The Chamber’s mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.
Good morning, Chairwoman Velázquez, Ranking Member Chabot, and members of the committee. My name is Michael Ryan and I am Executive Director and Senior Vice President of the U.S. Chamber Center for Capital Markets Competitiveness (the “CCMC”). The U.S. Chamber of Commerce is the world’s largest business federation, representing more than three million businesses and organizations of every size, sector, and region.

Introduction

I’m here today to discuss the impact of Sarbanes-Oxley (“SOX”) Section 404 on small public companies and, on behalf of the U.S. Chamber and our small business members, I would like to thank the chairwoman and the committee for holding this hearing and re-focusing attention on this very important issue.

On June 5 of this year, this committee held a similar hearing concerning the disproportionate and unnecessary burden that immediate application of SOX 404 would have on small companies. Since then, the Committee has asked and received answers from the SEC concerning its cost-benefit analysis in connection with SOX 404 implementation for non-accelerated filers. More recently, the U.S. Chamber, working with others, released the results of a survey conducted to quantify the expected cost to non-accelerated filers of immediate application of SOX 404(a) and the application of SOX 404(b) beginning a year from now, which is the current timeline for these two provisions.

As I begin my testimony, I would like to make five basic points:

First, small businesses are critical to the long-term health and vibrancy of the U.S. economy; they are the source of millions of jobs and the incubator of many of the next generation of innovative products and services.

Second, the U.S. Chamber supports the purposes of the Sarbanes Oxley Act, including the application of the Section 404 internal control provisions to small companies.

Third, while the recent changes to Section 404 implementation are positive steps forward, these changes are complex and will necessarily be more costly to implement during their first year than in future years.

Fourth, almost all regulation disproportionately burdens small businesses and this will undoubtedly be the case with Section 404.
And fifth, a one-year delay of Section 404(a) and/or 404(b) while the kinks are worked out of the new rule and guidance would significantly reduce this disproportionate burden on small public businesses.

Background

On November 8, the U.S. Chamber of Commerce released a study showing that, despite recent reforms, SOX Section 404 disproportionately burdens small businesses.

Unless the SEC or Congress takes action, the current timeline will require non-accelerated filers with a calendar year-end to begin complying with SOX 404(a) in early 2008 and SOX 404(b) in early 2009. While the SEC predicted that non-accelerated filers would not engage their auditors for SOX 404 compliance until the first half of 2008, more than 83% of respondents have already done so with respect to SOX 404(a) and more than 58% have done so with respect to SOX 404(b).

The study also shows that more than half of the companies responding with less than $75 million in market value will spend more than 3% of net income on SOX 404(a). Sixty three percent anticipate a cost increase in the next year due to compliance with 404(a) and 404(b). Finally, more than 58% of the respondents believe that SOX 404 will not help detect and prevent fraud.

Our study shows why small companies complying for the first time with SOX 404 should not be the guinea pigs for the improved rules adopted by the SEC and the PCAOB. We continue to support strong internal controls and believe that the improved rules, if implemented as intended, will address the challenges companies face in complying with Sarbanes-Oxley.

More than 96 percent of the Chamber’s members are small businesses with 100 or fewer employees, 70 percent of which have 10 or fewer employees. Yet, virtually all of the nation’s largest companies are also active members. Besides representing a cross-section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business – manufacturing, retailing, services, construction, wholesaling, and finance – is represented. Furthermore, the Chamber has substantial membership in all 50 states.

The Chamber has strongly supported many of the reforms in Sarbanes-Oxley, including ensuring that boards are more active, independent, and composed of members with significant financial and other expertise. In particular, we believe that having effective and independent audit committees provides important oversight over the work of internal and external accountants. Effective internal controls are an essential part of good financial governance at all companies.

However, the implementation of Section 404 has led to costs and regulatory burdens far beyond what Congress intended and well in excess of the benefits to shareholders and management. This is amplified among smaller public companies due to economies of scale. Companies feel they are getting less effective advice and support from their external auditors, and auditors are increasingly being second-guessed by their new regulator and the trial bar.

The result is predictable: Companies increasingly feel that the costs of being a public company outweigh the benefits, and an important tool companies have used to access capital is being eroded.
I know access to capital and the capital formation process is of particular interest to this committee. Small business drives much of the economic activity, innovation, and job creation in the United States. Over the last decade, for example, small businesses have generated 60 to 80 percent of net new jobs. These businesses made up 97 percent of exporters and produced 28 percent of the known export value in FY 2005. Small businesses employ 41 percent of high-tech workers and produce 13 to 14 times more patents per employee than large patenting businesses.

For well over a century, this has been the greatest country on Earth for entrepreneurs and innovators to access low-cost capital to start and expand a business. Transparent and liquid public markets have been a key part of this. Without these markets, small firms can’t get the venture capital or bank loans they need to buy new equipment, hire staff, or develop and market their products. Venture capital firms need a clear way get back their investment at a fair price. This usually means taking a company public. If the costs of becoming a public company are unnecessarily increased, then some companies will not get the venture capital they need, resulting in less innovation and competition within the marketplace. Banks also depend on the capital markets to securitize the loans they make to small companies, which allows for greater lending to small businesses.

Statistical evidence indicates that regulatory changes resulting from implementation of Section 404 of SOX have had a disproportionate impact on the cost of capital for smaller businesses that have already had to comply. For example, a $1 million to $2 million compliance price tag is an enormous burden on a company that has $3 million in net income. A study released by the GAO in April 2006 stated that public companies with market capitalization of $75 million or less paid a median of $1.14 in audit fees for every $100 in revenues. This compares to $0.13 in audit fees for public companies with market capitalization greater than $1 billion.

Fortunately, the costs associated with small business capital formation have come to the forefront of the agenda for financial markets’ regulators. The SEC and PCAOB have made a good-faith attempt at providing scalable rules and guidance to smaller companies. The question now is will it be implemented as intended?

**Correcting the Implementation of Section 404 of Sarbanes-Oxley**

The Chamber has been strongly supportive of most provisions of SOX and believes that SOX has had positive effects in causing boards, management, and external auditors to be more thorough and attentive in fulfilling their responsibilities. Our support for the Sarbanes Oxley Act includes the internal control provisions set forth in Section 404. And, we support the application of Section 404 to non-accelerated filers.

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2 Id.
3 Id.
The problem has been, as almost everyone agrees, the failed implementation of Section 404. The 168 words that comprise Section 404, as well as the accompanying Auditing Standard 2 (“AS2”), have created regulation that produces costs far in excess of benefits, particularly for small companies. As Chairman Cox has noted, “Congress never intended that the 404 process should become inflexible, burdensome, and wasteful. The objective of Section 404 is to provide meaningful disclosure to investors about the effectiveness of a company’s internal controls systems, without creating unnecessary compliance burdens or wasting shareholder resources.”

U.S. Chamber members have frequently expressed concern that the implementation of Section 404 has had a negative effect on the competitiveness of U.S. companies and the U.S. capital markets, and created burdens on companies and their management well beyond what Congress intended. While Section 404 was fundamentally conceived as a disclosure requirement to provide more information about internal controls, under AS2 it has evolved into a substantive requirement for specific levels of internal controls that goes far beyond the Congressional mandate.

When the SEC and PCAOB issued proposed revisions in December 2006, the Chamber voiced a number of concerns (see comment letter available at: http://www.sec.gov/comments/s7-24-06/s72406-213.pdf). Key recommendations included: ensuring a reasonable cost-benefit balance; performing a cost-benefit analysis after the rules are adopted; aligning SEC management guidance with AS5; clarifying terms such as material weakness, significant deficiency, and materiality; clarifying Auditing Standard 3; aligning Auditing Standard 4 with AS5; ensuring that the rules are both risk-based and scalable; providing more certainty regarding the proposed safe harbor; educating the public about the role and scope of an audit and that a restatement does not necessarily indicate a material weakness; allowing for greater use of the work of others; providing specific guidance on IT systems and controls; and promulgating additional guidance on footnote disclosure controls. The Chamber also raised serious concerns about the extent to which the new standards will improve “on the ground” implementation.

We once again applaud the initiative in May by the Securities and Exchange Commission (“SEC”) and the Public Company Accounting Oversight Board (“PCAOB”) to fix the implementation process of Section 404 to better reflect the intent of Congress and the needs of investors and companies. We view the PCAOB’s new auditing standard as well as the SEC’s guidance for companies as a significant step forward and we commend Chairman Cox and Chairman Olson for their leadership, time, and energy to bring balance to the system. In the end, we are hopeful that these changes will restore the balance we believe Congress had intended all along and will bring the costs more in line with the benefits.

Further, we recognize and strongly support the efforts the SEC and PCAOB have put forth since May to ensure that auditors and public companies alike fully understand the new rule and guidance and implement them in as cost effective manner as possible. These efforts have taken many forms, including hosting town hall meets around the country and issuing detailed guidance. We believe, however, that the need for this effort – and we agree that it was needed – only goes to support our argument for further delay for non-accelerated filers. That is, the changes put in place in May by the SEC and PCAOB are complex, not easily understood and will require a great deal of time and energy to work out the details. Therefore, implementation in 2007 and 2008 will necessarily be more costly than will be the case in future years when the transition pain will be behind us and the results of our survey support this. In the meantime, U.S.
small businesses should not have to serve as guinea pigs in this process and shoulder a disproportionate regulatory burden.

A Delay for Smaller Companies

The Chamber has called for a further delay in compliance with Section 404 for smaller public companies until the new rules and guidance have been fully tested by larger companies. Note that only companies with a market capitalization greater than $75 million have had to comply with Section 404 to-date. With a further delay for smaller businesses, we will be better able to leverage the experience of larger companies and the auditing profession to ensure that implementation costs are minimized. Failure to do this could significantly undermine the cost-cutting objectives of the new standards. We also need to remain prepared to make additional changes if the new rules don’t work as intended.

As it stands today, smaller companies will have to begin complying with the management requirements of Section 404(a) in their annual reports for fiscal years ending on or after December 15, 2007. They will have to comply with Section 404(b) requiring an auditor’s attestation report on internal control over financial reporting in their annual reports starting with the first annual report filed for the fiscal year ending on or after December 15, 2008.

Two of the five SEC Commissioners—Commissioner Atkins and Commissioner Casey—have publicly indicated a willingness to reconsider such a delay. The Senate Committee on Small Business and Entrepreneurship led by Chairman Kerry and Ranking Member Snowe held a hearing on April 18, and the Senators have publicly called for a further delay. The Office of Advocacy of the Small Business Administration has also joined in to ask the SEC to revisit the issue of compliance deadlines. And just last week Representative Spencer Bachus, Ranking Member of the House Financial Services Committee, sent a letter to Chairman Cox asking for a one-year delay in the implementation of Section 404(b). We once again urge this Committee to support this call for a reasonable, additional one-year extension for smaller issuers.

Additional Reforms to Enhance Small Business Competitiveness and Job Creation

The Chamber believes that SOX has become a catch-all term to refer to a broader set of issues facing the public markets and smaller public companies in particular. While Section 404 is a significant part of the problem, it is not the only part. U.S. companies are facing changing, retroactively applied accounting rules that are ever-increasing in complexity. As a result, one in 10 public companies was forced to restate its earnings last year. This system is not working for companies, investors, or auditors.

America’s securities class action litigation system is broken. It provides inadequate compensation to injured parties without deterring future wrongdoers. It fails to protect small, undiversified investors, who seldom receive more than pennies on the dollar, while attorneys on both sides rake in millions of dollars in fees. Moreover, several recent bipartisan reports have highlighted the damage done by the private securities litigation system to U.S. competitiveness in the global capital markets and, as a result, to the U.S. economy as a whole.

We have a regulatory structure filled with duplicative, inefficient, and, in some cases, contradictory guidance. Regulators struggle to keep up with the speed and technology changes of today’s rapidly changing markets. While no business should be forced to read the minds of the regulators, it is particularly difficult for smaller public companies to deal with these issues. The system is not working.
What Can We Do?

The challenge is clear and the voices are growing. The Chamber’s independent, bipartisan Commission on the Regulation of U.S. Capital Markets in the 21st Century and others, including Hal Scott from Harvard, Senator Schumer and Mayor Bloomberg and, most recently, the Financial Services Roundtable has echoed that the problems facing our competitiveness are real and action is needed. We should remain united in our goal to make the U.S. capital markets the most fair, efficient, transparent, and attractive in the world.

That is why the Chamber formed the Center for Capital Markets Competitiveness in March 2007. The Center was established to advance legislative, regulatory, and legal initiatives designed to strengthen the competitiveness of U.S. capital markets.

Granting a further delay for small business in complying with Section 404 would be a good step towards addressing these larger issues. But we cannot stop there. We need broad litigation and regulatory reform to retain our global capital markets leadership.

Conclusion

Chairwoman Velázquez, Ranking Member Chabot, and members of the committee, thank you for the opportunity to discuss these serious issues. The Chamber stands ready to work with you and others to improve the implementation of SOX 404—and we congratulate you for taking this important step by holding today’s hearing. We also applaud Chairman Cox and Chairman Olson for the work they have done.

In summary, we believe that we will only know if the efforts of the SEC and PCAOB have been successful until after we see how they are implemented. Therefore, we are again calling for a further delay of one full-year for smaller public companies before they must comply with Section 404. Finally, we urge Congress, the SEC, and other regulators to work together to address the additional critical issues that are making it increasingly difficult for leaders of smaller American companies to access the public capital markets to grow their businesses and create jobs.

Thank you again for the opportunity to be here today. We stand ready to take action on behalf of the business community to provide viable solutions that benefit business, workers, shareholders and our economy.