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THE SARBANES-OXLEY ACT 4 YEARS LATER: WHAT HAVE WE LEARNED?

HEARING

BEFORE THE

SUBCOMMITTEE ON REGULATORY AFFAIRS

OF THE

COMMITTEE ON
GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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THE SARBANES-OXLEY ACT 4 YEARS LATER: WHAT HAVE WE LEARNED?

WEDNESDAY, APRIL 5, 2006

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON REGULATORY AFFAIRS,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:08 a.m., in room 2154, Rayburn House Office Building, Hon. Candice S. Miller (chairman of the subcommittee) presiding.

Present: Representatives Miller, Westmoreland, Lynch, and Clay.

Staff present: Ed Schrock, staff director; Rosario Palmieri, deputy staff director; Kristina Husar and Joe Santiago, professional staff director; Benjamin Chance, clerk; Krista Boyd, minority counsel; and Jean Gosa, minority assistant clerk.

Mrs. MILLER. Good morning. Our third panelist is on his way, and I know our first panelist has another meeting to go to, and the ranking member said that was the sound of the "Big Dig" from Boston, so with that we will start.

I want to welcome everyone this morning, and the Subcommittee on Regulatory Affairs will come to order.

No one here can forget the turmoil caused by the corporate and accounting scandals involving Enron, Arthur Andersen, and certainly WorldCom as well. And as a reaction to the shocking behavior of all of these things, Congress acted very swiftly to pass legislation aimed at restoring order and trust in our Nation's financial markets, and with very good reason.

After all, financial investment in our public markets and public companies is good not only for the companies, but for the financial security of average Americans. The more liquid our financial markets, the less expensive it is for American companies to raise capital, to grow their business, and to provide investors with a healthy return on their investment. This system encourages small companies to expand and it is also a recipe for dynamic growth in the job market.

The Sarbanes-Oxley Act tried to restore investor confidence in the stock market by restricting accounting firms from performing a number of services for the companies that they audit. The act also required new disclosures for public companies and for the officers and directors of those companies. Among the other issues affected by the legislation are securities fraud, criminal and civil penalties for violating the security laws, blackouts for inside traders of pension fund shares, and protections for corporate whistleblowers.

However, Congress might have acted just a bit too quickly as many unintended consequences have made the law more costly to business and to small businesses, in particular, than originally thought. We are holding this hearing today to examine some of these consequences and to look at possible solutions.

Oftentimes it is very hard for policymakers to evaluate the cost and benefits of a regulation or a piece of legislation. In the case of Sarbanes-Oxley, we now have data which suggests that the cost of complying with specific provisions of the act is much greater than the actual benefits.

For example, while the SEC initially estimated the cost to comply with Section 404 to be about $91,000 per company or $1.24 billion in the aggregate, multiple studies pegged the actual compliance cost at $35 billion, which is, of course, nearly 30 times the original estimate.

But let's put this in perspective: Section 404 is only 168 words long, and if you use the $35 billion figure, that is almost $21 million per word, and that is just the initial startup cost.

As well, Section 404 has hit small and mid-size firms the hardest: as a percentage of revenue, smaller issuers in 2004 spent 11 times more on the Sarbanes-Oxley implementation than did larger companies. Micro-cap companies, with revenues under $100 million, saw an 84 percent increase in outside audit fees as a result of the law. Small cap companies with revenues between $100 million and $700 million saw a 92 percent increase in audit fees. And S&P 500 companies saw an increase of 55 percent in their audit fees.

Smaller companies have limited resources which are now being allocated to Section 404 compliance, and there is great concern that the regulatory burden of Section 404 is currently diminishing their competitiveness through higher operating costs and management distraction from business opportunities and other risks.

In addition to these high out-of-pocket costs, there may also be an opportunity cost that accompanies Section 404. When a company spends over $4 million a year to comply with a single regulation, they are unable to direct those substantial resources into capital formation, employee benefits and salaries, or even stock dividends. Moreover, the largest potential cost of Section 404 has yet to be quantified; the loss of opportunities for the American public to invest in small and innovative firms that have either delisted, gone dark, or declined to go public.

These corporate managers have determined that the cost of being a public company is no longer outweighed by the benefits the firm gained through access to the deep liquid markets of the American Stock Exchanges. Removing a company from the public exchanges is costly to a firm in terms of lost prestige, decreased liquidity, higher cost of capital. And it is conceivable that the decision to delist results in slower growth, poor returns on investment and a weaker position in the global market; and of course it also results in less job creation.

This is a tremendous hurdle that the American companies must overcome that most global competitors do not. Foreign companies that do not list their shares on American exchanges, do not face the same fixed cost imposed by Section 404. Accordingly, they are able

to invest their resources into research and development, customer discounts and other forms of value creation.

It is no wonder that at every hearing on regulation, witnesses always bring up Section 404 as a key regulation that is hurting Americans' ability to compete.

It is certainly clear that the time has come for this Congress to begin a dialog on this important subject, sort of put our ear to the ground and hear directly from those who are affected by Section 404.

So we certainly look forward to all the testimony of the witnesses today, and with that, I would recognize our ranking member, Representative Lynch, for his opening statement.

[The prepared statement of Hon. Candice S. Miller follows:]

Sarbanes-Oxley 4 years Later: What Have We Learned?

Opening Statement of Chairman Candice S. Miller

Committee on Government Reform
Subcommittee on Regulatory Affairs

Wednesday, April 5, 2006, 10:00 a.m.
2154 Rayburn House Office Building

Good morning. The Subcommittee on Regulatory Affairs will come to order. I would like to welcome everyone to our hearing today on the Sarbanes - Oxley Act.

No one can forget the turmoil caused by the corporate and accounting scandals involving Enron, Arthur Anderson, and WorldCom. As a reaction to the shocking behavior of these scoundrels, Congress acted swiftly to pass legislation aimed at restoring order and trust in our nation's financial markets. And with good reason.

After all, financial investment in our public markets and public companies is good not only for the companies, but for the financial security of average Americans. The more liquid our financial markets, the less expensive it is for American companies to raise capital to grow their business and provide investors with a healthy return on their investment. This system encourages small companies to expand; and it is also a recipe for dynamic growth in the job market.

The Sarbanes-Oxley Act tried to restore investor confidence in the stock market by restricting accounting firms from performing a number of services for the companies they audit. The Act also required new disclosures for public companies and for the officers and directors of those companies. Among the other issues affected by the legislation are securities fraud, criminal and civil penalties for violating the securities laws, blackouts for insider trades of pension fund shares, and protections for corporate whistleblowers.

However, Congress might have acted just a bit too quickly as many unintended consequences have made the law more costly to businesses, and to small businesses in particular, than originally thought. We are holding this hearing to examine some of these consequences and to look at possible solutions.

Oftentimes, it is hard for policy-makers to evaluate the costs and benefits of a regulation or piece of legislation.

In the case of Sarbanes-Oxley, we now have data which suggests that the cost of complying with specific provisions of the Act is greater than the actual benefits.

For example, while the SEC initially estimated the cost to comply with Section 404 to be $91,000 per company or $1.24 billion in the aggregate, multiple studies peg the actual compliance cost at $35 billion! That is nearly 30 times the original estimates!

But let's put this in perspective: Section 404 is only 168 words long- using the $35 billion figure, that is almost $21 million per word, and that is just for initial start up costs.

As well, Section 404 has hit small and midsized firms the hardest: As a percentage of revenue, smaller issuers in 2004 spent eleven (11) times more on SOX implementation than did larger companies.

- Microcap companies (with revenues under $100 million) saw an 84% increase in outside audit fees as a result of the law.
- Smallcap companies (with revenues between $100 million and $700 million) saw a 92% increase in audit fees.
- S & P 500 companies saw an increase of 55% in audit fees.

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In addition to these high out-of-pocket costs, there may also be an opportunity cost that accompanies Section 404. When a company spends over $4 million a year to comply with a single regulation, they are unable to direct these substantial resources into capital formation, employee's benefits and salaries, or even stock dividends. Moreover, the largest potential cost of Section 404 has yet to be quantified -- the loss of opportunities for the American public to invest in small and innovative firms that have either de-listed, gone dark, or declined to go public.

These corporate managers have determined that the cost of being a public company is no longer outweighed by the benefits the firm gains through access to the deep liquid markets of the American stock exchanges. Removing a company from the public exchanges is costly to a firm- in terms of lost prestige, decreased liquidity, and higher cost of capital. It is conceivable that the decision to delist results in slower growth, poorer returns on investment, and a weaker position in the global market. And, of course, less job creation.

This is a tremendous hurdle that American companies must overcome that most global competitors do not. Foreign companies that do not list their shares on American exchanges do not face the same fixed costs imposed by Section 404. Accordingly, they are able to invest their resources into research and development, customer discounts, and other forms of value creation.

It is no wonder that at every hearing on regulation witnesses bring up Section 404 as a key regulation that is hurting America's ability to compete.

It is clear that the time has come for Congress to begin a dialogue on this important subject, put our ear to the ground, and hear directly from those who are affected by Section 404.

I look forward to hearing the testimony of all our witnesses today. I'll now recognize the distinguished Ranking Member of the Subcommittee, Mr. Lynch for his opening statement.

Mr. LYNCH. Thank you Chairman Miller, and I appreciate the fact the we are holding this hearing. This is one of the most important securities related acts in the history of this country, and I think it is appropriate at this point to be reviewing its impact on medium and small-sized businesses.

I am pleased to join, as well, my colleagues, Mr. Feeney and Mr. Kirk, and I know Mr. Meeks is on his way, to look at this.

I hear a lot about this in my district. I want to associate myself with the remarks of the Chair. I understand the impetus of this act, the WorldCom and Enron scandals, and the lack of accountability that we had in our accounting practices, how investor reliability and accuracy had to be improved. But also, I am concerned with the unanticipated cost of compliance with especially Section 404 of the act, and I think we have to look very closely at that. There are definitely ways that we can improve the cost side of this equation, and not relinquish the accountability and the exactitude with which investors are helped in making their decisions.

I know for a fact that some of my own constituent businesses in my district have suggested that such a thorough process is done during those examination years, that it would be possible, perhaps, to look at biannual, every 2 years, to have the audits conducted and have a statement of compliance on those alternate years that would basically reduce the cost by 50 percent, even maintaining the existing language in place.

So there are ways that I think we can help small and medium-sized businesses in compliance with the act without sacrificing one bit of the accountability that is provided by the act. There have been some successes with Sarbanes-Oxley, and we don't wan to jettison that in our pursuit of reducing costs of simplifying the act.

I look forward to the comments of both our panels, and again, I appreciate Chairman Miller for convening this hearing.

Thank you.

Mrs. MILLER. Thank you.

Opening statement for Representative Clay?

Mr. CLAY. Thank you, Madam Chairman, for holding today's hearing on Sarbanes-Oxley and its impact on our smaller publicly traded companies. I welcome our witnesses, especially my colleagues and friends, Mr. Meeks, Mr. Feeney and Mr. Kirk.

When Sarbanes-Oxley was enacted in 2002, our capital markets were suffering from investor anxiety directly relating to major accounting scandals that rivaled the S&L failures of the 1980's. While Enron and WorldCom became the public poster children of corporate fraud, the fact is there were numerous companies who were forced to restate earnings and future estimates due to fraud and faulty accounting practices. A complicit public accounting industry made these activities not exceptions, but standard practices in order to appease their short-term profit-driven clients.

In response, Sarbanes-Oxley strengthened regulations over auditing practices, mandated executives to certify their annual financial statements, and increase penalties for accounting related fraud.

A cornerstone of this legislation was Section 404, which required publicly traded companies to attest to their internal control for financial reporting and related activities. while Section 404 is a reasonable mandate to ask of companies, some smaller companies find

compliance to be both cost prohibitive and time consuming. Although I am sympathetic to this claim, I am also wary, wary of returning to a period of lax internal practices and functions that will enable inadequate stewardship of investor resources.

It is my hope that new SEC regulations, along with recommendations from our witnesses today, can help us achieve a balance that provides both adequate investor protections and relief for well-managed small businesses.

This concludes my statement, Madam Chairman, and I yield back.

Mrs. MILLER. Other opening statements? Representative Westmoreland.

Mr. WESTMORELAND. Thank you, Madam Chairman. I appreciate you having this hearing. We have an advisory committee at home in the district, and on our banking and finance advisory committee, the one thing that I have heard is this Section 404 of the SOX.

I have often been told that Congress had two speeds, dead still and knee-jerk reaction, and I think this comes under the—this particular section of this bill came under the knee-jerk reaction. I don't know, out of the response to what happened maybe to Tyco and Enron and others, but they weren't prosecuted under this bill, they were prosecuted under laws that we already had on the books. And I think that you can see that there were laws there to protect and to punish those that caused the problem.

So I hope, Mrs. Chairman, that when we look at this, that we can come up with some type of legislation or suggestion that would take some of the burden off of the small and middle-size companies as far as these audit fees.

I had one small banker tell me that it was 10 percent of his bottom line to adhere to Sarbanes-Oxley. That is ridiculous. Audit fees, since 2003, have gone up anywhere from 75 to 90 percent. This should have been called the auditors employment act of 2003. I look forward to hearing from both panels, and I hope, Mrs. Chairman, that we can come up with some type of idea to really reform this to where not only does it protect the investors in the company, but brings about some rational thinking.

Thank you.

Mrs. MILLER. Thank you very much.

Our first witness this morning is our distinguished colleague, Representative Tom Feeney from the 24th Congressional District of the great State of Florida. Congressman Feeney is in his second term and serves currently as a Deputy Whip. He has quickly become a leading advocate for exposing and fighting waste, fraud and abuse in the Federal Government. He serves as well on the House Financial Services, sits on the House Judiciary and Science Committee, and was a member of the Sarbanes-Oxley "listening tour."

So Representative Feeney, the floor is yours. We look forward to your testimony, sir.

STATEMENTS OF HON. TOM FEENEY, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA; HON. MARK S. KIRK, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ILLINOIS; AND HON. GREGORY W. MEEKS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

STATEMENT OF HON. TOM FEENEY

Mr. FEENEY. Thank you, Madam Chairman, Ranking Member Lynch, and members of the subcommittee. I don't think I could say it any better than the four of you have just said it. Mrs. Miller, I thought your introduction was very well done. I think Mr. Lynch put it best, time is at a minimum for Congress to look at where we are because we have some data in.

I am very grateful to be joined by two colleagues, who, the three of us, with a couple of other colleagues, have engaged in a national listening tour to hear about some of the consequences of Sarbanes-Oxley.

Some have called it the most comprehensive and important corporate governance reform since FDR was President. And I was kind of surprised when I got here—because I was not here when Sarbanes-Oxley was passed—that businessmen, both small and big, chief financial officers, CEOs, beat a path to my door to beg for some relief from current impacts of Sarbanes-Oxley and for small and mid cap companies that are not yet directly impacted, beg for prospective relief.

I like to say, as my colleague did, that Congress has two speeds, zero and over-react, and it may be that in some ways we have over-reacted with respect to Sarbanes-Oxley. So I am glad, that on a bipartisan basis, we can look at the advantages and keep them, look at the disadvantages and reform or eliminate them.

We have heard some important positive things and effects from Sarbanes-Oxley. I want to make that clear from the beginning. So far from my portion of the listening tour I have concluded that there is general agreement that after SOX was passed we have tighter financial reporting, which is a good thing. Internal controls have improved across the board, and there is also more transparency in the overall auditing process. All of those things are cited approximately by Sarbanes-Oxley supporters as a reason that not all of this bill should be thrown out in its entirety. And as one suggestion, Section 404 is the target of virtually all of the major complaints. There have been some serious negatives in the way we have imposed and implemented Sarbanes-Oxley.

On January 6th the Wall Street Journal pointed out, for example, that New York loses its edge in snagging foreign listings. In the year 2000, $9 of every $10 raised by a foreign company in a public market was raised primarily in New York, and in the United States of America.

By the year 2005, the reverse was true, $9 of every $10 raised by a foreign company in a public exchange is now raised in places like Luxembourg and London exchanges, the biggest spread favoring London. This is a startling number to me, and candidly, I believe that we are slowly and steadily outsourcing America's world lead in the capital markets.

After a recent trip to Hong Kong, which Mr. Kirk was part of as well, I received very similar feedback regarding Sarbanes-Oxley from their Chief Financial Officer, Mr. Tung. He practically thanked me and Mr. Kirk for Sarbanes-Oxley and the competitive advantage it gave to the Hong Kong markets. The Financial Times stated in November 2005, "Over the past few years, as more global investors have begun to invest in Asia, the New York Stock Exchange appears to have lost its lore for the region's leading companies. The roots of New York's recent difficulties in winning Asian companies' listing lies in the high burden of regulations and compliance."

Many of the participants in the listening tour also noted that 404 compliance ignores the indirect costs, and I think the chairman pointed to the opportunity costs of Sarbanes-Oxley compliance. Some of America's best and brightest leaders on corporate governance boards are spending more time complying with bureaucratic and accounting regulations than they are building a better mousetrap, a cheaper mousetrap, and then marketing the mousetrap; and that is really what we want to do in order to get American advantage.

The opportunity cost is huge. A paper by Mr. Butler of Chapman University and AEI-Brookings Joint Center for Regulatory Studies, and Larry Ribstein of the University of Illinois School of Law cites the "direct compliance costs of SOX are about $6 billion per year, but this expense—which basically represents payments to accountants—is a small fraction of the total compliance costs for firms. The indirect costs from having to divert company resources are much greater and based on a back-of-the-envelope calculation of how SOX impacted American markets, they can be estimated at about $1.1 trillion." That is with a "T", and by the way, we have only impacted 5 percent of America's companies on the public markets so far.

Now, as the CEO of Sun Microsystems put it, Scott McNealy, "What Sarbanes-Oxley has done in some ways is like throwing buckets of sand into the gears of the market economy."

Madam Chairman, you have more of my testimony, but I see I have run out of time. I would just suggest that it is time that we take a serious look at the current impacts of Sarbanes-Oxley, the prospective impacts as mid-size and small companies are thrown into this briar patch, which is going to be very difficult for them to comply with, much more difficult than the large companies that are having such problems.

Finally, I will quote from the regulator. Mr. McDonough, the former regulator, who just recently retired as chairman of the Public Company Accounting Oversight Board. I quote him in part in a recent Wall Street Journal interview, because even he acknowledged that in some ways Sarbanes-Oxley implementation has gone way overboard. On October 12, 2005 he told the Journal, "In many cases it's clear that they [auditors] overdid it. There's no question that some auditors got it right on; there are other cases, in fact probably more, in which the auditors overdid it, and decided we better check everything under the sun. Why? Because [they're] also concerned about being sued—that it is appropriate for the well-being of the American people if companies have costs which simply don't have any appropriate offsetting benefit."

The bottom line is we have to do what benefits investors. If we are taking half of the bottom line out of the pockets of companies and giving it to auditors and to regulators, then financial investors around America are being hugely disadvantaged, and again, I want to thank the committee for paying attention to this very important issue to the American economy.

[The prepared statement of Hon. Tom Feeney follows:]

Congressman Tom Feeney Testimony
House Government Reform Committee
SUBCOMMITTEE ON REGULATORY AFFAIRS
"The Sarbanes-Oxley Act 4 years later: What have we Learned?"
April 5, 2006

Madame Chairman, Ranking Member Lynch and members of the Subcommittee, thank you for inviting me to testify today. I am Congressman Tom Feeney from the 24th District in Florida. I serve on the House Committees on Judiciary and Science as well as the House Committee on Financial Services which has jurisdiction over the Sarbanes-Oxley Act.

In July 2002, as a reaction to corporate scandals such as the Enron and WorldCom collapses, Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002, otherwise known as the Sarbanes-Oxley Act (SOX). SOX is said to be the most comprehensive and important corporate governance reform since Franklin Delano Roosevelt was in office. I was not a Member of Congress when this legislation was passed and signed into law. I was therefore surprised when members of the business community requested meeting after meeting to express their concern and down right panic about the perceived compliance costs of SOX. However, in my line of work I do understand that panic may sometimes be a result of a lack of the facts. I like to say that Congress only has two gears- "fail to act" and "overreact." I did not want to overreact to the concerns being laid out before me. So to further understand the Sarbanes-Oxley Act and the issues surrounding it, last year we--a bipartisan group of House colleagues--formed a coalition to participate in roundtables and listening sessions attended by leaders from business, academia, and the policy community. Our goal was to assess the cost versus the benefits of the Sarbanes-Oxley Act.

I have concluded thus far from my listening tour participation that there is general agreement that after SOX was passed, financial reporting is tighter, internal controls have improved, and that there is more transparency in the over all auditing process. SOX supporters cite that increased investor confidence has been a result of this increased transparency. In a March 6, 2006 speech given by James Turley, Chairman and CEO of

Ernst and Young, he states, "Sarbanes-Oxley and all of the other changes that have taken place are helping to restore public trust." He goes on to say "Now, I'm not suggesting that the Sarbanes-Oxley Act or any single action is behind these numbers. But they do clearly suggest that investor confidence and the resultant market activity have strengthened, and not in just a small way." Was the SOX legislation necessary or could it be that companies began to take a closer look at their internal controls after the accounting scandals of Enron and WorldCom? One common theme that I continued to hear during the listening tour was that you can not legislate morality and that SOX has punished the "good guys" because the "run-of-the-mill" fraud that was perpetrated upon investors of certain companies. However, they do concede that prior to SOX their internal controls needed to be sharpened and they feel as though they have done that from within. Many participants believe that external audits are redundant and therefore too costly and will do nothing to stop the "bad guys" from breaking the law.

We have also heard repeatedly that due to liabilities and potential penalties, these external auditors typically leave no stone unturned, making audits costly and time consuming for all businesses and unaffordable for small and medium sized businesses that are trying to compete in the global marketplace.

On January 6, 2006, the Wall Street Journal pointed out in an article titled "New York Loses Edge in Snagging Foreign Listings" that in 2000 "nine out of every 10 dollars raised by foreign companies through new stock offerings were done in New York rather than London or Luxembourg -- the two other main choices for listings like these -- according to data from Citigroup.

But by 2005, the reverse was true: Nine of every 10 dollars were raised through new company listings in London or Luxembourg, the biggest spread favoring London since 1990." This was a startling number to me. In fact, the day after I cited the number from the Wall Street Journal I received the following email from one of my constituents:

"I was part of a venture capital panel and the moderator, a prominent attorney in Silicon Valley, said that the senior management of the London Stock Exchange and its AIM (alternative

investment market) "felt guilty every time they visited Washington DC and didn't bring chocolates and flowers for Sarbanes and Oxley."

After a recent trip to Hong Kong, I received very similar feedback regarding SOX from their Chief Financial Officer, Mr. Tung. Mr. Tung practically thanked me and my colleague for SOX and the competitive advantage it gives the Hong Kong market. The Financial Times stated in November 2005, "Over the past few years, as more global investors have begun to invest in Asia, the New York Stock exchange appears to have lost its allure for the region's leading companies...The roots of New York's recent difficulties in winning Asian companies' listing lies in the high burden of regulations and compliance.

Many [listening tour] participants also noted that a focus on the dollar cost of [Section] 404 compliance ignores the indirect costs such as employee time and executive expertise that must be directed away from day-to-day business operations to comply with the new auditing requirements. This is a huge opportunity cost. A paper by Henry Butler of Chapman University and AEI-Brookings Joint Center for Regulatory Studies and Larry Ribstein of the University of Illinois School of Law cites the "direct compliance costs of SOX are about $6 billion per year, but this expense (which basically represents payments to accountants) is a small fraction of the total compliance costs for firms. The indirect costs from having to divert company resources are much greater and based on a back-of-the-envelope calculation of how SOX impacted American markets, they can be estimated at about $1.1 trillion." That is trillion with a T. As Sun Microsystems CEO Scott McNealy said of Sarbanes-Oxley it's like "throwing buckets of sand into the gears of the market economy." Listening tour participants complained that when facing these regulatory burdens in America they have two choices: go private or move overseas. For example, the Independent Community Bankers of America provided me with a spreadsheet as of December 6, 2005 identifying 75 community banks that have filed with the SEC to go private since January 1, 2003. Another example is the Vermont Teddy Bear Company that recently decided to go private. Elisabeth B. Robert, the Chief Executive in a May statement, referring to the Rule 404 work mandated by Sarbanes-Oxley said "As a private company, Vermont Teddy Bear will no longer face the challenges of a company trying to comply with increasingly complex and costly public company requirements." In a survey

of 147 public companies, Foley & Lardner, the New York law firm, found that 20% of respondents said they were considering going private, up from 13% in 2003. Statistics like these make me very concerned about investor opportunity. Fewer smaller firms in the market place have the potential of creating an investor class that is only able to invest in larger companies instead of investing in smaller companies with great growth potential. How different would the world be if Microsoft or Dell had decided not to go public or would have decided to go private after they reached a certain market cap to avoid complying with Sarbanes-Oxley? Those investors would have lost out on the great opportunity for wealth that they were able to be a part of.

Another issue of concern that has been brought to my attention is the impact of SOX on research and development. The Biotechnology Industry Organization was able to provide me with many examples like Mayland Biotech Company-a private company that utilizes blood cells to create drugs. Mayland Biotech has spent the last 12-18 months becoming SOX compliant. They estimate that the cost of ramping up for 404 is equal to 6-7 months of R&D costs. Another example is the New York Biotech Company-a public company with a market cap of $99M. New York Biotech has 65 employees and mainly focuses their work on spinal cord injury. They spend $4M for Clinical trial and R&D- for a possible product to cure spinal cord injuries. They have estimated that they spent $1 million on SOX compliance. That is 25% of their yearly budget.

In a letter addressed to the Securities and Exchange Commission's Office of the Small Business Policy Division of the Corporation Finance dated March 7, 2006, Grant Thornton states that "Section 404 requirements are not the source of the problem. The root cause is the lack of guidance for good internal controls that are applicable in myriad business situations." Contrary to Grant Thorton's take on Section 404, William McDonough, who retired early from his post as chairman of the Public Company Accounting Oversight Board (PCAOB) stated in a Wall Street Journal interview on Oct. 12, 2005:

> **"In many cases, it's clear that they [auditors] overdid it. There's no question that some auditors got it right on; there are other cases, in fact probably more, in which the auditors overdid it, and decided we better check**

> **everything under sun. Why? Because [they're] also concerned about being sued. Now, in the process, we think that because of the guidance we've given on the implementation of 404 ... that auditors are doing a better job in the second year. It's also perfectly clear to us that they've got a lot of room for additional improvement."**
>
> **"But in general, the reason that we are beating the drum so much on trying to make 404 more cost effective, is that it is inappropriate for the well-being of the American people if companies have costs which simply don't have any appropriate offsetting benefit."**

As Mr. Butler and Mr. Ribstein put it, "the immense costs of compliance have become apparent and business leaders question whether the act's supposed benefits actually represent any real gain over the previous era." The intent behind SOX was complete investor protection from fraud. However in the day and age of the internet and E*Trade, I am able to get online at any hour of the day and invest in any penny stock in Shanghai or anywhere else in the world. Unless Congress is going to police the capital markets of the world then I believe that capital will continue to flow toward less regulation.

I believe it is time to review the effects of Sarbanes-Oxley, keep what which is a net advantage to investors, and reform or eliminate those provisions that are a net disadvantage to investors.

Madame Chairman I will close out my testimony by saying this-it has become obvious to me after participating in the listening tour that this is not an issue that Congress can continue to ignore and it will just work itself out. Sarbanes-Oxley clarification is vital to keeping America's markets the best and strongest in the world. It has been an honor to testify before my distinguished colleagues. Again, thank you for inviting me.

Mrs. MILLER. Thank you very much, Representative Feeney.

And our next witness is another one of our distinguished colleagues. This is Representative Mark Kirk from the 10th Congressional District of Illinois. He is currently in his third term. He is a member of the House Appropriations Committee and also serves on three of its subcommittees, Foreign Ops, Military Quality of Life and Veterans Affairs, and Science, State, Justice and Commerce. He is certainly a strong supporter of legislation that eases Government regulations, and also another member of the Sarbanes-Oxley listening tour.

The floor is yours Representative Kirk. We look forward to your testimony, sir.

STATEMENT OF HON. MARK S. KIRK

Mr. KIRK. Thank you, Chairman Miller. I have some testimony that I would like to with unanimous consent insert for the record.

Mrs. MILLER. Without objection.

Mr. KIRK. And a letter from a wide industry of leading new industries for comments on this subject.

Sarbanes-Oxley addressed some critical weaknesses in public markets, but to put it simply, I think we all support Section 1 through 403 of Sarbanes-Oxley. It is just Section 404 I think that we have a bipartisan consensus on the need for reform. You see here wide agreement between conservatives, moderates and liberals that we need action. American Enterprise Institute, Nancy Pelosi, Eliot Spitzer, all agreeing that we need reform of Section 404.

I have a presentation here that answers a basic question, which is: Does 404 add investor value, and would a retiree making decisions about their IRA, ever use 404 data in making a buy or sell decision on their retirement savings for the cost and benefit of Sarbanes-Oxley? We see that we fit a need, especially in the mismanagement of America's largest companies. But we have to balance the compliance of the act with the cost of doing that. We see with small companies that there is a great imbalance.

My colleague from Florida quoted Bill McDonough that said that it would be inappropriate to spend too much on the compliance with this if we simply do not have an offsetting benefit, and what Chairman McDonough was driving toward, was, are we driving investor value? And I think, clearly, with the application of 404 to small companies, we are not. We see that SOX compliance already is costing about 50 times more than was estimated in 2002, exceeding about $6 billion so far. And the global position of the United States has been dramatically weakened in this area.

We have a bipartisan Republican and Democratic consensus that whatever else we do, American financial markets should lead, and we clearly see that because of Section 404 compliance costs, American financial markets are rapidly falling behind.

In our look at SOX and its application, we are also seeing a decline in R&D expenditures, and I think that is troubling for the long-term future.

If you look here at the next chart, you will see that we have a greatly disproportionate cost of compliance leveled on small businesses in America of publicly traded companies. And I will just

note, the category that I want to pay most attention to are companies less than $100 million, the great employers of the United States. The average $100 million employer, by the way, in America, makes a 6 percent profit, and so Sarbanes-Oxley, by taking away almost 3 percent of that profit, means that we have reduced the profitability of the most dynamic small business sector in America by half with this one section of one law.

We also see a trend of going private. You can see in the next slide, a well-known company, Vermont Teddy Bear, will not be in the public markets and will not offer their securities for sale to the public, citing this as a critical example of why they have turned to the private market.

Brookstone, SunGard Data Systems, Toys R Us, AMC Entertainment, Loehmann's, all going private. And remember, one of the basic points of Sarbanes-Oxley was transparency and accountability. All of that is lost when a public company becomes private, accomplishing just the exact opposite of the core function of the act.

In fact, Foley & Lardner reports, of 147 companies surveyed, 20 percent would like to go private. That is an almost doubling of the companies wanting to go in that direction.

By the way, that reverses a 400-year trend in capitalism of companies going from private markets, where capital is relatively expensive, to public markets where it is a bit less expensive. That should be a great concern.

When we look at other companies seeking a public alternative, we see that there is a great reluctance to go public, and we have a number of magazine articles and the Wall Street Journal reporting on that.

My colleague from Florida though listed probably the most dramatic effect of Sarbanes-Oxley, and that is almost the disappearance of foreign listings on U.S. markets. Whether you represent Boston, New York, Chicago, or one of our other financial centers, you do agree that all of this work should come to the United States. It doesn't mean just jobs in the financial sector and for stockbrokers, it also means jobs for American accountants and American lawyers. Every single dollar is lost when we don't have those foreign listings. And you can see a 90 percent drop in foreign work coming to the United States.

To conclude, we have been talking about three common sense reforms for Section 404. First of all, for small business relief, to look at the smallest companies in America. They represent only about 6 percent of the portfolio on the New York Stock Exchange, and to give them relief from 404, as the Commission and their Small Business Committee has been looking at.

Another common sense reform: to permit auditors and consultants to actually talk to each other to decide what compliance is. Right now, we have pushed many small publicly traded companies into a Bermuda Triangle of having their consultants on Sarbanes-Oxley not being able to discuss any major compliance issues with their auditors, and so you cannot get an answer of what is compliance.

And finally, to return to the traditional, Generally Accepted Accounting Principle of what a major problem is. We used to think of a material weakness as something that affected 5 percent of the

bottom line. We have lost that, and so right now we have a ridiculous situation where almost a box of lost pencils could be regarded as a material weakness. If every issue in the company is a material problem, then we have dramatically worsened the ability of anyone to manage their company, and I think that Sarbanes-Oxley was sold to the Congress as a way to help people run their companies, but if every issue is a material weakness, allowing trial lawyers to jeopardize the entire company, and therefore, the investor value, and where our retirees have put their funds, then we have actually worsened the problem, rather than improved it.

So I thank the committee and look forward to your questions.

[The prepared statement of Hon. Mark S. Kirk follows:]

TESTIMONY OF
REPRESENTATIVE MARK S. KIRK (IL-10)
BEFORE THE U.S HOUSE OF REPRESENTATIVES
COMMITTEE ON GOVERNMENT REFORM
SUBCOMMITEE ON REGULATORY AFFAIRS
APRIL 5, 2006

Chairwoman Miller and Ranking Member Lynch, in 2002, Congress passed legislation having the greatest regulatory impact on securities markets since the Securities Exchange Act of 1934 – the Sarbanes-Oxley Act, or SOX. When a law makes sweeping changes to the way public companies interact with their accountants, investment bankers, and shareholders, we must undertake interim reviews of its impact, and be prepared to initiate changes if this law has "unexpected" or "unintended" consequences. I commend you for acting as a catalyst to this process.

Since last summer, Congressman Feeney, Congressman Meeks and I have participated in bipartisan "listening sessions," with the intent of hearing from all stakeholders how SOX is working well, and what needs to be changed. We have been told that the law has brought benefits to investors, in the form of improved financial reporting and better transparency, leading to a better investor understanding of financial risks. On the other hand, smaller companies question that the time and money they direct to SOX Section 404 compliance instead of productive business activities gives the greatest value to their shareholders. This cost/benefit analysis has many variables, which are currently being evaluated by the SEC, the GAO, and now by Congress. The Smaller Public Company Advisory Committee formed by the SEC will be releasing its 140-page report later this month. The recommendations of this Committee should be given careful consideration.

For my testimony, I would like to submit the following PowerPoint presentation, which summarizes what we have heard during these last eight months of listening and fact-finding. I invite you to join us in future listening sessions. I can assure you that companies and investors are anxious to make their views known to Congress.

The Sarbanes-Oxley Act (SOX)

Assessing the Impact of Unintended Consequences

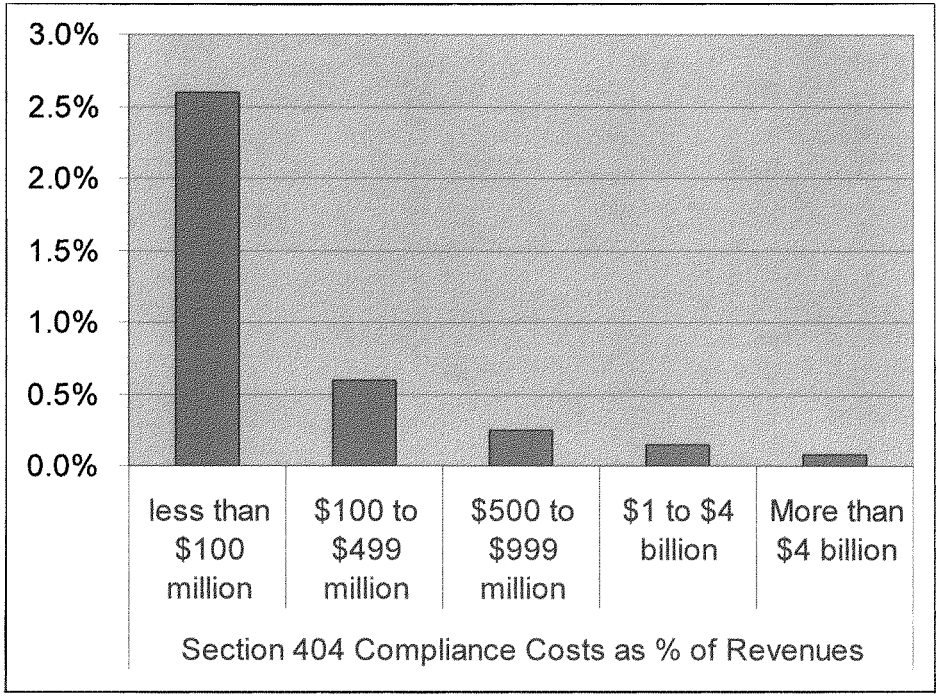
SOX Cost & Benefit

- SOX filled a public market need for greater accounting disclosure and independent assessment of a company's financial condition, bolstering investor confidence and stock market buoyancy eroded by the Enron and WorldCom scandals
- For large public companies, the direct cost of SOX compliance has been balanced by the benefit to investors who value transparency and greater financial disclosure; however, the burden of excess regulatory oversight has not been adequately measured
- For smaller public companies, the cost/benefit balance must still be evaluated

William McDonough, former PCAOB Chairman :
"… *it is inappropriate for the well-being of the American people if companies have costs which simply don't have any appropriate offsetting benefit.*" (Wall Street Journal, Oct. 2005)

SOX has direct and indirect costs that must be evaluated:

- **Profitability: SOX compliance is costing about 50 times more than estimated in 2002 and will exceed $6 billion in 2006 (AMR Research); as a percentage of revenue, smaller public companies bear a high cost with material bottom line impact**
- **Global Market Position: "Over the past few years, as more global investors have begun to invest in Asia, the New York Stock Exchange appears to have lost its allure for the region's leading companies…. The roots of New York's recent difficulties in winning Asian companies' listing lies in the high burden of regulations and compliance." (Financial Times, Nov. 2005)**
- **Global Corporate Competitiveness: SOX may be diverting and/or discouraging R&D expenditures (Cohen, University of Southern California)**



Sources: Corporate Insight and The Economist

By extending the date of small company 404 compliance a year, the SEC has acknowledged a potential cost/benefit imbalance

Going Private ...

"As a private company, Vermont Teddy Bear will no longer face the challenges of a company trying to comply with increasingly complex and costly public company requirements," – Elisabeth B. Robert, the company's chief executive

Company	Public Equity Moved to Private Investors	Date of Private Placement
Brookstone	$452 million	10/4/2005
Vermont Teddy Bear	$44 million	9/30/2005
SunGard Data Systems	$12.6 billion	8/11/2005
Toys R Us	$8.4 billion	7/21/2005
AMC Entertainment	$2.4 billion	12/23/2004
Loehmann's	$187 million	10/13/2004

In a survey of 147 public companies, Foley & Lardner found that 20% of respondents were considering going private – *up from 13% in 2003*

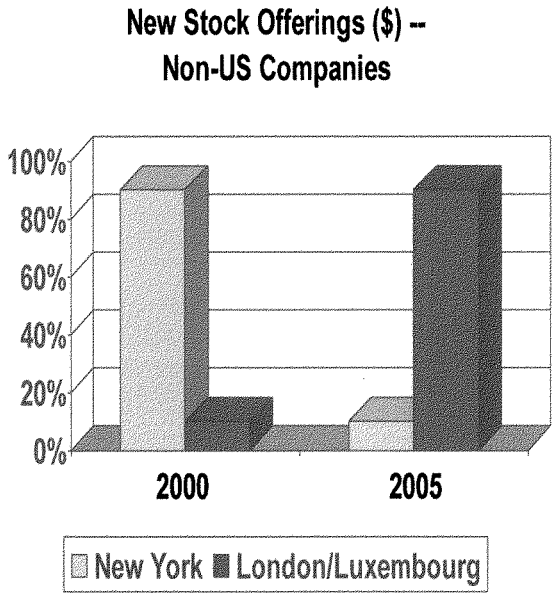
… Or Reluctant to Go Public

- "Because public companies need to comply with Sarbanes-Oxley …. (they) will face higher audit costs, higher insurance costs, and more regulatory-related duties for its staffers." – Inc. Magazine, *"What Does Sarbanes-Oxley Mean for Companies That Want to Go Public?,"* September 2005

- "But SOX has also had unintended consequences that generate complaints from small and mid-sized capitalization companies who say that their access to capital from publicly-traded stock markets has been made prohibitively expensive." – The Wall Street Journal op-ed by Bob Dole and Tom Daschle, *"Let's Reform the Reforms,"* October 2005

... Or Listing on Foreign Markets

As documented by The Wall Street Journal's December 2005 article, *"New York Loses Edge in Snagging Foreign Listings,"* Citigroup data shows U.S. stock market dominance slipping



In 2005, 23 out of the 25 largest Initial Public Offerings of stock (IPOs) chose not to register in the U.S. *Not one* of the top ten 2005 IPOs registered in the U.S.

Three Possible Reforms

- **Small Business Relief** – Exempt smaller public companies – the bottom 6% of public markets – from cost-prohibitive 404 reporting requirements, instead following financial statement rules applied to small business issuers

- **Permit Compliance Consultants to Speak with Auditors** – Modify the "independence rule" to allow prudent interaction between external auditors and internal consultants

- **Return to Accepted Accounting Definitions of what is a large problem** – Change the "material risk" standard for noting 404 weaknesses to a 5% *de minimus* criteria

Mrs. MILLER. Thank you very much.

Next the subcommittee will hear from another one of our distinguished colleagues, Representative Greg Meeks from the 6th District of New York. He is currently serving his fifth term in Congress, and he serves on the House Financial Services Committee, and also on the House International Relations Committee. He is a very strong advocate for consumers, and along with the other representatives who testified today, is also a member of the Sarbanes-Oxley listening tour.

So the floor is yours, Representative, and again, we certainly appreciate you joining us today and look forward to your testimony.

STATEMENT OF HON. GREGORY W. MEEKS

Mr. MEEKS. Thank you, Chairwoman Miller and Ranking Member Lynch.

I remember back in 2002 when the Enron scandal began to unfold. Week by week we learned more about the machinations of the senior executives of Enron that would ultimately lay low the seventh largest company in America, as well as one of the Big Six audit firms.

Immediately after that, the WorldCom scandal took front and center. Following the aftermath of numerous hearings, including us witnessing one senior executive after another plead guilty—or plead the Fifth—should have plead guilty—it was clear to members of the Financial Services Committee, as well as the majority of the rest of the House of Representatives, that Congress needed to act to maintain investor confidence in America's capital markets.

The resulting Sarbanes-Oxley legislation was designed to improve corporate governance by holding board of directors more responsible for their oversight of the corporation, hold the CEOs and CFOs to task if they knowingly signed off on inaccurate statements, strengthening auditor standards, and forcing publicly traded companies to review, and if need be, improve their internal controls that ultimately led to the production of their financial statements.

Let me say, Madam Chairman, that in the 8 years that I have sat on the Financial Services Committee, Sarbanes-Oxley is one of the two most significant pieces of legislation we have passed, along with Gramm-Leach-Bliley, which repealed the Depression Era Glass-Steagall Act.

In some ways SOX is more significant because it affects all publicly traded companies and not just the financial sector. After Sarbanes-Oxley was passed and the Public Company Accounting Oversight Board was created, the PCAOB opened for public comment on their proposed rulemaking for Section 404. Even then, comments that were received by the PCAOB from companies such as Microsoft, addressed concerns that the audit of internal controls where a public auditor must attend to the soundness of a company's internal controls system would significantly increase the cost of public audit.

During this time period, my office began conducting meetings with small groups of Tier 2 and Tier 3 accounting firms. The purpose of the meetings was to determine if the potential increase in the audit costs could be minimized by having the 404 work subcon-

tracted to small accounting firms. Under SOX, there is some leeway for the public auditor to "rely on the work of others" in providing their attestation on the soundness of the 404 audit.

Not only did I suggest this to the PCAOB in writing during their comment period, but my office also arranged a meeting with members of the National Association of Black Accountants and the PCAOB to discuss these issues. Unfortunately, this option was not deemed viable by the PCAOB due to potential supervisory constraints between the major auditor and the subcontracted company.

We are now some 4 years from the passing of Sarbanes-Oxley, and the jury appears to be deadlocked. Without question, Sarbanes-Oxley has achieved its goals in relation to improved corporate governance. As you know, I have joined with my colleagues, Congressman Kirk and Feeney, in a listening tour of companies that have to deal with Sarbanes-Oxley compliance. Companies listed on Nasdaq and the New York Stock Exchange, and members of the Chamber of Commerce, seem to concur on the corporate governance issues. There is a consensus that the board of directors have taken their fiduciary responsibilities more seriously, including meeting more, acting more independently of management, particularly in relation to the audit, and improving communication with shareholders.

Many companies have expressed how Section 404 has forced them to review and tighten their internal controls, making them a more efficient and secure company. This is clearly a part of what SOX was meant to do. However, some of our intentions have backfired, and we are forced to recognize that phrase that we hate to hear as legislators, "unintended consequences." Although there are several issues related to 404 compliance costs that I could mention, for the sake of time, I will limit my concerns to two issues.

The first is the effect that the significant cost in financial and human resources of SOX implementation is having on small cap companies, particularly biotech. The second is the overall cost to our capital markets from companies that have either delisted, not listed, or have listed overseas.

According to a survey conducted by Financial Executives International, member companies spent an average of $4.3 billion for costs associated with internal control compliance. I have heard of companies going from approximately $400,000 for audit costs to over $1 million. According to that same FEI study, companies with revenues over $25 billion, spent an average of more than $14 million. The reality is that large cap companies can absorb these costs, but small cap companies simply cannot.

In New York City we have an enclave of biotech firms. They are small firms whose primary business is research and development in health care, agriculture, industrial and environmental biotechnology products. In other words, their research leads to quality of life improvements that include cancer-related and other types of life-saving products.

For many of these companies, documentation and testing of internal controls is the responsibility of their internal audit departments. Since in most cases there are only a few staffers, many of whom are part time, these companies now have to hire additional personnel or engage outside consultants to perform the required in-

ternal control testing. Many of the smaller biotech companies have had to redirect 10 percent of their full-time employee resources to comply with SOX. The cost has ranged from $300,000 to $500,000 for increase in internal staff, and $800,000 to $1 million for external consultants.

I will give you one example. A New York biotech company that works on spinal cord injuries has a market capitalization of $99 million. It has 65 employees and survives on capital raised every round. It has a spending rate of $4 million for clinical trial and research and development for a possible product to cure spinal cord injuries. If it spends one million on SOX compliance, that equals 25 percent of its budget. That is an opportunity cost of $1 million that is not being spent on research to benefit humanity.

I know that it was not the intention of the Financial Services Committee or this Congress as a whole to divert funds from life-altering research.

My second concern, particularly as a Member from New York, is the issue of public listings of companies; 68.7 percent of companies are listed in the New York Stock Exchange, Nasdaq or the American Stock Exchange. This is a major artery in the lifeblood of the New York economy. According to Citigroup, as of the year 2000, $9 out of every $10 raised by foreign firms through new stock offerings was done in New York. In 2005, the $9 out of every $10 has moved to London or Luxembourg. In addition, hundreds of small corporations have already delisted.

Let me just give you this quote as I wrap up. This is from the March 17, 2006 article in the Houston Business Journal: "Today, hundreds of U.S. companies are considering tapping the London Exchange's AIM as a promising source of quick capital. Faced with costly compliance requirements under Sarbanes-Oxley regulations passed 4 years ago in the United States, a growing number of small domestic companies suddenly are more open to the idea of crossing the ocean to use the more lightly regulated AIM. The overseas option is being weighed against U.S. exchanges such as Nasdaq."

Now, as a member of the International Relations Committee, I am in favor of development of other countries, but not by creating an unfair advantage against American companies and American markets.

Let me close again by saying that I am not offering—I am not going to offer right this second a particular solution to the day, although, I do have remedies in mind. At this point I am still in a mode of listening to companies, American and foreign, so that I can offer a solution or support the solutions of my colleagues. I feel comfortable that we have heard and considered the best options before choosing any to avoid creating a bigger problem.

It is also important for me to hear particularly from more minority firms, who are too often left out and not heard. And I ask all to join with me so that we can make sure that all their voices are here, because they are very definitely being affected by the SOX regulations.

I end by just saying that this is not a Democrat or Republican issue. This is an American issue, and we have to work with this in a bipartisan manner to make sure that we don't continue with

unintended consequences, and that we resolve this issue fairly for our businesses.

Thank you, Madam Chair.

[The prepared statement of Hon. Gregory W. Meeks follows:]

Testimony of Congressman Gregory W. Meeks
Before the Government Reform Committee
April 5, 2006

Thank you, Chairwoman Miller, and Ranking Member Lynch. I remember back in 2002 when the Enron scandal began to unfold. Week by week we learned more about the machinations of the senior executives of Enron that would ultimately lay low the seventh largest company in America, as well as one of the Big Six accounting firms. Immediately after that the Worldcom scandal took front and center. Following the aftermath of numerous hearings which included witnessing one senior executive after another plead the fifth, it was clear to Members of the Financial Services Committee as well as a majority of the rest of the House of Representatives that Congress needed to act to maintain investor confidence in America's capital markets. The resulting Sarbanes-Oxley legislation was designed to improve corporate governance by holding Boards of Directors more responsible for their oversight of the corporation, holding CEOs and CFOs to task if they knowingly signed off on inaccurate financial statements, strengthening auditor standards, and forcing publicly traded companies to review and if need be improve their internal controls that ultimately lead to the production of their financial statements. Let me say Mr. Chairman that in the eight years that I have sat on the Financial Services Committee, Sarbanes-Oxley is one of the two most significant

pieces of legislation the we have passed along with Graham-Leach-Bliley which repealed the depression era Glass-Steagal Act. In some ways SOX is more significant because it affects all publicly traded companies and not just the financial sector.

After Sarbanes-Oxley was passed and the Public Company Accounting Oversight Board was created, the PCAOB had opened public company on their proposed rulemaking for Section 404. Even then, comments that were received by the PCAOB from companies such as Microsoft addressed concerns that the audit of internal control, where a public auditor must attest to the soundness of a company's internal control system, would significantly increase the cost of the public audit.

During this time period, my office began conducting meetings with a small group of Tier 2 and Tier 3 accounting firms. The purpose of the meetings was to determine if the potential increase in the audit cost could be minimized by having the 404 work subcontracted to smaller accounting firms. Under SOX there is some leeway for the public auditor to "rely on the work of others" in providing their attestation on the soundness of the 404 audit. Not only did I suggest this to the PCAOB in writing during their comment period, my office also arranged a meeting with Members of the National Association of Black Accountants and the PCAOB to

discuss these issues. Unfortunately, this option was not deemed viable by the PCAOB due to potential supervisory constraints between the major auditor and the subcontracted company.

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internal controls is the responsibility of their internal audit departments. Since in most cases these are only few staff, many of whom are part-time, these companies now have to hire additional personnel or engage outside consultants to perform the required internal control testing. Many of the smaller biotech companies have had to redirect 10 percent of their full time employee resources to comply with SOX. These costs have ranged from $300k to $500k for increased internal staff, and $800K to $1 million for external consultants.

I'll give you an example:

A New York Biotech Company that works on spinal cord injuries with public market capitalization of $99M. It has 65 employees and survives on capital raised every round. Its spending rate: $4M for Clinical trial - R&D- for a possible product to cure spinal cord injury.

If it spends $1M on SOX compliance that equals 25% of budget . That is an opportunity cost of $1million dollars that is not being spent on research to benefit humanity. I know that it was not the intention of the Financial Services Committee or this Congress as a whole to divert funds from life altering research.

My second concern, particularly as a Member from New York is the issue of public listings of companies. 68.7 percent of companies are listed in the New York Stock Exchange, NASDAQ or the American Stock Exchange. This is a major artery in the life blood of the New York economy. According to Citigroup, as of the year 2000, nine out of every ten dollars raised by foreign firms through new stock offerings was done in New York. In 2005, that nine out of every ten has moved to London and Luxembourg. In addition, hundreds of small corporations have already delisted.

This is a quote from the March 17, 2006 article in the Houston Business journal::

> "Today, hundreds of U.S. companies are considering tapping the London exchange's AIM as a promising source of quick capital. Faced with costly compliance requirements under Sarbanes-Oxley regulations passed four years ago in the U.S., a growing number of smaller domestic companies suddenly are more open to the idea of crossing the ocean to use the more lightly regulated AIM. The overseas option is being weighed against U.S. exchanges such as Nasdaq."

As a member of the International Relations Committee, I am all in favor of

the development of other countries, but not by creating an unfair advantage for American companies and American markets.

Let me close by saying that I am not going to offer any particular solutions today although I have certain remedies in mind. At this point I am still in the mode of listening to companies, American and foreign, so that when I offer a solution or support the solutions of my colleagues, I will feel comfortable that we have heard and considered the best options before choosing any and possibly creating a bigger problem. It is also important to me to hear from more minority firms who too often are left out these discussions and in turn the solutions and I invite my colleagues to of course join me in this.

As my fellow Members at this table know, the resolution to the unintended consequences created by Sarbanes-Oxley is not a democratic or republican issue. It is an issue of American economic health. Something that concerns us all. I hope to work with Members on both sides of the aisle on solutions that are good for corporate America, its labor force and our capital markets.

Thank you for this time.

Mrs. MILLER. Thank you so much. I think that was particularly well-said.

Let me thank all of our witnesses for being here and tell you how absolutely delighted I was to listen to all of your testimony and the opening statements of my colleagues here as well. And being still a relatively new Member of Congress, one of the most distressing things for me has been the partisan atmosphere around this place. I think we can look at this in a very bipartisan way. As you say, before we are Republicans or Democrats, we are all Americans first, and this is an American problem and something that we need to address in a bipartisan way. And I think we can do so.

I was a little bit concerned, even initially, calling this hearing. I wasn't here when Sarbanes-Oxley originally passed; I don't sit on the Financial Services Committee, either and have not been an official member of your listening tour. But I would think that you could probably go to all 435 Members and enlist any one of them, because we must all hear the same things in our district.

As I mentioned to our ranking member before we started here, I am just outside of Detroit, so you can imagine all the auto suppliers and the small and mid-size businesses that I come in contact with every time I am out in my district, and they know that I am the chairman of this Subcommittee on Regulatory Affairs. So I will ask them, what is the biggest problem that you have with onerous governmental burdens? And they—I mean, if you took Sarbanes-Oxley out of the vocabulary, they would almost have nothing left to say, because that is the first thing they want to talk about. And this is every type of business.

So it is something that we need to look at. This is a committee that has tried to look at various types of onerous governmental burdens. It was interesting, we were talking about manufacturing regulations, and here you have the National Manufacturers Association estimating that the structural costs of American-made goods are 23 to 24 points higher than any of our foreign competitors, and much of it is due to these kinds of things; particularly Section 404 in Sarbanes-Oxley. And when we do see jobs leaving our shores for other countries, like China or Mexico or India or what have you, guess what, those countries did not put this regulatory burden on us. We have done it to ourselves.

So it is a very appropriate thing, I think, for us to take a good look in the mirror and see where we can go with this.

I guess I would just throw this out to all of you as we—I think we are all concerned, of course, that we are not viewed as going soft on corporate governance after the rather horrific experiences that we went through with the Enrons and Tyco, etc. But if we were to revisit some of these corporate governance standards, do you think that some of the companies or even the American public might think that we are opening up a Pandora's Box? In other words, as bad as 404 is, that they are getting used to it? And the cost of compliance does seem to be coming down a bit as we are going through the second and third year of this. At least it is a known quantity.

Mr. KIRK. Let me just briefly answer that, if we look at the markets the way the SEC does and look at companies at $750 million in capitalization and below, and give some sort of 404 relief to $750

and below, you still have 94 percent of public markets under full Sarbanes-Oxley compliance controls. And so I think that we have protected the main part of investors, especially retirement investors that are largely, 94 percent, invested in the very large companies, but we have also lifted a tremendous burden off the small employers, which employ over half of all Americans. And so I think the way that the Small Business Advisor Committee of the SEC and the way the Commission has looked at this dividing line is a very helpful one for the Congress.

Mr. FEENEY. Well, I think it is a very real concern that investors are—you know, there is an Enron trial going on as we speak. I won't prejudge the outcome of that, but as the chairwoman said, there are lots of protections for investors out there. No protection is going to work against bad apples that really want to commit outright fraud. And the bottom line is nothing in 404 is going to protect investors from people that are really evil. And we need to explain to Americans that regulations are appropriate and necessary; redundancy and red tape that does not add to investor confidence is disadvantaging Americans.

I think, you know, Madam Chairman, you put it best, is foreign companies—to take Gregory's biotech example—is foreign companies are not spending 25 percent or 50 percent of their bottom line on compliance with redundant regulations and auditing, but instead putting money into finding the next cure for cancer or the next cure for AIDS. Good for humanity, but bad for the potential for American employers and American employees, and it puts us at a huge disadvantage.

So let's keep what is good. Explain to Americans. I think we are trying to build the case to keep what is good, review what is bad, and either reform it or get rid of it.

Mr. MEEKS. Let me just concur. I think that Representative Westmoreland said, you know, basically what we do sometimes, we have knee-jerk reactions. And I think that we have to understand that it sometimes happens. We react to a situation and we act fast. But we can't throw the baby out with the bath water. I think that from the testimony that I have heard from a lot of individuals around the country, they all agree that a lot of Sarbanes-Oxley is good. But we are focusing on, and what Representative Kirk just talked about, I believe that we can have a cap so that we can make sure that the intention of the Members of Congress is had. And we can do that without people coming back and talking about the fact that we are opening up Pandora's Box. We can do that by saying that we still have the investors' confidence that Congressman Feeney just mentioned, but that we are also making sure that we are keeping companies public or having the desire to come public and not go overseas.

Mr. KIRK. Madam Chairman, can I add one more thing?

Mrs. MILLER. Certainly.

Mr. KIRK. Because this really is about investor confidence at its bottom. If I want to get a credit card tonight, go online at 3 o'clock in the morning and invest in the futures in pork bellies on the Shanghai Market, I bet there is a way to do it. And ultimately, investors will find a way around the protections that we think we have built up around them. If we have added value, they will in-

vest their money in American markets. If we have added costs, they will find their way around it. That is happening with the major investors as we speak.

Mrs. MILLER. Yes. And I think Representative Kirk made a very good point when you were saying whether or not individual investors are actually looking at some of this data when they are deciding to invest in an IRA or what have you. So it is an interesting thing.

My other question would be——

Mr. KIRK. Can I just add——

Mrs. MILLER. Yes.

Mr. KIRK. My staff talked to the Commission yesterday and asked if they had any report of any investor using a 404 disclosure to buy or sell securities. And to date, the Commission has not one.

Mr. FEENEY. And neither do the rating services use 404. Moody's, Standard & Poors, they could care less about these things. And yet they are costing Americans—one estimate—$1.1 trillion to our economy and nobody is using the stuff.

Mrs. MILLER. Well, you know, we are from the Government. We are here to help them. [Laughter.]

What is your opinion on the lack of direct control, sort of the wiring diagram for this PCAOB, sort of the lack of direct control that the Congress has on that? Do you think their independence from congressional oversight is having any impact on their opinions, their guidance?

Mr. KIRK. The Board, obviously, had some difficulties in starting up. We went from eight employees to now over 400. So we are finally getting an ability to issue an opinion and to have some common sense in the application of the act. But we have not yet had the tsunami of full 404 compliance hit the small business sector yet. And that is the critical issue for the Congress. If we have 100 percent compliance requirements on the small business sector, we should understand that we are only affecting 6 percent of public markets but we are dramatically weakening the employers of half of all Americans. And so that is the concern I have for the PCAOB and their compliance burden.

Just imagine how many employers and how many public companies will be calling them, flooding their phone lines if a full requirement is imposed on them.

Mr. FEENEY. Madam Chairman, the problem is that everybody in the system is covering their rear ends. From the chief financial officer to the chief executive officer, they now have to certify total compliance with all of these things even if they had no knowledge. It is no longer a willful standard or a negligent standard, it is a zero-mistake standard. Everybody on the board of directors has to do that. The inside auditors that are advising the board of directors has to do that. The outside auditors, who are not allowed to talk to the inside auditors, they have no incentive whatsoever to use a reasonableness standard because they are going to be held personally, civilly, and perhaps criminally responsible for any mistake.

Thus the hyperbole about, you know, finding every box of paper clips for a global company like IBM, or every box of pencils, it really has almost gotten to that point. And also, as you point out, the Accounting Oversight Board, there is no incentive for them to be

reasonable. The incentive is to make sure that every single box that can be checked is checked. Nobody wants to be the guy that lost that box of paper clips.

Mr. MEEKS. I think that what Representative Feeney just said is right, because what he is talking about is basically reasonableness. And there is no incentive to be reasonable as of right now. It is protect yourself at all costs. And so therefore, you know, there is no room for you to do anything that may be a common-sense approach. It is if I don't make sure that I am absolutely 1,000—you know, even in criminal jurisprudence, you have beyond a reasonable doubt. This is not—this is zero doubt. So it is a standard that is so high that I don't know that it can be met.

Mrs. MILLER. Thank you.

Representative Lynch.

Mr. LYNCH. Thank you. And again, I thank the panel.

Let me ask you—and I understand the standard is a very high one and may in fact be unrealistic and it may have, as you have pointed out, negative consequences.

Let's just take from the existing Section 404. I do want to point out, though, that Section 404, when people are assessing, you know, whether to buy a certain stock, whether to invest publicly, they wouldn't look at 404. They would look at the numbers, the financial numbers, for the performance of the company itself, the profit and loss, their value. And what 404 does is it speaks to the accuracy or reliability of those numbers. You wouldn't look to Section 404. It is just a given that the companies to which it applies must comply.

What about the idea, however, that right now Section 404 requires an annual manager's statement, an annual assessment by the company supported by an outside auditor, you know, an independent auditor to come in here and say that the internal controls are in place and that they are reliable. That is a very extensive process. That is what is driving the costs of this rule.

It would seem to me that thorough of a process does not need to be repeated every single year, and that if in, you know, 2006 a company goes through this—and it is a painstaking process and extremely thorough—it would seem that in 2007 it should be sufficient to have those managers and the folks in control at the company certify that last year's controls and procedures are in effect. And that should be enough for reliability and what we are talking about. And then in the next year, 2008, if 2 years have gone by, obviously, there may be the need to go back to the full-blown, full-tilt assessment again.

But even if we adopted that system, where it is not annual, that we will trust for 1 year. If a company certifies that their internal controls and their internal procedures are still in place to the same degree or substantially to the same degree as they were in the previous year, that should be enough.

In my mind, that would cut everything in half without changing, you know, a period or a comma in any of this, and it still would provide that reliability and that accountability that we are looking for under the bill. Because there has been some improvement on transparency and other things that have been very good here. And we are stuck on 404. But it just seems to me that enormous

amounts of money and labor could be saved, without any measurable drop in quality of the reports and reliability for the investor, by going to a biannual reporting or biannual manager's statement on the reliability of internal controls and procedures.

What are your thoughts?

Mr. KIRK. Congressman, that is a very common-sense reform that would cut the work level in half. Also, remember what we are talking about. With a small publicly traded company, the entrepreneur largely sees the entire operation. We are talking about 10 and 20 employees. And so the issue of internal controls is entirely different than for an extremely large company where you really have some serious management issues.

But one of the things that we learned on this listening tour is when you talk to rating agencies, like Moody's or Standard & Poors, which for most investors issue the critical buy and sell signal or the data package they use to asses a security, the 404 disclosures are in the 10-Ks that are submitted by the publicly traded companies. And even the rating agencies say they are not using this data. It is so turgid, it is so user-unfriendly that it is not driving investor value for a buy or sell signal.

And then we have the issue of the London AIM Market, which is now marketed directly as a Sarbanes-Oxley-free environment. And I am worried because, you know, there is an unwritten story in the 1880's of how New York gained financial dominance over London and became the best and least expensive way to access capital markets and the financial center of the world market was transferred from London to the United States. They are beginning to gain back that financial leadership.

But that is a critical issue in the rise of China. Congressman Feeney and I, when we were talking to Chinese entrepreneurs in the emergence of this $1 trillion economy, said now, because of Sarbanes-Oxley, they would not think ever of listing in the United States because of these compliance costs. And they are talking about bringing small, $50, $100, $200 million companies to market and they do not want to bring this work to the United States, where 5 years ago all of the work came to the United States.

Mr. FEENEY. Congressman Lynch, you made a very common-sense recommendation. We have actually heard a couple of recommendations and we want to hear more before we make a recommendation of which one I would think would be preferable. One would be semiannual or every third or every fourth year have the outside audit; your internal procedures would have to remain the same. Another way to do it is to allow the exchanges to, for example, have everybody pay in based on a pro rata share of their market capitalization. If they have 1,000 companies and everybody is the same size, pay in to a little system and then have random testing like we do drug testing in some places. So that everybody has to stay on their toes, but they do not have to be duplicating and have this superfluous process where you have redundant mechanisms.

But I would say that doesn't resolve the whole problem. You still have the issue of if you place this burden on small and mid-cap size companies as it remains today, I am afraid you would never get the next Dell or Microsoft to go public. And American—not only would

they not grow to the size that they grew, but American investors would never have the opportunity to invest. I also believe the materiality standard is very important to address.

But if you did those three things, boy, I think you would get to 90 percent of the problem.

Mr. MEEKS. I think your approach is a common-sense approach and I think that is what the listening tour has helped me with. I have found that the companies that we have listened to, nobody is really trying to avoid the scrutiny or anything of that nature. Nobody even—because they all have basically been straightforward and honest in saying we want to make sure there is transparency, we want to make sure that our internal controls are in place. It is just a cost. And we have to figure out and come out with different ideas of how we reduce the cost.

And they came up themselves, voluntarily, with various ideas, you know, what Representative Feeney just talked about as far as—we can even act like a system like the IRS, where there are random audits. That would help us reduce our costs. We don't want to just say that we want to go back to the old way. We accept that things have changed. But we have to bring down the costs. And I think that is what the listening tour does. That is what has benefited me, is to hear good commonplace ideas on how we can make it better so that we don't have the unintended consequences ruling. And I think that we can do that.

Mr. LYNCH. OK, thank you.

I yield back.

Mrs. MILLER. Mr. Westmoreland.

Mr. WESTMORELAND. Thank you.

Mr. Kirk, you know, if you look at the total cost of WorldCom, Enron, and Global Crossing, it is about $155 billion. And I believe the Rochester School of Business just got through putting out the fact that this is costing $1.4 trillion. Is that a good common-sense approach to fighting the problem? What is the source, do you think, of the disparity in the cost that was expected or that the SEC expected this to cost, as compared to what it is costing? And what do you think made that difference?

Mr. KIRK. A couple of things. First of all, a lack of rationality in what is material. That is why it is so important to go back to the old traditional definition of materiality, because if every single lost pencil box is a material weakness, we are going to continue to have stories, as we do now, of CEOs spending a vast amount of their time trying to account for every single asset or liability, you know, almost on a real-time basis, rather than thinking about new markets and innovation and research and development that we traditionally associate with growing a company.

Another problem is we have four and a half major accounting firms. And generally, for a small employer, they will, when they seek to have a public accounting, will find that two or three of the large accounting firms are conflicted out because they are already working with competitors. And so the final accounting firm knows that they have this company in a box and will charge a very high price for their services.

And remember, in the world of Sarbanes-Oxley, you can't have one accounting firm. You have to have two. You have one account-

ing firm to actually certify your books and another one to advise you as to how to implement 404. And those two firms cannot coordinate their activities to issue you a compliance signal or a noncompliance signal.

So for all those reasons, we have costs that are very high.

Last, let me just say this. And this is what Congressman Lynch pointed out, that we have—404 is a very short section of law. Enormous discretion is given to the Commission and to the PCAOB. This hearing is going to help in the process, because if we send a signal from the Congress that we have broad-based bipartisan support for rationalizing the implementation of these regulations, the PCAOB and the Commission can take action on their own to dramatically lessen this process.

I think we are in the period here where, this year, this committee and our bipartisan group of members can send that signal. And my hope is the Board and the Commission will then take action to relieve this burden. And then, if not, I think the time comes next year for a listening tour to turn into a legislative tour.

But I hope that the Board and the Commission will see this action by the Congress and take their own authority.

Mrs. MILLER. Yes, Representative Lynch?

Mr. LYNCH. I just want to clarify. I believe I misspoke. I was talking about biennial, which is every 2 years, not biannual, twice a year. Biennial, OK? [Laughter.]

I don't want a riot going on out there.

Mrs. MILLER. We appreciate that clarification.

Representative Clay.

Mr. CLAY. Thank you, Madam Chair, and thank you both for your testimony.

In terms of the cost and compliance requirements under Section 404, how well is the accounting industry responding to the needs of industry? Are auditing firms recognizing the limits facing smaller capitalized firms in their evaluations and recommendations for corporate compliance? Both of you all can tackle it, please.

Mr. MEEKS. Well, that was just one of my points, where I said we had to open it up to tier 2 and tier 3 firms, because we were trying to make sure that there could be more competitiveness and more firms involved. When you have just the top firms, as Representative Kirk just talked about, they know, you know, two of the firms are already engaged, they know that they have the companies, and they can charge whatever they want to charge. They virtually have what is called a monopoly. That is driving costs up significantly.

So I, again, suggest that we need to look again at the opportunity of tier 2 and tier 3 firms being able to be involved as a subcontractor getting involved and I think that would help drive some of the costs down.

Mr. CLAY. And you also mentioned some significant barriers that prevent small-cap companies from becoming compliant. Give me an example.

Mr. MEEKS. What I was talking about, I mean, when you talk about they can't compete because they don't have the wherewithal to deal with the Big Four firms. And as a result, you know, you find that many minority firms are directly affected, cannot com-

pete, and thereby are out of business, and cannot have the opportunity to be the next Dell. We want to make sure that they are not left out of the game. And you have a significant number of minority accountants who are left out of the game. And this is a way that, I think, by adding them into the game, by adding tier 2 and tier 3 firms, then you are eliminating even some of the diversity issues that you may have in the industry by opening it up and giving everyone an opportunity.

Mr. CLAY. Mr. Kirk.

Mr. KIRK. I would certainly agree that Representative Meeks has pointed out a critical need for either the Commission or the Congress to act that would help out small minority accounting firms get into this. They don't have that opportunity now because they don't have the brand name and ability to access and advise a client in this way.

But even more importantly, in the wider market for small-cap companies to be able to expand and grow their business, you have to really, really think about becoming a public company now in America, given the liabilities and uncertainties that you face because of full 404 compliance. I would like it for minority companies to be able to go public in an easier way, not a more difficult way. And that is the problem.

Mr. CLAY. Let me shift and share with you both, one of the reasons I believe in Section 404, is that it forces companies to pay attention to their information technology systems that are often susceptible to hacking, information breaches, and other activities that have dire economic consequences. If Section 404 requirements are not met, how can a company be certain its information system's proprietary data are secure? Have any of you given thought to——

Mr. KIRK. I would just say remember what we are talking about, the information data system of a small company is probably two or three PCs in an office. We are talking about a common-sense approach of not going overboard. These are the most dynamic and largest employers in America, but they come in groups of 12 or 20 employees. So we are not talking about a very difficult control issue here. You are probably talking about one office suite and a set of computers that is similar to the set of computers in your own office.

You know, remember the irony here—404 does not imply to congressional offices. Imagine the challenges you would have as a small employer employing 18 people if you had two large accounting firms unleashed on your operation, and were told that one gasoline receipt that may have been misplaced is now a material weakness and you could be brought—brought suit against you on behalf of some trial lawyers.

That is the kind of issues that we are talking about, because I think every Member of Congress does understand that we employ 18 people, so we are exactly in the same position, management and control, as many of the companies that we are talking about.

Mr. MEEKS. Just look at my example of the biotech firm. I mean, this is a real example. This is what I had going—this is a biotech firm, mostly—a lot of part-time workers, very limited staff. And now they have to shift resources and shift people to comply, taking them away from the research and development that their existence is there for.

So we have to make more of a common-sense approach to this, because otherwise the burden of a company being able to survive as a public company will not continue to exist, and they will stay private.

Mr. CLAY. I thank you both for the response, and I agree, we need to find a balance.

Thank you, Madam Chairman.

Mrs. MILLER. Thank you all so very, very much. We certainly appreciate your time. And, you know, this is an oversight committee so it is appropriate, I think, that we begin a debate and have some oversight on various issues, certainly this Section 404. And I certainly agree with you all that—I am hoping that the Commission and the Board are listening to what is happening, as you are doing your listening tour on this.

Hopefully, this can't be any secret to them, the problems that are out there and that in a bipartisan way the Congress does intend to take some action if they don't become a little more proactive themselves and look at some common-sense solutions as well.

So again, we appreciate your time sincerely. We adjourn for the next panel to be seated.

[Recess.]

Mrs. MILLER. OK. We will call the committee back to order. Since this is an oversight committee with subpoena authority, although we did not swear in the last panel, I do hope that you will bear with us and please rise and raise your right hands. I would like to swear you in.

[Witnesses sworn.]

Mrs. MILLER. Thank you very much.

Our first witness on the second panel is Grace Hinchman, who joined the Financial Executives International in 1999 as vice president for government relations. In 2000, she was promoted to senior vice president of public affairs. FEI is a professional association for senior-level corporate financial executives and is dedicated to advancing ethical and responsible financial management.

The floor is yours, Ms. Hinchman. We certainly appreciate you joining with us today.

STATEMENTS OF GRACE L. HINCHMAN, SENIOR VICE PRESIDENT, FINANCIAL EXECUTIVES INTERNATIONAL; RICHARD A. HUBBELL, CHIEF EXECUTIVE OFFICER, RPC & MARINE PRODUCTS CORP.; ROBERT P. DOWSKI, CHIEF FINANCIAL OFFICER, ALLIED DEFENSE GROUP [ADG]; ALEX J. POLLOCK, RESIDENT FELLOW, AMERICAN ENTERPRISE INSTITUTE; AND DAMON A. SILVERS, ASSOCIATE GENERAL COUNSEL, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

STATEMENT OF GRACE L. HINCHMAN

Ms. HINCHMAN. Thank you, Madam Chairman Miller, Ranking Member Lynch, and members of the subcommittee, for this opportunity to appear before you today. My name is Grace Hinchman, and I am senior vice president of FEI. It is the leading organization of 15,000 members, including CFOs, treasurers, controllers, and other financial executives.

FEI members represent the preparer community; that is, the financial executives responsible for the preparation of financial statements. Importantly, we are also users of financial statements, relying on financial reports of other companies in our investment and credit decisions. In both roles as a preparer and as a user, we welcome today's hearing.

FEI strongly supports the goals of Sarbanes-Oxley. Overall, the SEC and the PCAOB have done an impressive job in striking a balance between efficiency and cost-effectiveness, while maintaining the intent of the statute. However, the rules and standards related to the implementation of Section 404 require significant attention.

Although the SEC maintains final authority over the rules and standards to implement the requirements of 404, much of the rulemaking and standard setting has come from the PCAOB's Auditing Standard No. 2 [AS2].

Since the SEC's approval of AS2 in June 2004, the PCAOB and the SEC have released additional guidance to supplement AS2 through policy statements, detailed staff Q&As and roundtable discussions. FEI recognizes that this additional guidance has been helpful to both preparers and auditors alike, but they have fallen short in providing a completely effective and efficient implementation process.

FEI firmly believes that Section 404 is workable and does not require congressional action. Both the SEC and the PCAOB have the authority today to right-size AS2 and Section 404 so they meet the capabilities of all public companies, large and small.

I would be remiss if I did not mention the overall cost/benefit of Sarbanes-Oxley. As recently as last month, FEI surveyed 274 public company members with average revenues of nearly $6 billion to gauge Section 404 compliance costs, and this survey is the fourth survey that we have done over the last several years, and Congressman Meeks had made reference to one in his testimony.

The survey that we just did in March, last month, showed that in total companies audit attestation fees represent 44 percent of their total annual audit costs. The average company, which is a company of $6 billion in annual revenues, expended approximately $1 million in internal costs, or approximately 21,000 internal people hours. For year two filers, this average was only a 12-percent decrease from their first year of implementation. External costs for non-auditor-related consultants and vendors were $2.3 million. This was a decrease of approximately 22 percent for year two filers. Finally, audit fees were approximately $1.4 million, or a decrease of 13 percent for year two filers.

What this survey shows is that while companies have experienced some reduction in their cost of compliance, primarily their external costs, they are less than we had anticipated. As a result, the costs of Section 404 remain high and continue to be disproportionate to the requirements of annual compliance.

In conclusion, FEI is confident that the SEC and the PCAOB are up to the task of right-sizing compliance requirements of Section 404 of Sarbanes-Oxley and they possess the authority to meet this challenge. We believe that a more balanced approach will be achieved and that this right-sizing will further reduce the costs of Sarbanes-Oxley.

That concludes my remarks, and I would like to thank Madam Chairwoman and the members of the subcommittee for inviting FEI to participate in today's hearing.

[The prepared statement of Ms. Hinchman follows:]

TESTIMONY OF

GRACE L. HINCHMAN

SENIOR VICE PRESIDENT

FINANCIAL EXECUTIVES INTERNATIONAL

BEFORE THE

U.S. HOUSE OF REPRESENTATIVES

GOVERNMENT REFORM SUBCOMMITTEE on REGULATORY AFFAIRS of THE COMMITTEE ON GOVERNMENT REFORM

AT A HEARING ON

THE SECURITIES AND EXCHANGE COMMISSION'S IMPLEMENTATION OF THE SARBANES-OXLEY ACT, WITH PARTICULAR ATTENTION ON THE REQUIREMENTS OF SECTION 404

APRIL 5, 2006

Thank you Chairman Miller, Ranking Member Lynch and Members of the Subcommittee for this opportunity to appear before you today. I have prepared remarks, I would respectfully request that the full text of my testimony and all supporting materials be entered into the public record.

My name is Grace Hinchman and I am the Senior Vice President of Financial Executives International (FEI). FEI is the leading organization of 15,000 members including CFOs, Treasurers, Controllers, and other senior financial executives. I am pleased to have the opportunity to share the views of our members with you today on the important issue of the SEC's implementation of the Sarbanes-Oxley Act and in particular Section 404 of the Act, which addresses internal control over financial reporting.

STRENGTHENING CORPORATE GOVERANCE, INTERNAL CONTROLS

First, FEI strongly supports the goals of the Sarbanes-Oxley Act, as it has enhanced the role of corporate financial executives and created a greater appreciation for their role within the corporate environment and among the public generally. Specifically, Section 404 of the Act has also strengthened the ability of financial executives to institute continuous improvements in internal controls and financial reporting and to gain enhanced "buy-in" by all employees of the need for strong internal controls. The Act has resulted in the following positive developments:

- Strengthening the tone at the top by requiring certifications of financial statements by CEOs and CFOs, and by requiring management and auditors' reports on internal controls over financial reporting;
- Strengthening the incentives for high quality financial reporting that can be relied upon by the public, by increasing penalties for doing otherwise, including, importantly, the

federal sentencing guidelines for criminal conduct in connection with fraudulent financial reporting;

- Strengthening the requirements for audit committees, which play such a critical role in corporate governance on behalf of the investing public;
- Making the internal control process more rigorous, and heightening accountability; and
- Limiting transactions such as loans to officers, which is part and parcel of good corporate governance.

Even before Sarbanes – Oxley, internal controls were a long established management tool used to detect and correct deficiencies. Companies have long had what are referred to as "management letters" from their auditors in which certain internal control weaknesses are noted in addition to reports of their own internal audit staff. The Sarbanes-Oxley Act has added gravitas to the impact of any reports of substantive internal control weaknesses and the need to correct them by raising the bar of public disclosure of material weaknesses. Today, public companies, both large and small, must show that their system of internal control over financial reporting is effective and without material weaknesses. This focus on strength and effectiveness in a company's system of internal controls should enhance a shareholders faith in the integrity of a company's financial reporting data. FEI believes it is critical, that in order for Section 404 of Sarbanes-Oxley to be most effective, requirements of a management assessment and supporting attestation on internal controls must be integrated with management's and auditor's efforts surrounding the presentation and audit of a company's financial reporting.

Overall, FEI believes that the heightened emphasis on internal controls, corporate governance and the enhanced role of financial executives brought about by Sarbanes – Oxley have all been very positive.

IMPLEMENTING THE SARBANES-OXLEY ACT OF 2002

While many of the mandates of the Sarbanes-Oxley Act were effective upon the adoption of the legislation, much of the Act directed the SEC and PCAOB to develop the "rules" of implementation of the Act. Generally, the SEC and the PCAOB have done an impressive job in fulfilling a difficult task by striking a balance in efficiency and cost effectiveness while maintaining the integrity and intent of the statute. However, the rules and standards related to the implementation of Section 404 of the Act still require significant attention.

I would be amiss if I did not acknowledge the SEC's recognition of the additional "regulatory overload" its proposal to accelerate the 10-K and 10-Q filing deadlines presented to publicly held companies especially in light of the new Sarbanes – Oxley compliance requirements. Moreover, the Commission has remained mindful of this "regulatory overload" by remaining flexible and demonstrating a willingness to postpone the final implementation of the accelerated filing deadlines and allow companies to devote resources to Section 404 implementation.

FOCUS ON INTERNAL CONTROLS

Over the past few years, FEI has been especially active in working with its members to provide assistance for effective and efficient implementation of the Act generally and Section 404 specifically including the PCAOB's Auditing Standard No. 2, (AS2) *Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

FEI's Committee on Corporate Reporting (CCR) has held two sessions with Section 404 project leaders from many of the Fortune 100 companies to share practices for implementation, and to identify efficiencies as well as areas for improvement. These sessions and their outcomes were documented in two reports by FEI's Research Foundation (FERF) in May and November 2005, which I have included in my written testimony.

FEI's President and CEO, Colleen Cunningham, as well as members of CCR, participated on the SEC's and the PCAOB's Roundtable on Internal Control Reporting in April 2005. We look forward to participating again at the next Roundtable scheduled for May 10, 2006. We believe that these Roundtables are critical to successfully implementing and sustaining the process surrounding Section 404 for preparers and auditors alike. We applaud the SEC and the PCAOB for organizing these sessions.

Additionally, several of FEI's technical and policy committees have filed numerous comment letters on Section 404 implementation issues but we consistently acknowledge that the SEC and the PCAOB are working diligently to achieve an effective and efficient process for Section 404. There are continuing concerns by many FEI members about particular issues that are becoming increasingly evident especially regarding the overall cost of compliance and the ability for many companies to sustain their ability to meet these regulatory requirements.

Although, the SEC maintains final authority over the rules and standards to implement the requirements of Section 404, much of the rule-making and standards setting has come from the PCAOB's AS2. Since the SEC's approval of AS2 on June 17, 2004, the PCAOB and the SEC have continued to release additional guidance to supplement AS2 through policy statements and detailed Staff Q&As. While we believe this additional guidance has been helpful to both

preparers and auditors alike, they have fallen short of providing a completely effective and efficient implementation process.

In May 2005, as a result of the feedback received at their April 2005 Roundtable, the SEC and the PCAOB issued additional guidance intended to create greater efficiencies in implementing Year Two of Section 404. FEI continues to support the key tenets of the May 2005 SEC and PCAOB guidance but we believe that additional focus and attention is needed on some of the most critically important tenets:

- The need for integration of the audit of internal controls with the audit of a company's financial statements;
- The need to use a top-down, risk based approach to implementation;
- The need to exercise flexibility and use of judgment in using the work of others.

FEI firmly believes that Section 404 of Sarbanes-Oxley is workable and does not require Congressional action. Instead, the SEC and the PCAOB need to take a reasoned approach to sustaining implementation and to focus auditors and companies more on embracing the key tenets of the SEC and PCAOB guidance versus drowning in the minutia of detailed documentation.

SMALLER COMPANY CONCERNS

The SEC should be commended for its work in establishing the Advisory Committee on Smaller Public Companies (ACSPC) to review and consider the regulatory issues affecting smaller public companies especially the impact of Sarbanes-Oxley compliance. FEI recognizes the concerns with the significant and even disproportionate economic impact the Sarbanes-Oxley Act continues to have on smaller companies.

Smaller companies simply do not have the resources found in the larger companies to sustain the financial and personnel requirements of Sarbanes-Oxley. Smaller public companies are anxious about the high cost of implementing the Sarbanes-Oxley provisions, especially the 404 provisions. FEI believes that some relief is warranted, especially to the micro cap companies. If something does not change, FEI is concerned that many micro cap companies may be driven into extinction in their efforts to comply with the Sarbanes-Oxley requirements. FEI's Small Public Company Task Force (SPCTF), recently filed comments regarding the SEC's ACSPC's recommendations. A copy of FEI's SPCTF comment letter is attached. The SPCTF recommends that further study and guidance is needed to address the core issue of improving the cost-benefit equation of complying with Section 404.

Both the SEC and the PCAOB have the authority today to tailor compliance of Section 404 so it meets the capabilities of all public companies large and small. Such guidance should come in the form of "right-sizing" AS2 in a separate standard directed at smaller public companies in particular, or through "right-sizing" AS2 to address the needs of small and large companies alike. The "right-sized" standard can reflect learnings of the SEC ACSPC as well as information provided at the upcoming May SEC-PCAOB roundtable. FEI remains convinced that the regulatory and standards setting processes possess adequate authority and flexibility to address the Section 404 implementation challenges.

In addition, consideration should be given as to whether the SEC needs to issue further guidance for management, and smaller public company management in particular. As has been widely noted, the SEC's management reporting rule under Section 404 provided sparse guidance for management, and AS2 became the de facto guidance. Although the Committee Of Sponsoring Organizations (COSO) is developing guidance for smaller public companies, it is

not yet final and it is unclear whether such guidance will be helpful to smaller public companies in its final form. As one of the sponsoring organizations for COSO, FEI does not support elevating COSO to a standard-setting role.

COST- BENEFIT OF IMPLEMENTATION

I would be remiss if I do not focus a portion of my remarks on the overall cost-benefit of the Sarbanes-Oxley Act. We appreciate the SEC's and PCAOB's acknowledgment that cost of implementation is high. The degree of testing and documentation of internal controls forms the largest part of the cost, and incorporates the need to pay internal staff, both finance and internal audit, as well as the external auditor, and other external experts such as software consultants, to enhance systems related to testing, documenting, and reporting on internal controls. We especially note the significant cost impact on smaller public companies, as they simply do not have the resources to carry out the reporting requirements. The benefit side of the equation, while it includes the strengthening of the role of the financial reporting and internal control process, increased shareholder confidence is still much more difficult to measure and quantify. While FEI certainly supports such intangible benefits, we believe that good corporate governance encompasses not only strong internal controls, but also an eye toward budget, profitability, and as such, cost-benefit issues.

FEI continues to urge regulators to maintain flexibility and judgment that would promote efficiencies rather than redundancies, and minimize extraneous, labor-intensive procedures that are time consuming and expensive. While we do believe that greater efficiencies have been witnessed in year two of implementing Section 404, FEI remains hopeful that more reasonable approaches will continue to be developed that will further reduce the cost of compliance as regulators, preparers, and auditors work together to implement the spirit of the SEC rules and

PCAOB standards. It is our hope that reasonableness will prevail, particularly in the roll forward of continuous testing and documentation in future years.

FEI's COST SURVEY on IMPLEMENTING SECTION 404

FEI has been surveying its membership on Section 404 Implementation costs since May 2003. In March 2006, FEI surveyed 274 public companies, with average revenues of $5.7 billion, (the range being under $25 million to over $25 billion in revenues) to gauge Section 404 compliance cost estimates. Of the 274 respondents, 193 were second year filers, 56 were first year filers, and 25 had not yet filed their results. The survey results showed:

- The total cost of compliance with Sarbanes-Oxley Section 404 is now estimated at $3.70 million for the average company.
- Total cost is a function of internal costs such as internal audit, external costs other than the auditor (such as external consultants and software packages) and audit fees attributable specifically to the Section 404 internal control attestation.
- According to the survey, the average company expended $1.06 million in internal costs (a decrease of 12.2% for second year filers from their first year of implementation), $1.26 million in external costs (a decrease of 21.7%) and $1.38 million in auditor fees (a decrease of 12.7%).
- In total, companies indicated that audit attestation fees represent 44.2% of their total annual audit fees.
- In looking at the implementation cost based on a company's market capitalization, on average, a microcap company with market capitalization less than $128.2 million had total costs of $1.19 million, a small cap company with market capitalization between

$128.2 and $787.1 million had total costs of $1.29 million and a large public company with a market capitalization greater than $787.1 million had $5.33 million in total costs.

Based on the data obtained, it appears that even in its second year of implementation, while companies have experienced some reduction in costs, most significantly in the area of external costs other than the auditor, the cost of Sarbanes-Oxley Section 404 compliance remains high, and continues to be disproportionate to the burdens associated with annual compliance.

WORKING TOWARDS A SOLUTION

In conclusion, FEI supports the efforts of the SEC and the PCAOB in implementing the requirements of the Sarbanes-Oxley Act of 2002 However, it is evident that more work needs to be done in implementing Section 404 of the Act. We are confident that the SEC and PCAOB are up to the task and they possess the authority to do so. Through continuous study, review and feedback from large company and small company preparers, auditors, regulators and investors by the SEC and the PCAOB, FEI is confident that a reasoned approach to Section 404 implementation that is "right-sized" for all public companies will be achieved.

That concludes my remarks. I want to thank the Chairman and members of the Subcommittee for inviting me to participate in today's hearing.

Mrs. MILLER. Thank you so much.

Our next witness is Richard Hubbell. He is the president and chief executive officer of RPC, Inc., which is a position he has held since 2003. He is also the president and chief operating officer of Marine Products Corp., a position that he has held since February 2001. Prior to this, he was president and chief operating officer of RPC, Inc., and also was an executive vice president of Rollins Communications, which he joined in February 1970.

Mr. Hubbell, we appreciate you joining with us today, and we look forward to your testimony, sir.

STATEMENT OF RICHARD A. HUBBELL

Mr. HUBBELL. Well, thank you very much. As mentioned, I am the chief executive officer of RPC, which is a small oilfield service company providing services and equipment to producers of oil and gas in the petroleum-producing regions of the United States and a few international markets. RPC has approximately 1,600 employees, the majority of which are in the domestic United States. In order to deal with the cyclical nature of our business and provide the best possible return to our shareholders, we acquired a pleasure boat manufacturer in 1986. A few years ago, we decided that it was in the best interests of our shareholders to form a separate company and spin that pleasure boat manufacturer off. So that is why I am president and CEO of two New York Stock Exchange companies.

Marine Products Corp. is the third largest manufacturer of sterndriven pleasure boats in the United States. We have two domestic manufacturing facilities and approximately 1,100 domestic employees. Our strategies have provided good long-term returns to our shareholders. Today, the combined market capitalization of the two companies is approximately $1.7 billion.

As a result of the spin-off transaction I just outlined, I manage a small corporate headquarters staff that handles the common corporate functions of these two public companies. We believe that it is in the best interests of our shareholders to have this common headquarters structure, because it allows us to spread the costs and leverage the knowledge of our staff over such functions as accounting, public company reporting and compliance, and financial management. It also allows us to work more effectively with outside constituents such as our public accounting firm and our shareholders.

We managed the implementation of the Sarbanes-Oxley Act of 2002 in the same manner. For these companies, which are relatively small, this implementation created a large and ongoing structure which is expensive for our shareholders and time-consuming for our corporate and field employees. For example, during the last year prior to the implementation of Sarbanes-Oxley, our public company compliance costs for each company were approximately $70,000. After the implementation of Sarbanes-Oxley, our ongoing annual costs increased to $1 million per company. So I have heard quotes of costs increasing 100 percent. Ours is way, way more than that.

I acknowledge the loss of confidence in the integrity of the business community that shook our society a few years ago, and I agree

that decisive measures had to be taken in order to restore public confidence. I believe that my companies have benefited in certain ways from the documentation of internal controls, tightening of policies and procedures, and enhanced transparency in our operations and financial reporting that have resulted from our compliance with Sarbanes-Oxley.

However, I also believe that my companies and our shareholders have not benefited in proportion to the expenses we have incurred. In addition, I believe that we have suffered certain opportunity costs since we are now spending more time to comply with and document policies and procedures than we had in the past. This means that we can devote less time to the analysis of our financial and operational results, management of the operations of our businesses, and the intangible aspects of company management that relate to experience and judgment. Sarbanes-Oxley has made many companies consider going private and has, I believe, prevented others from becoming public. This limits access to the capital markets for U.S. companies and, in the long run, damages American competitiveness in the global marketplace.

In addition, I have serious concerns about the approach to the implementation of Section 404. The text of the provision itself is brief and ambiguous, and it provides a great deal of leeway to a company's public accounting firm as to what the accounting firm believes to be effective internal controls. In the case of my companies, we are a "controlled corporation," both of them "controlled corporations," with high insider ownership, and common sense dictates that a different level of testing and documentation than for public companies with a larger shareholder base. I believe that in the current environment, public accounting firms have been overzealous in their interpretation of 404, and in many cases have abandoned basic concepts of materiality and common sense. To allow public accounting firms to have this level of control ignores several conflicts of interest, because there is an inherent economic incentive to spend more time and conduct more testing on internal controls. As a result of the implementation of Section 404, the work required by public companies to comply with 404 has been overly burdensome and without a proportionate benefit to the financial community or investing public.

Thank you very much.

[The prepared statement of Mr. Hubbell follows:]

Testimony of Richard A. Hubbell before the Government Reform Subcommittee on Regulatory Affairs of the U.S. House of Representatives, April 5, 2006

I am the chief executive officer of RPC, a small oilfield services company providing services and equipment to producers of oil and gas in the petroleum-producing regions of the United States and a few international markets. RPC has approximately 1,600 employees, the majority of whom are in the domestic U.S. In order to deal with the cyclical nature of our business and provide the best possible returns to our shareholders, we acquired a pleasure boat manufacturer in 1986. A few years ago, we decided that it was in the best interests of our shareholders to form a separate company and spin off our pleasure boat manufacturer. We formed Marine Products Corporation to accomplish this, and it became a separate public company five years ago. Marine Products Corporation is the third-largest manufacturer of sterndrive pleasure boats in the United States, with two domestic manufacturing facilities and approximately 1,100 domestic employees. Our strategies have provided good long-term returns to our shareholders. Today, the combined market capitalization of the two companies is approximately $1.7 billion.

As a result of the spin-off transaction I just outlined, I manage a small corporate headquarters staff that handles the common corporate functions of these two public companies. We believe that it is in the best interests of our shareholders to have this common headquarters structure, because it allows us to spread the costs and leverage the knowledge of this staff over such functions as accounting, public company reporting and compliance and financial management. It also allows us to work more effectively with outside constituents such as our public accounting firm and our shareholders.

We managed the implementation of the Sarbanes-Oxley Act of 2002 in the same manner. For my companies, which are relatively small, this implementation created a large and ongoing structure which is expensive for our shareholders and time-consuming for our corporate and field employees. For example, during the last year prior to the implementation of Sarbanes-Oxley, our public company compliance costs for each company were approximately $70 thousand. After the implementation of Sarbanes-Oxley, our ongoing annual costs have grown to over $1 million per company.

I acknowledge the loss of confidence in the integrity of the business community that shook our society a few years ago, and I agree that decisive measures had to be taken in order to restore public confidence. I believe that my companies have benefited in certain ways from the documentation of internal controls, tightening of policies and procedures, and enhanced transparency in our operations and financial reporting that have resulted from our compliance with the Sarbanes-Oxley Act.

However, I also believe that my companies and our shareholders have not benefited in proportion to the expenses we have incurred. In addition, I believe that we have suffered certain opportunity costs, since we now spend more time to comply with and document policies and procedures than we had in the past. This means that we can devote less time to the analysis of our financial and operational results, management of the operations of our businesses, and the intangible aspects of company management that relate to

experience and judgment. Sarbanes-Oxley has made many companies consider going private and has, I believe, prevented others from becoming public. This limits access to capital markets for U.S. companies, and in the long run, damages American competitiveness in the global marketplace.

In addition, I have serious concerns about the approach to the implementation of Section 404 of the Sarbanes-Oxley Act. The text of the provision itself is brief and ambiguous, and it provides a great deal of leeway to a company's public accounting firm as to what the accounting firm believes to be effective internal controls. In the case of my companies, we are "controlled corporations" with high insider ownership, and common sense dictates a different level of testing and documentation than for public companies with a larger shareholder base. I believe that in the current environment, public accounting firms have been overzealous in their interpretation of Section 404, and in many cases have abandoned basic concepts of materiality and common sense. To allow public accounting firms to have this level of control ignores several conflicts of interest, because there is an inherent economic incentive to spend more time and conduct more testing on internal controls, which both reduces the risk of missing a weakness in a client's internal controls and allows them to charge higher fees. As a result of the interpretation of Section 404 of the Sarbanes-Oxley Act, the work required by public companies to comply with Section 404 of the Act has been overly burdensome without a proportionate benefit to the financial community or investing public.

Mrs. MILLER. Thank you.

Our next witness is Mr. Robert Dowski. He has over 20 years of domestic and international experience in strategic planning, corporate financial reporting, and financial accounting systems. Prior to joining Allied Defense Group, he was a senior vice president and CFO of New Star, Inc. His financial management background includes positions with Gillette, GE, Space Net, Telecorp, PCS, and Hughes Network Systems.

Mr. Dowski, you have the floor. We look forward to your testimony, sir.

STATEMENT OF ROBERT P. DOWSKI

Mr. DOWSKI. Thank you very much. I think ADG should be a poster child for SOX. For those of you who have had a chance to look us up on the Internet, you know that the company has suffered through a restatement related to FAS 133. That is an ongoing process. We have been delayed in filing our 10-K and, in fact, have been working 80 hours a week with offsetting and corresponding amount of hours from our auditors trying to get through our second-year SOX issues. So this is a topic that is near and dear to my heart. So, with that, let me go through the testimony.

ADG is a small public company. We are headquartered in Vienna, VA, and have seven operating units located overseas in Belgium and here in Texas and California. We design and manufacture medium caliber ammunition and products for the security, surveillance, and video transmission markets. We have approximately 700 employees and in 2005 produced approximately $110 million in revenues. Our largest operating unit produces $60 million of revenue and our smallest produces $6 million. We uncharacteristically lost over $20 million on the bottom line in 2005. 2005 was also the second year of our SOX implementation.

I must be honest, Chairwoman Miller, and tell you that not all of that loss was attributable to our SOX compliance efforts. But like many other companies in the United States, we spent a great deal of time and effort trying to meet a set of one-size-fits-all regulations that did not, as enacted and thereafter interpreted, adequately differentiate between a company the size of ADG versus IBM.

I come before the committee as a believer in the primary goals of the Sarbanes-Oxley legislation: providing more timely, accurate, and transparent information for investors. ADG believes that a well-run company should have and maintain good internal controls. As a company working hand in hand with our public auditors, we have made significant progress in improving our internal controls, and we will continue on that journey in 2006 and beyond.

But it has come at a cost. In 2005, we spent over $108 million on external fees for SOX compliance and auditing. We spent that much and probably more on internal resources on documentation, testing, and related activities. That $3.6 million in 2005 equates to over 62 cents of negative earnings for our shareholders, not to mention the unmeasured opportunity costs of efforts not spent on improving revenue, profit, and productivity within the company.

Robert Greifeld, president and CEO of Nasdaq, in a recent Wall Street Journal editorial summarized the situation very well. He

said, "The burden of compliance is onerous, the cost is significant, and it falls disproportionately on smaller companies that are least able to pay." Their research has shown that the burden on small companies, as a percentage of revenue basis, is 11 times that of large companies.

He went on to say, and we agree, that "SOX is important, by and large it works. We have spent 3 years to assess its strengths and problems. Perhaps 90 percent of all complaints have their genesis in 20 lines of text in Section 404. The time has come to address those 404 concerns without diluting the essential investor protections that are the true legacy of SOX. Specifically, we should adopt the recommendations of the SEC's Advisory Committee on Smaller Public Companies, which has proposed an exemption from 404 for companies with less than $128 million in market cap and revenues under $125 million. Companies with up to $787 million in market cap, as long as they had revenues of less than $250 million, would receive a partial exemption. The companies exempted account for only 6 percent of the U.S. market cap—which means 404 would still apply fully to 94 percent of equity market capitalization."

ADG agrees with these observations and supports his call for reforms and exemptions.

In their discussion on cost/benefit, the Committee on Sponsoring Organizations [COSO], states that, "The challenge under 404 is to find the right balance. Excessive control is costly and counterproductive." ADG believes that auditors should not have a one-size-fits-all checklist when auditing companies of different sizes, and regulators should amend the current rules to accommodate the special needs and circumstances faced by smaller companies.

In smaller companies, such as ADG, the simple lack of people can be a liability. For example, it can be more difficult to achieve separation of duties that 404 calls for in many areas because of flatter organizations and smaller staffs. We have some operating units that have less than 40 people. Workers and managers in those typically have multiple roles and responsibilities, so you have a higher dependence on people doing the right thing. You also typically have a higher degree of direct and explicit knowledge of day-to-day activities since managers are much closer to the daily transactions than their peers at bigger companies. And yet there is no recognition of that in the standards of the transparency. Managers and executives should be allowed to place more reliance on monitoring than on control activities under those circumstances.

The existing paradigm of documentation and testing creates huge burdens in small companies. Controls that exist but are not properly documented and tested internally are not considered by auditors in their assessments under SOX. Offsetting informal controls that are ingrained into the culture of small companies do not receive any credit in the existing evaluation process. We agree with COSO that internal control should be a process designed to provide reasonable assurance regarding the reliability of financial reporting. But we also agree with the rule of thumb for internal controls that benefits should outweigh the costs. The current construct of 404 does not meet that criteria. If employees are spending excessive hours on fine-tuning internal controls, updating documentation, testing controls, evaluating and re-evaluating financial re-

ports, and compiling more extensive information for their board of directors and audit committee, then other more important activities are not getting done.

ADG agrees that it is time to address the 404 concerns without diluting the essential investor protections that are the true legacy of SOX. Proposals for exemptions for smaller companies should be considered. We should re-examine the standards for defining and measuring internal controls at large, medium, and small companies. It makes no sense to have one set of standards that apply equally to IBM and ADG.

I realize I am out of time. Can I continue?

Mrs. MILLER. A few moments.

Mr. DOWSKI. Let me make one final statement. Personally, I believe that auditors do not commit fraud. Dishonest people inside of companies do, and I think we have seen that in the press. Congress should increase the civil and criminal penalties on those people who violate the trust of shareholders. Violators should be forced to forfeit their assets and spend years in jail. When people who have defrauded investors and fellow employees out of billions of dollars are allowed to keep their fancy homes and other offshore assets, then how on Earth does punishment fit the crime?

People with high ethical standards are the best defense of the public interest.

Thank you for this opportunity to testify.

[The prepared statement of Mr. Dowski follows:]

Robert P. Dowski
Chief Financial Officer
Allied Defense Group (ADG)

Testimony
Before the Committee on Government Reforms, Subcommittee on Regulatory Affairs
Unites States House of Representatives

Hearing on the Securities and Exchange Commissions (SEC) implementation of the Sarbanes Oxley Act

Good morning Chairman Miller and members of the subcommittee. My name is Robert Dowski and I am Chief Financial Officer of the Allied Defense Group – also know as ADG. It's an honor for me to be here before the Committee on Government Reform representing ADG, its management team and Board of Directors.

ADG is small public company. We are headquartered in Vienna, Virginia and have 7 operating units located overseas in Belgium and here in Texas and California. We design and manufacture medium caliber ammunition and products for the security, surveillance and video transmission markets. We have approximately 700 employees and in 2005 produced approximately 110M$ in revenues. Our largest operating unit produced 60M$ of revenue and our smallest produced 6M$. We uncharacteristically lost over 20M$ on the bottom line in 2005. 2005 was also the second year of our SOX implementation.

I must be honest, Chairwoman Miller - and tell you that not all of that loss was not attributable to our SOX compliance efforts – but – like many other companies in the United States – we spent a great deal of time and effort trying to meet a set of one size fits all regulations that did not – as enacted and thereafter interpreted – adequately differentiate between a company the size of ADG or IBM

I come before the committee as a believer in the primary goals of the Sarbanes-Oxley legislation: Providing more timely, accurate and transparent information for investors. ADG believes a well run company should have and maintain good internal controls. As a company, working hand in hand with our public auditors – we have made significant progress in improving our internal controls – and we will continue on that journey in 2006 and beyond.

But is has come at a cost. In 2005 we spent over 1.8M$ on external fees for SOX compliance and auditing. We spent that much and probably more on internal resources on documentation, testing and related activities. That 3.6M$ equates to over $0.62 per share of negative earnings for our shareholders – not to mention the unmeasured opportunity costs of efforts not spent on improving revenue, profit and productivity within the company.

Robert Greifeld – President and CEO of Nasdaq in a recent Wall Street Journal editorial summarized the situation with very well – "the burden of compliance is onerous, the cost is significant, and it falls disproportionately on smaller companies that are least able to pay. Our research has shown that the burden on small companies, on a percentage of revenue basis, is 11 times that of a large company."

He went on to say that " SOX is important, by in large it works. We have had three years to assess its strengths and problems. Perhaps 90% of all complaints have their genesis in 20 lines of text in Section 404. The time has come to address those 404 concerns without diluting the essential investor protections that are the true legacy of SOX. Specifically we should adopt the recommendations of the SEC's Advisory Committee on Smaller Public Companies, which has proposed an exemption from 404 for companies with less than 128M$ in market cap and revenues under 125M$. Companies with up to 787M$ in

market cap, as long as they had revenues of less than 250M$, – would receive a partial exemption. The companies exempted account for only 6% of the US market cap – which means 404 would still apply fully to 94% of equity market capitalization."

ADG agrees with Mr Greifeld's observations and supports his call for reform and exemptions.

In their discussion on cost/benefit, the Committee of Sponsoring Organizations (COSO) states that: "The challenge under 404 is to find the right balance. Excessive control is costly and counterproductive". ADG believes that auditors should not have a one size fits all checklist when auditing companies of very different sizes, and regulators should amend the current rules to accommodate the special needs and circumstances faced by smaller companies.

In smaller companies such as ADG the simple lack of people can be a liability. For example: it can be more difficult to achieve separation of duties – that 404 calls for in many areas - because of flatter organizations and smaller staffs. We have some operating units that have less than 40 people. Workers and managers at those units typically have multiple roles and responsibilities – so you have a higher dependence on people doing the right thing. You also typically have a higher degree of direct and explicit knowledge of day to day activities – since the managers are much closer to daily transactions than their peers at bigger companies and yet there is no recognition in the standards for that inner transparency. Managers and executives should be allowed to place more reliance on monitoring than control activities under those circumstances.

The existing paradigm of documentation and testing creates huge burdens in small companies. Controls that exist but are not properly documented and tested internally are not considered by the auditors in their assessments. Off setting informal controls that are ingrained into the culture of smaller companies do not receive any credit in the existing evaluation process. We agree with COSO that internal control should be a process designed to provide reasonable assurance regarding the reliability of financial reporting. But we also agree with the rule of thumb for internal controls that benefits should outweigh the costs. The current construct of Section 404 does not meet that criteria. If employees are spending excessive hours on fine tuning internal controls, updating documentation, testing controls, evaluating and re-evaluating financial reports and compiling more extensive information for their board of directors – other more important activities – like growing revenues, improving margins and increasing shareholder value will suffer.

ADG agrees that the time has come to address 404 concerns without diluting the essential investor protections that are the true legacy of SOX. Proposals for exemptions for smaller companies should be considered. We should reexamine the standards for defining and measuring internal controls at large, medium and small companies. It makes no sense to have one set of standards that apply equally to IBM and ADG.

The Public Company Accounting Oversight Board (PCAOB) should spend more time and energy providing guidance for interpreting reasonable standards under Section 404 and less effort assessing liability and sanctions on public auditing companies. The goal should be for external auditors to conduct streamlined, cost effective examinations of internal controls and the accuracy of financial reporting. Auditors should once again be a resource for the company in arriving at the right answers to ensure accuracy and transparency.

Auditors don't commit fraud - dishonest people inside companies do. Congress should increase the civil and criminal penalties on those people who violate the trust of shareholders. Violators should forfeit all of their assets and spend years in jail. When people who have defrauded investors and fellow employees out of billion of dollars are allowed to keep their fancy homes and other off shore assets – then how on earth does the punishment fit the crime?

People with high ethical standards are the best defense of the public interest.

Thank you for this opportunity to present my views before the committee. I hope my comments have made some small contribution to your efforts to evaluate the effectiveness of Section 404. I would be happy to answer any questions you might have.

Mrs. MILLER. Thank you very much.

Our next witness is Mr. Alex Pollock. He has been a resident fellow at American Enterprise Institute since 2004, focusing on financial policy issues, including government-sponsored enterprises, Social Security reform, accounting standards, and the issues that have been raised by the Sarbanes-Oxley Act. Previously he spent 35 years in banking, including 12 years as a president and chief executive officer of the Federal Home Loan Bank of Chicago.

We appreciate your testimony here today, Mr. Pollock. The floor is yours, sir.

STATEMENT OF ALEX J. POLLOCK

Mr. POLLOCK. Thank you very much, Madam Chairman, Ranking Member Lynch. I very much thank you for the opportunity to testify today, and these are my personal views on the issues. This hearing is very important and most timely. Everybody on the panels and on the subcommittee has repeated the amazing evidence from the market, from businesses all over the country, about the problems with Sarbanes-Oxley implementation. It is a great right in America of the people to petition their representatives for redress. I do not think there is any doubt that the people are petitioning the representatives for redress of the consequences of Sarbanes-Oxley, which was an act done with great good intentions, and as you pointed out, Madam Chairman, in your opening comments, we have had unintended, very adverse consequences. It is obvious this has been a tremendously expensive exercise in the creation of paperwork and bureaucracy, and the total costs of this exercise far outweigh the benefits which are likely to arise from it. And the burden of all this is, as many people have said, disproportionately high for smaller companies.

It is important to remember that when excess costs are imposed on companies, they are actually imposed on shareholders, and it does not protect the shareholders to impose excess costs on them. Moreover, in my opinion, the historical record is very clear that the mechanical requirements which characterize the implementation of Sarbanes-Oxley will not prevent, when the next bubble and boom time comes, the next set of frauds and scandals, which always appear during these times, and we will have our future Enrons and WorldComs, notwithstanding this mass of expensive paperwork.

I want to quote from a typical experience with Sarbanes-Oxley implementation. This is a letter to the SEC from one company. They note the "concentration on minutia . . . redundant and inefficient operations, creation of an adversarial relationship with the audit firm . . . form over function . . . and unrealistic requirements . . ."

The British Confederation of Industry, looking from abroad, points out, quite correctly, that "Dealing with risks on the basis of a remote likelihood," which is the Sarbanes-Oxley implementation standard, not in the act itself but as implemented, "other than a remote likelihood," that this not only imposes huge costs but makes the whole thing a nitpicking process, as we have heard from many people.

And as has been noted, the SEC's Advisory Committee on Smaller Public Companies says that for the smaller public companies, relief from 404 is urgently needed.

As has been noted, a highly interesting commentator, Eliot Spitzer, has described Sarbanes-Oxley implementation as an "unbelievable burden on small companies."

And what is apparent is that Congress did not intend all of this. The SEC did not intend it. Even the PCAOB did not intend it. This is all a runaway effect basically of fear, the fear on a lot of people's parts, and especially the fear on the part of accounting firms that they will be criticized for doing something wrong. They saw Arthur Andersen be destroyed.

But, on the other hand, for these accounting firms, the implementation of Sarbanes-Oxley has been a revenue and a profit bonanza, quite the opposite of what the Senate committee report on Section 404 stated, namely, "The Committee does not intend that the auditor's evaluation be the . . . basis for increased charges or fees." There is a line with great irony read in retrospect.

I would like to suggest that Congress should act. I don't think it is wise to wait for the regulatory bureaucracies to do this. And I would like to highlight three steps I believe Congress should take. I think you should also do some things to restructure the PCAOB which are in my written testimony, but I will not mention them this morning.

First, the best case would be to enact the provisions of H.R. 1641, a bill introduced last year by Congressman Flake of Arizona, which would, very simply, and in my view elegantly, make Section 404 of Sarbanes-Oxley voluntary as opposed to mandatory. This is an approach well suited to a market economy and a free society, and I simply point out that if investors really want the kind of heavy-handed documentation of internal controls called for by 404, an article of religious faith on the part of its proponents, then the companies will do it because the investors will demand it. I think we need to find out what investors really value, and this voluntary approach would do it.

At the very minimum, as many other people have said, Congress should address Section 404 for smaller public companies, and the best way to do that is make it voluntary for smaller public companies. I do not actually think that exemption, which is talked about by the Advisory Committee, is the best approach. I would like to say voluntary with explanation and disclosure. So you as management, you decide how you are going to address internal controls. You disclose and explain it to the shareholders. They can make up their minds. We ought to, at a minimum, do that for smaller companies, best case for everybody.

The second point, Congress should instruct the PCAOB to change the internal control review standard from this "other than a remote likelihood" to "a material risk of loss or fraud." This was brought up on the first panel. I think it is exactly right, and it is the only way to get the accountants acting right.

Third, Congress should state clearly that it understands the true nature of accounting, which is that accounting is not something objective but something full of subjective judgments, estimates of the future, which is unknowable, debatable competing accounting theo-

ries and complex compromises, art not science, and, therefore, it is essential to have the accountants closely advising and counseling their clients on the application of the ever more complex accounting standards which the Financial Accounting Standards Board is producing. And we have lost that, as has also been discussed.

In conclusion, I think it is critical to take a number of steps, and I think Congress should take them, to bring under control the unintended effects, intended by nobody, which have proved so remarkably costly, bureaucratic, and inefficient, and they have been caused by the way that Sarbanes-Oxley has been implemented. I hope Congress will take these steps.

Thanks again for the chance to be here.

[The prepared statement of Mr. Pollock follows:]

Testimony of

Alex J. Pollock
Resident Fellow
American Enterprise Institute

To the Subcommittee on Regulatory Affairs

Of the Committee on Government Reform

Hearing on the SEC's Implementation of the Sarbanes-Oxley Act

April 5, 2006

Addressing the Unintended Burdens of the Sarbanes-Oxley Act

Madame Chairman, Ranking Member Lynch and members of the Subcommittee, thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow of the American Enterprise Institute, and these are my personal views on the need for action to address the unintended, but very real, excessive burdens and bureaucracy created by the implementation of the Sarbanes-Oxley Act of 2002.

Implementation Bureaucracy

This hearing is important and timely. With more than three years of national experience with Sarbanes-Oxley implementation to consider, Congress can now easily see that its good intentions have resulted in notable adverse consequences. I am sure you have heard a lot about this from the businesses in your own districts.

Let us start with the most obvious unintended results. Sarbanes-Oxley implementation activities, particularly the Section 404 certifications which have become notorious, have created a tremendously expensive amount of paperwork and bureaucracy. The explicit costs alone are extremely high and disproportionately high for smaller companies. The implicit costs of employee and management time and effort are high. In addition, there

are the opportunity costs of diversion of management focus from playing offense to playing defense.

The total costs far outweigh the benefits which are likely to arise from them, especially for smaller companies.

This is especially true because the testimony of history is quite clear on the reliable regularity with which frauds and scandals accompany investment booms and bubbles. In my opinion, the detailed rules, bureaucratic overhead, and mechanical requirements which characterize Sarbanes-Oxley implementation will not prevent fraud and scandal during the next boom when it comes.

In a typical view of its Sarbanes-Oxley experience, frankly expressed, one smaller company's letter to the SEC describes the following: "concentration on minutia…redundant and inefficient…adversarial relationship with audit firm…form over function…unrealistic requirements on small and developing companies." It further points out that the cost of all this, which far exceeded the estimates, is of course money taken away from its shareholders.

A letter from the British Confederation of Industry correctly observes that "Dealing with risks on the basis of a remote likelihood," which is the Sarbanes-Oxley implementation approach, "not only imposes huge costs but also makes this a nitpicking process."

An American trade association letter describes, "An atmosphere of near paranoia…the public accounting firms have increased their aversion to risk to an extreme degree."

On the disproportionate negative impact on smaller companies, the SEC's Advisory Committee on Smaller Public Companies has recently concluded: "The result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete…. We believe Section 404 represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed."

Another commentator, Eliot Spitzer, has described Sarbanes-Oxley implementation as an "unbelievable burden on small companies."

Congress clearly did not intend all this. The SEC did not intend it either, nor did it know what the effects of its regulation would be. This is apparent from the initial SEC estimate of a cost of $91,000 per company on average, an estimate which appears to be low by a factor of 50 or so. Either the SEC staff had very little understanding of what their regulation actually required, or interpretation of the regulation morphed in ways never imagined. Indeed, the SEC and the PCAOB subsequently criticized the accounting firms quite sharply for what Sarbanes-Oxley implementation has become.

In short, no one intended the outcome we've got. I believe it's time to fix it.

Effects on Accounting Firms

The flip side of the enormous expense and distraction for companies is that for the large public accounting firms, Sarbanes-Oxley implementation has been a revenue and profit bonanza. One journalist called it the greatest wealth transfer of modern times, from shareholders of companies to partners of accounting firms.

This is especially ironic since Congress was quite clear that this was not its intent. The Senate Committee Report on Section 404 was specific: "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"! (emphasis added) . Nevertheless, virtually every audit committee in the country has helplessly watched its audit fees escalate dramatically, unable to exercise any judgment about whether the expensive routines make sense for their shareholders.

A second irony is that the implementation of an act dedicated to controlling conflicts of interest has created an obvious conflict of interest for the accounting firms themselves. The more massive the Sarbanes-Oxley routines, the more memos, procedures and risk control descriptions which are generated, the more often they are reviewed and revised, the more meetings, the more interviews of managers, the more time it all takes, the more profitable the accounting firms become. No wonder they take out advertisements praising Sarbanes-Oxley!

In response to these developments, the "Pollock Proposal" is to expand Sarbanes-Oxley internal control requirements to cover the accounting firms themselves. Since they impose huge costs and nitpicking procedures on everybody else, they should have to go through the same Section 404 routines as a prerequisite to practicing on other people. I expect that, first, they would fail the reviews, and second, their views and reviews of others would become more reasonable.

Another perverse effect of Sarbanes-Oxley implementation is that, as another company wrote to the SEC, "External auditors are reluctant to give advice with regard to interpretation and application of complex accounting rules to avoid possible criticism from the PCAOB in regards to their independence." A related comment: "Almost every significant audit-related decision is now being referred to the firm's national offices rather than being addressed at the practice level."

In other words, the PCAOB environment has made public accountants afraid to carry out the core function which defines a profession: exercising judgment. I consider this the reduction to absurdity of the effects of Sarbanes-Oxley implementation on accounting behavior-- and a striking disservice to the companies trying to cope with the ever more convoluted accounting rules propounded by the FASB. Note that this issue suggests that we also need to review the PCAOB.

Reform of Sarbanes-Oxley Implementation

Learning from unambiguous experience, Congress now has the opportunity to correct the expensive morass of problems resulting from the implementation of Sarbanes-Oxley in ways neither it nor anyone else ever intended, and to bring the costs to shareholders and the benefit to shareholders into balance.

Here's what I believe Congress should do:

1. Enact the provisions of HR 1641, introduced last year by Congressman Jeff Flake of Arizona. HR 1641 would make Section 404 of Sarbanes-Oxley voluntary, as opposed to mandatory. This approach would be well suited to a market economy and a free society.

If investors actually want the kind of heavy internal control documentation 404 demands, then the companies will do it because investors will demand it. Investors will punish those companies which opt out.

If, on the other hand, investors conclude that resources would be better spent elsewhere-- on research, or introducing new products, or customer service, for example-- then companies will do that and the investors will react accordingly.

2. If a totally voluntary approach be viewed as politically impossible, at a minimum make Section 404 voluntary for smaller public companies. Exemption from these requirements for these companies is recommended by the SEC's Advisory Committee on Smaller Public Companies.

I believe that "voluntary with disclosure and explanation" would be a better concept than simple "exemption." The company should decide what approach it will take to internal control certification and explain to its investors why it has so chosen. Investors can consider the company's logic and make up their own mind.

3. Instruct the PCAOB to change its review standard from "other than a remote likelihood" to "a material risk of loss or fraud." I think this is essential to improve the implementation behavior of the accounting firms.

4. State clearly that Congress does not have the naïve belief that accounting is something objective, but rather understands, as every financial professional does, that accounting is full of more or less subjective judgments, estimates of the unknowable future, and debatable competing theories. As the saying goes, it is art, and by no means science.

Therefore the express instruction of Congress should be that consultation, judgment and professional advice on the application of accounting standards is expected and demanded of accounting firms.

5. Instruct the PCAOB to require a Section 404 regime for the public accounting firms themselves, as a condition of their public trust, on the same standards as apply to public companies.

6. Mandate a report from the SEC and the GAO comparing the British principles-based Turnbull Guidance on corporate risk controls to the approach taken by Sarbanes-Oxley implementation.

7. Bring the PCAOB under Congressional authority as a regulatory agency should be, subject to appropriations, oversight and a normal appointments process, and move PCAOB assessments, as they are for any other regulator, to the regulated entities.

8. Finally, enact a sunset or reauthorization requirement for Section 404 of Sarbanes-Oxley five years from now. That would be 2011, a decade after the scandals which gave it birth, with correspondingly greater experience, knowledge and perspective for all concerned.

I believe these steps would bring under control the unintended effects, which have proved so remarkably costly, bureaucratic and inefficient, caused by the way Sarbanes-Oxley has been implemented.

Thank you again for the chance to be here today.

Mrs. MILLER. Thank you so much.

And our final panelist today is Damon Silvers. He is an associate general counsel for the AFL–CIO. His responsibilities include corporate governance, pension, and general business law issues. He is a member of the Public Company Accounting Oversight Board Standing Advisory Group. He is also a member of the Financial Accounting Standards Board User Advisory Council and a member of the American Bar Association's Subcommittee on International Corporate Governance.

We welcome you to the committee today, Mr. Silvers, and the floor is yours, sir.

STATEMENT OF DAMON A. SILVERS

Mr. SILVERS. Thank you very much, Chairwoman Miller, Congressman Lynch. On behalf of the AFL–CIO, I express our appreciation for being able to be here today and to discuss this obviously very important issue.

I will say that before I begin my formal remarks, in very large part, we very much agree with what Ms. Hinchman said. Not all my remarks go straight to those points, and I don't want to associate myself with hers.

Ms. HINCHMAN. And we do not often agree with the AFL–CIO. Thank you. [Laughter.]

Mr. SILVERS. Right. And as I said to Mr. Parks at the last hearing he and I testified at, it is an unusual experience. But, nonetheless, we do.

Union members participate in benefit plans with over $5 trillion in assets, and our actual union-sponsored plans have approximately $400 billion in assets. Those workers' pension funds are broadly invested in a variety of small-cap and total market index funds and are sizable shareholders in many small public companies. I have attached to my testimony a letter from one such fund that provides benefits to our members, the Florida State Board of Investment, that describes the ways in which that large fund is deeply invested in small companies.

Union members participate in the capital markets also as individual shareholders and, like other investors, are frequently asked by brokers to consider investing in small and micro-cap companies. And I am particularly honored to be, I think, the only investor representative here speaking today.

The integrity of public company financial statements is a prerequisite to the functioning of our capital markets. When investors lose confidence in financial statement integrity, stock and bond prices fall, interest rates for businesses rise, and investors seek out markets in which they have more confidence. With the current account deficit running at a rate in excess of $2 billion a day, the United States simply cannot afford to undermine the integrity of its capital markets in whole or in part, and that was the circumstance in which we found ourselves in the summer of 2002, at the time in which the Sarbanes-Oxley Act was enacted.

However, the Sarbanes-Oxley Act did not create the requirement that companies maintain adequate internal controls. That requirement has been a matter of law for public companies since 1977. It has simply been a law that companies have ignored.

Internal controls are among the most important mechanisms that ensure that company financial statements are honest and accurate. They range from passwords on key spread sheets to systems for counting inventory. If internal controls are weak, that weakness casts doubt on the accuracy of company financial statements. In the absence of effective internal controls, company financial statements simply cannot be relied upon.

Weak internal controls are strongly correlated with problems in company financial statements. Since larger companies—accelerated filers—began to comply with SOX 404 more than a year ago, according to the corporate governance firm Glass Lewis, most public company financial restatements have been at companies that have also had weaknesses in their internal controls.

Small public companies disproportionately are involved in these restatements and in SEC enforcement actions. According, again, to Glass Lewis, in 2005 the smallest companies were more than twice as likely to have to restate their financials as large companies. Dana Hermanson, a professor of accounting at Kennesaw State University, has found that smaller public companies "have accounted for the vast majority of accounting fraud causes brought by the Securities and Exchange Commission."

Consequently, the AFL–CIO opposes any effort to exempt any public company from its clear obligations under the Sarbanes-Oxley Act with respect to internal controls. In addition, we strongly oppose any stealth effort to turn the audit of internal controls into anything other than what the statute requires—an audit sufficiently substantive to support an attestation by the audit firm that management's own assessment of its internal controls is correct.

And we are not alone. Contrary to some of what has been said this morning, there is virtual unanimity in both the institutional and individual investor community about the importance of protecting the current scope of 404, a consensus which includes institutionally oriented organizations like the Council of Institutional Investors, and organizations oriented toward individual investors like the American Association of Retired Persons and the Consumer Federation of America.

In addition, distinguished financial leaders like the former chairman of the Federal Reserve, Paul Volcker, and former SEC Chairman, Arthur Levitt, have opposed weakening 404 and specifically warn Congress that the effort to do so could rank with other disastrous efforts by Congress to deregulated industries such as the savings and loan industry if it were to move forward.

There are two ways of thinking about the costs versus the benefits of internal control audits. The first way is to try and compare the costs of complying with SOX 404 with the costs involved, for example, in the collapse of a large-cap public company. According to the folks who oppose the application of 404, total costs were approximately $35 billion in 2004. This is approximately a third of a percent of the market cap of the companies involved, a ratio, for example, that is comparable to what I pay for fire insurance for my home. And it is less than half of the cost of any one of the major corporate collapses that occurred in just one company in 2001 and 2002.

By the way, other people have very different numbers for what the costs are here. Audit Analytics, for example, cites the total audit costs, not 404 but total audit costs, for the Russell 3000 in 2004 as $2.7 billion.

The second way to think about it is to compare the costs with the benefits that accrue at the individual company level from company management getting a tighter grip on their business and being able to manage more precisely. There has been some discussion of those benefits here on this panel, and they were described by Jeffrey Immelt, the CEO of General Electric, when he said, "I think SOX 404 is helpful. It takes the control discipline we use in our factories and applies it to our financial statements."

Since 1933, the Federal Government has required companies that wish to sell their securities to the public to bear a number of costs related to investor protection. Each of these costs is higher as a percentage of either assets, revenues, or profits for small companies than for larger companies, and particularly is higher than revenue numbers for small startup-stage companies. Each of these costs has an effective minimum, regardless of the size of the public company. Therefore, it is easy to draw charts that look dramatic but are, in fact, misleading about the impact on small companies of any kind of investor protection.

The real question is: What are the minimum requirements to access the public markets, to call our members on the phone and try to sell them your stock?

Now, of course, investors do not have an interest—and this comes to Ms. Hinchman's testimony. We do not have an interest in needlessly expensive internal control audits or audits driven by conflicts of interest and accounting firms' desire to recapture consulting revenue they had before, and a variety of other things that we suspect may be going on. And we do believe that in 2004 the audit firms did overcharge the public companies and investors were harmed by that.

However, the appropriate response to that is the regulatory response from the SEC and the PCAOB, and not wholesale exemptions from vital investor protections, and sensible changes in the guidelines and rules, such as Arthur Levitt's proposal for reducing duplicate internal control documentation that is simply inappropriate and a waste of everyone's time and money.

Ultimately, those who want to weaken Sarbanes-Oxley and exempt wholesale the majority of public companies who seek to sell their shares and bonds to individual investors, they must answer the question: Why should Congress allow a company that cannot attest or receive outside attestation that it has effective internal controls, why should such a company be allowed to sell shares or bonds to the investing public? And Congress, furthermore, if it wishes to go in that direction, will have to explain to the victims of future accounting fraud why it was that when we had a tough law that restored investor confidence we weakened it.

Thank you.

[The prepared statement of Mr. Silvers follows:]

Testimony of Damon A. Silvers

Associate General Counsel

American Federation of Labor and Congress of Industrial Organizations

Hearing on the Internal Controls Provisions of the Sarbanes-Oxley Act of 2002

Regulatory Affairs Subcommittee

Committee on Government Reform

United States House of Representatives

April 5, 2006

Good morning Chairwoman Miller and Congressman Lynch. My name is Damon Silvers and I am an Associate General Counsel of the American Federation of Labor and Congress of Industrial Organizations. The AFL-CIO appreciates the opportunity to testify on the vital issue of the internal controls provisions of the Sarbanes Oxley Act of 2002 have had on our capital markets and in particular the question of whether smaller public companies should have to comply with the internal controls provisions of the Act.

Union members participate in benefit plans with over $5 trillion in assets. Union-sponsored pension plans hold approximately $400 billion in assets. Workers' pension funds are broadly invested in a variety of small-cap and total market index funds and are sizable shareholders in many small public companies.[1] Most importantly for this issue union members participate in the capital markets as individual shareholders and like other

[1] Attached to my testimony is a letter to the SEC from one large pension fund, the Florida State Board of Administration which in the context of explaining why they believe all public companies should comply with Section 404 details the extent and manner in which they invest through indexes in small company equity.

investors are frequently asked by brokers to consider investing in small or micro cap companies.

Since 1977, public companies have been required to have adequate internal controls—however, until the passage of the Sarbanes-Oxley Act there was no specific mechanism for holding public companies accountable to the law. Section 404 of the Sarbanes-Oxley Act requires the management of all publicly traded companies to assess the strength of their companies' internal controls, and then requires that each public company's external auditor attest to the accuracy of that assessment.

Section 404 is a vital component of the integrated series of measures contained within the Sarbanes-Oxley Act designed to regulate conflicts of interest in the governance and financial management of public corporations. It is one of four measures within the Senate version of the Sarbanes-Oxley Act that were incorporated into the Act in conference specifically directed at the widespread problems with the integrity of public company financial statements. The other three measures are the limitations on non-audit consulting by audit firms, the establishment of the Public Company Accounting Oversight Board to oversee the auditors of public companies, and the requirements that the officers of public companies certify the accuracy of their companies' financial statements.

It is impossible to overestimate the importance of the integrity of public company financial statements to the functioning of our capital markets. When investors lose

confidence in financial statement integrity, stock and bond prices fall, interest rates rise, and investors seek out markets in which they have more confidence. With a current account deficit running at a rate in excess of $2 billion per day, the United States simply cannot afford to undermine the integrity of its capital markets in whole or in part.

The enactment of the Sarbanes-Oxley Act in the summer of 2002, together with the successful launch of the PCAOB was critical to restoring the confidence of investors both here and abroad in the integrity of US financial statements. Now, almost four years later, there are those who would weaken investor protections. Perhaps the best known statement of this point of view appears in the recommendations of the Small Business Advisory Committee ("Committee") established by the Securities and Exchange Commission ("SEC"), which has proposed that small public companies be exempt from the internal controls provisions of Sarbanes-Oxley and that the definition of an audit of internal controls be weakened for companies with market capitalization up to $700 million.[2]

[2] The Small Business Advisory Committee's recommendations, in addition to being substantively misguided, also assume mistakenly that the Securities and Exchange Commission has the power to exempt public companies from Section 404 or to waive the requirement that there be an outside audit of companies' internal controls assessment. Section 404 of the Sarbanes-Oxley Act explicitly requires all public companies to attest to the adequacy of their internal controls and to obtain an outside audit of their attestation. The Sarbanes-Oxley Act provides an explicit exemption for investment companies and no further exemptions. Consequently, neither the Commission nor the PCAOB have the authority to either exempt public companies from complying with these internal controls provisions or from obtaining a genuine audit of their attestation. This issue is discussed in the dissent to the Advisory Committee's final report by Kurt Schacht, the sole investor representative on the Committee, and is the subject of a letter from a group of leading securities law professors to the SEC and the PCAOB which is attached as an exhibit.

The Small Business Advisory Committee's recommendations would exempt a large percentage, perhaps as high as 80% of all public companies, from having to provide investors with transparency with respect to the effectiveness of their internal controls. Companies with a market cap of less than $128 million and revenue of no more than $125 million would be exempt completely from 404 requirements. Larger companies, with a market cap of up to $787 million and revenues of no more than $250 million, would not be required to undergo a genuine audit in which an independent, outside auditor tests their internal controls. According to the Advisory Committee itself, this would exempt companies with over $1 trillion in market capitalization from having to obtain an outside audit of the adequacy of their internal controls.

The AFL-CIO opposes any effort to exempt any public company from its clear obligations under the Sarbanes-Oxley Act. In addition, we strongly oppose any stealth effort to turn the audit of internal controls into anything other than what the statute requires—an audit sufficiently substantive to support an attestation by the audit firm that management's own assessment of its company's internal controls is correct. We believe it is irresponsible to allow companies without effective internal controls to sell securities to our members and the investing public. And we are not alone. There is virtual unanimity in both the institutional and individual investor community about the importance of protecting the current scope of Section 404—a consensus which includes the Council of Institutional Investors, the American Association of Retired Persons, the

Consumer Federation of America and the Ohio and Florida Retirement Systems. Each of their comment letters are attached. In addition, distinguished financial leaders like the former Chairman of the Federal Reserve Paul Volcker and former SEC Chairman Arthur Levitt have opposed weakening 404. Their letter is also attached.

Public companies by definition are companies whose compliance structures are sufficiently developed to allow these companies to sell their securities to the general public without placing the public in undue jeopardy of being defrauded or victimized by material error. That line of thinking is what produced the Securities Act of 1933 and the Securities Exchange Act of 1934, and it has motivated the federal securities regulation system since those Acts were adopted.

Not all companies are public. The United States has the most robust private capital market in the world, substantially made up of investors who specialize in evaluating private market opportunities. Private companies are entitled to assume their investors are highly sophisticated parties with an ability to independently assess the reliability of a private companies' financial statements through direct contact with management. Public companies, on the other hand, are allowed to market their securities to the public—to people with neither the time nor the expertise to be able to assess accuracy of company financial statements—to read them yes—to determine whether they are fraudulent or mistaken, no.

Since 1933, the federal government has required companies that wish to sell their securities to the public to bear a number of costs related to investor protection—including filing fees to the Securities and Exchange Commission, the costs of preparing prospectuses and periodic reports, including hiring lawyers, obtaining a clean report from an outside auditor and the like. Each of these costs is higher as a percentage of either assets or revenues or profits for smaller companies than for larger companies—and each has an effective minimum regardless of the size of the public company. Consequently charts that show that audit costs or 404 compliance costs as a percentage of revenues rise as companies size shrinks, and rise steeply at the microcap level could easily be reproduced for a variety of costs inherent at being a public company—from the legal fees to the copying or information technology costs.[3]

Why is an assessment and audit of internal financial controls necessary? Internal controls are the mechanisms that ensure that company financial statements are honest and accurate. They range from passwords on key spreadsheets to systems for counting inventory. If internal controls are weak, that weakness casts doubt on the accuracy of company financial statements. In the absence of internal controls, company financial statements simply cannot be relied upon. For that reason, the AFL-CIO believes that any

[3] For example, the Advisory Commission's report on page 31 shows a chart of audit fees as a percentage of revenue. For public companies with market capitalization of less than $25 million it climbed steeply from 2000 to 2004.. This is not at all surprising in light of the commitment on the part of the Congress, the SEC and PCAOB to restore integrity to the audit process by removing the subsidy and corrupting influence of non-audit related services. Assuming revenues of $12.5 million on average for these companies, many of whom are early stage ventures with very little revenue, the climb of approximately 1% in revenue represents an annual increase in audit costs over the four year period of approximately $125,000.

company seeking money from the investing public must have an outside audit of the adequacy of its internal controls. Otherwise our members, their benefit funds, and the public are being asked to take a risk they cannot manage—the risk that the financial statements of the company in which they might invest their money are wrong.

Weak internal controls are strongly correlated with problems in company financial statements. Since larger companies (accelerated filers) began to comply with Section 404 more than a year ago, according to the corporate governance firm Glass Lewis most public company financial restatements have been at companies that have also had weaknesses in their internal controls.

While small companies will bear a disproportionate set of costs in complying with 404, small public companies also disproportionately are involved in restatements and SEC enforcement actions. According to Glass Lewis in 2005 the smallest companies were more than twice as likely to have to restate their financials as large companies. Dana R. Hermanson, a professor of accounting at Kennesaw State University, has found that smaller public companies "have accounted for the vast majority of accounting fraud cases brought by the Securities and Exchange Commission."

Finally, there is the issue of cost-benefit analysis. For accelerated filers, there are two ways of thinking about the costs versus the benefits. The first way is to try and compare the costs of complying with Section 404 with the costs involved in the collapse of a large capitalization public company. The costs of 404 compliance across the entire

public company universe according to those who oppose 404 was $35 billion, which is approximately a third of a percent of the market capitalization of the companies involved and is less than half the losses suffered from just one of the major corporate collapses that gave rise to Sarbanes-Oxley. To my mind and in the minds of most investors even this high estimate (compare Audit Analytics study that shows total audit costs including 404 for all companies in the Russell 3000 as $2.7 billion) seems like a reasonable insurance payment.[4]

The second way to think about it is to compare the costs with the benefits that accrue at the individual company level from company management getting a tighter grip on their business and being able to manage more precisely. These are the benefits alluded to by Jeffrey Immelt of General Electric when he said "I think SOX 404 is helpful. It takes the control discipline we use in our factories and applies it to our financial statements."

Of course, investors do not have an interest in needlessly expensive internal control audits, and there is merit to the view some have expressed that public company

[4] Committee staff has cited a graduate student dissertation that estimates negative market reaction to Sarbanes-Oxley as costing investors over $1 trillion. This paper suffers from numerous methodological flaws, primarily the characterization of political events so as to make their coincidence with market moves fit the author's hypothesis (e.g. every political event that coincides with a market downturn is characterized as a pro-regulatory event regardless of the event's actual meaning) and is contradicted by other multiple other studies, e.g. Rezaee, Z. and P. Jain, 2003. The Sarbanes-Oxley act of 2002 and security market behavior and Li, H., M. Pincus, and S. Rego, 2004. Market reaction to events surrounding the Sarbanes-Oxley Act of 2002. Working paper, University of Iowa.

auditors have overcharged companies in the initial round of audits. However, the appropriate response is not the repeal of investor protections, but sensible changes in the guidelines and rules for both issuers and auditors. For starters, the SEC should consider providing substantially more guidance to issuers in preparing their attestation on internal controls. Secondly, as Arthur Levitt discusses in his attached op-ed piece, there are a number of areas where audit firms appear to have inappropriately duplicated internal control documentation. In all of these areas the SEC and the PCAOB should be working between now and 2007 to lessen the burden on all issuers, and in particular smaller issuers.

But ultimately, the AFL-CIO believes that those who want to weaken Sarbanes-Oxley must answer the question—why should a company that cannot attest to the adequacy of its internal financial controls be able to offer its securities to the investing public?

In conclusion, the AFL-CIO is prepared to assist this committee as you continue your work in this vital area of investor protection and capital markets integrity. We appreciate the opportunity to testify today. Thank you.

Mrs. MILLER. Thank you all so very much.

Mr. Hubbell, I was interested to hear of your background in the marina business. My family was from the marina business, and I remember during the 1980's when Congress had some unintended consequences in the marina industry, the boating industry, when they passed the luxury tax and they wanted to make sure that they were taxing the rich. And, of course, what they did instead was drive most of the boat manufacturer companies that employed just average workers all over our Nation out of business, and the wealthy ended up buying boats from foreign nations and just documenting those boats offshore and bringing them in. So people do find a way all around that, and Sarbanes-Oxley, in some ways is, again, the unintended consequences, I think, of an action by Congress, unfortunately.

Let me just ask generally one question. You know, we have said that the goal with Sarbanes-Oxley, of course, is full transparency and internal controls and tightening of financial reporting. How can we actually bring down the cost? I thought it was interesting to hear Mr. Dowski talk about the president of Nasdaq, some of the various recommendations that he had made. And Mr. Pollock mentioned about Representative Flake's piece of legislation about voluntary compliance. I am not quite sure about all of that, but I would just pick up a little bit on what Representative Lynch brought up earlier, which I thought was, again, as was mentioned, a common-sense approach.

What is your thought about actually, rather than just changing 404, making it—that you would do reporting every other year or, even as Representative Feeney had mentioned, that you do something similar to what the IRS currently does with all of our tax returns, just a random sampling, which seems to be able to keep the entire Nation on its toes. Why not utilize that type of an approach here? I just throw that out to the panel.

Mr. HUBBELL. If I could comment on that, I think all those are good ideas. I think more importantly there have to be definitions applied, and somebody mentioned earlier this morning about materiality. Our net profit in both of our companies, after tax, for this prior year was about $80 million net after tax. And our auditing firm was using materiality of $100,000. Now, whenever you get to that small number, if that is their threshold, it took them a lot of time to try to look for $100,000 things.

So I think if we could apply some definitions—in the case of our company, we are controlled corporation; insiders own 60 percent, so it would be hard to argue that anything we do is in violation of the stockholders' interest. So it is things like that, I think just some definitions.

Mrs. MILLER. Yes?

Mr. POLLOCK. Madam Chairman, I think that once every 2 years would be a distinct improvement on every year. Once every 3 years would be better. A voluntary standard would be even better.

As I said in my testimony, you do not help shareholders by imposing excessive costs done to standards which are unreasonable, which the "other than a remote likelihood" standard is, in my judgment, entirely unreasonable. And that is what generates a lot of the excess paperwork, that plus the fear on the part of the account-

ing firms that any mistake is life-threatening in terms of professional life. When you are operating under fear like that you get unreasonable sorts of responses.

So I think we ought to move in a positive direction, and I would support anything in a positive direction, but I would take several other steps besides the ones suggested.

Ms. HINCHMAN. Madam Chairman.

Mrs. MILLER. Mr. Silvers first.

Mr. SILVERS. I think that the question is very well posed. I think that it is clear that we are in current—while as you can tell from my testimony we feel very strongly that public companies ought to have audited assessments of their internal controls and that individual investors particularly will be put at risk by, say, a voluntary system or an exemption, big institutions will have various ways of protecting themselves, and individuals I think will not.

Given that those things are—that is our position, we do feel that it is important to explore the very question you are asking, which is: How can this be made more cost-effective? How can it be right-sized? And I like Ms. Hinchman's phrase there very much.

I do not believe that running out—extending the time periods—I mean, A, I think as Congressman Lynch indicated, doing this every 2 years would require a change in the statute. I do not believe that is the right approach. I believe it is well intentioned, and I believe there are more dangerous things than doing that. But I do not believe it is the right approach, and here is why: because investors want to have annual financial statements they can rely upon, and having adequate internal controls at all times is a vital component of having a financial statement annually that you can rely upon.

Now, that being said, I think that there is a reasonable basis—and I am affected by the testimony I have heard about this—that to look at the issue of whether the standard for materiality is the right—has been rightly phrased here.

Now, frankly, I don't think that is Congress' job to do that. I think that we in general have an accounting system at every level where we rely upon independent bodies—FASB, COSO, PCAOB—to set these standards and to deal with the technical issues. But I think that this is one area that might be worth looking at.

I also think that there are a variety of ways in which the practice in this area has become duplicative, and I think the best statement, as I indicated in my testimony, around this issue was the one by Arthur Levitt, just pointing out places where it appears that audit firm practice has essentially documented things twice.

Finally, something that a number of commentators have noted about this situation is that while the PCAOB has given extensive guidance to audit firms as to what to do, almost no guidance has been given to issuers, to the folks at this table, as to how they ought to prepare their assessment. This is a responsibility that lies with the SEC. I do not want to be critical of the SEC. I think both under Chairman Cox and Chairman Donaldson that the Commission has been very ably led today and in recent years. But this has slipped through and needs to be addressed.

The focus here throughout ought to be, again, this concept of right-sizing. We do need to see to it that audit firms know the dif-

ference between a 60-person company and a 600,000-person company, and that ought not to be too hard and should not require weakening fundamental investor protections.

Mrs. MILLER. Ms. Hinchman.

Ms. HINCHMAN. Yes, thank you, chairman. I think that one of the things that was talked about in the earlier panel—and Mr. Hubbell had made reference to it as well—is this whole concern about materiality and about how the internal control audits are conducted. And I think that this is the big challenge, and FEI does believe that the PCAOB and the SEC has a very important role to help guide companies through that process. And I had mentioned in my verbal testimony that there were often Q&As from staff to try and give further guidance, and there were some tenets and principles that were articulated by the PCAOB and the SEC over the last 2 years to try and articulate and direct companies and auditors in particular to take a risk-based approach to their audit, and to effectively not be concerned about, as I like to say, count the pencils in the supply room, but really look at the challenges that are going to be a high risk to the entire enterprise or company.

And I think what Mr. Silvers says is absolutely true, that I think that the PCAOB and the SEC are up to the task to give the guidance to companies versus a company that has 60 employees versus 2,000 employees. And there is an opportunity to scale the requirements and compliance for these provisions to those different size companies without an outright exemption.

Mr. POLLOCK. My colleagues have a lot more faith in regulatory agencies than I do, Madam Chairman.

Mrs. MILLER. Mr. Dowski.

Mr. DOWSKI. Yes, I listen with fascination to people that are not involved on a day-to-day basis with running companies. I will give you an example of the current standards of reasonableness in terms of the implementation of SOX 404. We have a company in California called MS Microwave. It has 40 employees, does about $10 million of revenue, surveillance equipment.

Under the current SOX regulations, they have an IT department that is actually one individual who runs their servers and keeps all their PCs up. We failed our SOX audit out there for many reasons, but one of which was we did not have adequate controls under IT. According to the SOX regulations that are enforced today by the auditing firms and by the PCAOB, that one individual had to hold a meeting, had to write out minutes, had to actually invite somebody else to the meeting so that there would be a witness to the meeting, and had to do that on a quarterly basis and review the statuses of his IT environment with at least two outside experts. That was deemed to be efficient and effective IT controls.

It is insane. The way it is being enforced is insane. And I am not—I think there are a lot of arguments to be said against making exemptions. The problem is that 404 is all of 20 pages. Simply, somebody has to sit down and say, look, we cannot apply the same standard uniformly to a very large company and a very small company. There has to be an interpretation of the definition of reasonableness and materiality that many of the people have talked about, anecdotally or directly. And that is the thing, when you get right down to it, that drives small companies, like ADG, which is

really a collection of seven even smaller companies, it drives you to drink because the standards are just unreasonable. You have separation of control duties. Three different people have to handle the checks. Somebody has to request the check. Somebody else has to print the check. And the third person has to sign it. In some organizations, we have one person doing the same thing, and yet it is a material weakness because we do not have those controls in place. It is just insane. So there has to be a standard of reasonableness applied.

Mrs. MILLER. Thank you.

Representative Lynch.

Mr. LYNCH. Thank you, Madam Chairman.

First of all, I just want to say, just as a matter of disclosure, I actually am a member of the AFL–CIO. I am an active member. I pay my dues every month, so I am probably an investor as well.

I do want to say that—you know, and I have concerns from that end. I participate in a pension fund and a lot of my constituents do as well. And so I am very interested in the transparency and the accountability and the security that is provided by certain aspects of Sarbanes-Oxley.

But I also know that these smaller businesses are really an incubator of great innovation in this country and that the burdens here are disproportionate to the protections they are providing.

I heard Ms. Hinchman and also Mr. Pollock, they both sort of hit on the material risk standard, if you will, and whether or not moving to that standard would satisfy the concerns that you have raised. And I just—we have to have some balance here. We have to have some balance, because right now I think just the costs that we are talking about.

And so I want anyone who feels equipped to address that issue—and I also want to talk about the biennial issue here about having these full, independent audits done every other year, because I have to say that having sat on a union pension fund, you know, as a trustee, the fact that a company has to go through this process in, say, the odd-number year and then they realize that the next year they are attesting to the internal controls and procedures that they have in place, it seems very odd that they would leap off that standard in the even-number years knowing that they are going to be inspected again on the odd-number year. I just do not see that divergence occurring under realistic circumstances. So I am less concerned with the every-other-year situation.

But you may be right. It may not be the ideal solution here. Maybe it is something along Mr. Pollock's line of thought where it is voluntary in a sense, but with, you know, encouragement with the SEC and PCAOB, I don't know.

The last—and I know I have given too many questions already, but Mr. Pollock and Ms. Hinchman also suggested that the SEC and the PCAOB already have the ability to do this internally, and you are right, I think they are well equipped to do that. But are they willing to? That seems to be my question. And do they not need under the circumstances some—do we need to act here? I get the sense that we do because nothing is happening. I would love to see this thing handled by the SEC or PCAOB, but I just do not know, with everything else they have going there—my goodness,

we do not even have folks at the SEC to train and to coach the issuers in these cases how to go about compliance with Sarbanes-Oxley.

So I am a little bit skeptical that they would be able to leap into the fray here and come up with a regulatory solution.

Ms. HINCHMAN. Mr. Lynch, I think part of the challenge is, particularly with the PCAOB, when AS2 was issued, that they really did rely very heavily on what is called principle-based accounting. And they did that intentionally because there was a drive in the accounting, financial reporting world to go in that direction.

Mr. LYNCH. Principle as opposed to rule-based?

Ms. HINCHMAN. Correct.

Mr. LYNCH. OK.

Ms. HINCHMAN. But our auditing profession is very much reliant on rules-based accounting, and so it has been a very difficult transaction for the auditors to rely on AS2 and to make the determinations for how to interpret those principles, predominantly because of liability concerns. And we are sympathetic to that issue. I think that is a big part of what is driving the procedures and the way that people are performing these audits these days.

But from year one to year two, I think that you have been able to see a growing sense of confidence, both on the auditor's part and also on management's part, on how to conduct these internal audits. And I think that would go a long way, if the PCAOB could give a little more rules-based direction on how to interpret and use AS2 and get out of some of the examples that Mr. Dowski had made mention to earlier, and allow them to really focus with confidence on a risk-based assessment on how to conduct the internal audit.

I also think that the SEC does need to step up to the plate more, in terms of giving guidance to the issuers, as you said.

Mr. POLLOCK. Congressman, I very much share your skepticism on whether the SEC and PCAOB would step up to this issue. It is quite clear that the SEC did not know what its regulation would entail. These are unintended consequences from their point of view as well, also for the PCAOB. They did not understand, when they were regulating, what was going to happen.

Both the SEC and the PCAOB have subsequently quite severely criticized the accounting firms for what they have done, and as our colleague suggested here, the accountants, of course, have a rather serious conflict of interest in that the more burden there is, the more profitable they become.

But neither the SEC nor the PCAOB accepted any responsibility for the morass of bureaucracy they caused, and if you think about the incentives, unlike Congress, which is a balancing body, to balance interests and balance costs and benefits, the incentive structure of any regulatory body is to avoid embarrassment at all costs and to be quite insensitive to the costs imposed on other people in order to make sure that you do not get in trouble. And I think we have that problem with both of these agencies.

If I may just add one other comment, I do think that the status of the PCAOB needs to be reformed as well. It is clearly functionally a regulatory body. It needs to be brought under congressional oversight, appropriation, and control, just like every other regu-

lator, and I do think that was a mistake in Sarbanes-Oxley which should be rectified.

Mr. SILVERS. Congressman, let me answer the two questions that you sort of posed conceptually, and then I want to make a remark about the regulatory agencies as well.

The question of doing an internal control audit every 2 years as opposed to every year really raises the question of: Is the internal control audit an integrated whole with the audit of financial statements? In our view it is. If you are not—and, you know, one could take the view that we only need an audit of the financial statements every 2 years. But if you are going to represent to investors on an annual basis that on X date you can rely on these numbers, you also need to, I think, provide investors an assurance that the process that produced those numbers has some integrity to it.

I think that we are now sitting at a moment where we have just been through the startup period against a background in which public companies had essentially been lax in relation to internal controls because no one was watching. As I said in my testimony, there has been a requirement to have adequate internal controls for public companies for close to 30 years. But when people actually started, you know, opening up the hood and looking to see what was there, it turned out that really that was not what was going on at all.

Now, so I think that is the conceptual issue your proposal raises, and candidly, I have heard it for the first time today, and my reaction I think would be the reaction of many people in the investor community, that we want an annual audited financial statement that we can count on and that integration matters. I mean, I understand what you are trying to achieve and am sympathetic with your ends, but I am not sure that is the right way to do it.

Now, in relationship to the materiality standard, I do think that is an area that ought to be looked at, but I want to give you this warning. A, as I said earlier, I think this is an area—these kinds of standards are traditionally an area in the accounting area where Congress has deferred to these independent agencies on the details. It is very much the kind of oversight process the chairwoman alluded to before.

The warning around materiality is this: If you have too high a number threshold around internal controls materiality, you run the risk that auditors will not be looking—that neither the internal financial controls people nor the auditors will be paying much attention to symptoms of larger problems, that very big problems tend to start small.

I do not pretend to know what the right answer is here, but when you think about getting to the right answer, it is not just a question of is that particular control of that particular account likely to blow the company up. It is, are you learning something by looking at that, the weakness of that control that tells you that there are larger systemic risks. And we have to build that in somehow into the process.

Now, finally, with respect to the regulatory agencies, the Nation owes a deep debt of gratitude to the Public Company Accounting Oversight Board. When it was established in the fall of 2002, we were in a crisis period. Thanks to Bill McDonough and to his suc-

cessor, Bill Gradison, who is the Acting Chair, and the very good people who worked there, the fundamental integrity of the financial reporting system in the United States is not really in doubt today in the way it was in September 2002.

I do not believe it is fair to characterize them the way that my friend Mr. Pollock has. Those people are dedicated servants to the Nation and we owe them a debt. Can they—and their colleagues at the SEC, whom I have equal and profound respect for, can they do the right-sizing that is really needed here? And I think the answer is unquestionably yes. Not only can they, but really no one else can. This involves a level of detail, expertise, and interaction with the various components here and attention over time that only those agencies really have, in conjunction with COSO, I believe. I do not think there is really an alternative, and I think that they are eminently able to do it.

Mr. DOWSKI. I think that the key issue is whether or not they are willing to, in the environment that we are in today, take a risk and step out and interpret those rules in a less than uniform way. I think that is—you know, I think that is really at the heart of the debate on 404 if you really sort of break it down and look at why a lot of companies like ADG are saying that this is just not a workable implementation plan.

You know, I think Ms. Hinchman hit on a good point in that there has to be a shift from historical rules-based to principle-based interpretation in a lot of the implementation areas, and that PCAOB has started down that path, but the auditors in the environment are in with the increased liability and what they saw happen to Arthur Andersen are simply sitting there wants to check the box. And if they have a schedule that they have to fill out and they cannot check every box, then they are going to keep working it until you can get closer to checking those boxes. They will make that one guy hold a meeting and write up some minutes and document it so they can check that box. And that is the thing that really has to be changed and adjusted. Whether the PCAOB can do it or the SEC can do it or whether Congress should do it, I mean, I think we ought to use the organizations we have and put the onus back on auditors.

The other issue is that auditors have gone from being an advisor to companies to being an antagonist with companies, and that is really something that has happened. I have been doing this for 20 years, and since 2002, the biggest thing that has changed is the rules have gotten more complicated, and you cannot call up your audit partner and ask, "Here is what I think about the interpretation of this opinion and here is what we are doing. Do you think this is the right thing?" They will not give you an answer. They will say, "Write it up. Send it to us, and we may or may not tell you that it is an issue." They may or may not tell you that during the quarter, and then at the end of the year, they will come back with a whole list of other questions that you did not answer correctly. And that is part of this, I think, environment that has to change and improve as we move through, you know, the reactions that we all had to what happened in 2002, and to an environment where this thing becomes a lot more rational.

I mean, nobody is going to argue that the shareholders do not—are not entitled to good internal controls. I think people in the financial profession have been stressing good financial controls because they are the basis on which you make reliable financial statements. You know, long before this came up, people were focused on controls. The breakage now is because we have now taken one standard for what is an acceptable internal control and we are applying it uniformly against the landscape of the American economy, and it just does not make any sense at the practical level.

Mr. LYNCH. Thank you.

Mrs. MILLER. Thank you all so very, very much, sincerely, for your attendance today. I think this has been really a fascinating hearing, and again, I think the impetus for the hearing was everybody seeing that something is wrong with the 404 and the way that it is being implemented, and as many of you mentioned, the Commission and the Board certainly have the ability to be proactive and to do something short of Congress taking legislative action and whether or not they have the will. A way that they may have the will is to see that Congress—there is sort of a growing momentum here congressionally for some action, and we would like to preclude that kind of a thing if they would move on something more reasonable. The standard always has to be reasonable.

So we appreciate you all coming and appreciate the ranking member, and with that the meeting will be adjourned.

[Whereupon, at 12:19 p.m., the subcommittee was adjourned.]

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