine's manufacturing sector has been decimated over the last decade. More than 20,700 manufacturing jobs in Maine have disappeared between August 2000 and August 2006. What can the SEC and the PCAOB do to promote the growth and strength of the U.S. manufacturing sector and manufacturing jobs?

ANSWER:

Both the SEC and the PCAOB can affect the cost of regulation, and doing so in a positive way can reduce the cost of capital for manufacturing firms, which as you note are facing exceptionally difficult competitive conditions both in Maine and across the U.S.

We continually review our regulations with a view towards reducing the burdens of being a public company and to remove obstacles to raising capital, consistent with investor protection. Our focus on significantly reducing the costs of internal control compliance mandated by Section 404 of the Sarbanes-Oxley Act of 2002 will further the needs of manufacturing businesses as well as other companies. Similarly, our recent proposals to streamline the capital-raising process for small businesses should result in benefits for small and medium-size firms in the manufacturing sector.

These improvements that the SEC recently proposed include:

- Giving businesses broader access to the expedited "shelf" registration process for their own securities offerings, which previously was available only to big companies.

- Cutting paperwork for thousands of manufacturing businesses, by allowing them to raise capital in a private offering after filing a simplified Form D online.

- Establishing shortened holding periods for restricted securities, making it easier for shareholders in small manufacturing firms to put their securities on the market sooner and hopefully reducing the discount that small businesses must absorb to sell restricted securities.

- Giving issuers the benefit of a new, limited offering exemption from Securities Act registration requirements for offerings and sales of securities to a newly defined category of "qualified purchasers" in which limited advertising would be permitted.

- Eliminating the limit on the number of employees who can receive stock options from private firms, improving the ability of manufacturing companies to attract and retain talent without prematurely triggering the public registration and reporting requirements of the Exchange Act.

- Providing a simplified system of disclosure for almost 1,600 additional smaller public companies, an increase of over 45% in the number of small companies that are currently eligible.

3. Developing Cost-Effective Procedures for Internal Controls Reporting

The Small Business Administration's Office of Advocacy recently sent a letter to the SEC and the PCAOB regarding the Section 404 internal controls

requirements currently being finalized. The letter states that "based on small business comments, Advocacy believes that the Section 404 requirements may still impose large and disproportionate costs on small public companies after these proposals are finalized." The Office of Advocacy also asserts that these new requirements may reduce "the ability of a new generation of small, innovative companies from seeking capital in the U.S. capital markets." Please discuss the Office of Advocacy's assessment of the impact of the pending rules. Do the SEC and the PCAOB agree with this assessment? How can the SEC's and the PCAOB's final rules mitigate potential disproportionate costs on small public companies? Should non-accelerated filers be exempted from Section 404 requirements as the Office of Advocacy recommends?

ANSWER:

The requirements to which the Office of Advocacy refers are, of course, those of Section 404 of the Sarbanes-Oxley Act, which is a congressional mandate that contains no exemption for small businesses (nor any express exemptive authority for the SEC). Since we lack exemptive authority, we have only been able to defer implementation for smaller companies – and we have done so four times, most recently deferring the audit requirement until 2009. Consistent with our legislative mandate, the Commission is working diligently to make implementation for all issuers, including eventually smaller public companies, as efficient and effective as possible.

It is, of course, up to Congress, not the SEC, to consider amending the statute to exempt non-accelerated filers from Section 404. We think improvements in the financial reporting process for all companies are important for promoting investor confidence in our markets.[1] By including Section 404 in the Sarbanes-Oxley Act, Congress focused on internal control over financial reporting as a critical factor in reducing the occurrence of fraudulent financial reporting, and contributing to the integrity of the financial reporting process. A 1999 report commissioned by the organizations that sponsored the Treadway Commission presented evidence to suggest that the incidence of financial fraud was greater in small companies.[2] As you know, the primary goal of the Sarbanes-Oxley Act is to enhance the quality of reporting and increase investor confidence in the fairness and integrity of the securities markets. Congress should consider the impact an exemption from the requirements to evaluate, and report on, those internal controls for small entities would have on investor confidence in small entities and those entities' access to capital in the public markets.

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[1] Commenters on the Exposure Draft of the Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (Mar. 3, 2006), available at http://www.sec.gov/rules/other/33-8666fr.pdf, expressed similar views.

[2] See Beasley, Carcello and Hermanson, Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies (Mar. 1999) (study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission).

The SEC's new Interpretive Guidance is focused on how a small company might approach 404 differently, and more efficiently, than a large company. For example:

- A smaller company would probably follow fewer and different steps in evaluating whether its controls will provide reasonable assurance about the reliability of its financial reports.

- Management in a smaller company can go about obtaining information on whether its controls operate as designed in different and less elaborate ways than would be necessary in a large company.

- The documentation needed to provide reasonable support for a smaller company's controls will normally be less than what's required in a larger company.

4. Sarbanes-Oxley and Executive Compensation.
Do Sarbanes-Oxley's requirements reduce companies' ability to manipulate executive compensation?

ANSWER:

Yes. The Sarbanes-Oxley Act has had a positive and remedial impact on companies' executive compensation practices, most notably in one important respect: Sarbanes-Oxley and the Commission's related rulemaking have considerably lessened the opportunity for companies and their officers and directors to improperly manipulate the date on which stock option awards are granted and/or exercised.

Before Sarbanes-Oxley, officers and directors were not required to contemporaneously disclose their receipt of stock option grants or exercise of their stock options. In many cases, the disclosure of this information (via a Form 5 filed by the company) was not required until after the end of the fiscal year in which the transaction took place. This delay in reporting provided the opportunity for companies to misrepresent the date of an option award to make it appear that the option was granted at an earlier date – and at a lower price – than when the award was actually made. The intent of backdating option grants is to allow the option recipient potentially to realize larger eventual gains, but still characterize the options as having been granted "at-the-money" – disguising the fact that the company actually granted the options "in-the-money." In this way, companies were able to give the option recipient a larger "upside" benefit while at the same time minimizing the compensation expense of the award to the company.

Sarbanes-Oxley made these kinds of abusive practices much harder to conceal by requiring real-time disclosure of option grants and option exercises. Following the mandate provided by Section 403 of the Sarbanes-Oxley Act, the Commission in August 2002 revised its rules governing ownership reports by company insiders to require that officers and directors disclose any transactions in their companies' equity securities within two business days. Not only must option grants now be reported within two

business days, but this information is required to be filed electronically through the Commission's EDGAR filing system. This allows the public almost instant access to information about stock option grants. The need to report option grants no later than two days after the event, combined with the enhanced transparency of electronic filing, makes it prohibitively more difficult for companies to manipulate the grant date of option awards.

In addition to Sarbanes-Oxley, last year the Commission independently adopted comprehensive revisions to its rules governing the disclosure of executive and director compensation, requiring public companies to more thoroughly disclose their compensation awards, policies, and procedures. The improved clarity and transparency of compensation disclosures that these rules require may also have a significant impact on companies' ability to manipulate executive compensation.

Are practices like spring-loading stock option grants an indicator that companies are finding new ways to get around the requirements that govern executive compensation in Sarbanes-Oxley and the tax code?

ANSWER:

We do not believe that practices like "spring-loading" of stock option grants are necessarily an indicator that companies are finding new ways to get around the requirements that govern executive compensation. These timing practices have occurred prior to, and irrespective of, the requirements of Sarbanes-Oxley and there is evidence that abuses in this area have significantly diminished since the enactment of Sarbanes-Oxley.

What else should the government do to reduce the manipulation of the rules governing executive compensation?

ANSWER:

The new executive compensation disclosure rules are only now taking effect. In the current proxy season, companies are still filing their first disclosures under the new rules. The Commission staff is in the process of reviewing the executive compensation disclosure of several hundred companies who have filed their annual proxy statements thus far. The staff intends to publish a report summarizing its review of this disclosure before the end of the year, but we think it is premature at this point to make any overarching statements or judgments about the disclosures.

Before the Commission makes any recommendations on additional governmental action, the Commission must evaluate the results of its ongoing executive compensation reviews.

Questions for SEC Chairman Cox from Senator Pryor

1. Various observers have cited the current internal control requirements as a factor in the marked decrease in domestic initial public offerings (IPOs) in recent years. For example, Senator Schumer has raised these kinds of concerns. Can you comment on this assertion and the extent to which the new initiatives regarding Section 404 might or might not have an impact in this vital area?

ANSWER:

While some high profile foreign IPOs no longer list in the U.S., a steady stream of foreign companies continue to tap the U.S. markets. In fact, according to Thomson Financial, this year is on pace to add the most foreign listings on U.S. exchanges since 1997. It was also recently reported that foreign companies accounted for 23.4% of IPO proceeds last year – the highest amount since 1994.

On December 15, 2006, the Commission adopted amendments to its rules granting relief from the Section 404 requirements for companies that are new to Exchange Act reporting. The final rules provide all newly public companies with a transition period that relieves them from having to comply with the Section 404 requirements in the first annual report that they file after becoming an Exchange Act reporting company. The transition period applies to a company that has become public through an initial public offering (equity or debt) or a registered exchange offer or that otherwise has become subject to the Exchange Act reporting requirements. It also includes a foreign private issuer that is listing on a U.S. exchange for the first time. The transition period is intended to permit newly public companies to concentrate on their initial securities offerings, in cases where they become subject to Exchange Act reporting as a result of such an offering, and to prepare for their first annual report without the additional burden of having to comply with the Section 404 requirements at the same time. These amendments became effective in February of this year and are expected to minimize the need for companies to make a substantial investment of time and money to prepare for Section 404 compliance before they become public companies.

The Commission's publication of interpretive guidance on how management can conduct an evaluation of internal control over financial reporting, and the PCAOB's revisions to the Auditing Standard on internal control are designed to improve implementation of the Section 404 reporting requirements for all companies. We expect that these improvements in implementation will be viewed favorably by companies determining whether to undertake an initial public offering in the United States.

2. A number of organizations like the American Bankers Association have raised concerns about the non-accelerated filers; the smaller publicly held companies with less than $75 million worth of outstanding shares who are scheduled to comply with the section in the fall of this year. They are concerned that the management of such firms will be faced with the vexing problem of deciding on whether to apply current SEC and PCAOB guidance on Section 404, or to wait until the new auditing standards and guidance are adopted in their final forms, when they make their 2007 annual reports. Would you please comment on this issue?

ANSWER:

I am pleased to report that the Commission has already approved new guidance for management and a new standard for auditors to reduce the cost and improve the quality of compliance with Section 404. Companies are already making use of this guidance in preparing their 2007 annual reports, which for calendar year filers will be due in the spring of 2008.

For non-accelerated filers, their first annual reports with internal control audit assessments will not be due until 2009.

3. There is some research that has found that on average, firms with material weaknesses tend to be both smaller and worse financial performers than their industry counterparts. Would you please comment on the impact that the new developments in auditing standards and guidance could have on the issue of material weakness and smaller firms?

ANSWER:

As you note, there is some evidence to suggest that smaller companies tend to have a higher rate of material weaknesses.[3] The data also shows that for companies that are already complying with our rules implementing Section 404, there is a decline in the number of companies that are reporting material weaknesses each year and, on average, a

[3] According to Audit Analytics' data, 12% of filers with market capitalizations of less than $75 million reported ineffective ICFR and only 6% of filers with market capitalization of $75 million or greater reported ineffective ICFR.

lower number of material weaknesses being disclosed for each company reporting material weaknesses in each year.[4] This data suggests that Section 404 and the requirements of our rules results in focus by management to remediate internal control deficiencies, thus improving their internal controls.

[4] According to Audit Analytics' data, 16% of all companies filing 404 reports in year 1 reported, on average, 2.56 material weaknesses. In year 2, 11% of all filers reported, on average, 2.35 material weaknesses. In year 3, as of May 31, 2007, 7% of all filers have reported, on average, 2.09 material weaknesses

Questions for the Record from Senator Enzi

Senate Committee on Small Business and Entrepreneurship Hearing on:

"Sarbanes-Oxley and Small Business: Addressing Proposed Regulatory Changes and their Impact on Capital Markets"

PANEL I

Questions for Chairman Cox:

1) Among all accelerated filers now compliant with Section 404 of the Sarbanes-Oxley Act, approximately what percentage of their costs are attributed to management's evaluations of a company's internal controls? What percentage is attributed to the external audit?

ANSWER:

Over the past three years, the Commission has received various estimates of Section 404 compliance costs, primarily in connection with our April 2005 and May 2006 Roundtables on Internal Control Reporting and Auditing Provisions. These estimates were obtained from surveys of companies with public float of over $75 million. The most recent of these historical estimates of the early compliance costs incurred by the relatively larger companies indicate that costs ranged from $860,000 to $5.4 million per company, depending on the survey.[5] While the survey results attempted to disaggregate the costs to management from those of the audits, it is our experience that because there was no guidance for management to use in performing its responsibilities under Section 404, the old and costly audit standard drove management's behavior as well. For this reason, the reported amounts attributed to management versus the external audit are likely not representative of the underlying source of costs.[6]

1A) Have filer costs decreased in the four years of accelerated filer audits? If so, what do you attribute this cost reduction to?

ANSWER:

The Commission has received estimates of Section 404 compliance costs, primarily in connection with our April 2005 and May 2006 Roundtables on Internal Control Reporting and Auditing Provisions. These surveys indicate that the cost of compliance

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[5] See, for example, Financial Executives International Survey on Sarbanes-Oxley Section 404 Implementation (March, 2006) ("FEI Survey") and CRA International Sarbanes-Oxley Section 404 Costs and Implementation Issues: Spring 2006 Survey Update ("CRA Survey").

[6] The surveys indicated that audit fees comprised approximately 33% to 39% of total costs of compliance, with smaller companies at the higher end of that range.

with the Section 404 requirements has decreased from year one to year two.[7] For example, one survey indicated that average management costs fell 22.7% and audit fees fell 13% from year one to year two.[8] Another survey indicated that the average total cost of compliance in year two decreased 30.7% and 43.9%, respectively, for smaller and larger companies.[9] Additionally, we have reason to believe that costs of compliance decreased again for year three.[10]

These surveys indicated that the decrease in compliance costs is attributable to a number of factors, including: reduced time to update documentation and testing in periods after the initial year; reduced reliance by management on external consultants to assist management in completing its evaluation; and more effective and efficient evaluation efforts by both management and the auditor after the initial year.

2) I remain very concerned about the effect of federal regulation on the cost of capital formation in the U.S. markets. There has been a lot of attention paid recently to the perceived flight of capital away from the United States to foreign markets. Have initial public offerings on American exchanges decreased since the passage of Sarbanes-Oxley in 2002? Has there been a decrease in foreign companies seeking a listing on American exchanges during this time?

ANSWER:

At the SEC, we recognize that our capital markets are changing at an accelerating pace and that we are living in a very dynamic and competitive global marketplace. There are more opportunities to raise money and deeper, more varied pools of capital than ever before. So while the United States has the leading position in the world and the biggest markets and the deepest and most liquid markets – that is not a birth right. We have to constantly earn it. That is true for our private sector and it is true for our regulatory system. As regulators, we must constantly work to sharpen our competitive edge as well.

While some high profile foreign IPOs no longer list in the U.S., a steady stream of foreign companies continue to tap the U.S. markets. In fact, according to Thomson Financial, this year is on pace to add the most foreign listings on U.S. exchanges since 1997. It was also recently reported that foreign companies accounted for 23.4% of IPO proceeds last year – the highest amount since 1994.

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[7] For purposes of this response, the Commission has focused on surveys that were received from commenters in multiple years, in order to ensure comparability from year-to-year. Therefore, we have not included in our response data received on costs of compliance for surveys that were only performed in the initial year of compliance.

[8] FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping (April 6, 2006).

[9] CRA Survey

[10] While no cost surveys were submitted to the Commission, the Commission staff is aware that FEI updated their cost survey in May 2007. The press release regarding the availability of the survey indicated that the average costs of compliance for year three was 23% less than the corresponding year two costs. May 16, 2007 News Release.

Available data on initial public offerings ("IPOs") and new foreign listings since the passage of the Sarbanes-Oxley Act are provided below:

Year	Number of IPOs	Amount of IPOs (Billions of $)	Number of New Foreign Listings	
			NYSE	Nasdaq
2001	104	37.9	51	6
2002	98	26.4	33	6
2003	88	18.6	16	5
2004	260	51.9	20	19
2005	221	39.1	19	38
2006	236	49.9	29	26

Sources: PricewaterhouseCoopers, US IPO Watch: 2006 Analysis and Trends; NYSE and Nasdaq

3) A large degree of efficiency can be gained in tailoring internal control frameworks for small companies. How has the SEC focused its efforts in this regard? How much scalability will be allowed for small companies preparing their internal control framework for an external audit?

ANSWER:

We agree that a large degree of efficiency can be gained in tailoring internal control frameworks for small companies. The SEC's Interpretive Guidance recognizes that smaller public companies generally have less complex internal control systems than larger public companies.[11] The Interpretive Guidance is intended to assist management of smaller public companies in scaling and tailoring their evaluation methods and procedures to fit the facts and circumstances in ways that may not be appropriate for larger companies with more complex internal controls systems.

The Interpretive Guidance is intended to allow management appropriate flexibility to design an evaluation process that is right for each particular company. Smaller public companies can use this guidance to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances. We are encouraging smaller public companies to take advantage of the flexibility and scalability afforded in the new guidance to conduct an evaluation of internal controls that is both efficient and effective at identifying material weaknesses.

In order to help smaller companies better understand how they can tailor their evaluation efforts, the guidance specifically highlights some of the key areas where the evaluation at a smaller company might be different and less costly than for a larger company. For example, three key points within the evaluation process are the overall determination of effectiveness of the design of controls, the testing of the operating effectiveness, and the

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[11] Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006) at 39-40, ("Advisory Committee Report") available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

documentation needed to sufficiently support both. The Interpretive Guidance includes guidance on each of those points, indicating how a smaller company may accomplish those requirements of the evaluation process.

The guidance also explains other ways that a small company might approach 404 differently than a large company. For example:

- A smaller company would probably follow fewer and different steps in evaluating whether its controls will provide reasonable assurance about the reliability of its financial reports.

- Management in a smaller company can go about obtaining information on whether its controls operate as designed in different and less elaborate ways than would be necessary in a large company.

- The documentation needed to provide reasonable support for a smaller company's controls will normally be less than what's required in a larger company.

3A) Are you confident that these changes will decrease the costs of implementation?

ANSWER:

Yes. Based upon feedback that we've received through the public comment process we believe that the rule changes and the interpretive guidance, combined with the revised auditing standard, should enable companies to complete their annual evaluations in a more efficient and effective manner.

RESPONSES BY PCAOB CHAIRMAN OLSON TO QUESTIONS FROM CHAIRMAN KERRY

Responses to U.S Senate Small Business Committee's Questions for the Record May 29, 2007, Questions from Chairman Kerry

Question 1. Lessons learned through Sarbanes-Oxley implementation. Currently 50% of public companies have had three years experience to implement Section 404 of Sarbanes-Oxley During this time, these companies have seen costs come down significantly as much as half of the amount of the first year costs. To what factors do we owe this cost phenomenon? What lessons have we learned? How can this information benefit the other 50% of public companies including smaller public companies that are gearing up to comply? What are the first year challenges for small public companies when they comply with the law?

Response to Question 1:
The Public Company Accounting Oversight Board ("the PCAOB" or "the Board") has observed reports that the costs of providing the investing public audited assessments of the effectiveness of companies' internal control have come down since the first year of implementation of the Sarbanes-Oxley Act of 2002's ("the Act") internal control requirements. Through the Board's monitoring of the implementation of its auditing standard on internal control, Auditing Standard No. 2 ("AS No. 2"), the Board has identified and from time to time reported on certain areas that posed challenges to companies and auditors in the first year of implementation. Specifically, the Board found that, in the first year of implementation of AS No. 2, both issuers and auditing firms faced challenges arising from the limited time period surrounding the Act's passage, the adoption of implementing rules, and the time that issuers and auditors had to initially implement Section 404; a shortage of staff with prior training and experience in designing, evaluating, and testing controls; and related strains of available resources. These challenges were compounded at those companies that needed to make significant improvements in their internal control systems to make up for deferred maintenance of those systems. In addition, the Board found that firms could improve the efficiency of their internal control audits by, among other things, (1) integrating more fully the audit of internal control with the audit of the financial statements; (2) using a top-down approach to testing controls; (3) altering the nature, timing, and extent of their testing to reflect the level of risk; and (4) increasing their use of the work of others to the extent permitted by the auditing standard. After monitoring the second year of auditing firms' implementation, the Board noted certain progress in improving the efficiency of internal control audits. The Board found that many of these improvements resulted from, among other things, issuers' and auditors' additional experience and changes that auditors made in their methodologies and staff training, in many cases in response to PCAOB guidance.[1]

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[1] For a more detailed analysis of the Board's findings regarding the first two years of the implementation of AS No. 2, see PCAOB Release No. 2005-023, Report on the Initial Implementation of AS No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (November 30, 2005), and PCAOB Release No. 2007-004, Report on the Second-Year Implementation of AS No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (April 18, 2007), both of which can be found on the PCAOB website at www.pcaobus.org.

Some smaller companies and their auditors may face these same challenges in their first years of compliance with Section 404. The Board has, however, taken several steps to assist auditors in meeting those challenges. Most importantly, the Board last month adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements* ("AS No. 5"), which, if approved by the SEC, will replace AS No. 2. AS No. 5 focuses auditors on the most important matters in the audit of internal control over financial reporting and eliminates procedures that the Board believes are unnecessary to an effective audit of internal control. Through the new standard, the Board has sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. The Board also has announced that it will provide guidance on auditing internal control in smaller companies later this year. Finally, the Board is committed to promoting proper implementation of the new standard through, among other things, its inspections and the Board's Forums on Auditing in the Small Business Environment.

Question 2: Available tools for helping small businesses with compliance. What tools are available currently to aid smaller public companies as they gear up to comply with Section 404? Please describe the PCAOB's small business guide as well as other tools that might be out there that you believe might be particularly useful.

Response to Question 2:
The PCAOB is taking several steps to assist small public companies to comply with Section 404. First, as discussed in more detail in the response to Question 3, AS No. 5 provides examples of common differences in internal control in larger, more complex companies and smaller, less complex public companies. The Board believes that smaller public companies will benefit from the scaling concepts that are incorporated throughout the standard. These provisions will be reinforced by guidance on auditing internal control in smaller companies that the Board plans to issue later this year. The implementation guidance will assist auditors in applying the principles in AS No. 5 in the context of an audit of a smaller company. Representatives from firms who audit smaller companies are actively participating in this project to develop implementation guidance. Also, the Board will continue its outreach to small firms and issuers through its Forums on Auditing in the Small Business Environment held each year throughout the country. In addition, after three years of experience with internal control audits, firms and professional associations have developed various implementation guides; the Board expects these efforts to continue.

Further, the following tools related to the design and evaluation of internal control systems are also available to small businesses:

On May 23, 2007, the SEC approved interpretive guidance for management regarding its evaluation and assessment of internal control over financial reporting. The SEC has noted that the new guidance will help public companies strengthen their internal control over financial reporting while reducing unnecessary costs, particularly at smaller companies.

The Committee of Sponsoring Organizations for the Treadway Commission (COSO) in 1992 issued *Internal Control - Integrated Framework* to help businesses assess and improve their internal control systems. In June 2006, COSO issued guidance for smaller public companies on using the Framework to design and implement cost-effective internal control over financial reporting.

Question 3: PCAOB efforts on behalf of small auditing companies. Smaller companies are likely to be audited by smaller audit firms, almost 800 of whom are registered with the PCAOB. What is PCAOB doing to assist the smaller audit firms when it comes to their readiness and ability to cam,' out their audit responsibilities in both an efficient and effective way?

Response to Question 3:
The Board recognizes the challenges that smaller audit firms face in implementing a significant new auditing standard, especially those firms that have not yet performed audits of internal control, and the Board has already begun providing assistance to these firms. First, the newly adopted AS No. 5 allows auditors to tailor their audit approach to the facts and circumstances including size and complexity of any company, large or small. Throughout its text, AS No. 5 incorporates principles related to ways in which audits of smaller, less complex companies may differ from those of larger and more complex ones. These provisions will be reinforced by guidance on auditing internal control in smaller companies that the Board plans to provide later this year. Further, the Board will continue its outreach across the country to small firms and companies through its Forums on Auditing in the Small Business Environment. The Board will hold eight such forums during 2007. The Board believes that these efforts should help smaller firms perform high quality, efficient audits.

RESPONSES BY PCAOB CHAIRMAN OLSON TO QUESTIONS FROM SENATOR SNOWE

May 29, 2007, Questions from Senator Snowe

***Question 1**: Sarbanes-Oxley Safe Harbor for Accountants. What is the PCAOB's view of establishing damage limits or specific safe harbor measures for audit turns? Would a safe harbor for auditors benefit small firms or reduce their audit costs? If safe harbors for audit firms are appropriate, how should they be structured? What other steps, in addition to safe harbors, could policy makers take to ensure the viability of a vibrant and competitive audit industry on which investors can rely?*

Response to Question 1:
The mandate of the PCAOB is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. To fulfill this mandate, Congress gave the PCAOB the power, among others, to establish auditing and other professional practice standards. This authority does not extend, however, to the establishment of limits on private liability, which is outside of the Board's purview. We note that the Treasury Department recently announced the formation of an advisory committee to study, among other things, options available to strengthen the auditing profession's financial soundness.

The Board agrees that a vibrant and competitive audit profession enhances audit quality, and has observed first-hand how some small firms distinguish themselves professionally and competitively by performing high-quality audits. The Board's supervisory approach to its inspections, which includes an active dialogue between Board staff and the firm, helps those firms that want to improve the quality of their audits and their ability to compete for public company audit clients.

***Question 2**: International Competition and Sarbanes-Oxley. With increasing international competitiveness and the strong rise of foreign markets, how should Sarbanes-Oxley be further reformed to help American small businesses remain competitive in the global marketplace? How can the SEC and the PCAOB prevent outsourcing in the financial services sector to avoid repeating what happened in the U.S. manufacturing sector?*

Response to Question 2:
The issue of competitiveness has been at the forefront of financial policy debate recently and has spurred the release of several reports on the subject. Some of these reports have suggested that the U.S. regulatory structure, approach, and requirements present challenges to the competitiveness of U.S. capital markets. Others have indicated that the U.S. regulatory system, and in particular the U.S. investor protection regime, serves as the foundation of our markets' strength and success. In any event, though, given the global nature of our market place and the potential for unnecessary burden, it is essential that financial regulators, including the PCAOB, work to effectively carry out their mandates while being mindful of the importance of eliminating compliance costs that are unnecessary to achieve the intended benefits of our system. Based on this challenge, the PCAOB routinely monitors its requirements and their implementation. With regard to Section 404 of the Act and the newly adopted AS No. 5, effective implementation of the

new standard is a priority of the Board and will include a number of interwoven initiatives, ranging from outreach to inspections. The market will bear out how the new standard affects overall audit costs, but in revising its standard, the PCAOB has been committed to providing for a quality audit that is tailored to the unique attributes of a given company. While the Board has not observed a significant trend toward the outsourcing of audits, the Board will continue to monitor its registrants' business practices as they relate to audits of public companies.

***Question 3**: Manufacturing. Maine's manufacturing sector has been decimated over the last decade. More than 20,700 manufacturing jobs in Maine have disappeared between August 2000 and August 2006. What can the SEC and PCAOB so to promote the growth and strength of the U.S. manufacturing sector and manufacturing jobs?*

Response to Question 3:
The Board's work to oversee the auditors of public companies protects the interests of investors and furthers the public interest in the preparation of informative, accurate, and independent audit reports. The Board believes that sound financial reporting enhances the overall health of the U.S. capital markets and economy. Moreover, as described in detail above in the answer to Question 2, due to the global nature of our market place and the potential for unnecessary burden, the Board works to effectively carry out its mandates while being mindful of the need to eliminate unnecessary costs.

***Question 4**: Developing Cost-Effective Procedures for internal Controls Reporting. The Small Business Administration's Office of Advocacy recently sent a letter to the SEC and PCAOB regarding the Section 404 internal controls requirements currently being finalized. The letter states that "based on small business comments, Advocacy believes that the Section 404 requirements my still impose large and disproportionate costs on small public companies after these proposals are finalized." The Office of Advocacy also asserts that these new requirements may reduce "the ability of a new generation of small, innovative companies form seeking capital in the U.S. capital markets." Please discuss the Office of Advocacy's assessment of the impact of the pending rules. Do the SEC and the PCAOB agree with this assessment? How can the SEC's and PCAOB's final rules mitigate potential disproportionate costs on small public companies? Should non-accelerated filers be exempted from Section 404 requirements as the Office of Advocacy recommends?*

Response to Question 4:
In formulating a final standard, the Board paid particular attention to the concerns of smaller companies and their auditors, including those concerns included in the letter from the SBA's Office of Advocacy. The Board believes that its final standard appropriately emphasizes differences in internal control between small and large companies. Specifically, to help auditors identify opportunities to tailor the audit to the size and complexity of the company, AS No. 5 incorporates a list of attributes of smaller, less complex companies and notes that a less complex company might achieve its control objectives differently than a more complex one. Throughout the standard, notes to particular audit requirements provide principles related to tailoring the requirement to the

specific circumstances of a smaller, less complex company or business unit. The Board believes that an effective system of internal control is critical to protecting the interests of investors at any public company, regardless of its size. Whether certain companies should be exempted from the requirements of Section 404, however, is beyond the Board's purview. Rather, the Board's responsibility is to provide a standard that results in an effective audit for all companies required by the SEC to obtain an audit of internal control.

***Question 5**: Sarbanes-Oxley and Executive Compensation. Do Sarbanes-Oxley's requirements reduce companies' ability to manipulate executive compensation? Are practices like spring-loading stock option grants an indicator that companies are finding new ways to get around the requirements that govern executive compensation in Sarbanes-Oxley and the tax code? What else should the government do to reduce the manipulation of the rules governing executive compensation?*

Response to Question 5:
The Act appears to have significantly reduced the incidence of backdated option grants. Specifically, the SEC's rules implementing Section 403 of the Act require public company officers and directors to report their receipt of stock options within two business days of the grant. Previously, such persons were generally not required to report option grants until 45 days after the fiscal year in which they were received. Given the new filing requirement, the ability to backdate option grants to coincide with low stock prices is greatly curtailed.

The PCAOB does not regulate accounting or disclosures by public companies, nor does it administer the corporate governance requirements imposed on public companies by the Act. Rather, the PCAOB's role is to enhance the quality of the audits of public companies' financial statements. Towards that end, in July 2006, the PCAOB issued Staff Audit Practice Alert No. 1, Matters Related to Timing and Accounting for Option Grants. The Practice Alert advised auditors that backdating options grants and similar practices may have implications for audits of financial statements or of internal control over financial reporting and discussed factors that may be relevant in assessing the risks related to these matters. In addition, we note that the SEC has recently taken action in the area of executive compensation, including through its rulemaking on executive compensation disclosure.

RESPONSES BY PCAOB CHAIRMAN OLSON TO QUESTIONS FROM SENATOR PRYOR

May 29, 2007, Questions from Senator Pryor

***Question 1**: You state in your written testimony that the Board received thoughtful comments on its proposed revisions to the auditing standard on internal control. What were the principal concerns expressed in these comments?*

Response to Question 1:
The Board received 175 letters on its proposals. On the whole, these comments expressed support for the direction of the Board's proposal. The comments helped the Board to refine the proposed standard to provide additional clarity and to further help the auditor to focus on the most important matters in auditing the internal control over financial reporting. The Board's adopting release for AS No. 5, dated May 24, 2007, describes the comments received on the proposals, as well as the Board's response. As discussed in the Board's release, the comments covered a wide range of issues, from alignment between the PCAOB standard and SEC management guidance, to various aspects of performing the ICFR audit, to implementation of the new standard.[1]

***Question 2**: In developing the pmposed revision to its auditing standard on internal control, did the Board attempt to estimate the extent to which audit costs would be reduced for small companies? For example, might costs be reduced by a third?*

Response to Question 2:
AS No. 5 reflects the Board's monitoring of registered firms' implementation of AS No. 2 over two reporting seasons. The Board's monitoring included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies. Based on this monitoring, the Board believes that in many cases the new standard will result in a reduction in audit effort, as compared to the audits currently performed under AS No. 2. The Board has not, however, attempted to quantify the extent to which audit costs would be reduced for small companies.

In proposing AS No. 5, the Board noted that it had heard a consistent message that compliance with the internal control provisions of the Act had required greater effort and resulted in higher costs than expected. The Board decided to revise its standard, in part, because it agreed that its standard should not require auditors to perform procedures that are not necessary to achieve the intended benefits of the internal control audit. Accordingly, the Board specifically sought comment on whether and how much the proposed revisions to AS No. 2 would reduce audit hours. While commenters did not provide such estimates, in adopting its revised standard, the Board sought to eliminate

[1] For a more detailed discussion of the comment letters received by the Board, see PCAOB Release No. 2007-005, AS No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated With an Audit of Financial Statements, and Related Independence Rule and Conforming Amendments (May 24, 2007), which can be found on the PCAOB website at www.pcaobus.org.

unnecessary procedures and make the audit scalable for companies of all sizes. Finally, as part of its approval process, the SEC has requested comment on, among other things, whether AS No. 5 will "reduce expected audit costs under Section 404, particularly for smaller companies, to result in cost-effective, integrated audits."

***Question 3**: The proposed revision to the auditing standard on internal control places greater emphasis on auditors' judgment in designing and cariying out audits. But does this not expose auditors to more risk of adverse findings in Board inspections? What steps will the Board take to ensure that auditors will not constantly be "second guessed" in their judgments?*

Response to Question 3:
The Board is aware of the importance of its inspections program to the successful implementation of a principles-based standard, such as AS No. 5, that requires the use of professional judgment. PCAOB inspections of registered firms are designed to assess the level of compliance of the firm with the Board's and the SEC's rules, as well as with auditing and other professional standards. In doing so, the Board makes every attempt to ensure that inspectors do not substitute their own judgment for that of the auditors.

The Board believes that the consistent and thoughtful implementation of AS No. 5 is critical to its success. AS No. 5 provides auditors with the flexibility to apply the standard in a manner that is appropriate to each audit. The Board is committed to effective monitoring of firms' compliance with the new standard and, as it announced upon adoption of the new standard, intends to adjust and implement its inspection program to be consistent with the new standard.

***Question 4**: The Board and the SEC are publicly committed to aligning the two sets of guidance that they will finalize regarding internal control. But do not auditing (which attempts to protect investors) and management (which is concerned about operational efficiency) ultimately have conflicting objectives? How can there be an alignment of guidance that strikes appropriate balance in all circumstances?*

Response to Question 4:
In formulating a new standard on auditing internal control, the Board has been mindful of the inherent differences in the roles and responsibilities of management and the auditor. Because of these differences, two separate regulatory requirements exist . AS No. 5, formulated by the Board for auditors, and SEC management guidance for issuers' management. At the same time, the Board believes that the general concepts necessary for an understanding of internal control should be described in the same way in the Board's standard on an audit of internal control and in the SEC's management guidance. The Board worked closely with the SEC to identify those areas where the direction to management and to the auditor needs to be consistent. Accordingly, among other things, the Board uses the same key terms and definitions that the SEC uses in its management guidance and related rules.

RESPONSES BY PCAOB CHAIRMAN OLSON TO QUESTIONS FROM SENATOR ENZI

May 29, 2007, Questions from Senator Enzi:

Question 1*: I filed a comment letter to Chairman Olson in January on the proposed changes to the PCAOB guidance for Section 404 audits. In this letter, I stated that the scalability of the external audit for smaller companies has a huge potential for cost savings. Scalability is crucial because, as the 2006 GAO report noted, smaller companies often have more centralized management and less complex processes. These elements can help external auditors test internal control frameworks efficiently. Under the PCAOB guidance, how will auditors account for the nature of smaller companies in their audits? How will your small company audit guide be integrated into the revised auditing standard when it is released later this year?*

Response to Question 1:
AS No. 5 is a principles-based standard that requires the use of professional judgment to determine what procedures are necessary under the particular facts and circumstances. The standard focuses the auditor on a top-down, risk-based approach and provides principles the auditor can apply to scale the audit to fit the size and complexity of a given company. These principles will be reinforced by guidance on auditing internal control in smaller companies that the Board plans to provide later this year. The guidance is intended to provide practical information on how the principles in the standard can be applied in the audit of a smaller company and therefore will not be part of the standard itself. The guidance and standard will, of course, be closely aligned.

Question 1a*: How will auditors determine how and when to use their professional judgment in scaling audits for small companies? Has the PCAQB provided enough guidance for auditors to recognize small companies and feel comfortable using a more efficient audit process?*

Response to Question 1a:
Because the general principles regarding scalability are included directly in AS No. 5 and because the Board will be following-up with more detailed guidance on auditing internal control in smaller companies later this year, auditors should be more comfortable tailoring their audits based on the size and complexity of the company. As mentioned above, this guidance is included within the "Scaling the Audit" section of AS No. 5, as well as throughout the standard, and additional detail, such as examples, will be included in the implementation guidance for auditors of smaller public companies.

Question 2*: In my comment letter, I also touched on the definition of "material weakness." I believe the PCAOB is correct in focusing on this definition, along with that of "significant deficiency," as areas for improvement because uncovering financial control deficiencies are central to the work of an auditor. Now that the second year of implementation for Auditing Standard No. 2 is complete, how do you understand external auditors to be applying the term "more than remote" in today's audits?*

Response to Question 2:
As your question notes, the definition of material weakness is central to the scoping and

conduct of an audit of internal control. After the first year of implementation of AS No. 2, the Board noted anecdotal claims suggesting that some auditors applied a more stringent threshold to the evaluation of control deficiencies than the definitions in AS No. 2 require. Consequently, the Board provided guidance noting that under AS No. 2, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable." AS No. 5 incorporates that guidance in the standard itself. Specifically, as discussed below, the Board has revised the definition of "material weakness," including replacing the phrase "more than remote" with a "reasonable possibility." This change should drive improvements in the application of the definition, as well as aligning the PCAOB's definition of this term with the definition used by the SEC in its management guidance.

***Question 2a**: Several of the comment letters expressed unease with the new deficiency definition, "reasonable possibility." I am deeply concerned that this new definition may not lower audit costs if auditors understand the terms "more than remote" and "reasonable possibility" to be the same. Will the PCAOB respond to this concern? How will the PCAQB ensure that the new definitions actually cause a positive change in auditor behavior?*

Response to Question 2a:
The Board received a wide range of comments on its proposed definition of "material weakness." Some commenters, as your question notes, suggested that the proposed definition would not change how audits are carried out, while a number of other commenters believed that the proposed definition would reduce unnecessary effort spent on identifying and analyzing deficiencies. Ultimately, the Board decided to adopt the definition of material weakness within AS No. 5 substantially as proposed. The Board did so in order to align its definition of material weakness with the definition of the same term adopted by the SEC in its rules and because the Board believes that "reasonable possibility" most accurately and clearly describes those internal control deficiencies that auditors should be concerned about during the audit of internal control. The definition is based on earlier guidance that noted that the phrase "more than remote" means the same thing as "at least reasonably possible." Although the two phrases describe the same threshold, the Board was concerned that auditors were applying the phrase "more than remote" to mean something less likely than "a reasonable possibility." The Board believes that use of the phrase "reasonable possibility" will avoid this misunderstanding and will result in the appropriate application of the definition of "material weakness."

***Question 3**: As I mentioned in my Committee statement, the GAO report released last April mentioned that smaller accounting firms may receive more business as a result of more companies becoming Section 404 compliant. In your discussions with small accounting firms and during the PCAOB small auditor forums, do you believe these firms are adequately preparing to conduct 404 audits? If so, how are they preparing?*

Response to Question 3:
The Board has observed smaller firms preparing to perform integrated audits in several ways. As your question notes, many smaller firms have participated in the PCAOB's

Forums on Auditing in the Small Business Environment. The PCAOB established this program in November of 2004 and continued it in 2005 in ten cities across the United States. The forums were extremely well received; the Board continued offering the program in eight cities in 2006. The Board will also hold sessions in eight cities this year. The forums enable PCAOB staff and Board members to meet directly with representatives of small companies and small public accounting firms to discuss how PCAOB auditing standards and inspections affect them. The feedback received from these forums assists the PCAOB in understanding and considering the unique needs of the small business community.

In addition, smaller firms are actively participating in the PCAOB's project to provide implementation guidance for auditors of smaller public companies and are providing the Board with valuable and timely feedback and assistance in developing this guidance.

Finally, some smaller audit firms have performed engagements under AS No. 2 for some of their clients that are accelerated filers, as defined by the Securities and Exchange Commission. As a result, they are able to leverage this work and experience as they prepare to perform audits under AS No. 5 for accelerated and non-accelerated filers.

***Question 3a**: Do you believe that, once external audits are required of smaller companies, there will be an adequate number of qualified accounting firms to do the job?*

Response to Question 3a:
As of May 15, 2007, there were over 1,700 firms registered with the PCAOB, all of which may provide audits to public companies. The Board has taken several steps to assist these firms with meeting challenges associated with audits of internal control. Most importantly, the newly adopted AS No. 5 focuses auditors on the most important matters in the audit of internal control over financial reporting and eliminates procedures that the Board believes are unnecessary to an effective audit of internal control. Through the new standard, the Board has sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In addition, the Board will provide guidance on auditing internal control in smaller companies later this year. Finally, the Board is committed to promoting proper implementation of the new standard through, among other things, its inspections and the Board's Forums on Auditing in the Small Business Environment.

***Question 4**: How can larger accounting firms play an advisory role in helping smaller firms and companies complete their 404 audits?*

Response to Question 4:
Many larger accounting firms participate in accounting conferences and provide their views and experiences on particular issues. These conferences are held throughout the year at various locations around the country, thus enabling accounting firms of all sizes to benefit from the information provided. In addition, larger firms often provide training via web casts and text materials that are available to the public, which are additional ways for smaller firms and companies to obtain training.

RESPONSES BY RICHARD WASIELEWSKI TO QUESTIONS FROM SENATOR PRYOR

Question 1. You have a copy of the letter sent to SEC Chairman Cox and PCAOB Chairman Olson from Senators Kerry and Snowe, as well as the SEC and PCAOB responses in the binder. [The referenced letters appear in Appendix Material Submitted on pages 126–131.] The SEC response notes that four separate extensions have been given to small businesses regarding compliance with Section 404 of the Sarbanes-Oxley Act, with the most recent extension granted on December 2006. The December 2006 extension said that non-accelerated filers (less than $75 million in market cap) had to comply with Section 404(a) providing management's assertions on internal controls for calendar years ending after December 15, 2007, and with Section 404(b) external auditor's internal controls audit for calendar years ending after December 15, 2008.

Given that the SEC granted four extensions in order for small businesses to have more time to comply with Sarbanes-Oxley Section 404, what have you been doing during this time to get your own company's internal controls in order? What challenges have you found? Have you discussed this with your external auditor?

Response. [Submitted in a question and answer format as follows:]

What have you been doing with the extension time?

Our relatively small finance department continues to spend a disproportionate amount of time on increasing regulatory compliance rather than supporting the business and operations. When time permits we are implementing internal control policies and procedures with clearly defined roles and responsibilities, priority management, risk assessment, monitoring, and corrective actions for continued improvement according to generally accepted best practices and the latest guidance. We have been able to use this time to draft and organize a formal document of our internal control policy and procedures. We are currently working on updating this document and beginning to develop test plans and tracking of our critical and material control points. The final step will be to formalize the management assessment process.

An additional extension will allow us to continue to build upon our current internal control processes without the time and cost pressures of the current deadlines and requirements as well as, have a chance to review and incorporate the new SEC and PCAOB interpretive audit standard guidance for management assessment and auditor reporting.

What challenges have you found?

Our challenge continues to be the time required to develop and implement a formal and documented internal control process while trying to support our business and the increased compliance costs of our audit, consulting and GAAP advising fees due to the increased demand for auditor resources.

Have you discussed this with your external auditor?

We have as part of our audit committee meetings continued to update our auditor on our progress. They are waiting to see what the new guidance will be and to what extent we can incorporate into our internal control plans this year given the late release date.

Thank you again for the opportunity to provide additional input to the committee.

RESPONSES BY JOSEPH PICHE TO QUESTIONS FROM SENATOR PRYOR

Question 1. You have a copy of the letter sent to SEC Chairman Cox and PCAOB Chairman Olson from Senators Kerry and Snowe, as well as the SEC and PCAOB responses in the binder. [The referenced letters appear in Appendix Material Submitted on pages 126–131.] The SEC response notes that four separate extensions have been given to small businesses regarding compliance with Section 404 of the Sarbanes-Oxley Act, with the most recent extension granted on December 2006. The December 2006 extension said that non-accelerated filers (less than $75 million in market cap) had to comply with Section 404(a) providing management's assertions on internal controls for calendar years ending after December 15, 2007, and with Section 404(b) external auditor's internal controls audit for calendar years ending after December 15, 2008.

Given that the SEC granted four extensions in order for small businesses to have more time to comply with Sarbanes-Oxley Section 404, what have you been doing during this time to get your own company's internal controls in order? What challenges have you found? Have you discussed this with your external auditor?

Response. [Mr. Piche's response to question 1 was not available at the time the hearing record was printed.]

Question 2. There are intangible effects of Sarbanes-Oxley that impact corporate management. The requirements that the CEO and CFO certify their company's financial statements, coupled with the Act's implicit notion that the directors are "gatekeepers" capable of preventing fraud, has focused boards of directors on compliance matters instead of corporate strategy; anecdotal evidence suggests that more time is spent on compliance in today's boardrooms than on the business of the company. Mr. Piche, in your testimony you mention the increase in the cost of Directors' and Officers' (D&O) insurance, an increase of 500 percent since the Act's enactment, and that the increased liability imposed by the Act makes it simply not worth the risk to serve on a board of directors without insurance. Please explain what other impact the Act has on the board. Is there evidence to suggest that directors spend more time on compliance issues rather than corporate strategy?

Response. [Mr. Piche's response to question 2 was not available at the time the hearing record was printed.]

United States Senate
COMMITTEE ON SMALL BUSINESS & ENTREPRENEURSHIP
WASHINGTON, DC 20510–6350

February 23, 2007

The Honorable Christopher Cox
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

The Honorable Mark W. Olson
Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006

Dear Chairmen Cox and Olson:

Just a few years ago, the trust and confidence of the American people in their financial markets was seriously eroded by the emergence of a series of corporate accounting scandals. The Sarbanes-Oxley Act of 2002 helped restore confidence in our capital markets and increasing accountability to the corporate governance of public companies.

We support the efforts of the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) to ease the regulatory burden of Section 404 of the Act by issuing new interpretative guidance on internal controls for small public companies. We believe these final proposals will help to reduce the costs, and the time, that small public companies spend complying with Sarbanes Oxley Act of 2002.

However, as these rules have not yet been finalized, we respectfully request that the implementation date of Section 404 for small public companies be delayed for up to one additional year from the date that both the SEC and the PCAOB issue their final Section 404 guidance. We believe this extension will provide small public companies the appropriate amount of time needed to comply with these new compliance and auditing standards.

If the SEC chooses to defer these implementation dates for an additional year, it is our understanding that calendar year filers would have until the 2008 annual report to file their management internal control reports and until the 2009 annual report to file the auditor's attestation report. This additional time would make it easier for many small businesses to make the transition to the new internal controls requirements.

Additionally, we also request that the SEC and PCAOB carefully consider all comments by small public companies, especially non-accelerated filers, before setting a final implementation date for the new auditing standards. We believe the comments made by small businesses concerning the proposed rules will give the SEC and the PCAOB the best guidance as to the amount of time non-accelerated filers will require to appropriately implement the new compliance and auditing standard.

In making these requests, we acknowledge the SEC's previous postponement of the date by which smaller public companies were required to comply with the Act's internal control reporting requirements. We believe this extension was wise and appreciate the SEC's willingness to respond to the needs of small issuers.

Small public companies are vital participants of U.S. capital markets as well as critical components of future economic growth and high-wage job creation. However, according to a recent United States Government Accounting Office study, the cost of compliance and the time needed for small public companies to comply with the Sarbanes-Oxley regulations has been disproportionately higher than for large public companies.

While most large companies are effectively dealing with Sarbanes-Oxley's changes, many small public companies continue to have difficulties in complying with the Act's moving auditing standards. Published reports show the number of restatements of financial results for large companies declined by approximately 20 percent in 2006. Inversely, small public companies, with assets of less than $75 million, saw the number of restatements increase by 42 percent in 2006. This increase demonstrates the additional costs and burdens small businesses face as they continue to update their internal control processes while they await the final SEC and PCAOB guidance governing these controls.

We urge the SEC to consider giving small public companies this much needed extension. We believe this process will help reduce the costs and increase the attractiveness for small public companies to participate in United States capital markets. Ultimately, our sensitivity to the needs and concerns of smaller public companies will help promote the strength of the U.S. economy and enable dynamic private firms to grow by helping them become thriving, innovative public companies.

Thank you in advance for your consideration of this request.

JOHN F. KERRY
Chair

OLYMPIA J. SNOWE
Ranking Member

PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
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March 7, 2007

The Honorable John F. Kerry
Chairman, Committee on Small, Business & Entrepreneurship
United States Senate
428A Russell Senate Office Building
Washington, DC 20510-6350

Dear Chairman Kerry:

On behalf of the Public Company Accounting Oversight Board, I wish to thank you for your February 23, 2007 letter concerning Section 404 of the Sarbanes-Oxley Act and small public companies. Through its enactment of the Sarbanes-Oxley Act, Congress entrusted the Board with the important mission of furthering the public interest in the preparation of informative, accurate, and independent audit reports. We appreciate your input as we strive to carry out that mission, including improving the implementation of the Act's internal control requirements.

In your letter, you note the importance of small public companies as engines of future economic growth and job creation. We strongly agree that small public companies play a key role in the U.S. economy, and unnecessary costs related to Section 404 should be eliminated. We appreciate your view that our recently proposed auditing standard is a step towards that goal.

In your letter, you also request that the Securities and Exchange Commission extend the date by which small public companies would be required to comply with Section 404. In its recent final rule extending the Section 404 compliance dates for non-accelerated filers, the SEC stated that it will consider further compliance date extensions—for both the requirement to file management's assessment of internal control and the requirement to file the related auditor's report—based on the timing of its final guidance and its consideration of the Board's proposed auditing standard. The Board will coordinate with the SEC to make the transition to Section 404 compliance for non-accelerated filers as smooth as possible. Moreover, the Board's standard on auditing internal control will not apply to audits of non-accelerated filers until they are required by the Commission to obtain an audit of internal control.

Your letter also notes the importance of public comment to the regulatory process. The Board strongly agrees with your views. As we move towards adopting a standard that protects the interests of investors while providing for a more risk-based and scalable audit of internal control, we will carefully consider all comment letters that we receive.

PCAOB
Public Company Accounting Oversight Board

Thank you once again for your letter. I look forward to continuing to work with you and your colleagues on the Senate Committee on Small Business and Entrepreneurship. Please feel free to call me at (202) 207- 9201, or have your staff contact Mary Moore Hamrick, Director, Office of External Relations, at (202) 207-9170, should you have any questions.

Sincerely,

Mark W. Olson
Chairman

cc: Senator Olympia J. Snowe
Chairman Christopher Cox, SEC

CHRISTOPHER COX
CHAIRMAN

HEADQUARTERS
100 F STREET, NE
WASHINGTON, DC 20549

REGIONAL OFFICES
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DISTRICT OFFICES
BOSTON, PHILADELPHIA, ATLANTA,
FORT WORTH, SALT LAKE CITY,
SAN FRANCISCO

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

April 5, 2007

The Honorable John F. Kerry
Chairman
Committee on Small Business & Entrepreneurship
United States Senate
Washington, DC 20510-6350

Dear Chairman Kerry:

Thank you for your recent letter in which you express your support for improving implementation of Section 404 of the Sarbanes-Oxley Act of 2002, particularly with respect to smaller public companies.

As you know, companies subject to the periodic reporting requirements of the Securities Exchange Act of 1934 with a public float of less than $75 million have not yet become subject to the Section 404 requirements. In your letter, you request that the Commission and PCAOB carefully consider all of the comments from smaller public companies on the Commission's proposed interpretive guidance for management on evaluating internal control over financial reporting and on the PCAOB's proposal to replace Auditing Standard No. 2 with a new auditing standard before setting final compliance dates for smaller companies. I assure you that the Commission will do so.

I agree with you on the importance of soliciting the views of companies and other interested parties on the Commission's guidance before issuing it in final form to make sure that the guidance is appropriate and will be useful. The public comment period on our interpretive guidance closed on February 26, 2007 and we received nearly 200 letters of comment. Additionally, the comment period on the PCAOB's proposal to replace Auditing Standard No. 2 with a new auditing standard also closed on February 26th. The PCAOB is evaluating the public comments, and we will work closely with them towards the adoption of a revised standard.

You also urge the Commission to consider a delay of the currently scheduled compliance dates for smaller public companies for an additional year from the time that the interpretive guidance and revised audit standard are issued in final form. To date, the Commission has approved four separate extensions of the Section 404 compliance dates for smaller public companies, the last of which was in December 2006. In the December 2006 release granting the last extension, the Commission stated that, if we have not issued additional guidance for management on how to complete its assessment of internal control over financial reporting in time to be of sufficient assistance for companies as they prepare their annual reports filed for

fiscal years ending on or after December 15, 2007, we will consider whether we should further postpone the compliance date. We similarly stated that we will consider further postponing the December 15, 2008 compliance date for auditor attestation reports after the Commission has approved the new auditing standard to replace Auditing Standard No. 2.

Until the Commission should adopt final interpretive guidance and approve a final auditing standard to replace Auditing Standard No. 2, it would be premature for the Commission to decide whether an additional extension is warranted. Once the Commission has approved new guidance and a new auditing standard, I can assure you that the Commission will at that time consider whether smaller companies will need more time to comply with the Section 404 requirements. Please be assured that our primary objective is to make the Section 404 compliance process as efficient as possible for all companies.

Thank you again for writing to express the Committee's views on this important subject. I look forward to the opportunity to discuss these issues further with you and the Committee at your April 18 hearing.

Sincerely,

Christopher Cox
Chairman

COMMENTS FOR THE RECORD

Statement of Senator Mike Enzi

Senate Committee on Small Business Hearing on:

"Sarbanes-Oxley and Small Business: Addressing Proposed Regulatory Changes and their Impact on Capital Markets"

April 18, 2007

As a member of the Senate Committee on Small Business and the Senate Banking Committee, I have been at the forefront of this issue since Sarbanes-Oxley was first drafted in 2002. During those early days, the United States capital markets were in a tailspin. The accounting scandals at Enron and WorldCom damaged America's confidence in our markets, and our economy was in decline as a result. After passage of Sarbanes-Oxley, we have seen confidence rise once more, and our economy continues to expand, creating jobs and wealth for more Americans than ever before. The Sarbanes-Oxley Act is contributing to this expansion because investors again feel confident when they invest in American financial markets. Public company operations are more transparent and CEOs are held accountable for the actions of their employees.

One needs only to read the papers to see the benefits of Sarbanes-Oxley. The options backdating scandal that is being investigated by the SEC has reached some of the largest and most recognizable companies in America. Yet the scope of this scandal was limited to practices prior to the enactment of Sarbanes-Oxley. There is little doubt the Act has helped in this regard.

However, the implementation of Sarbanes-Oxley is not complete, and this is the reason why we are here today. About half of all publically-traded companies, those under $75 million in market capitalization, have yet to implement the requirements of Sarbanes-Oxley as they relate to internal controls, commonly referred to as Section 404. The concerns about the price of Section 404 voiced by small businesses are well-founded, and action should be taken to reduce these costs. I expect Chairman Cox and Chairman Olson to discuss some of these ideas today. However, as most small businesses have yet to experience a 404 audit, there is also a lot of mystery and speculation surrounding the projected costs. Today is an opportunity to clarify the small business situation and dispel some of the rumors.

All public companies should be responsible stewards of the public's trust, and therefore should be able to withstand a certain level of public scrutiny. This is the heart of Sarbanes-Oxley and Section 404. It is also central to the mission of the Public

Company Accounting Oversight Board (the "Board"), which oversees accountants who audit large and small companies.

The Board is in a strategic position that gives them the opportunity to lower the cost of audit fees borne by small companies through their guidance. And they have taken multiple steps to lower costs, including encouraging a change to the audit culture itself. For example, I was pleased when the revised guidance issued last December by the Board emphasized auditor's use of the work of others. Allowing auditors to look at the big picture by reviewing past audits and management's evaluation can significantly reduce the costs of Section 404 audits to smaller businesses. By removing the "Principle Evidence Provision," the Board is promoting a significant change within the auditor community, and the industry must be receptive to it if small businesses will see reduced costs.

There is also a continued role for the Board in working with smaller audit firms as they attempt to perform Section 404 audits for the first time. In April 2006, the Government Accountability Office (GAO) issued a report requested by Senator Snowe and me requiring an investigation of the potential costs of Sarbanes-Oxley on small businesses. One of the developments predicted by this report was a bigger role for smaller accounting firms performing 404 audits. In anticipation of this, the Board has been holding forums across the country to assist small firms to prepare for these audits. These forums have been invaluable, and the proactive approach exhibited by the Board will no doubt reduce costs for small companies in the future.

I am optimistic that the larger accounting firms, who have been auditing large companies for four years now, will also be able to assist smaller firms to overcome the steep learning curve. There is a wealth of knowledge to be gained from the first four years of accelerated filers and their auditors, and using that knowledge can reduce costs for those reporting for the first time.

Another concern described in the GAO report was the effect of "deferred maintenance" by smaller public companies. All public companies have been required to establish and maintain internal controls since 1977. It is clear that many smaller companies have faced particular challenges in this regard, due to the economies of scale and the different management structure of smaller companies. I am very concerned that this will lead to higher costs when small businesses are required to comply with Section 404.

The Securities and Exchange Commission (the "Commission") has taken a proactive approach in this area as well. In the revised guidance, the Commission established a two-year strategy for smaller companies, requiring internal control evaluation from management in Year One, and an external audit in Year Two. This is the right approach for small business, and introducing a level of scalability for small public companies in the Commission's guidance has enormous potential for reducing costs.

I am pleased that the Commission and the Board have worked collaboratively on their Section 404 guidance. Complementary guidance, along with a close attention paid to the nature of smaller companies, is the best strategy for successful implementation of Section 404 of the Sarbanes-Oxley Act.

The Committee on Small Business knows that the economies of scale create a disproportionate burden for smaller companies, in Sarbanes-Oxley implementation or any other federal regulation. This was confirmed by the GAO study released last year on Section 404. Yet the key to overcoming this disadvantage is clear and concise guidance from the Board and the Commission, not legislative reform. This was the conclusion reached by the McKinsey Report on global competitiveness, also known as the Schumer-Bloomberg Report, and industry roundtables held by the Department of the Treasury and the Chamber of Commerce held earlier this year.

I strongly urge both the Commission and the Board to continue to work to overcome this disadvantage for small companies. This includes guidance for Section 404 audits that are top-down and risk-based. Auditors must be encouraged to use their professional judgement without fear of liability, and small companies must be confident that, if they follow management guidance, they will create effective and compliant internal controls. It has been five years since the passage of the Sarbanes-Oxley Act, and it is time to overcome the final hurdles preventing implementation of this law for all public companies.

I look forward to the testimony of Chairman Cox and Chairman Olson, and continuing my dialogue with them as they refine their guidance. Implementation of Sarbanes-Oxley is key to the success of our markets. Accountability, transparency, and strong internal controls benefit investors and businesses alike.

Advocacy: the voice of small business in government

Statement submitted by

The Honorable Thomas M. Sullivan
Chief Counsel for Advocacy
U.S. Small Business Administration

U.S. Senate Committee on Small Business & Entrepreneurship

Hearing Date: April 18, 2007
Topic: Sarbanes-Oxley and Small Business:
Addressing Proposed Regulatory Changes and their
Impacts on Capital Markets

I am submitting this written statement because a death in my family prevents me from presenting testimony in person. I commend the U.S. Senate Committee on Small Business & Entrepreneurship for holding this hearing. And, I thank you for soliciting my views. The topic of how the Sarbanes-Oxley Act impacts small business is an important one and the small business community will benefit by this Committee's focus on the proposals under consideration by the U.S. Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB).

Congress established the Office of Advocacy to represent the views of small entities before Congress and Federal agencies. The Office of Advocacy (Advocacy) is an independent office within the U.S. Small Business Administration (SBA), and therefore the comments expressed in this statement do not necessarily reflect the position of the Administration or the SBA. Advocacy takes its direction from small businesses; therefore my remarks will be a reflection of what small business groups have shared with Advocacy. One of Advocacy's main responsibilities is to ensure agency compliance with the Regulatory Flexibility Act (RFA). The RFA's main purpose is to make certain that small entities are given due consideration when agencies promulgate regulations.[1]

Advocacy's involvement with the Sarbanes-Oxley Act (the Act) began in 2002, when our office asked Chairman Oxley and Chairman Sarbanes to include flexibility in the bill then being considered that would be sufficient to avoid unnecessary impacts to small businesses. Since the passage of the Act, small business representatives have contacted Advocacy to inform us of their concerns with the new audit requirements of Section 404. Advocacy has submitted numerous comment letters to the SEC and the

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[1] *Regulatory Flexibility Act of 1980*, Pub. L. No. 96-354, 94 Stat. 1164 (1980) (codified as amended at 5 U.S.C. § 601 et seq.).

PCAOB communicating these small business concerns.[2] Small businesses are worried that auditors, when faced with a new requirement to sign off on a company's internal controls, will employ expensive and time-consuming audit procedures. There is a compelling record demonstrating that the costs of complying with Section 404 are large and disproportionately high for small public companies. These entities have told Advocacy that changes to the requirements of Section 404 of the Act are necessary. Advocacy believes that the excessive cost of Section 404 internal controls reporting may restrict a new generation of small innovative companies from seeking capital in the U.S. capital markets.

To its credit, after the passage of the Sarbanes-Oxley Act, the Commission quickly realized the costs inherent in complying with Section 404 and delayed the implementation of Section 404 for small businesses. I would like to thank Chairman Cox and Chairman Olson for their leadership, hard work, and on-going dedication in the difficult process of implementing Section 404. The SEC and the PCAOB should also be commended for their job in reaching out to small public companies to understand the impacts and problems with Section 404. In 2005, the SEC chartered the Advisory Committee on Smaller Public Companies (Advisory Committee) to assess the impact of the Act on smaller companies, and make recommendations for changes. After a year of deliberations and solicitation of public input, the Advisory Committee made its final written recommendations last year. The SEC and the PCAOB have also held roundtables to solicit input from small public companies, and listened to the concerns of the small business community.

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[2] Archive of Advocacy comment letters on the Section 404 of the Act, http://www.sba.gov/advo.

Advocacy hosted its own small business roundtable in January 2007 to solicit input from small business representatives on the new proposals undertaken by the SEC and the PCAOB.[3] This roundtable followed years of dialogue between Advocacy and small entities concerning the implementation of the Act. Advocacy commends the staff members of the SEC and the PCAOB who attended this roundtable and explained the proposals, answered questions, and listened to issues of the small business community. Small businesses raised significant concerns with these proposals, including: (1) the need for further clarifications of major provisions from these proposals, (2) the need to examine whether these proposals actually reduce compliance costs and provide scalability for small public companies, and (3) the need for more time to implement the new requirements.

Based on these comments, Advocacy strongly recommends that the SEC continue to provide further extensions for small public companies until such time as more cost-effective procedures for internal controls can be developed. Additionally, Advocacy urges Congress to exempt smaller public companies from Section 404(b).

I. Background on Section 404- One Size Does Not Fit All

Congress enacted the Sarbanes-Oxley Act of 2002 (the Act)[4] in response to public concern about high-profile fraudulent financial reporting by companies like Enron and Worldcom. Section 404 of the Act requires public companies to report on their internal controls over financial reporting, or about systems they have in place to guard against fraudulent transactions. Section 404(a) requires management to establish and maintain an

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[3] Small business concerns from this roundtable are summarized in a comment letter from Thomas M. Sullivan, Chief Counsel, Office of Advocacy, SBA, to the SEC and the PCOAB (Feb. 21, 2007), *available at*: http://www.sba.gov/advo/laws/comments/sec07_0221.html.

[4] *Sarbanes-Oxley Act of 2002*, Pub. L. 107-204, Title IV, 116 Stat. 789 (2002) (codified in 15 U.S.C. § 7262).

adequate internal control structure and include in its annual report to the SEC an assessment or a report of the effectiveness of these internal controls. Section 404(b) requires that management hire an outside auditing firm to submit an audit report attesting to, and reporting on the management's assessment of the company's internal controls.[5] The ultimate goal of this section is to ensure the accuracy of a company's financial reports, and thus improve investor confidence. The Public Company Accounting Oversight Board, a non-profit corporation created by the Act to oversee the auditors of public companies, created Auditing Standard No.2 (AS-2) as a guide for auditors evaluating a company's internal controls reporting under Section 404(b).

The SEC's own Advisory Committee on Smaller Public Companies has concluded that a big problem with Section 404 was the implementation of AS-2, a prescriptive 300-page "grade book" for auditors evaluating public companies.[6] External auditors have applied this one-size-fits-all standard to both large and small companies. Companies have reported that auditors are not focusing on risks to financial reporting, but are auditing every process, which created redundancies and excessive costs. In the absence of management guidance, companies have been obliged to use the complicated AS-2 as a *de facto* guidance. Small public companies have experienced challenges in implementing AS-2, because it does not take into account the different characteristics that affect a company's financial reporting risks and internal controls, such as differences in organizational structure, ability to segregate duties and amount of resources available for Section 404 compliance.

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[5] 15 U.S.C. § 7262.

[6] SEC Advisory Committee on Smaller Public Companies, Final Report of the SEC Advisory Committee on Smaller Public Companies 32 (Apr. 23, 2006) (*Advisory Committee Report*), *available at*: http://www.sec.gov/info/smallbus/acspc.shtml.

II. Section 404 Imposes Disproportionate Costs On Smaller Public Companies

Due to the problems with Section 404 and AS-2, the costs of implementing Section 404 have greatly exceeded those originally anticipated by the SEC. In June 2003, the SEC estimated that "the average annual internal cost of compliance with Section 404 over the *first three years* would be $91,000, and that cost would be proportional relative to the size of the company."[7] To the contrary, all evidence indicates that Section 404 compliance costs are dramatically higher. A survey of actual compliance costs conducted by Financial Executives International in 2006 found that first-year compliance costs for Section 404 were $3.8 million for accelerated filers and $935,000 for smaller public companies or non-accelerated filers.[8]

Smaller public companies are likely to be hit especially hard by the costs of compliance with Section 404. The 2005 Advocacy-funded study by W. Mark Crain, *The Impact of Regulatory Costs on Small Firms,* found that, in general, small businesses are disproportionately affected by federal regulations.[9] Crain found that small firms with fewer than 20 employees annually spend 45 percent more per employee than larger firms to comply with federal regulations.[10] Likewise, the report by the SEC's Advisory Committee on Smaller Public Companies noted that Section 404 costs in relation to revenue will be disproportionately borne by smaller public companies.[11] This report found that small public companies with a market capitalization of under $100 million are expected to spend 2.55 percent of their revenue on Section 404 compliance, while larger

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[7] *Advisory Committee Report*, at 29 (emphasis added).
[8] FEI, *Survey on SOX Section 404 Implementation*, Exhibit A: Costs by Filing Status (March 2006).
[9] *The Impact of Federal Regulations on Small Firms*, an Advocacy-funded study by W. Mark Crain, Sept. 2005 *available at*: http://www.sba.gov/advo/research/rs264tot.pdf.
[10] *Id.*
[11] *Advisory Committee Report*, at 33.

companies with a market capitalization of over $1 billion are expected to spend 0.16 percent of their revenue on such costs.[12]

Moreover, recent studies by the Committee on Capital Markets Regulation,[13] McKinsey & Company,[14] and the U.S. Chamber of Commerce[15] provide evidence that the burdensome Section 404 requirements have already made the United States capital markets an increasingly unattractive environment to list shares, decreasing the number of initial public offerings (IPOs), and forcing companies to go private or to foreign stock exchanges. In a study by Foley & Lardner LLP, 81 percent of respondents felt that the Section 404 requirements were too strict, and 21 percent of respondents are considering going private as a result.[16] The Section 404 requirements will likely impose major obstacles to small public companies seeking capital, perhaps to such an extent that their application to small issuers would dissuade small businesses entirely from accessing U.S. capital markets.

III. Small Entities Have Expressed Serious Concerns with Both Proposals

Advocacy acknowledges the efforts undertaken by the SEC and the PCAOB to make internal controls reporting requirements more cost-effective and efficient for small public companies. The SEC's proposed management guidance attempts to set forth a

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[12] *Id.*

[13] Committee on Capital Markets Regulation, *Interim Report of the Committee on Capital Markets Regulation* (Nov. 30, 2006), *available at*: http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[14] McKinsey & Co, *Sustaining New York's and the US Global Financial Services Leadership* (Jan. 22, 2007), *available at:* http://schumer.senate.gov/SchumerWebsite/pressroom/special_reports/2007/NY_REPORT%20_FINAL.pdf.

[15] Commission on the Regulation of U.S. Capital Markets in the 21st Century, *Report and Recommendations* (March 2007), *available at*: http://www.uschamber.com/portal/capmarkets/default.

[16] Thomas E. Hartman, Foley & Lardner LLP, *The Cost of Being Public in the Era of Sarbanes-Oxley* (June 16, 2005), *available at:* http://www.fei.org/download/foley_6_16_2005.pdf.

"top-down, risk-based" approach for management to complete Section 404(a).[17] The PCAOB also revised the controversial Auditing Standard No. 2, incorporating the same "top-down, risk-based" approach.[18]

Despite these efforts, small businesses continue to have serious concerns about Section 404. On January 26, 2007, Advocacy held a small business roundtable, including small business owners and representatives, trade association staff, congressional staffers, and personnel from the SEC and the PCAOB. Participants raised the following concerns with the SEC's management guidance and the PCAOB's revised auditing standard:

1) Small Businesses Request Clarification of Major Provisions in Both Proposals

a. The SEC and the PCAOB Must Resolve Differences Between the Management Guidance and the Revised Auditing Standard

The Institute of Management Accountants has commented that the SEC and the PCAOB have created two conflicting rule books for the same task of internal controls reporting, and this is a source of confusion and complexity.[19] For example, small businesses are concerned that the SEC's management guidance is vague and "principles-based" to provide scalability for the management of small public companies, while the PCAOB's revised auditing standard is more prescriptive and detailed on how auditors must evaluate a management's internal controls reporting process. Small businesses have stated that they will be using the PCAOB's revised auditing standard as their *de facto* guidance, because they are afraid that following the SEC's management guidance will

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[17] *Management's Report on Internal Control Over Financial Reporting; Proposed interpretation; Proposed Rule*, 71 *Fed. Reg.* 77,635 (Dec. 27, 2006).

[18] *Proposed Auditing Standard-An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Proposals*, Release No. 2006-007 (Public Company Accounting Oversight Board, Dec. 2006).

[19] Comment letter from Paul A. Sharman, President and CEO, Institute of Management Accountants, to the SEC and the PCOAB (Feb. 13, 2007) (*IMA Comment Letter*), *available at*: http://www.sec.gov/comments/s7-24-06/lddevonish-mills5470.pdf.

result in a negative audit by an auditor utilizing a more detailed and prescriptive auditing standard. Advocacy recommends that the SEC add practical information in the management guidance on how management can complete a scaled internal controls report. For example, the U.S. Chamber of Commerce has commented that the SEC guidance could use more illustrative examples and feedback of how the guidance should be implemented, such as examples of insufficient compliance measures as well as overly conservative implementation.[20] Advocacy also recommends that the SEC and the PCAOB work together to make the revised auditing standard less prescriptive.

The Institute of Management Accountants and the U.S. Chamber of Commerce have commented on very significant inconsistencies between the two documents, including the process of identifying controls and significant accounts, and definitions such as material weakness, significant deficiency, and materiality.[21] Advocacy also recommends that the SEC and PCAOB work together to make sure that these inconsistencies are harmonized.

b. The SEC and the PCAOB Should Address Management and Auditor Liability

Participants at the roundtable raised the issue of liability in the Section 404 process as an important factor that most impedes the ability of these proposals to provide a scalable and cost-effective audit. These small business representatives stated that the management of small public companies needs assurances that they will not be held liable for completing a scaled-down report pursuant to the management guidance. In particular,

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[20] Comment letter from David C. Chavern, Chief Operating Officer and Senior Vice President, to the SEC and the PCAOB (February 26, 2007) (*U.S. Chamber of Commerce Letter*), *available at:* http://www.sec.gov/comments/s7-24-06/s72406-213.pdf.

[21] *IMA Comment Letter,* at 2; *U.S. Chamber of Commerce Letter*, at 4.

small businesses seek clarification of the provision which states that "the proposed amendments would be similar to a non-exclusive safe-harbor."[22] Participants of the roundtable asked for further details of the safe harbor, such as how this safe harbor can be claimed and what type of liability protection this would afford.

Participants noted that auditors also need assurances from the PCAOB that they will not be penalized for auditing and approving a scaled management report in the PCAOB inspections process. One participant at the roundtable stated that auditors are attributing a large percentage of their auditing fees to the potential liability and litigation exposure for these Section 404 audits. These new Section 404 requirements are likely increasing the potential liability of auditors and increasing the costs of these audits.

2) The SEC and the PCAOB Need to Examine Whether Proposals Reduce the Compliance Costs and Provide Scalability for Small Public Companies

Participants at Advocacy's roundtable commented that the SEC's management guidance and the PCAOB's revised auditing standard do not provide enough guidance on how small public companies can scale their audits to make them cost-effective. Small public companies need further guidance on ways that their audit of internal controls can be tailored, in the form of illustrations, case studies and examples.

Small business representatives also suggested that the rules implementing Section 404 not be implemented until these proposals have been fully tested to determine whether they will actually result in scalability and cost savings for small public companies. Such testing would allow for corrections in the standard, if the testing shows that the standard needs revision.

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[22] 71 *Fed. Reg.* at 77,649 (Dec. 27, 2006).

3) Small Public Companies Need More Time to Implement New Requirements

Small public companies expressed concern with the timing of these draft proposals. Although the SEC and the PCAOB just released these proposals in December 2006, most small public companies will still be expected to complete a management report on internal controls reporting by the end of the year and submit an auditor's report attesting to these internal controls next year.[23] Neither of these proposals has been finalized, and the SEC and the PCAOB still need to complete major revisions to their respective proposals. Participants at the Advocacy's roundtable strongly recommended that the SEC provide a further extension for small public companies in order to provide management with extra time to understand and implement these complex Section 404 proposals. Small entities commented that they had already planned and budgeted for FY 2007 the prior year, and it would be difficult and costly to start a new internal control reporting process in the middle of spring 2007.

Participants at the roundtable explained that it will take a longer time for small public companies to create and implement any new internal controls reporting process. Although small public companies regularly submit annual financial reports to the SEC, the internal controls reporting process is time intensive because it adds the new requirements of identifying processes, assessing risk levels, and documenting and testing the internal controls. Small companies are at a disadvantage in complying with Section 404 because they have more informal processes and fewer personnel and accountants. William Zaiser, the Chief Financial Officer at a MHI Hospitality Corporation, a small

[23] 71 *Fed. Reg.* 76,580 (Dec. 21, 2006). Under the SEC's extensions, non-accelerated filers would submit a management assessment report with its annual report for the first fiscal year ending on or after December 15, 2007. These entities would not be required to submit an auditor's attestation report until the following year, or the first fiscal year ending on or after December 15, 2008.

public company with a market capitalization of $64 million, hired an external consultant, and it still took four months to begin the internal controls reporting process. Zaiser stated that it would be very difficult if his company had to start the Section 404 process at this later date because his company would have to hire extra staff, or he would have to devote a large amount of his time to this project.[24] According to a Government Accountability Office survey of small business companies in 2005, 81 percent of the respondents hired a separate accounting firm or external consultants to assist them with Section 404 requirements, at an individual cost of $3,000 to $1.4 million.[25]

IV. Regulatory Flexibility Act Determinations

Advocacy commends the SEC and the PCAOB for developing these proposals in an effort to make Section 404 more cost-effective and efficient for small companies. Advocacy strongly recommends that the SEC continue to provide further extensions for small public companies until such time as more cost-effective procedures for internal controls reporting can be developed.

Advocacy also recommends that the SEC complete a revised final regulatory flexibility analysis (FRFA) of the final reporting procedures under Section 604 of the Regulatory Flexibility Act. The last regulatory analysis was completed in August 14, 2003, and this final regulatory flexibility analysis severely underestimates the cost of compliance with Section 404 of the Act. The SEC's 2003 FRFA states that small public companies will be "subject to an added reporting burden of approximately 398 hours and the portion of that burden that is reflected as the cost associated with outside

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[24] Telephone interview with William J. Zaiser, Chief Financial Officer, MHI Hospitality Corporation, in Greenbelt, Md. (Feb. 13, 2007).

[25] GAO, *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*, at 17. (April 2006) *available at*: http://www.gao.gov/new.items/d06361.pdf.

professionals is approximately $35,286 [per year]. We believe, however, that the annual average burden and costs for small issuers are much lower."[26] Current industry estimates place the Section 404 compliance burden at almost $1 million per year for small public companies.[27]

Advocacy also recommends that the SEC complete a required Small Business Compliance Guide for this rule. Under Section 212 of the Small Business Regulatory Enforcement Fairness Act (SBREFA), "for each rule or group of related rules for which an agency is required to prepare a final regulatory flexibility analysis...the agency shall publish one or more guides to assist small entities in complying with the rule."[28]

V. Legislative Recommendations

Advocacy suggests that Congress revise Section 404 of the Act to exempt smaller public companies from the requirements of Section 404(b). This is consistent with the SEC's Advisory Committee report, which recommended that smaller public companies be held to a different compliance standard.[29]

Advocacy recommends that Congress require the SEC and the PCAOB to submit a report with recommendations to the relevant committees of Congress, including the U.S. House Small Business Committee and the U.S. Senate Small Business & Entrepreneurship Committee, assessing the impact of Section 404 on smaller public companies after two years of implementation.

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[26] *Management's Report on Internal Control Over Financial Reporting an Certification of Disclosure In Exchange Act Periodic Reports*, Exchange Act Release No. 3308238; 34047986; IC-26068 (Aug. 14, 2003), *available at:* http://www.sec.gov/rules/final/33-8238.htm.
[27] *See* Note 8.
[28] *Small Business Regulatory Enforcement Fairness Act*, Pub. L. 104-121, Title II, 110 Stat. 857 (1996) (codified in various sections of 5 U.S.C. § 601 et seq.).
[29] *Advisory Committee Report*, at 4.

VI. Conclusion

Advocacy has worked closely with the SEC and the PCAOB since the Sarbanes-Oxley Act was enacted in 2002 and appreciates their continuing efforts to make the internal controls process less burdensome for small public companies. Based on input provided by small businesses at our roundtable, Advocacy strongly recommends that the SEC and the PCAOB continue to seek further flexibility for small public companies and an extension of time to comply with the requirements. Additionally, Advocacy urges Congress to exempt smaller public companies from Section 404(b).

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Testimony of

Mark B. Leahey, Esq.
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(MDMA)

Before the Committee on Small Business & Entrepreneurship
United States Senate

"Sarbanes-Oxley and Small Business: Addressing Proposed Regulatory Changes and Their Impact on Capital Markets"

April 18, 2007

Chairman Kerry, Ranking Member Snowe and the Members of the Small Business and Entrepreneurship Committee:

On behalf of the Medical Device Manufacturers Association (MDMA), I want to thank you for providing the opportunity to submit written testimony today on the proposed regulatory changes to implement the Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) by the Securities and Exchange Commission (Commission) and the Public Company Accounting Oversight Board (PCAOB) and their impact on the emerging medical device industry. As one of the driving forces of innovation, MDMA member companies play a critical role in furthering the growth and competitiveness of the U.S. biomedical sector and the U.S. capital markets.

The MDMA is a national trade association, representing over a hundred innovative medical device companies engaged in the research and development of cutting edge and novel biomedical device products necessary to treat and improve the lives of patients in all areas of healthcare including oncology, vascular therapy, pain management, and neurological disease diagnosis, to name a few. The medical technology industry is comprised mostly of small businesses with 80 percent of the companies having less than 50 employees. Ninety-eight percent of the industry has less than 500 employees.

As a representative of one of the most innovative high growth sectors of the American economy -- one in which the U.S. maintains a global leadership position -- my testimony will focus on the recent SOX Section 404 regulatory revisions proposed by the Commission and the PCAOB[1] and the additional reforms necessary to achieve meaningful reforms that are important to the investors.

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1 SEC proposed rule concerning "Management's Report on Internal Control Over Financial Reporting" - Release Nos. 33-8762; 24-54976 (File No. S7-24-06); PCAOB proposed audit standard - "An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements" and Related Other Proposals -- Release No. 2006-007 (Rulemaking Docket No. 021).

Let me start by saying that we fully appreciate and agree with the Congressional intent behind Section 404 – to enhance investor protection and financial integrity of public companies. MDMA members strongly support this goal. Where Section 404 has been rendered ineffective and costly has been in the implementation process.

The disproportionate cost impact of SOX Section 404 on the long-term competitiveness of America's most innovative and high growth sectors such as the medical device industry are high, costing small companies with low revenues and less than 50 employees over $500,000 in external audit fees.

The Commission and the PCAOB have repeatedly acknowledged the high cost burdens of Section 404 compliance on smaller public companies and the need for scaled and proportional reforms.[2] The high cost burdens for the smaller companies are also well documented in the final report by the SEC's Advisory Committee for Smaller Public Companies, which recommended fundamental reforms after its year-long review of Section 404 implementation because it found that the current "one-size-fits-all" auditor driven approach greatly hampers the ability of smaller public companies to invest in research and development, gain access to public capital markets, and thereby jeopardizes the competitiveness of smaller companies that are the growth engines of the American economy.[3]

The U.S. Government Accountability Office (GAO) has made similar findings in its report to this Committee on April, 2006, stating that smaller public companies at the bottom 6 percent of total U.S. market capitalization pay up to $1.4 million in external audit fees for Section 404 compliance. In fact, 47 percent of the companies reported that Section 404 compliance resulted in significant "opportunity costs" by draining resources away from innovation and research.[4]

The impact of Section 404 costs on the U.S. economy and the medical device industry's global competitiveness is also of great concern. The recent study on the impact of section 404 on the U.S. capital markets by the non-partisan Committee on Capital Markets Regulation[5] is particularly instructive in describing the current market trends and the circumstances in which American company's ability to access capital may be decreasing. The Committee found that the U.S. market share of global initial public offerings has fallen from 48 percent in the 1990s to 7.2 percent in 2006, and that enhancing shareholder rights while at the same time reducing overly-burdensome regulations such as Section 404 may help in reducing this declining trend.

The Members of this Committee may have undoubtedly heard of anecdotal references by foreign firms, the majority of whom will be subject to Section 404 compliance beginning July 15, 2007, that they are foregoing the U.S. capital markets and listing overseas due, in large part, to Section 404. In fact, the SEC Commissioner Atkins in his letter to the *Wall Street Journal* on June 10,

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2 Ibid.
3 Final Report of the Advisory Committee on Smaller Public Companies to the Securities and Exchange Commission (April 23, 2006)
4 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 (GAO 06-361)
5 The Committee on Capital Markets Regulation is an independent and bipartisan group comprised of 24 leaders from the investor community, business, finance, law, accounting, and academia. It began its work in 2006 and is directed by Prof. Hal S. Scott, Nomura Professor and Director of Program on International Financial Systems at Harvard Law School. The Committee Co-Chairs are Glenn Hubbard, Dean of Columbia Business School, and John L. Thornton, Chairman of the Brookings Institution.

2006, indicated that in 2005, nine out of every ten dollars raised by non- U.S. companies through new stock offerings were issued overseas, while the reverse was true just six years ago in 2000. In addition, it is the experience of MDMA's private company members that an initial public offering may not be seen as the optimum path to liquidity for their investors due to the amount of cost burdens associated with Section 404 readiness. This issue has been previously noted by the head of the Division of Corporation Finance at the Commission as well.[6]

Proposed SEC and PCAOB Revisions and Need for Further Reform:

Although we appreciate the Commission and the PCAOB's stated goals[7] of reforming Section 404 requirements and the corresponding PCAOB's audit standards to achieve cost efficiencies, scalability and risk based reforms, the proposed new management guidelines and the Auditing Standard Number 5 (AS5), fail to achieve the purported principle based reform framework with the specificity and the integration necessary to achieve the reforms critical to smaller public companies.

In our September 12, 2006 comment letter to the Commission on its Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, MDMA, along with several other high growth industry organizations representing healthcare technology, biotechnology, information and communications technology, electronics and semiconductor industries, recommended the need for a management driven, principle based reform framework that is integrated, scaled, risk based, and cost effective.

The adoption and incorporation of the recommended reform framework principles will be critical now more than ever as the Commission and the PCAOB finalize their revisions of the management guidelines and the AS5. We request the Members of this Committee to urge the Commission and the PCAOB to adopt the following principle based reform framework, which will provide fundamental Section 404 reforms and address the significant compliance burdens facing the smaller public companies today.

Integrated Principle Based Reform Framework Needed:

- **Reforms must reflect a rational cost-benefit balance.** Cost burdens imposed by the increasing complexity of required internal controls must yield increased benefits in assuring greater investor confidence.

  The current AS5 fails to sufficiently address the need for a cost-benefit balance as it continues to give wide discretion to the auditors on the amount of work required. It also fails to provide economically sound methods of assessing the cost-benefit analysis. It is essential that smaller companies are not faced with having to complete a "checklist" of internal controls driven by auditor prescribed terms. Instead, the management's assessment process and the external audit procedures must be integrated with the

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6 See, the letter from John W. White, the new and current head of the Division of Corporation Finance at the SEC, submitted in connection with the SEC's 2005 Roundtable on Section 404, available at http://www.sec.gov/news/press/4-497.shtml.
7 SEC Chairman Cox's statement and PCAOB Chairman Olson's statement at the SEC open meeting on April 4, 2007 *http://www.pcaob.org/News_and_Events/Events/2007/Speech/04-04_Olson.aspx*; http://www.sec.gov/news/speech/2007/spch040407cc.htm.

financial statement audit processes with additional guidance on defining the scope of the audits.

Only with these revisions will the implementation be fully within the original intent of the law. As the U.S. Senate Committee Report on Section 404 indicate the legislative history is clear on this point: "The Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees."[8] If the prescriptive nature of the AS5 is not revised further, smaller companies will continue to face the high cost burdens due to the prescriptive nature of the auditor defined requirements.

- **Internal control requirements should be "scaled" and "proportional" to the size of revenues and complexity of corporate structures.** In achieving scaled and proportional reforms that are risk based, it is critical that Section 404 reforms establish a concrete basis for the required levels of internal controls.

  As recognized by the Advisory Committee in its Final Report, Section 404 reform should be based on revenue metric in addition to market capitalization. This approach reflects corporate reality in that revenues drive the complexity of corporate structures and the corresponding need for increased internal controls to protect against financial fraud. In fact, reforms should support management's incentive to maintain an effective and integrated system of internal controls to produce accurate financial reports, which are most important to investors.

  The internal controls necessary to meet Section 404 should be integrated and consistent with the levels of controls necessary to meet the CEO and CFO certifications of company financials as required under Section 302 of SOX.

- **New rules should clearly define the meaning of materiality and risk in assessing the integrity of the financial statements.** The rules must provide a clearly defined framework of assessing risk with a focus on entity level controls and more clearly defined materiality rules.

  The current AS5 still requires qualitative materiality rules without further guidance on how to assess the "reasonable possibility" of a material misstatement. Given the prescriptive nature of AS5 and the lack of clear standards, the new rules also lead to inefficiencies and duplicate testing of internal controls. The current AS5 deters both management and auditors from taking a cohesive integrated risk-based approach by failing to provide a clear mandate for auditors to rely on the monitoring and testing done by the management or the internal auditors.

  For smaller companies, the lack of cohesive and integrated mechanisms to determine

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8 The Legislative History Of The Sarbanes-Oxley Act Of 2002: Accounting Reform And Investor Protection Issues Raised By Enron And Other Public Companies (S. Hrg. 107–948)

materiality and risk in assessing internal controls could once again lead to an auditor driven process that results in high cost burdens for the companies.

- **Frequency of internal control testing should be determined by changes in established baseline entity-wide controls.** The new AS5 fails to recognize the value of cumulative knowledge and relevance of changes in key control areas that matter to the reporting of financial statements. Periodic testing or testing when a material change has occurred could alleviate the excessive duplication year after year that further adds to high cost burdens imposed by Section 404.

- **Unless and until a new reform framework is implemented, additional deferral should be provided for non accelerated filers and newly public companies.** We fully support the Commission's proposal to provide further implementation deferrals for non-accelerated filers (small companies under $75 million in market capitalization) and for newly public companies.

  Unless and until a new AS5 has proven to be cost effective, risk based, scaled and proportional to the complexity of the companies, we believe it is critical to further delay both the management assessment and external auditor attestation requirements for non accelerated filers as well as newly public companies until a settled guidance can be provided and the new AS5 has been implemented for a reasonable time. In fact, non accelerated filers and newly public companies should be required to comply with Section 404 only after a full assessment can be made by the GAO on the cost/burden impact of the new AS5 rules.

Conclusion

As a representative of one of the high-growth sectors of the U.S. economy, the MDMA members and I appreciate this opportunity to submit written testimony to the Committee. We believe that principle-based reforms that focus on cost effectiveness, that are risk based, and scaled and proportional to the level of company revenues and complexity of corporate structures, will achieve the original intent of Section 404 –internal controls that provide investors with the optimal level of confidence in the financial integrity of public companies.

We thank you for your consideration of our views and we urge the Committee to request the Commission and PCAOB for their careful consideration of the additional reforms outlined in our testimony.

Sincerely,

Mark B. Leahey, Esq.
Executive Director
Medical Device Manufacturers Association

Statement on behalf of the

Independent Community Bankers of America
Washington, DC

"Sarbanes Oxley and Small Business: Addressing Proposed Regulatory Changes and Their Impact on Capital Markets"

United States Senate Committee on
Small Business and Entrepreneurship

April 18, 2007

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer this statement before the Senate's Small Business and Entrepreneurship Committee concerning the impact that the recent proposed guidance under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) will have on small business and the capital markets. Section 404 requires publicly held companies to include an assessment by management of the effectiveness of a company's financial controls and procedures in their annual reports and to have the company's auditor attest to management's assessment of the effectiveness of the company's internal controls and procedures.

The Securities and Exchange Commission (SEC) recently proposed new guidance for management under SOX Section 404(a) (the "SEC Guidance"). At the same time, the Public Company Accounting Oversight Board (PCAOB) proposed a new internal control auditing standard under SOX Section 404(b), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (referred to hereafter as Auditing Standard No. 5 or "AS5"), that would supersede Auditing Standard Number 2. The purpose of both the SEC Guidance and proposed AS5 is to (1) clarify the requirements of SOX Section 404(a) for management and (2) simplify and scale the internal control audit required by Section 404(b) so that outside auditors would focus on those matters most important to internal control.

Summary of ICBA's Position

- While the SEC Guidance and proposed AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, ICBA still has doubts that it will reduce 404 audit costs, particularly for smaller public companies.

- ICBA recommends at least another one year delay in the Section 404 due dates for non-accelerated filers so that they will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. The additional one-year delay would give the SEC and the PCAOB an opportunity to evaluate the impact and the cost effectiveness of their proposed guidance on accelerated filers and would also give non-accelerated filers that have no experience with

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[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org

Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

- To indicate that it is serious about reducing costs, ICBA believes that the SEC should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs.

- A closer alignment is needed between the broad and principles-based SEC Guidance and the more prescriptive AS5. Also, terms such as "material deficiency" and "reasonable assurance" need to be defined more clearly. The proposed SEC Guidance and AS5 should also address the use of bank management reports and bank examination reports.

- While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.

General Comments Concerning AS5 and the SEC Guidance

We commend the SEC and the PCAOB for their efforts to create a scalable, top-down approach for SOX 404 audits. As noted in the release for the SEC Guidance, the SEC Advisory Committee on Smaller Public Companies raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of SOX 404. Some of the concerns stemmed from the implementation of AS2 and the fact that auditors were engaged in excessive testing of controls and requiring unnecessary documentation to comply with SOX 404.

While the SEC Guidance and proposed AS5 may curtail excessive testing of controls and reduce some of the unnecessary documentation required by SOX 404 audits, we still have doubts that it will reduce 404 audit costs, particularly for smaller public companies. We note, for instance, that AS5 has not been field tested so there is no evidence to suggest that, despite the proposed standard's focus on scalability and risk-based testing, auditors will significantly change their audit procedures or reduce the time they take to perform a 404 audit.

ICBA recommends at least another one year delay in the Section 404 due dates for non-accelerated filers so that calendar year filers will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. The one-year delay would accomplish several things. First, it would give the SEC and the PCAOB an opportunity to evaluate the cost effectiveness of their controls on accelerated filers. If, for instance, the SEC Guidance and AS5 have little impact on SOX 404 audit costs for the 2007 and 2008 accelerated filers, then the SEC and the PCAOB will have time to revise the guidance and the new standard before it is fully implemented by non-accelerated filers. Second, a one-year delay would also give non-accelerated filers that have no experience with Section 404 additional time to understand and apply the new guidance and establish a new internal control framework.

ICBA also believes that the SEC and the PCAOB should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. For instance, the SEC should state that the goal is to reduce average internal control audit costs by a certain percentage—say 20%, with a commitment that if the revised standard does not meet that goal, then the standard will be revised further. It is too ambiguous for the SEC or the PCAOB to state that their goal is to increase the "cost effectiveness of the 404 audit" or "to eliminate unnecessary audit procedures" particularly when there has been no field testing of the new standard and therefore no assurance that it will reduce costs. A specific benchmark or goal would convey to the industry that the SEC and the PCAOB is serious about reducing the overall costs of SOX 404 and is committed to achieving that goal.

The SEC Guidance and Proposed AS5 Should be Better Aligned

As acknowledged by SEC Chairman Christopher Cox at the recent joint public hearing on SOX 404[2], **a closer alignment is needed between the broad and principles-based SEC Guidance and the more prescriptive AS5.** Both management and auditors should be able to look to both documents for a consistent and detailed approach to assessing internal controls. AS5 should focus on how to audit the company's internal controls whereas the SEC Guidance should concentrate on how an internal control framework should be established.

In the case of non-accelerated filers that have not begun their SOX 404 audits, the temptation will be for management to use the more specific and detailed AS5 for guidance rather than the SEC Guidance since it lays out more clearly what the auditors will expect in the way of an internal control framework. Without greater alignment between the SEC Guidance and AS5, we predict that the SEC Guidance would become less relevant to smaller public companies—exactly the scenario that the SEC wants to avoid—and that management would rely more on their auditors to determine how a good internal control framework should be implemented.

ICA also recommends that the SEC Guidance include more illustrations of how the guidance should be implemented particularly for smaller public companies. For instance, AS5 indicates clearly how an auditor should assess a company's control environment but the SEC Guidance only makes a passing reference to it and does not provide any specific evaluation criteria or any information on what constitutes a poor

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[2] The Securities and Exchange Commission met at a public meeting on April 4, 2007. The Commissioners urged the SEC staff to continue to work closely with the PCAOB to make the internal controls provisions of SOX 404 more efficient and cost effective. The Commissioners also directed the staff to focus the remaining work in four areas: aligning AS5 with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions and terms; scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies, encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment; and following a principles-based approach to determining when and to what extent the auditor can use the work of others

control environment. AS5 lists a number of specific factors for identifying significant accounts but the SEC Guidance has no parallel guidance for management and has few illustrations to help managers identify significant accounts. AS5 sets forth certain specific points for auditors to consider in evaluating the effectiveness of IT systems for smaller companies whereas the SEC Guidance has no such comparable discussion of IT systems.

Defined Terms Need to be Clearer

While we agree that the SEC and the PCAOB have made some progress in clarifying some of the defined terms used in AS2, we believe there is more room for improvement. Specifically, there will still be confusion about what constitutes a "material weakness" and how management should identify material weaknesses. AS2 currently defines a material weakness as a control deficiency, or a combination of control deficiencies, that result in more than a remote likelihood that a material misstatement of the company's annual or interim financial statements will not be prevented or detected. In the proposed AS5 and SEC Guidance, the SEC and the PCAOB use the same definition but substitute "reasonable possibility" for "more than a remote chance."

While "reasonable possibility" is clearer than "more than a remote chance" and possibly raises the threshold to some degree, the definition still requires management and auditors to prove a negative—that no material weaknesses exist—as opposed to affirmatively proving the effectiveness of internal controls. This negative approach—proving that no material weaknesses exist—places an enormous burden on auditors and management who must attest to the internal control over financial reporting and encourages them to be very conservative with their testing and documentation.

ICBA believes a more precise definition of "material deficiency" is needed that is tied to the impact on a company's earnings. Last year, ICBA supported the COMPETE Act,[3] introduced by Rep. Tom Feeney (R-Fla.), that directed the SEC and the PCAOB to use a 5% de minimus standard (e.g., 5% of profits) under AS2 for noting material deficiency. Furthermore, if management and the auditors must prove the negative—that there are no "material deficiencies" in their internal controls—then there should be greater clarity as to how companies both large and small can achieve that goal. The guidance should also indicate at what point a combination of control deficiencies give rise to a material weakness. Illustrations of different control deficiencies that rise to a material weakness would be useful. Both the SEC Guidance and AS5 should be clear enough so that management does not have to consult with their auditors every time there is an issue about a "material deficiency."

There are other examples of defined terms that need to be clarified. For instance, the SEC Guidance indicates that management is required to assess whether a company's internal controls are effective in providing "reasonable assurance" regarding the reliability of financial reporting. "Reasonable assurance" is defined as assurance that would "satisfy prudent officials in the conduct of their own affairs." This definition is entirely too vague. At a minimum, the SEC should provide illustrations so that

[3] HR 5404, known as the "Competitive and Open Markets that Protect and Enhance the Treatment of Entrepreneurs Act."

companies have a clearer idea of what it means to be "reasonably assured." As mentioned above, the guidance should be clear enough that management does not have to constantly refer to experts (i.e., an outside auditor) to understand the definitions.

The "Principal Evidence" Provision in AS2 Should Be Eliminated

ICBA commends the PCAOB for proposing a new auditing standard, *Considering and Using the Work of Others in an Audit*, which would replace AU section 322 and provide direction to auditors for using the work of others in both the audit of internal control reporting and the audit of the financial statements. We agree that a single, unified framework for the auditor's use of the work of others would remove barriers to the integration of the internal control audit and the audit of financial statements. We understand that the new standard will replace the provisions in AS2 that dealt with using the work of others.

We also applaud the PCAOB for eliminating (or not including in the new standard) the "principal evidence" provision in AS2 which required the auditor's own work to provide the principal evidence for the auditor's opinion. The "principal evidence" provision contributed to the high cost of SOX 404 audits because it was interpreted by many auditors to mean that under no circumstances could the auditor rely on the work of others. For instance, the work of internal auditors was often ignored by outside auditors because of the "principal evidence" provision in AS2.

The SEC Guidance and AS5 Should Address Bank Management and Examination Reports

Besides being examined periodically for compliance and safety and soundness, banks are also subject to the internal control requirements of Section 36 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and Part 363 of the FDIC regulations. ICBA recommends that the proposed new standard and SEC Guidance address the use by management and by auditors of bank internal control management reports and bank examination reports. These reports provide valuable insight into a bank's internal controls and cover many of the same issues that are required under proposed AS5.

The SEC Guidance Should Provide a Clear Safe-Harbor for Management

As proposed, the SEC Guidance says that the proposed amendments to Rules 13a-15(c) and 15d-15(c) will make the SEC Guidance "similar" to a non-exclusive safe-harbor. ICBA recommends that the SEC provide a clear safe harbor for management under the Securities and Exchange Act of 1934 provided that management has complied with all aspects of the SEC Guidance. A clear safe harbor would make it more likely that management will detect material weaknesses and disclose them since management will realize that it has some legal protection under the Exchange Act. Furthermore, management will be more likely to rely on its own interpretation of the guidance and not constantly seek advice from auditors.

The SEC rules contain a number of safe harbors that have been very successful, including Rule 144A under the Securities Act of 1933 which provides a safe harbor from registration for re-sales of privately placed securities to qualified institutional buyers and Regulation D, which is a safe harbor from registration for certain private placements of securities. In each case, these safe harbors have provided a clear way for parties to comply under the securities laws. The SEC should provide a clear safe harbor for management under the Exchange Act that provides legal protection similar to these other safe harbors.

Even With a Scalable AS5, ICBA Endorses a Small Company 404 Exemption

ICBA commends the SEC and the PCAOB for their endorsement of a scalable approach to SOX 404 audits. Proposed AS5, for instance, does include a section on scalability that discusses the six areas of the audit that are often affected by the attributes of smaller, less-complex companies. For each of these areas, the proposed standard describes the principles the auditor should apply in order to obtain sufficient competent evidence in a reasonable manner. We understand that this part of the proposed AS5 will provide the foundation for planned guidance on auditing internal control in smaller companies to be issued later this year.

While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition. Even with a revised auditing standard, we believe that smaller public companies would still be subject to unnecessarily extensive auditing of detailed control processes under Section 404 by auditors unduly concerned about their liability and being second guessed by the PCAOB.

ICBA strongly endorses the primary recommendations of the SEC's Advisory Committee on Smaller Public Companies including (a) exempting micro-cap companies (with equity capitalizations of $128 million or less) that have revenue of less than $125 million from the internal control attestation requirements of SOX Section 404 and (b) exempting small-cap companies (with equity capitalizations of between $128 million and $787 million) that have revenue of less than $250 million from the external audit requirements of SOX Section 404. We agree with the Advisory Committee that with more limited resources, fewer internal personnel and less revenue with which to offset the costs of Section 404 compliance, both micro-cap and small-cap companies have been disproportionately impacted by the burdens associated with Section 404 compliance. We also agree that the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large companies, are of less value for micro-cap and small-cap companies, that rely to a greater degree on "tone at the top" and high-level monitoring controls, to influence accurate financial reporting.

The proportionately larger costs for smaller public companies to comply with Section 404 adversely affect their ability to compete with larger public companies and even with foreign competition. This reduction in the competitiveness of U.S. smaller public companies hurts their capital formation ability and, as a result, hurts the U.S. economy.

For community banks, Section 404 costs have been particularly significant. ICBA's 2005 survey of Section 404 costs for community banks revealed that the average community bank would spend during 2005 more than $200,000 and devote over 2,000 internal staff hours to comply with Section 404.[4] These costs far outweigh the benefits for these small companies.

Conclusion

Since proposed AS5 has not been field tested, ICBA recommends at least another one year delay in the Section 404 due dates for non-accelerated filers so they will have until the due date for their 2008 annual report to file their management internal control reports and the due date for their 2009 annual report to file the auditor's attestation report. To indicate that it is serious about reducing costs, ICBA also believes that the SEC should propose a quantitative benchmark or goal for the new standard that is tied to a reduction in overall SOX 404 audit costs. While a risk-based and scalable AS2 may reduce some of the high costs of SOX Section 404, ICBA still believes that smaller public companies should be partially or fully exempted from Section 404 in order to be competitive with larger companies and foreign competition.

ICBA appreciates the opportunity to offer this statement before the Senate Small Business and Entrepreneurship Committee concerning the impact that the recent proposed guidance under Section 404 of the Sarbanes-Oxley Act will have on small business and the capital markets.

[4] For a complete description of ICBA's Section 404 Survey of Community Banks, see ICBA's comment letter to the SEC dated March 31, 2005 concerning the formation and goals of the Advisory Committee.

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