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Via e-mail to: rule-comments@sec.gov

U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549-1090
Attention: Elizabeth M. Murphy, Secretary

Reference: S7-29-10 December 15, 2010

Dear Ms. Murphy,

Thank you for the opportunity to provide comments on the SEC's planned study on reducing the burden of complying with section 404(b) of the Sarbanes-Oxley Act of 2002 for certain smaller public companies. I have worked in internal audit and in accounting functions at subsidiaries and a holding company and as the controller of funds of private equity funds. In addition, I have performed a study of the impact of Switzerland's new requirement for an audit of the existence of internal control over financial reporting (ICFR) on the audit fees of Swiss companies listed on the Zurich stock exchange. I hope that my knowledge in those fields can provide some valuable suggestions for the planned study.

I strongly recommend that the SEC proposes the research questions, methodology, data definition and data sources for its study for public comment in order to enable feedback on possible flaws in those areas before the data collection and analysis phase of the study. I also recommend that the SEC asks the GAO to do the same for their study of the impact of exempting non-accelerated filers from compliance with section 404(b) of the Sarbanes-Oxley Act of 2002.

In addition, the SEC could analyze the following options to reduce the cost of compliance with section 404(b) of the Sarbanes-Oxley Act of 2002 while protecting investors in non-accelerated filers and smaller accelerated filers

1. Options to reduce the cost of auditing ICFR while protecting investors

1.1 Require disclosure that no audit of the effectiveness of ICFR was performed

The issuer should be required to disclose that the effectiveness of ICFR was not audited due to an exemption of the SEC for issuers that are neither accelerated filers nor large accelerated filers. This disclosure could be similar to the disclosure that is required by the instructions to item 308 of regulation S-K for newly public companies.

The auditor should be required to disclose in its audit report that it did not audit ICFR for the purpose of expressing an opinion on its effectiveness, but only to determine the timing and scope of its audit procedures for purposes of expressing an opinion on the financial statements. The SEC could include such a requirement in Rule 2-02 of regulation S-X and/or the PCAOB could require such language in audit reports in its auditing standards.

1.2 Require disclosure of information obtained during the financial statement audit

The SEC could require issuers that are not required to have an audit of the effectiveness of their internal control over financial reporting (ICFR) to disclose in their quarterly and annual report (where applicable):
- any material weakness in ICFR that was communicated to the issuer by its auditors as required by the PCAOB's auditing standards
- any adjustments to the financial statements that were presented to the auditors as a basis for the audit, which were identified by the auditors
- any restatement of previously publicly disclosed financial statements or information that is based on financial statements (e.g. earnings releases) due to fraud or error that occurred during the quarter or during the fiscal year (in the case of an annual report).
- an explanation why those adjustments and restatements were not prevented by the issuer's ICFR
- any planned or actual changes to ICFR in response to such audit adjustments or restatements
- an explanation why the issuer chose not to make any changes to ICFR in response to such audit adjustments and restatements
- a confirmation by the auditor that all material weaknesses and all audit adjustments that were communicated to the issuer are disclosed by the issuer

1.3 Provide guidance about the impact of audit adjustments on restatements on management's assessment

The SEC should consider providing guidance for issuer's about their obligations to react to audit adjustments and restatements due to fraud or error. Such guidance could cover investigating the reasons for such adjustments and restatements, changes to ICFR where the cost of control justifies the benefit and any impact on management's assessment of the effectiveness of ICFR and of the effectiveness of disclosure controls and procedures.

1.4 Require a noisy withdrawal of CFOs and key accounting personnel

The SEC could consider requiring issuers to disclose whether any disagreement over any matter of accounting principles or practices or financial statement disclosure was one of the reasons for the departure or the announcement of the departure of the chief financial officer or key accounting personnel (i.e. something similar to item 304 of regulation S-K). The fact that key accounting staff are leaving an issuer or that their employment was terminated by the issuers and certain reasons for that are important disclosures to investors.

1.5 Extend the exemption from compliance with section 404(b) to smaller accelerated filers

The SEC should estimate the cost of compliance with section 404(b) for smaller accelerated filers, should disclose this cost to investors in smaller non-accelerated filers and should ask those investors about their assessment of the relationship between the costs and the benefits. The SEC could also ask investors in non-accelerated filers and in smaller accelerated filers what maximum percentage reduction in net profit after taxes they would be willing to bear in order to receive more accurate and reliable financial reporting.

The SEC should then consider, whether to permanently exempt smaller accelerated filers or at smaller accelerated filers that do not meet certain annual revenue thresholds from compliance with section 404(b) of the Sarbanes-Oxley Act of 2002. The SEC should be mindful that the

market capitalization of certain accelerated filers primarily reflects the investors' expectations that certain small research oriented companies will be able to develop a product and to generate profit *in the future*. Those companies may be very small in terms of total assets and revenues and may have fewer resources to bear the cost of a section 404(b) audit than other accelerated filers with a similar market capitalization. In addition, the valuation implied by this market capitalization and the investment decisions of the investors are primarily not based on the financial statements, but on non-financial disclosures, such as the results of certain clinical trial milestones, certain FDA approvals or the granting of patent protection. The financial statements of such issuers will primarily consist of cash expenses and of a few assets. It is questionable, whether the effectiveness of ICFR for the preparation of financial statements that are not very relevant for investment decisions by investors should be subject to an audit at companies who do not have many resources to bear this additional cost.

1.6 Require an audit of the effectiveness of ICFR less frequently than every year

After the study that was suggested above, the SEC could consider, whether to require an audit of the effectiveness of ICFR less frequently than every year (e.g. every three years or every five years). However, this will only result in less compliance cost if issuers have the market power to pressure their auditors to lower their audit fees for years during which no additional audit of the effectiveness of ICFR needs to be provided.

1.7 Only require an opinion on the effectiveness of the design of ICFR

The SEC could consider requiring an audit opinion of ICFR that requires fewer audit procedures and thus a lower audit fee (e.g. an opinion on the design effectiveness of ICFR and whether controls have been placed in operation).

Starting with financial years beginning on or after January 1, 2008, Switzerland required certain public companies and large and medium private companies with limited liability to have an audit of the "existence" of internal control over financial reporting. The requirements for such an audit are similar to a SAS 70 type I opinion (i.e. the auditor audits the design of controls and whether they have been put in operation). However, the audit opinion only states whether a system of internal control for the preparation of the consolidated financial statements or for the individual financial statements exists. However, the Swiss auditing standard does not require an opinion on the effectiveness of the design of ICFR.

I have studied the impact of this new requirement to have an opinion on the existence of ICFR on the audit fees of Swiss companies that are listed on the Zurich stock exchange. I used an audit fee regression model of publicly disclosed audit fees and audit fee determinants for the financial years 2006 to 2008 that controls for other factors that influence audit fees. The regression coefficient for the opinion on the existence of ICFR dummy variable implies an average increase in audit fees by 10% at companies that received an opinion on the existence of ICFR in the financial year 2008 and that did not receive a different kind of opinion on ICFR (e.g. on the effectiveness of ICFR or on the suitability of the design of ICFR).[1]

[1] *See* Georg Merkl (2010), "Auswirkungen des neuen Revisionsrechts auf die Prüfungshonorare von SIX-kotierten Schweizer Unternehmen", Schweizerische Zeitschrift für Gesellschafts- und Kapitalmarktrecht sowie Umstrukturierungen, No. 3/2010, p. 360-368, the details of the research methodology are available on request.

2. Review existing research on listing choices of companies and interview companies

The SEC should review existing research on factors that influence listing decisions of companies and decisions to go private or to go dark.[2] Any study of the effect of the cost of section 404(b) on the choice to list on a national securities exchange in the U.S., on a foreign securities exchange, to go private or to go dark would need to include these other factors as control variables. In addition, listing choices may vary over time. For example the current valuations implied by the ratio of enterprise value to EBITDA that are implied in stock prices when adjusting for net financial debt may fluctuate over time and imply a more favourable climate to go public. Furthermore, the SEC should study changes to listing eligibility criteria of stock exchanges over time. Companies may qualify for a listing under the eligibility criteria of a foreign stock exchange, but may not be able to fulfil the eligibility criteria for U.S. securities exchanges. Due to the multitude of factors, it will be very difficult to isolate the effect of the cost of section 404(b) on listing choices. The SEC should be very cautious to interpret the results and should prominently disclose any limitations and caveats of a study by the SEC. In addition, the SEC could interview U.S. and foreign companies that would have fulfilled the listing criteria of national securities exchanges in the U.S., but that chose to list on foreign securities exchanges, about their reasons for not listing on a national securities exchange in the U.S.

3. Remedy certain weaknesses in the SEC's recent section 404 cost-benefit study

3.1 Interview investors in non-accelerated filers about their cost-benefit assessment

The SEC did not interview any investors in non-accelerated filers or securities analysts that cover non-accelerated filers in its recent study of the costs and benefits of compliance with section 404 of the Sarbanes-Oxley Act of 2002. The SEC's only interviewed eight individuals from five investors, five individuals from two corporate lenders, fifteen individuals from six companies that provide securities analysis and two individuals from one credit rating agency (i.e. only 30 individuals in total) in its recent study. In addition, although the decision whether to exempt non-accelerated filers was one of the reasons and possible uses of this recent study, *none* of the interviewed investors invested in non-accelerated filers and *none* of the interviewed securities analysts analyzed non-accelerated filers.[3]

To address this major weakness of the study, the SEC should identify non-accelerated filers and smaller accelerated filers through annual reports filed with the SEC and through their market capitalization in financial databases. The SEC could then identify larger shareholders in those companies through the use of the information on security ownership of certain

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[2] *See* Craig Doidge, G. Andrew Karolyi & René M. Stulz (2009), "Has New York become less competitive than London in global markets? Evaluating foreign listing choices over time", Journal of Financial Economics Vol. 91, p. 253-277; Joseph D. Piotroski & Suraj Srinivasan (2008), "Regulation and Bonding: The Sarbanes-Oxley Act and the Flow of International Listings", Journal of Accounting Research Vol 46 No. 2, p. 383-426; András Marosi & Nadia Massoud (2008), "You Can Enter but You Cannot Leave…" : U.S. Securities Markets and Foreign Firms, The Journal of Finance, Vol. 63 No. 5, p. 2477-2506; Christian Leuz, Alexander Triantis & Tracy Yue Wang (2008), "Why do firms go dark? Causes and economic consequences of voluntary SEC deregistrations", Journal of Accounting and Economics, Vol. 45, p. 181-208; Ellen Engel, Rachel M. Hayes & Xue Wang (2007), "The Sarbanes-Oxley Act and firm's going-private decisions", Journal of Accounting and Economics, Vol. 44, p. 116-145; for an overview see also Robert Prentice, "Sarbanes-Oxley: The Evidence Regarding the Impact of SOX 404 (2007), Cardozo Law Review, Vol. 29 No. 2, p. 733-785, http://cardozolawreview.com/Joomla1.5/content/29-2/29.2_prentice.pdf

[3] SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, October 2, 2009, http://www.sec.gov/news/studies/2009/sox-404_study.pdf, p. 85

beneficial owners in the annual reports that is required by item 308 of regulation S-K. In addition, the SEC could identify shareholders of such companies through filings made by investment managers. The SEC could primarily identify investors in companies that responded to the optional benefit part of the SEC's recent section 404 cost-benefit study in order to ask follow-up questions and to provide cost disclosures to those investors during the interviews.

3.2 Inform investors about the cost before asking about their cost-benefit-assessment

The objective of the requirement of audits of the effectiveness of internal control over financial reporting is to protect investors through more accurate and reliable financial reporting. However, the investors indirectly bear the cost of regulation for their protection in the form of reduced profits after tax (investors in equity) or in the form of reduced earnings before interest, taxes, depreciation and amortization (EBITDA) that are available to service debt (investors in debt). Any costs for the protection of investors that are ultimately borne by these investors should not exceed the benefits for these investors. However, the investors typically *do not know* the costs of compliance with section 404 because they are not disclosed to investors. The SEC conceded in its recent cost-benefit study that users of financial statements generally would not be expected to have direct insight into companies' cost of compliance with section 404.[4] Furthermore, the users of financial statements that were interviewed during this study generally indicated that they could not provide direct insights into the cost of section 404 compliance.[5] Investors cannot make a meaningful assessment of the costs and benefits of compliance with section 404(b) unless they know the estimated costs.

As a consequence, the SEC should disclose the estimated cost of compliance with section 404 of the respective public company in which an investor is invested during the interview in a form that is meaningful to the investor, such as the percentage reduction in net profit after taxes or in EBITDA and then let them make an *informed* judgement whether the costs outweigh the benefits. The SEC should estimate the cost of compliance with section 404(b) for non-accelerated filers and for smaller accelerated filers using the cost data from its previous study. The SEC should then obtain the profit before tax from financial years prior to the year of first compliance with section 404(b) and calculate the profit before tax less the estimated compliance cost. In a next step, the SEC could apply the average tax rate implied by the difference between profit before tax and profit after tax in the financial statements to calculate the adjusted profit after tax and after section 404(b) compliance costs. During the interview the SEC could then inform investors that the estimated cost of compliance with section 404(b) is equivalent to a percentage reduction in net profit after tax of X% for the company that they are invested and ask them about their assessment of the relationship between the cost of compliance and the benefits perceived by them.

3.3 Replace estimates of section 404(b) audit fees with estimates from an audit fee model

A major drawback of the SEC's recent study was its reliance on public companies' *estimates* of the cost of the audit of the effectiveness of internal control over financial reporting (ICFR) as a percentage of the total audit fee charged by their registered public accounting firm and its affiliated firms. The study did not ask any open questions about the basis for these estimates, such as whether auditors separately disclosed the fee for the audit of the effectiveness of ICFR.

[4] SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, p. 87
[5] SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, p. 88

Since the audit of the effectiveness of ICFR and of the financial statements is performed by registered public accounting firms and since the role of public companies in the audit is limited to providing access to their accounting records and answering questions from their auditors, the audit procedures performed by the audit firm are essentially a black box for the public companies' staff. In addition, a traditional audit of financial statement has always included an audit of the design and of the effectiveness of parts of ICFR. As a consequence, the incremental audit effort to audit the entire ICFR for purposes of providing an opinion on its effectiveness is also hard for auditors to identify and to track on their internal time sheets. So many auditors are likely not to separately disclose the fee or the amount of audit hours billed for the audit of the effectiveness of ICFR on the audit fee invoice to their clients. Even if they do, the reliability of such separate fee amounts is likely to be limited due to the difficulty of identifying the incremental effort, In fact, most of the auditors that were interviewed in the SEC study expressed the view that audit companies do not provide information to companies to distinguish the fees due to the financial statement audit from fees due to the audit of ICFR. In addition, most of the interviewed auditors asserted that they could not isolate the portion of the audit fees associated with testing internal controls that is incremental to what would be necessary for a traditional audit of the financial statements.[6]

As a consequence, the SEC should consider estimating the audit fee for auditing the effectiveness of ICFR as the difference between the actual audit fee for the integrated audit and an estimated audit fee for the traditional audit of the financial statements. Such an approach has been used in existing academic research on the impact of section 404.[7] The audit fee model would use audit fees and audit fee determinants for prior financial years without section 404(b) audit opinions from small accelerated filers and then apply the coefficients from the model to audit fee determinant values for financial years with section 404(b) audit opinions for those filers in order to arrive at an estimated audit fee for the traditional audit of the financial statement in these integrated audit years for those small accelerated filers. The SEC could also use audit fee models to calculate the estimated section 404(b) audit fee that non-accelerated filers would need to pay.[8]

4. Review past cost-benefit estimation practices and determine need for improvement

4.1 Public disclosure of reasons for disagreeing with cost-benefit data from the SEC study

After the publication of the SEC's recent study on the costs and benefits of compliance with section 404 of the Sarbanes-Oxley Act of 2002, the SEC decided not to make another temporary exemption for non-accelerated filers from compliance with section 404(b). To my knowledge, there was no open meeting of the Commission and no other public disclosure of the SEC's consideration of the results of the SEC study of the costs and benefits of compliance with section 404 and the SEC's reasons for this decision in light of those results. This is surprising, because a majority of the public companies that were surveyed in the SEC study, especially smaller companies, felt that the costs of compliance with section 404 outweighed the benefits.[9] In addition, some users of financial statements that were

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[6] SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, p. 94

[7] *See* Caren Schelleman, Rogier Deumes & Maria Finkeldei (2007), "SOX 404 Related Audit Fees and their Determinants" (unpublished working paper, 2007), available at Maastricht University

[8] *See* R. Mithu Dey & Mary W. Sullivan, "What Will Non-Accelerated Filers Have to Pay for the Section 404 Internal Control Audit?" (unpublished working paper, 2009), available at http://www.fdewb.unimaas.nl/ISAR2009/02_15_Dey_Sullivan.pdf

[9] SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, October 2, 2009, p. 96 and 61-64

interviewed in the SEC study indicated that the improvements resulting form section 404 compliance may not justify the associated costs, especially for the smaller companies.[10] In the case of such a subject matter that has created substantial public interest and interest by congressional committees, it would have been preferable to have some government in the sunshine and explanations of the basis for this decision. In the end, Congress ultimately chose to override this decision of the SEC by permanently exempting non-accelerated filers from compliance with section 404(b) of the Sarbanes-Oxley Act of 2002 directly in the statute. In my opinion, the SEC should be more transparent about its reasons for taking regulatory actions that impose significant costs on a larger number of businesses. In cases where commenters, academic studies or the SEC's own studies have the opinion that the costs of regulation outweigh the benefits from regulation, there is an even greater need to explain why those legitimate opinions or facts are not considered relevant enough to refrain from regulation or to exempt businesses from regulation.

4.2 Include costs of PCAOB auditing standards from cost estimates in SEC rulemaking

In its final rule to implement section 404 of the Sarbanes-Oxley Act of 2002, the SEC did not include the costs associated with the auditor's attestation report, although many commenters suggested that those might be substantial.[11] The SEC explained the lack of inclusion of those costs with the fact that the PCAOB, rather than the Commission is responsible for attestation standards. [12] The SEC also did not include a cost-benefit analysis later in its notice of filing of a proposed rule on Auditing Standard No. 2 or in its order approving this auditing standard.[13] Such an exclusion of costs of a regulatory action that the SEC delegates to a quasi-governmental organization and that needs to be approved by the SEC to become legally binding, seems to at least violate the spirit and maybe even the letter of the applicable rules for rulemaking. Both rules prepared by the SEC itself and rules prepared by the PCAOB or self-regulatory organizations can impose significant costs to issuers or pooled investment vehicles, which are ultimately born by the investors in the form of lower net profits after tax or higher administrative fees for funds.

4.3 Revising cost and benefit estimates and revising the need for regulation

The SEC should consider revising cost and benefit estimates that it made in final rule when experiences of actual costs or benefits after the implementation of that rule suggest that the original estimates were materially different. After issuing its rule implementing section 404 of the Sarbanes-Oxley Act in 2003, the SEC received indications about actual compliance costs from various parties, such as Financial Executives International that the cost estimates by the SEC grossly understated the actual costs. However, the SEC did not perform an updated analysis of the costs and benefits of compliance in its subsequent rules that provided temporary exemptions for certain categories of issuers from compliance with section 404.

The SEC should consider obtaining legal advice whether its past practices in quantifying the costs and benefits of temporary exemptions of certain classes of issuers from compliance with

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[10] SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, October 2, 2009, p. 91-92

[11] SEC Release No. 33-8238, Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, June 5, 2003, http://www.sec.gov/rules/final/33-8238.htm, section V.B.

[12] SEC Release No. 33-8238, section IV.D. footnote 169

[13] SEC Release No. 33-49544, http://www.sec.gov/rules/pcaob/34-49544.htm, and SEC Release No. 33-49884, http://www.sec.gov/rules/pcaob/34-49884.htm

section 404 in the form of avoided costs of compliance have not only fulfilled the letter of the law, but also the spirit of the law.

4.4 Timeliness of the SEC cost-benefit study

The SEC should review the factors that contributed to the long delay between the announcement of the cost-benefit-study to the Senate Committee on Banking, Housing and Urban Affairs and the completion of the study to avoid such problems in future studies. While it is understandable that the data collection could only begin after public companies had completed their audit of the effectiveness of their ICFR as of the end of their fiscal year 2007 and had filed their annual reports and proxy statements for that year, the methodology and the websurvey site could have been developed before that and the analysis of the data and the follow-up phone interviews should not have taken that long. In addition, it seemed unusual to outsiders that a professor from Wakeforest University was commissioned to perform the section 404 cost-benefit study. It seemed odd, that the study was not assigned to an academic that had already performed studies of the impact of regulation or changes to auditing standards on audit fees or studies on internal control over financial reporting in top accounting journals.

The U.S. House of Representatives Committee on Small Business initially demanded a study of the costs and benefits of compliance with section 404 of the Sarbanes-Oxley Act of 2002 for non-accelerated filers from the SEC in June 2007.[14] As a consequence, the former SEC Chairman Cox first announced a study of the costs and benefits of compliance with section 404 of the Sarbanes-Oxley Act of 2002 in his testimony to the U.S. Senate Committee on Banking, Housing and Urban Affairs on July 31, 2007. The start of a study of "real world" cost and benefit data was announced in a press release on February 1, 2008. It took until January 31, 2009 for the SEC to complete the survey phase of the study.[15] Eight months later on October 2, 2009 the SEC finally released the results of the study.[16] In total, it took the SEC over two years to issue the study after it initially promised such a study to the Senate Committee on Banking, Housing and Urban Affairs.

I appreciate the opportunity to comment on these matters and hope that my comments are useful in the rulemaking process. Please do not hesitate to contact me by e-mail if you have any follow-up questions.

Respectfully submitted,

Georg Merkl

[14] U.S. House of Representatives Committee on Small Business letter to SEC Chairman Cox, June 11, 2007
[15] SEC press release no. 2009-7, January 16, 2009, http://www.sec.gov/news/press/2009/2009-7.htm
[16] SEC Study of the Sarbanes-Oxley Act of 2002 Section 404 Internal Control over Financial Reporting Requirements, October 2, 2009, http://www.sec.gov/news/studies/2009/sox-404_study.pdf