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BEFORE

THE SEC ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES

WEDNESDAY, DECEMBER 14, 2005

I appreciate the opportunity to address the entire committee on the work of the 404 subcommittee and want to acknowledge all of my colleagues' hard work. It was a pleasure working with them.

As a committee, we have reviewed several issues affecting smaller public companies. It is clear however, that the impacts of Section 404 of Sarbanes-Oxley, particularly the implementation costs, have proven to be by far the most challenging. While I do not agree with several subcommittee recommendations, Section 404 is one of the key issues to focus on. Solutions to its overly burdensome cost, particularly on small issuers, are not simple.

Notwithstanding that I am the lone dissenting vote on the subcommittee, I do want to acknowledge that this group has examined this topic closely. They fully considered my concerns and those of others who commented on the proper ways to "fix" 404. We discussed dozens of ways and options for reducing costs, while maintaining investor protections.

We all agree that the costs of SOX are the real issue. They have been too high, exceeding all estimates, and they hit small companies much more significantly. There have been numerous cost studies and other anecdotal comments on whether these costs are or will be coming down in subsequent years. I think the evidence will only be clear once we have actual data in the coming months, because this is clearly not yet at a point of equilibrium. For many companies that have yet to go through the process, the initial costs will be high. There is no question about this.

Also, we all agree that internal controls at public companies are important. They are an important feature for accurate financial reporting, investor protection, and market integrity. Some argue that internal controls have been somewhat neglected, and SOX has tried to bring about some assurance that adequate controls are in place and working as desired. How the markets get that assurance -- that is, the level to which these internal controls need to be verified and tested by management and outside auditors -- is the rub.

The subcommittee goal was to reduce the cost burdens but maintain the investor protections associated with Section 404. These need not be mutually exclusive. My concern, and the basis for my dissent, is that the panel's recommendations make them mutually exclusive. We seem to say you can't have meaningful cost reductions unless you eliminate 404, including the investor protections.

Our biggest concern is that the main recommendations give a flat-out exemption from all auditor 404 involvement in reviewing and confirming internal controls. This is not for just a few, but for what will effectively be more than 80 percent of the public companies in this country.

One could cite any number of flaws in this approach, but three in particular stand out:

- First, the entire premise of SOX was to bolster investor confidence by requiring meaningful corporate governance and financial reporting reforms. Properly designed and functioning internal controls over financial reporting were and are a cornerstone of this legislation. Proper structuring and implementation of 404 requirements are very different from eliminating these completely for a broad segment of U.S. companies. That approach works against the statute's legislative intent and the directive that we heard from both Chairman Donaldson and Chairman Cox.
- Second, it is unclear to many whether the broad exemptive recommendations of this subcommittee are even within the commission's legal authority. Comprehensive, sweeping exemptions from Section 404 may not be possible under the current legislation, which specifically excluded Section 404 from the Securities and Exchange Act of 1934. As the full committee works toward final recommendations, it would be well served to resolve that issue, as I expect there will be legal challenges of this authority.
- Finally, and maybe most importantly, small public companies need checks and balances over financial reporting. They consistently have more misstatements and restatements of financial information, nearly twice the rate of large firms, according to one report. Alarming, they also make up the bulk of accounting fraud cases under review by regulators and the courts (one study puts it at 75 percent of the cases from 1998-2003).

A more balanced approach to fixing SOX 404 is to continue requiring manager assertions and auditor attestation of internal controls, but direct the appropriate regulatory and defacto standard-setting bodies (the Committee of Sponsoring Organizations of the Treadway Commission (COSO), the Public Company Accounting Oversight Board) and the SEC to develop specific guidance for small companies. These would specifically outline appropriate control structures and the auditing scope for small companies under 404 – a SOX 'light' approach.

Much of the outline for this approach appears in Recommendation 3 of the subcommittee's report. However, it comes only as a fall-back alternative to the exemptive recommendations. To ensure continued investor confidence in our markets, we deserve an approach that preserves the investor protection aspects of 404 while lowering costs to implement and verify proper internal controls over financial reporting.

It is clear that we need to do something for small companies. But giving them a pass on any verification and oversight of internal controls will come back to haunt us.

The subcommittee's recommendations will now attract a fuller public debate on some very important public policy issues. I would offer this challenge to investors and, indeed, all participants in the financial reporting process to get involved in commenting on these recommendations. It is important to reach the proper balance between cost and investor protection. Realignment not elimination of Section 404 is needed to accomplish that.