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### Highlights from SEC, PCAOB, FASB and IASB News- Including Sarbanes-Oxley Section 404 Requirements

#### SEC Seeks Input on 7 Questions for AS5; Univ. Pitt, Univ GA Studies Shed Light on Intended, Unintended Consequences of Sarbox

Yesterday (June 18) the SEC posted an unusual [“Notice of Additional Solicitation of Comments”](#) dated June 15, 2007, relating to PCAOB’s AS5. The June 15 Notice seeks comment on seven specific questions that pertain to AS5 – PCAOB’s new standard on internal control audits, replacing AS2. This notice seeking “additional” comment is in addition to SEC’s previous (June 7) [Notice of Filing of AS5](#) and related request for comment. From searching the SEC website, this is the first time I can tell the SEC has released a “notice of **additional** solicitation of comment” on top of a routine notice of filing and request for comment before approving SRO (self-regulatory organization) rulemaking, including PCAOB rulemaking.

The seven questions in SEC’s June 15 Notice on AS5 seek comment on:

- materiality
- significant deficiencies,
- multiple deficiencies and combinations of deficiencies (as they aggregate to significant deficiencies and material weaknesses),
- control deficiencies specified by AS5 and the SEC’s related interpretive guidance which would prevent the auditor from concluding a company’s internal control over financial reporting is “effective,”
- whether AS5 is “sufficiently clear about the extent to which auditors can use the work of others,”
- whether AS5 will “reduce expected audit costs under Section 404, particularly for smaller public companies, to result in cost-effective, integrated audits,” and
- whether AS5 “inappropriately discourage[s] or restrict[s] auditors from scaling audits, particularly for smaller companies.”

The comment deadline on SEC’s Notice(s) re: AS5 is July 12, after which SEC will decide whether to approve – or disapprove – AS5.

According to SEC Commissioner Paul Atkins, regulators want “a real comment period” on AS5, as quoted by Dow Jones Newswire’s Judith Burns in her article yesterday, [“SEC Raises Questions on New Audit Standard.”](#)

“I want to make sure we get it right this time,” said SEC’s Atkins, as quoted by Dow Jones’ Burns. “If we don’t get it right, I really do think Congress will step in,” he added.

Speaking of Congress... in addition to calls for additional extensions of Sarbox for small businesses requested by the chairs and ranking members of the Senate and House small business committees as previously reported, Rep. Scott Garrett proposed a bill on June 14 entitled the “Sarbanes-Oxley Compliance Extension Act” (H.R. 2727), which would give at least one more year for small companies to comply with Section 404 and related internal control reporting rules, as noted in this June 14 [press release](#). Garrett is also the sponsor of the AMERICA Act proposed earlier this year (H.R. 1049), the Amend Misinterpreted Excessive Regulation in Corporate America Act, which

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would, among other things, create an ombudsman for the PCAOB, and require Presidential appointments of PCAOB board members at Cabinet level salaries, as reported by Richard Hill in [this article](#) in today's BNA Daily Report for Executives (sub req'd).

PCAOB spokeswoman Colleen Brennan was quoted by Dow Jones' Burns saying: "Internal control over financial reporting is vitally important to American businesses and their investors, and everyone wants to get it right."

### **Univ. GA, Univ. Pitt Studies Shed Light on Intended – and Unintended – Consequences of Sarbox**

In related news, two new academic studies shed light on some of the intended, and unintended, consequences of Sarbox.

#### **Univ. Pitt Study Featured at AEI Program “Is Sarbanes-Oxley Impairing Risk Taking?”**

One study was featured at a program yesterday sponsored by the [American Enterprise Institute \(AEI\)](#), self-described as a “private, nonpartisan, not-for-profit institution dedicated to research and education on issues of government, politics, economics, and social welfare,” and described in this [Reuters article](#) yesterday as having “close ties to the Bush administration.”

AEI's June 18 program, “[Is Sarbanes-Oxley Impairing Corporate Risk Taking?](#)” was chaired by AEI Fellow Peter Wallison, and presenters included three Univ. of Pittsburgh Professors - Leonce Bargeron, Kenneth Lehn, and Chad Zutter - who recently published a study entitled: “[Sarbanes-Oxley and Corporate Risk Taking](#),” which acknowledges at the bottom of the cover page “funding support for the preparation of this paper from the National Research Institute at the American Enterprise Institute.” As summarized in the Reuters article, the Univ. of Pitt study of 4,000 U.S. public companies found that: “the Sarbanes-Oxley corporate reform law has a chilling effect on risk-taking as many companies seek to conserve cash instead of developing new products or services.”

An alternative explanation was also provided at the AEI program by Charles Calomiris, a business professor at Columbia University, who said, according to the [Reuters article](#), that “there could be other explanations for the data, including a trend of increasing risk acceptance and an increasing entrepreneurial spirit in the United Kingdom.”

#### **Univ. GA Study on Unintended Consequences of Sarbox on Directors**

Separately, three professors from the Terry College of Business at the University of Georgia (two currently professors there: Jeff Netter and James Linck, and one a formal doctoral student there, Tina Yang (now at Clemson Univ.), published a study June 14 entitled: “The Effects and Unintended Consequences of the Sarbanes-Oxley Act, and its Era, on the Supply and Demand for Directors.”

As noted in this [press release](#), the Univ. of GA study found that “the landmark Sarbanes-Oxley Act of 2002 and related rule changes of the major stock exchanges have dramatically altered the makeup of corporate boards, making them larger and more independent. The legislation also had the unintended effect of increasing director pay by more than 50 percent.”

The authors of the Univ. GA study found that, in the post-SOX world

- **“median pay per directors rose by more than 50%... with higher costs of director pay ... disproportionately borne by small companies.”** Additionally, the study found: **“Under SOX, directors now face more legal liability for corporate malfeasance, and their director and officer (D&O) insurance premiums have increased sharply as a**

**consequence,” rising more than 264%** from 2001 to 2004 for a sample of S&P 500 firms.

- **NOTE:** These findings and similar findings regarding “disproportionate costs” on small companies which relate to relatively fixed costs is not surprising, given the smaller denominator used in the formulas pertaining to smaller companies (sales, assets or market cap as appropriate). However, it is instructive to be aware of barriers smaller companies face in meeting requirements that involve relatively fixed costs, or are not as scalable, in terms of consequences – intended or unintended – that can impact a companies’ ability to go public, or remain a public company.
- **“Director workload also increased post-SOX.** The researchers found that audit committees met roughly twice as often after the law was implemented, from an average of 2.6 meetings per year for small firms in 2001 to 5.1 meetings per year in 2004. Audit committees of large firms met an average of 4.5 times per year in 2001 and 8.2 times in 2004.” Study co-author Linck said: “Members of the audit committee really have to work harder post-SOX and are much more accountable,” adding, “Some firms even pay additional fees to members of the audit committee, which was rare before SOX.”
  - **NOTE:** This finding of increased work-load and time commitment of audit committee members post-Sarbox is also not surprising, and indeed would appear to be one of the **intended** consequences of Sarbox. Dating back to pre-Sarbox days, two former Chief Accountants of the SEC called for an enhanced role for audit committees, in speeches entitled [“Audit Committees: A Call to Action”](#) dated Feb. 21, 2001, and [“Audit Committees: A Roadmap for Establishing Accountability,”](#) dated March 10, 2001, by then-Chief Accountant of the SEC Lynn Turner, who emphasized the “three D’s:” “Due Diligence and Documentation,” as well as recommendations of the Blue Ribbon Panel on Audit Effectiveness, the O’Malley Panel, COSO and others, and in a speech given March 31, 2002 by then-Chief Accountant Robert K. Herdman entitled: [“Making Audit Committees More Effective,”](#) which recommended the following “short-list” for audit committees: “(1) Control the agenda, (2) Be diligent, and (3) Take the time.”

### Additional Sarbox Guidance

Additional guidance relating to the Sarbanes-Oxley Act broadly can be found in [“The Complete Guide to Sarbanes-Oxley”](#) by [Professor Stephen M. Bainbridge](#), of UCLA Law School, whose [blog](#) is [here](#) .

See also Lord & Benoit’s [“Sarbanes-Oxley Section 404: 10 Threats to Compliance for Smaller Companies”](#) and their [online presentation](#) on 404 dated March 19, 2007 . (Lord & Benoit cleverly cornered the domain name [www.section404.org](#) . )

Jun 19, 2007, 12:26 PM by Edith Orenstein

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