United States Government Accountability Office

GAO

Report to the Committee on Small Business and Entrepreneurship, U.S. Senate

April 2006

SARBANES-OXLEY ACT

Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies

GAO

Accountability * Integrity * Reliability

GAO-06-361

GAO
Accountability • Integrity • Reliability

Highlights

Highlights of GAO-06-361, a report to the Committee on Small Business and Entrepreneurship, U.S. Senate

April 2006

SARBANES-OXLEY ACT

Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies

Why GAO Did This Study

Congress passed the Sarbanes-Oxley Act to help protect investors and restore investor confidence. While the act has generally been recognized as important and necessary, some concerns have been expressed about the cost for small businesses. In this report, GAO (1) analyzes the impact of the Sarbanes-Oxley Act on smaller public companies, particularly in terms of compliance costs; (2) describes responses of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) to concerns raised by smaller public companies; and (3) analyzes smaller public companies' access to auditing services and the extent to which the share of public companies audited by mid-sized and small accounting firms has changed since the act was passed.

What GAO Recommends

SEC should (1) assess sufficiency of internal control guidance for smaller public companies, (2) coordinate with PCAOB to ensure consistency of section 404 auditing standards with any additional internal control guidance for public companies, and (3) if further relief is deemed appropriate, analyze the unique characteristics of smaller public companies and their investors to ensure that the objectives of investor protection are met and any relief provided is targeted and limited.

www.gao.gov/cgi-bin/getrpt?GAO-06-361.

To view the full product, including the scope and methodology, click on the link above. For more information, contact William B. Shear, (202) 512-8678 or shearw@gao.gov, or Jeanette M. Franzel, (202) 512-9471 or franzelj@gao.gov.

What GAO Found

Regulators, public companies, audit firms, and investors generally agree that the Sarbanes-Oxley Act of 2002 has had a positive and significant impact on investor protection and confidence. However, for smaller public companies (defined in this report as $700 million or less in market capitalization), the cost of compliance has been disproportionately higher (as a percentage of revenues) than for large public companies, particularly with respect to the internal control reporting provisions in section 404 and related audit fees. Smaller public companies noted that resource limitations and questions regarding the application of existing internal control over financial reporting guidance to smaller public companies contributed to challenges they face in implementing section 404. The costs associated with complying with the act, along with other market factors, may be encouraging some companies to become private. The companies going private were small by any measure and represented 2 percent of public companies in 2004. The full impact of the act on smaller public companies remains unclear because the majority of smaller public companies have not fully implemented section 404.

To address concerns from smaller public companies, SEC extended the section 404 deadline for smaller companies with less than $75 million in market capitalization, with the latest extension to 2007. Additionally, SEC and PCAOB issued guidance intended to make the section 404 compliance process more economical, efficient, and effective. SEC also encouraged the Committee of Sponsoring Organizations of the Treadway Commission (COSO), to develop guidance for smaller public companies in implementing internal control over financial reporting in a cost-effective manner. COSO's guidance had not been finalized as of March 2006. SEC also formed an advisory committee to examine, among other things, the impact of the act on smaller public companies. The committee plans to issue a report in April 2006 that will recommend, in effect, a tiered approach with certain smaller public companies partially or fully exempt from section 404, "unless and until" a framework for assessing internal control over financial reporting is developed that recognizes the characteristics and needs of smaller public companies. As SEC considers these recommendations, it is essential that the overriding purpose of the Sarbanes-Oxley Act—investor protection—is preserved and that SEC assess available guidance to determine if additional supplemental or clarifying guidance for smaller public companies is needed.

Smaller public companies have been able to obtain access to needed audit services and many moved from the largest accounting firms to mid-sized and small firms. The reasons for these changes range from audit cost and service concerns cited by companies to client profitability and risk concerns cited by accounting firms, including capacity constraints and assessments of client risk. Overall, mid-sized and small accounting firms conducted 30 percent of total public company audits in 2004—up from 22 percent in 2002. However, large accounting firms continue to dominate the overall market, auditing 98 percent of U.S. publicly traded company sales or revenues.

Contents

Letter		1
	Results in Brief	4
	Background	9
	Smaller Public Companies Have Incurred Disproportionately Higher Audit Costs in Implementing the Act, but Impact on Access to Capital Remains Unclear	14
	SEC and PCAOB Have Been Addressing Smaller Company Concerns Associated with the Implementation of Section 404	26
	Sarbanes-Oxley Act Requirements Minimally Affected Smaller Private Companies, Except for Those Seeking to Enter the Public Market	36
	Smaller Companies Appear to Have Been Able to Obtain Needed Auditor Services, Although the Overall Audit Market Remained Highly Concentrated	42
	Conclusions	52
	Recommendations	58
	Agency Comments and Our Evaluation	58
Appendix I	**Objectives, Scope, and Methodology**	61
Appendix II	**Additional Details about GAO's Analysis of Companies Going Private**	73
Appendix III	**Comments from the Securities and Exchange Commission**	84
Appendix IV	**Comments from the Public Company Accounting Oversight Board**	86
Appendix V	**GAO Contacts and Staff Acknowledgments**	87

Tables

Table 1: Summary of Selected Sarbanes-Oxley Act Provisions Affecting Public Companies and Registered Accounting Firms 11
Table 2: Primary Reasons Cited by Companies for Going Private, 1998-2005, by Percent 23
Table 3: SEC Extensions of Section 404 Compliance Dates 27
Table 4: IPO Direct Expenses as a Percentage of Company's Revenues, by Size 38
Table 5: Companies Changing Accounting Firms, 2003-2004 44
Table 6: Cross-sectional Comparison of Request Letter Questions, Our Report Objectives, and Selected Findings 61
Table 7: Reason for Going Private, by Category Descriptions 80

Figures

Figure 1: Median Audit Fees as a Percentage of 2003 and 2004 Revenues Reported by Public Companies as of August 11, 2005 16
Figure 2: Total Number of Companies Identified as Going Private, 1998-2005 22
Figure 3: Where Companies Traded Prior to Deregistration, July 2003-March 2005 25
Figure 4: IPO and Stock Market Performance, 1998-2005 39
Figure 5: Average Size of Companies Changing Auditors, 2003-2004, by Type of Accounting Firm Change 46
Figure 6: Percentage of Clients Audited by Revenue Category, 4 Largest Accounting Firms versus Mid-sized and Small Accounting Firms, 2004 49
Figure 7: Total Number of IPOs, by Size of Accounting Firm, 1999–2004 51
Figure 8: Total Number of Companies Identified as Going Private from 1998 to 2005 77

Abbreviations

AMEX	American Stock Exchange
CEO	chief executive officer
CFO	chief financial officer
COSO	Committee of Sponsoring Organizations of the Treadway Commission
EDGAR	Electronic Data Gathering, Analysis, and Retrieval system
FCPA	Foreign Corrupt Practices Act of 1977
HHI	Hirschman-Herfindahl Index
IPO	initial public offering
NASD	National Association of Securities Dealers, Inc.
NASDAQ	The Nasdaq Stock Market, Inc
NYSE	New York Stock Exchange
PCAOB	Public Company Accounting Oversight Board
QPL	Questionnaire Programming Language
OTCBB	Over the Counter Bulletin Board
SAS	statistical analysis software
SBA	Small Business Administration
SEC	Securities and Exchange Commission
SPO	secondary public offering

GAO
Accountability * Integrity * Reliability

United States Government Accountability Office
Washington, DC 20548

April 13, 2006

The Honorable Olympia J. Snowe
Chair
Committee on Small Business and Entrepreneurship
United States Senate

The Honorable Michael B. Enzi
United States Senate

In response to numerous corporate failures arising from corporate mismanagement and fraud, Congress passed the Sarbanes-Oxley Act of 2002.[1] Generally recognized as one of the most significant market reforms since the passage of the securities legislation of the 1930s, the act is intended to help protect investors and restore investor confidence by improving the accuracy, reliability, and transparency of corporate financial reporting and disclosures, and reinforce the importance of corporate ethical standards. Public and investor confidence in the fairness of financial reporting and corporate ethics is critical to the effective functioning of our capital markets. The act's requirements apply to all public companies regardless of size and the public accounting firms that audit them.

The act established the Public Company Accounting Oversight Board (PCAOB) as a private-sector non-profit organization to oversee the audits of public companies that are subject to securities laws. PCAOB, which is subject to oversight by the Securities and Exchange Commission (SEC), is responsible for establishing related auditing, quality control, ethics, and auditor independence standards. The act also addresses auditor independence and the relationship between auditors and the public companies they audit. The act requires public companies to assess the effectiveness of their internal control over financial reporting and for their external auditors to report on management's assessment and the

[1]Pub. L. No. 107-204, 116 Stat. 745 (July 30, 2002).

effectiveness of internal controls.[2] The act also contains provisions intended to make chief executive officers (CEO) and chief financial officers (CFO) more accountable, improve the oversight role of boards of directors and audit committees, and provide whistleblower protection. Finally, the act expanded the SEC's oversight powers and mandated new and expanded criminal penalties for securities fraud and other corporate violations.

The specific objectives of this report are to (1) analyze the impact of the Sarbanes-Oxley Act on smaller public companies, including costs of compliance and access to capital; (2) describe SEC's and PCAOB's efforts related to the implementation of the act and their responses to concerns raised by smaller public companies and the accounting firms that audit them; (3) analyze the impact of the act on smaller privately held companies, including costs, ability to access public markets, and the extent to which states and capital markets have imposed similar requirements on privately held companies; and (4) analyze smaller companies' access to auditing services and the extent to which the share of public companies audited by small accounting firms has changed since the enactment of the act.[3]

To address these objectives, we reviewed information from a variety of sources, including the legislative history of the act, relevant regulatory pronouncements and public comments, research studies and papers, and other stakeholders (such as trade groups and market participants). To analyze the impact of the act on smaller public companies, we obtained data from SEC filings provided through a licensing agreement with Audit Analytics, and analyzed data elements including auditing fees and auditor

[2]Internal control is defined as a process effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives: (1) effectiveness and efficiency of operations; (2) reliability of financial reporting; and (3) compliance with laws and regulations. Internal control over financial reporting is a process that a company puts in place to provide reasonable assurance regarding the reliability of financial reporting and the integrity of the financial statement preparation process.

[3]For the purposes of this report, we use the term smaller public company to refer to a company with a market capitalization of $700 million or less unless otherwise noted. We use the term large accounting firms to refer to the top four U.S. accounting firms in terms of total revenue in fiscal year 2004—Deloitte & Touche LLP, Ernst & Young LLP, PricewaterhouseCoopers LLP, and KPMG LLP; mid-sized firms to refer to the four next largest U.S. firms—Grant Thornton LLP, BDO Seidman LLP, Crowe Chizek & Company LLC, and McGladrey & Pullen LLP; and small firms to refer to all other accounting firms in the United States., which consist of regional and local firms.

changes to determine costs of compliance.[4] Similarly, we constructed a database of public companies that went private using SEC filings and press releases retrieved from Lexis-Nexis, an online periodical database. To obtain information on smaller public companies' experiences with Sarbanes-Oxley Act compliance, we also conducted a survey of companies with market capitalization of $700 million or less and annual revenues of $100 million or less that, as of August 11, 2005, reported to SEC that they had complied with the act's internal control-related requirements. One hundred fifty-eight of 591 companies completed the survey, for an overall response rate of 27 percent.[5] Additionally, we held discussions with representatives of SEC, the Small Business Administration (SBA), PCAOB, smaller public companies, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), financial service providers, rating agencies, institutional investors, trade groups, accounting firms, and other market participants.[6]

Because SEC has extended the date by which registered public companies with less than $75 million in public float (known as non-accelerated filers) had to comply with the act's internal control-related provisions (section 404) to their first fiscal year ending on or after July 15, 2007, we could not analyze the impact of the internal control provisions of the act for a significant number of smaller public companies (SEC estimates that non-accelerated filers represent about 60 percent of all registered public

[4]Audit Analytics is an online market intelligence service that provides information on U.S. public companies registered with SEC and accounting firms.

[5]We conducted an analysis to determine whether the respondents to our survey differed from the population of 591 companies in company assets, revenue, market capitalization, or type of company (based on the North American Industrial Classification System code) and found no evidence of substantial non-response bias on these characteristics. However, because of the low response rate, we do not consider these data to be a probability sample of all smaller public companies.

[6]COSO was originally formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an independent private-sector initiative that studied the causal factors that can lead to fraudulent financial reporting and developed recommendations for public companies and their independent auditors, SEC and other regulators, and educational institutions.

companies).[7] Thus, to gain some insight into the potential impact these provisions may have on smaller public companies, we analyzed public data and other information related to the experiences of public companies that have fully implemented the act's provisions. To determine the act's impact on smaller privately held companies, we interviewed officials about state requirements comparable to key Sarbanes-Oxley provisions and representatives of smaller private companies and financial institutions about capital access requirements. We also analyzed data on companies' initial public offering (IPO) and secondary public offering (SPO) from SEC filings. To assess changes in the domestic public company audit market, we used public data—for 2002 and 2004—on public companies and their external accounting firms to determine how the number and mix of domestic public company audit clients had changed for firms other than the large accounting firms. As requested by your staff, we addressed nine specific questions contained in your request letter.

Appendix I contains a more complete description of our scope and methodology, including a cross-sectional comparison between the nine specific questions contained in the request letter and the four objectives of this report. We conducted our work in California, Connecticut, Georgia, Maryland, New Jersey, New York, Virginia, and Washington, D.C., from November 2004 through March 2006 in accordance with generally accepted government auditing standards.

Results in Brief

While regulators, public companies, auditors, and investors generally agree that the Sarbanes-Oxley Act has had a positive impact on investor protection, available data indicate that smaller public companies face

[7] Until recently, SEC distinguished between two types of public companies for financial reporting purposes—accelerated filers and non-accelerated filers. SEC defined a public company as an accelerated filer if it met certain conditions, namely that the company had a public float of $75 million or more as of the last business day of its most recently completed second fiscal quarter and the company filed at least one annual report with SEC. A non-accelerated filer is generally a public company that had a public float of less than $75 million as of the last business day of its most recently completed second fiscal quarter. In December 2005, SEC created a new category, the large accelerated filer. A large accelerated filer is generally a public company that had a public float of $700 million or more as of the last business day of its most recently completed second fiscal quarter. SEC also redefined an accelerated filer as a company that had at least $75 million but less than $700 million in public float. Accelerated filers and large accelerated filers are subject to shorter financial reporting deadlines than non-accelerated filers. SEC defines public float as the aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer.

disproportionately higher costs (as a percentage of revenues) in complying with the act, consistent with the findings of the Small Business Administration on the impact of regulations generally on small businesses. While smaller companies historically have paid disproportionately higher audit fees than larger companies as a percent of revenues, the percentage difference between median audit fees paid by smaller versus larger public companies grew in 2004, particularly for companies that implemented the act's internal control provisions (section 404). Smaller public companies also cited other costs of compliance with section 404 and other provisions of the act, such as the use of resources for compliance rather than for other business activities. Moreover, the characteristics of smaller companies, including resource and expertise limitations and lack of familiarity with formal internal control frameworks, contributed to the difficulties and costs they experienced in implementing the act's requirements. This situation was also impacted by the fact that many companies documented their internal control for the first time and needed to make significant improvements to their internal control as part of their first year of implementing section 404, despite the fact that most have been required by law since 1977 to have implemented a system of internal accounting controls. Smaller public companies and accounting firms noted that the complexity of the internal control framework and the scope and complexity of the audit standard and related guidance for auditors on section 404 issued during rather than prior to the initial year of implementation contributed to the costs and challenges experienced in the first year of implementation.[8] It is generally expected that compliance costs for section 404 will decrease in subsequent years, given the first-year investment in documenting internal controls. The act, along with other market forces, appeared to have been a factor in the increase in public companies deregistering with SEC (going private)—from 143 in 2001 to 245 in 2004. However, these companies were small by any measure (market capitalization, revenue, or assets) and represented 2 percent of public companies in 2004. Based on our survey responses and discussions with smaller public companies that implemented section 404, it appears that the act has not adversely affected the ability of those smaller public companies to raise capital. However, it is too soon to assess fully the impact of the act on access to capital, particularly because of the large number of smaller public companies—the more than 5,900 small public

[8]This report focuses on smaller public companies, but some of the identified challenges and costs may also be present in larger public companies.

companies considered by SEC to be non-accelerated filers—that have been given an extension by SEC to implement section 404.

In response to concerns that smaller public companies raised about Sarbanes-Oxley Act requirements as implemented, particularly section 404, SEC and PCAOB have undertaken efforts to help the companies meet the requirements of the act. SEC initially provided those smaller public companies that are non-accelerated filers with additional time to comply with section 404 and subsequently extended the deadline several times, with the latest extension to July 15, 2007. SEC also formed an Advisory Committee on Smaller Public Companies to examine the impact of the act on smaller public companies. On March 3, 2006, the committee issued an exposure draft of its final report for public comment that contained recommendations that, if adopted by SEC, would exempt up to 70 percent of all public companies and 6 percent of U.S. equity market capitalization from all or some of the provisions of section 404, "unless and until" a framework for assessing internal control over financial reporting is developed that recognizes the characteristics and needs for smaller public companies. Specifically, the committee proposed that "microcap" companies (companies with market capitalization below $128 million) with revenues below $125 million and "smallcap" companies (companies with market capitalization between $128 million and $787 million) with revenues below $10 million would not have to comply with section 404(a) and section (b), management's and the external auditor's assessment and reporting on internal control over financial reporting, respectively. "Smallcap" companies with revenues between $10 million and $250 million would not have to comply with section 404(b), the external auditor's attestation on management's internal control assessment and the effectiveness of internal control over financial reporting. Following a public comment period, the committee is scheduled to issue its final recommendations in April 2006, at which time the recommendations would be considered by SEC. Additionally, SEC asked COSO to develop guidance designed to assist smaller public companies in using COSO's internal control framework in a small business environment. COSO issued a draft for public comment in October 2005, and plans to finalize the guidance in early 2006. While not specifically focused on small business issues, SEC held a public "roundtable" in April 2005, in which GAO participated, that gave public companies and accounting firms an opportunity to provide feedback to SEC and PCAOB on what went well and what did not during the first year of section 404 implementation. In response, SEC and PCAOB issued additional section 404 guidance in May 2005. PCAOB also issued a report on November 30, 2005, that detailed inefficiencies companies experienced in the implementation of its auditing standard on internal control. SEC and PCAOB plan to hold another roundtable on the second year of section 404 implementation in May 2006. However, because many efforts—particularly SEC's response to the exemption recommendations and COSO's efforts to provide guidance on using its internal control framework in a small business environment—are ongoing, smaller public companies may be deferring efforts to implement section 404 until such issues are resolved.

While the act does not impose new requirements on privately held companies, companies choosing to go public must realistically spend time and funds in order to demonstrate their ability to comply with the act, section 404 in particular, to attract investors who will seek the assurances and protections that compliance with section 404 provides. Such requirements, along with other factors, may have been a contributing factor in the reduced number of initial public offerings (IPO) issued by small companies. However, the overall performance of the stock market and changes in listing standards also likely affected the number of IPOs. From 1999 through 2004, IPOs by companies with revenues of $25 million or less decreased substantially from 70 percent of all IPOs in 1999 to about 46 percent in 2004. For those privately held companies not intending to go public, our research and discussions with representatives of financial institutions suggested that financing sources were generally not imposing requirements on private companies similar to those contained in the Sarbanes-Oxley Act as a condition for obtaining access to capital or other financial services. While a number of states proposed legislation with provisions similar to the Sarbanes-Oxley Act following its passage, three states passed legislation calling for private companies or nonprofit organizations to adopt requirements similar to some of the act's corporate governance provisions. In addition, our interviews and review of available research indicate that some privately held companies have voluntarily adopted some of the act's enhanced governance practices because they believe these practices make pragmatic business sense. Specifically, they have adopted practices such as CEO/CFO financial statement certification, appointment of independent directors, corporate codes of ethics, whistleblower procedures, and approval of nonaudit services by the board.

Smaller public companies have been able to obtain access to needed audit services since the passage of the act; however, data show that a substantial number of smaller public companies have moved from the large accounting firms to mid-sized and small firms. Many of these moves resulted from the resignation of a large accounting firm. The reasons for these changes range from audit cost and service concerns cited by companies to client profitability and risk concerns cited by accounting firms, including capacity constraints and assessments of client risk. As a result, mid-sized and small accounting firms increased their share of smaller public company audits during 2002–2004. Our analysis of the risk characteristics of the companies leaving the large accounting firms shows that mid-sized and small accounting firms appear to be taking on a higher percentage of public companies with accounting issues such as going concern qualifications and other “risk” issues. Overall, mid-sized and small accounting firms conducted 30 percent of the total number of public company audits in 2004—up from 22 percent in 2002. However, the overall market for audit services remains highly concentrated, with companies audited by large firms representing 98 percent of total U.S. publicly traded company sales (revenues). In the long run, the act may reduce some of the competitive challenges faced by mid-sized and small accounting firms. For example, mid-sized and small accounting firms could increase opportunities to enhance their recognition and acceptance among capital market participants as a result of operating under PCAOB’s registration and inspection process.

We have two concerns with certain draft recommendations from the Advisory Committee on Smaller Public Companies related to internal control. Our first concern relates to lack of specificity in the recommendations. While calling for an internal control framework that recognizes the needs of smaller public companies, the recommendations do not address what needs to be done to establish such a framework or what such a framework might include. In reviewing the implementation of section 404 for larger public companies, we noted that many, if not most, of the significant problems and challenges related to implementation issues rather than the internal control framework itself. We think it is essential that public companies, both large and small, have appropriate guidance on how to effectively implement the internal control framework and assess and report on the operating effectiveness of their internal control over financial reporting. Our second concern relates to the ambiguity surrounding the conditional nature of the “unless and until” provisions of the recommendations and the potential impact that may result for a large number of public companies that would qualify for either full or partial exemption from the requirements of section 404. Our concerns also include the additional time that may be needed to resolve the concerns of smaller public companies and the impact any further regulatory relief may have in delaying important investor protections associated with section 404.

When SEC begins its assessment of the final recommendations of its small business advisory committee, it is essential that SEC balance the key principle behind the Sarbanes-Oxley Act—investor protection—against the goal of reducing unnecessary regulatory burden on smaller public companies. This report recommends that, in considering the concerns of the Advisory Committee on Smaller Public Companies regarding the ability of smaller public companies to effectively implement section 404, SEC should (1) assess whether the current guidance, particularly guidance on management's assessment of internal control over financial reporting, is sufficient or whether additional action is needed to help smaller public companies meet the requirements of section 404; (2) coordinate with PCAOB to help ensure that section 404-related audit standards and guidance are consistent with any additional guidance applicable to management's assessment of internal control and identify additional ways in which auditors of public companies can achieve more economical, effective, and efficient implementation of the standards and guidance related to internal control over financial reporting; and (3) if further relief is deemed appropriate, analyze and consider the unique characteristics of smaller public companies and their investors in determining categories of companies for which additional relief may be appropriate so that the objectives of investor protection are adequately met and any relief is targeted and limited.

We provided a draft of this report to the Chairman of SEC and the Acting Chairman of PCAOB for review and comment. We received written comments from SEC and PCAOB that are discussed in this report and reprinted in appendixes III and IV. SEC agreed that the Sarbanes-Oxley Act has had a positive impact on investor protection and confidence, and that smaller public companies face particular challenges in implementing certain provisions of the act, notably section 404. SEC stated that our recommendations should provide a useful framework for consideration of its advisory committee's final recommendations. PCAOB stated that it is committed to working with SEC on our recommendations and that it is essential to maintain the overriding purpose of the Sarbanes-Oxley Act of investor protection while seeking to make its implementation as efficient and effective as possible. Both SEC and PCAOB provided technical comments that were incorporated into the report as appropriate.

Background

Responding to corporate failures and fraud that resulted in substantial financial losses to institutional and individual investors, Congress passed the Sarbanes-Oxley Act in 2002. As shown in table 1, the act contains provisions affecting the corporate governance, auditing, and financial reporting of public companies, including provisions intended to deter and punish corporate accounting fraud and corruption.[9]

The Sarbanes-Oxley Act generally applies to those companies required to file reports with SEC under the Securities Exchange Act of 1934 and does not differentiate between small and large businesses.[10] The definition of small varies among agencies, but SEC generally calls companies that had less than $75 million in public float non-accelerated filers. Accelerated filers are required by SEC regulations to file their annual and quarterly reports to SEC on an accelerated basis compared to non-accelerated filers. As of 2005, SEC estimated that about 60 percent —5,971 companies—of all registered public companies were non-accelerated filers. SEC recently further differentiated smaller companies from what it calls "well-known seasoned issuers"—those largest companies ($700 million or more in public float) with the most active market following, institutional ownership, and analyst coverage.[11]

[9]While there is no standard definition of corporate governance, it can broadly be taken to refer to the system by which companies are directed and controlled, including the role of the board of directors, management, shareholders, and other stakeholders. According to the Organisation for Economic Co-operation and Development, corporate governance provides the structure through which the objectives of the company are set and the means of attaining those objectives and monitoring performance are determined.

[10]In addition to those companies required to file reports with SEC under the Securities Exchange Act of 1934, the Sarbanes-Oxley Act also applies to companies considered to be issuers that have filed a Securities Act of 1933 registration statement that is not yet effective.

[11]SEC also has a specific category of smaller companies called "small business issuers" that may use separate reporting requirements designed to be less onerous than those applicable to larger filers. Generally, "small business issuers" have less than $25 million in revenues and public float. See 17 C.F.R. § 228.10(a)(1).

Table 1: Summary of Selected Sarbanes-Oxley Act Provisions Affecting Public Companies and Registered Accounting Firms

Provision	Main requirements
Section 101: Public Company Accounting Oversight Board	Establishes the PCAOB to oversee the audit of public companies that are subject to the securities laws.
Section 201: Services Outside the Scope of Practice of Auditors	Registered accounting firms cannot provide certain nonaudit services to a public company if the firm also serves as the auditor of the financial statements for the public company. Examples of prohibited nonaudit services include bookkeeping, appraisal or valuation services, internal audit outsourcing services, and management functions.
Section 301: Public Company Audit Committees	Listed company audit committees are responsible for the appointment, compensation, and oversight of the registered accounting firm, including the resolution of disagreements between the registered accounting firm and company management regarding financial reporting. Audit committee members must be independent.
Section 302: Corporate Responsibility for Financial Reports	For each annual and quarterly report filed with SEC, the CEO and CFO must certify that they have reviewed the report and, based on their knowledge, the report does not contain untrue statements or omissions of a material fact resulting in a misleading report and that, based on their knowledge, the financial information in the report is fairly presented.
Section 404: Management Assessment of Internal Controls	This section consists of two parts (a and b). First, in each annual report filed with SEC, company management must state its responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and assess the effectiveness of its internal control structure and procedures for financial reporting. Second, the registered accounting firm must attest to, and report on, management's assessment of the effectiveness of its internal control over financial reporting.
Section 407: Disclosure of Audit Committee Financial Expert	Public companies must disclose in periodic reports to SEC whether the audit committee includes at least one member who is a financial expert and, if not, the reasons why.

Source: GAO.

Title I of the act establishes PCAOB as a private-sector nonprofit organization to oversee the audits of public companies that are subject to the securities laws. PCAOB is subject to SEC oversight. The act gives PCAOB four primary areas of responsibility:

- registration of accounting firms that audit public companies in the U.S. securities markets;
- inspections of registered accounting firms;
- establishment of auditing, quality control, and ethics standards for registered accounting firms; and
- investigation and discipline of registered accounting firms for violations of law or professional standards.

Title II of the act addresses auditor independence. It prohibits the registered external auditor of a public company from providing certain nonaudit services to that public company audit client. Title II also specifies communication that is required between auditors and the public company's audit committee (or board of directors) and requires periodic rotation of the audit partners managing a public company's audits.

Titles III and IV of the act focus on corporate responsibility and enhanced financial disclosures. Title III addresses listed company audit committees, including responsibilities and independence, and corporate responsibilities for financial reports, including certifications by corporate officers in annual and quarterly reports, among other provisions. Title IV addresses disclosures in financial reporting and transactions involving management and principal stockholders and other provisions such as internal control over financial reporting. More specifically, section 404 of the act establishes requirements for companies to publicly report on management's responsibility for establishing and maintaining an adequate internal control structure, including controls over financial reporting and the results of management's assessment of the effectiveness of internal control over financial reporting. Section 404 also requires the firms that serve as external auditors for public companies to attest to the assessment made by the companies' management, and report on the results of their attestation and whether they agree with management's assessment of the company's internal control over financial reporting.

SEC and PCAOB have issued regulations, standards, and guidance to implement the Sarbanes-Oxley Act. For instance, both SEC regulations and PCAOB's Auditing Standard Number 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements" state that management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due process procedures, including the broad distribution of the framework for public comment. Both the SEC guidance and PCAOB's auditing standard cite the COSO principles as providing a suitable framework for purposes of section 404 compliance. In 1992, COSO issued its "Internal Control—Integrated Framework" (the COSO Framework) to help businesses and other entities assess and enhance their internal control. Since that time, the COSO framework has been recognized by regulatory standards setters and others as a comprehensive framework for evaluating internal control, including internal control over financial reporting. The COSO framework includes a common definition of internal control and criteria against which companies could evaluate the effectiveness of their internal control systems.[12] The framework consists of five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring. While SEC and PCAOB do not mandate the use of any particular framework, PCAOB states that the framework used by a company should have elements that encompass the five COSO components on internal control.

Internal control generally serves as a first line of defense in safeguarding assets and preventing and detecting errors and fraud. Internal control is defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of the following objectives: (1) effectiveness and efficiency of operations; (2) reliability of financial reporting; and (3) compliance with laws and regulations. Internal control over financial reporting is further defined in the SEC regulations implementing section 404. These regulations define internal control over financial reporting as providing reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements, including those policies and procedures that

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

PCAOB's Auditing Standard No. 2 reiterates this definition of internal control over financial reporting. Internal control is not a new requirement for public companies. In December 1977, as a result of corporate

[12] COSO, *Internal Control – Integrated Framework*, 1992 and 1994.

falsification of records and improper accounting, Congress enacted the Foreign Corrupt Practices Act (FCPA).[13] The FCPA's internal accounting control requirements were intended to prevent fraudulent financial reporting, among other things. The FCPA required companies to: (1) make and keep books, records, and accounts that in reasonable detail accurately and fairly reflect the transactions and dispositions of assets and (2) develop and maintain a system of internal accounting controls sufficient to provide reasonable assurance over the recording and executing of transactions, the preparation of financial statements in accordance with standards, and maintaining accountability for assets.

Smaller Public Companies Have Incurred Disproportionately Higher Audit Costs in Implementing the Act, but Impact on Access to Capital Remains Unclear

Based on our analysis, costs associated with implementing the Sarbanes-Oxley Act—particularly those costs associated with the internal control provisions in section 404—were disproportionately higher (as a percentage of revenues) for smaller public companies. In complying with the act, smaller companies noted that they incurred higher audit fees and other costs, such as hiring more staff or paying for outside consultants, to comply with the act's provisions. Further, resource and expertise limitations that characterize many smaller companies as well as their general lack of familiarity or experience with formal internal control frameworks contributed to the challenges and increased costs they faced during section 404 implementation. Along with other market factors, the act may have encouraged a relatively small number of smaller public companies to go private, foregoing sources of funding that were potentially more diversified and may be less expensive for many of these companies. However, the ultimate impact of the Sarbanes-Oxley Act on smaller public companies' access to capital remains unclear because of the limited time that the act has been in effect and the large number of smaller public companies that have not yet fully implemented the act's internal control provisions.

Smaller Public Companies Incurred Disproportionately Higher Audit Costs

Our analysis indicates that audit fees have increased considerably since the passage of the act, particularly for those smaller public companies that have fully implemented the act. Both smaller and larger public companies have identified the internal control provisions in section 404 as the most costly to implement. However, audit fees may have also increased because of the current environment surrounding public company audits including,

[13]Pub. L. No. 95-213, 91 Stat. 1494 (Dec. 19, 1977).

among other things, the new regulatory oversight of audit firms, new requirements related to audit documentation, and legal risk. Figure 1 contains data reported by public companies on audit fees paid to external auditors before and after the section 404 provisions became effective for accelerated filers in 2004. Based on this data, we found that (1) audit fees already were disproportionately greater as a percentage of revenues for smaller public companies in 2003 and (2) the disparity in smaller and larger public companies' audit fees as a percentage of revenues increased for those companies that implemented section 404 in 2004.[14] For example, of the companies that reported implementing section 404, public companies with market capitalization of $75 million or less paid a median $1.14 in audit fees for every $100 of revenues compared to $0.13 in audit fees for public companies with market capitalization greater than $1 billion.[15] Among public companies with market capitalization of $75 million or less (2,263 in total), the 66 companies that implemented section 404 paid a median $0.35 more per $100 in revenues compared to those that had not implemented section 404. However, using publicly reported audit fees as an indicator of the act's compliance costs has some limitations. First, the audit fees reported by companies that complied with section 404 should include fees for both the internal control audit and the financial statement audit. As a result, we could not isolate the audit fees associated with section 404. Second, the fees paid to the external auditor do not include other costs companies incurred to comply with section 404 requirements, such as testing and documenting internal controls and fees paid to external consultants. While the spread between what smallest and largest public companies that implemented section 404 paid as a percentage of revenue increased between 2003 and 2004, we also noted that, as a percentage of revenue, the relative disproportionality between the audit fees paid by smaller public companies and the largest public companies remained roughly the same between 2003 and 2004. However, unlike audit fees, these costs are not separately reported and, therefore, are difficult to analyze and measure.

[14]We also looked at audit fees as a percentage of market capitalization. While there is less of a disparity when this measure is used, a significant difference is still observable between smaller and larger public companies.

[15]As noted in figure 1, public companies with market capitalization between $75 million and $250 million paid roughly 4.1 times what public companies with market capitalization greater than $1 billion paid in 2003. For those public companies that reported implementing section 404, this ratio increased only slightly to 4.3.

Figure 1: Median Audit Fees as a Percentage of 2003 and 2004 Revenues Reported by Public Companies as of Aug. 11, 2005

Number and percentage of companies that filed internal control reports for first year of section 404 implementation		Company size (market capitalization in millions)	Median audit fee as a percentage of revenues: 2003 (all companies)	Companies that did not file internal control reports (2004)[a]	Companies that filed internal control reports (2004)[b]	Difference between 404 filers and nonfilers (2004)
66 of 2,263	3%	>$0-$75	.64%	.79	1.14	.35%
520 of 1,188	44	>75-250	.29	.35	.56	.21
376 of 641	59	>250-500	.18	.26	.40	.14
184 of 309	60	>500-700	.15	.20	.30	.10
183 of 283	65	>700-1,000	.13	.12	.25	.12
927 of 1,342	69	>1,000	.07	.07	.13	.06

2003 (all companies)

Companies that did not file internal control reports (2004)[a]

Companies that filed internal control reports (2004)[b]

Source: GAO analysis of Audit Analytics data.

Note: Our analysis is based on companies' end of the fiscal year market capitalization. SEC's criteria for categories of filers (accelerated versus non-accelerated filers) are based on companies' public float as of the end of their second quarter. Due to the timing difference, some of the companies identified in this analysis as having market capitalization of less than $75 million may have been accelerated filers under SEC's criteria.

[a]In addition to non-accelerated filers that were granted extensions, this includes accelerated filers that had not filed their internal control reports to SEC for reasons such as (1) the company's fiscal year ended before November 15, 2004, which pushed their reporting date to late 2005 or early 2006, or (2) the company was delinquent in implementing section 404.

[b]Some of these companies were non-accelerated filers that decided to file internal control reports voluntarily.

Smaller Public Companies Incurred Other Costs in Complying with the Act

According to executives of smaller public companies that we contacted, smaller companies incurred substantial costs in addition to the fees they paid to their external auditors to comply with section 404 and other provisions of the act. For example, 128 of the 158 smaller public companies that responded to our survey (81 percent of respondents) had hired a separate accounting firm or consultant to assist them in meeting section 404 requirements. Services provided included assistance with developing methodologies to comply with section 404, documenting and testing internal controls, and helping management assess the effectiveness of internal controls and remediate identified internal control weaknesses. These smaller companies reported paying fees to external consultants for the period leading up to their first section 404 report that ranged from $3,000 to more than $1.4 million. Many also reported costs related to training and hiring of new or temporary staff to implement the act's requirements. Additionally, some of the smaller companies that responded to our survey reported that their CFOs and accounting staff spent as much as 90 percent of their time for the period leading up to their first section 404 report on Sarbanes-Oxley Act compliance-related issues. Finally, many of the smaller public companies incurred missed "opportunity costs" to comply with the act that were significant. For example, nearly half (47 percent) of the companies that responded to our survey reported deferring or canceling operational improvements and more than one-third (39 percent) indicated that they deferred or cancelled information technology investments.

While most companies, including the majority of the smaller public companies that responded to our survey and that we interviewed, cited section 404 as the most difficult provision to implement, smaller public companies reported challenges in complying with other Sarbanes-Oxley Act provisions as well. Nearly 69 percent of the smaller public companies that responded to our survey said that the act's auditor independence requirements had decreased the amount of advice that they received from their external auditor on accounting- and tax-related matters. About half the companies that responded to our survey indicated that they incurred additional expenses by hiring outside counsel for assistance in complying with various requirements of the act. Examples mentioned included legal assistance with drafting charters for board committees, drafting a code of ethics, establishing whistleblower protection, and reviewing CEO and CFO certification requirements. About 13 percent of the smaller public companies reported incurring costs to appoint a financial expert to serve on the audit committee, and about 6 percent reported incurring costs to appoint other independent members to serve on the audit committee. While these types of costs were consistent with those reported for larger companies, the impact on smaller public companies was likely greater given their more limited revenues and resources.

Smaller Companies Have Different Characteristics Than Larger Companies, Some of Which Contributed to Higher Implementation Costs

While public companies—both large and small—have been required to establish and maintain internal accounting controls since the Foreign Corrupt Practices Act of 1977, most public companies and their external auditors generally had limited practical experience in implementing and using a structured framework for internal control over financial reporting as envisioned by the implementing regulations for section 404.[16] Our survey of smaller public companies and our discussions with external auditors indicated that the internal control framework—that is the COSO framework—referred to in SEC's regulations and PCAOB's standards implementing section 404 was not widely used by public companies, especially smaller companies, prior to the Sarbanes-Oxley Act.

Many companies documented their internal controls for the first time as part of their first year implementation efforts to comply with section 404. As a result, many companies probably underestimated the time and resources necessary to comply with section 404, partly because of their lack of experience or familiarity with the framework. These challenges were undoubtedly compounded in companies that needed to make significant improvements in their internal control systems to make up for deferred maintenance of those systems. While this was largely true for both larger and smaller companies, regulators (SEC and PCAOB), public accounting firms, and others have indicated that smaller public companies often face particular challenges in implementing effective internal control over financial reporting.[17]

Resource limitations make it more difficult for smaller public companies to achieve economies of scale, segregate duties and responsibilities, and hire qualified accounting personnel to prepare and report financial information. Smaller companies are inherently less able to take advantage of economies of scale because they face higher fixed per unit costs than

[16]See "Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," 68 *Federal Register* 36636 (June 18, 2003) (final rule).

[17]See COSO's exposure draft, "Guidance for Smaller Public Companies Reporting on Internal Control over Financial Reporting" (Oct. 26, 2005), for a discussion of the challenges that smaller companies face in implementing effective internal control over financial reporting.

larger companies with more resources and employees. Implementing the functions required to segregate transaction duties in a smaller company absorbs a larger percentage of the company's revenues or assets than in a larger company. About 60 percent of the smaller public companies that responded to our survey said that it was difficult to implement effective segregation of duties. Several executives told us that it was difficult to segregate duties due to limited resources. According to COSO's draft guidance for smaller public companies, smaller companies can develop and implement compensating controls when resource constraints compromise the ability to segregate duties. The American Institute of Certified Public Accountants noted that smaller public companies often do not have the internal audit functions referred to in COSO's internal framework guidance. Other executives commented that it was difficult to achieve effective internal control over financial reporting because they lacked expertise within their internal accounting staff. For example, according to an executive from a company that reported a material weakness in its section 404 report, the financial accounting standards for stock options were too complex for his staff and it was easier to have its auditor fix the mistakes and cite the company for a material weakness in internal control over financial reporting. Two other executives told us that their auditors cited their companies with material weaknesses in internal controls over financial reporting for not having appropriate internal accounting staff; to remediate this weakness, the companies had to hire additional staff.

According to COSO, however, some of the unique characteristics of smaller companies create opportunities to more efficiently achieve effective internal control over financial reporting and more efficiently evaluate internal control which can facilitate compliance with section 404. These opportunities can result from more centralized management oversight of the business, and greater exposure and transparency with the senior levels of the company that often exist in a smaller company. For instance, management's hands-on approach in smaller companies can create opportunities for less formal and less expensive communications and control procedures without decreasing their quality. To the extent that smaller companies have less complex product lines and processes, and/or centralized geographic concentrations in operations, the process of achieving and evaluating effective internal control over financial reporting could be simplified.

According to SEC, another characteristic of smaller public companies is that they tend to be much more closely held than larger public companies; insiders such as founders, directors, and executive officers hold a high percentage of shares in the companies. Further, CFOs of smaller public companies frequently play a more integrated operational role than their larger company counterparts. According to a recommendation by participants at the September 2005 Government-Business Forum on Small Business Capital Formation hosted by SEC, these types of shareholders are classic insiders who do not need significant SEC protection.[18] According to SEC's Office of Economic Analysis, among public companies with a market capitalization of $125 million or less, insiders own on average approximately 30 percent of the company's shares. Although the "insider" shareholders owners may not have the same need for significant investor SEC protection as investors in broadly held companies, minority shareholders who are not insiders may have a need for such protection.

Complexity, Scope, and Timing of PCAOB Guidance also Appeared to Influence Cost of Section 404 Implementation

Accounting firms and public companies also have noted that the scope, complexity, and timing of PCAOB's Auditing Standard No. 2 contributed to the challenges and higher costs in the first year of implementation of section 404. PCAOB's Auditing Standard No. 2 establishes new audit requirements and governs both the auditor's assessment of controls and its attestation to management's report. PCAOB first issued an exposure draft of the standard for comment by interested parties on October 7, 2003. The Board received 194 comment letters from a variety of interested parties, including auditors, investors, internal auditors, public companies, regulators, and others. Due to the time needed to draft the standard, evaluate the comment letters, and finalize the standard, PCAOB did not issue the final standard until March 2004—more than 8 months after SEC issued its final regulations on section 404 and part way into the initial year of implementation for accelerated filers. SEC, which under the act is responsible for approving standards issued by PCAOB, did not approve Auditing Standard No. 2 until June 17, 2004. As a result of both timing and unfamiliarity with PCAOB's Auditing Standard No. 2, auditors were not prepared to integrate the internal control over financial reporting attestation and financial audits in the first year of implementation as envisioned by Auditing Standard No. 2.

Furthermore, according to PCAOB, auditors were not always consistent in their interpretation and application of Auditing Standard No. 2. In PCAOB's report on the initial implementation of Auditing Standard No. 2,

[18] SEC, *24th Annual SEC Government-Business Forum on Small Business Capital Formation, Final Report* (Washington, D.C.: November 2005).

the Board found that both auditors and public companies faced enormous challenges in the first year of implementation arising from the limited time frames for implementing the new requirements; a shortage of staff with prior training and experience in designing, evaluating, and testing controls; and related strains on available resources.[19] The Board found that some audits performed under these circumstances were not as effective or efficient as they should have been. Auditing firms and a number of public companies have stated that they expect subsequent years' compliance costs for section 404 to decrease.

Costs Associated with the Sarbanes-Oxley Act May Have Impacted the Decision of Some Smaller Public Companies to Go Private, but Other Factors also Influenced Decision to Go Private

Since the passage of the act in July 2002, the number of companies going private (that is, ceasing to report to SEC by voluntarily deregistering their common stock) increased significantly.[20] As shown in figure 2, the number of public companies that went private has increased significantly from 143 in 2001 to 245 in 2004, with the greatest increase occurring during 2003.[21] However, the 245 companies represented 2 percent of public companies as of January 31, 2004. Based on the trends observed in 2003 and 2004 and the 80 companies that went private in the first quarter of 2005, we project that the number of companies going private will have risen more than 87 percent, from the 143 in 2001 to a projected 267 through the end of 2005. Our analysis also indicated that companies going private during this entire

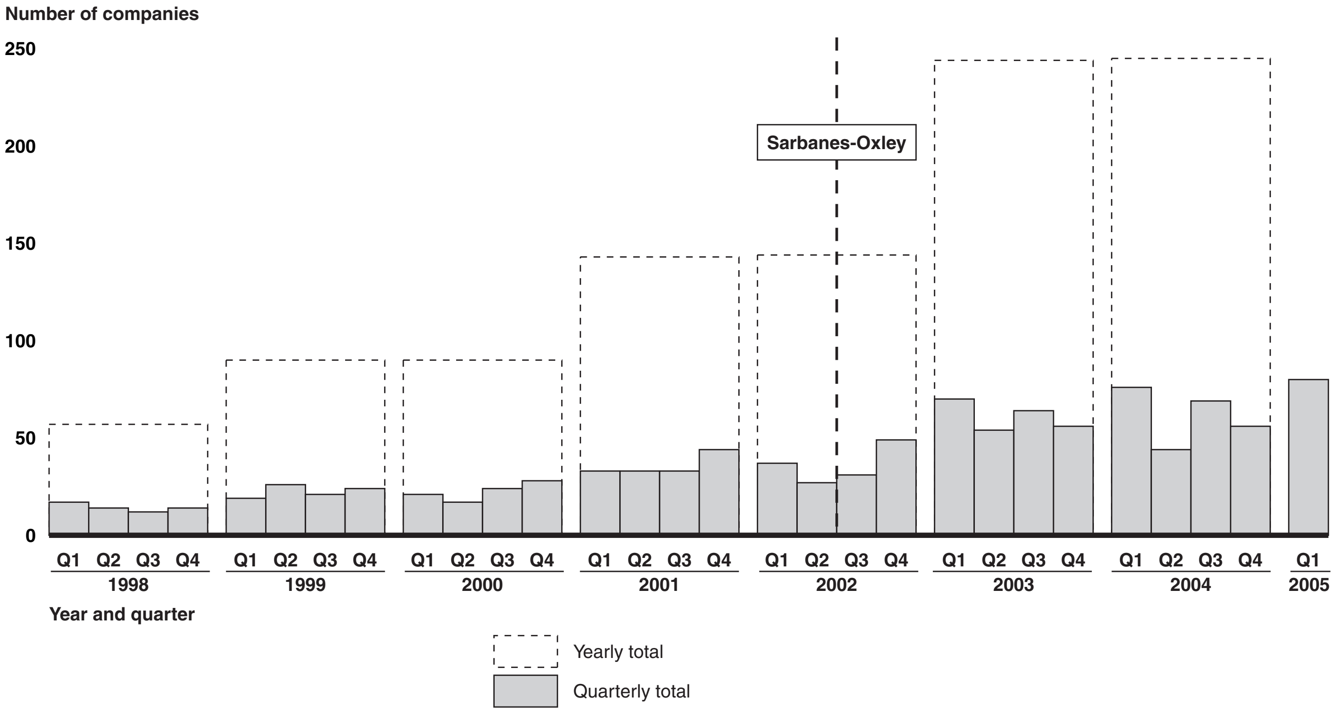
[19]PCAOB Release No. 2005-023 *Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (Washington, D.C.: Nov. 30, 2005).

[20]According to the "Fast Answers" section of SEC's website, "a company goes private when it reduces the number of its shareholders to fewer than 300 and is no longer required to file reports with SEC." See www.sec.gov/answers/gopriv.htm. Stock of these companies no longer trades on the major markets; however, companies can and do continue trading on the less regulated Pink Sheets, which have no minimum listing standards. When a company suspends its duty to report to SEC but continues to trade on the Pink Sheets, it is commonly referred to as having "gone dark," since investors no longer have access to information in the form of 8-Ks or quarterly and annual financial statements filed with SEC. Or, after deregistering, some companies elect to become "fully private" and are no longer traded or listed on any market. For purposes of this report, we consider both types of companies—"gone dark" and "fully private"—as private. As such, the terms deregistering and "going private" are used interchangeably in this report. See appendix II for more details on the definition of "going private" used in this report.

[21]We eliminated companies that deregistered common stock as a result of acquisitions and mergers that were not "going private" transactions, liquidations, reorganizations, bankruptcy filings, or re-emergences. We also eliminated duplicate filings and filings by foreign registrants. These trends are consistent with a number of studies we identified, although data collection methodologies differ across samples. See appendix II for a full discussion of GAO's analysis.

period were disproportionately small by any measure (market capitalization, revenue, or assets).

Figure 2: Total Number of Companies Identified as Going Private, 1998-2005



Source: GAO analysis of SEC data.

Note: Includes companies that deregistered, but continued to trade over the less-regulated Pink Sheets ("went dark") and shell companies and blank check companies. Does not include companies that filed for, or are emerging from, bankruptcy, have liquidated or are in the process of liquidating, were headquartered in a foreign country, or were acquired by or merged into another company unless the transaction was initiated by an affiliate of the company and the company became a private entity. See appendix II for a fuller discussion of our analysis.

The costs associated with public company status were most often cited as a reason for going private (see table 2). While there are many reasons for a company deregistering—including the inability to benefit from its public company status—the percentage of deregistered companies citing the direct cost associated with maintaining public company status grew from 12 percent in 1998 to 62 percent during the first quarter of 2005. These costs include the accounting, legal, and administrative costs associated with compliance with SEC's reporting requirements as well as other expenses such as those related to managing shareholder accounts. The number of companies citing indirect costs, such as the time and resources needed to comply with securities regulations, also has increased since the passage of the Sarbanes-Oxley Act.[22] In 2002, 64 companies that went private cited cost as one of the reasons for the decision; however, that number increased to 143 and 130 companies in 2003 and 2004, respectively. Many of the companies mentioned both the direct and indirect costs associated with maintaining their public company status. Over half of the companies that cited costs mentioned the Sarbanes-Oxley Act specifically (roughly 58 percent in 2004 and 2005 and 41 percent in 2003). For smaller public companies, the costs of complying with securities laws likely required a greater portion of their revenues, and cost considerations (indirect and direct) were the leading reasons for companies exiting the public market, even prior to the enactment of the Sarbanes-Oxley Act.[23]

Table 2: Primary Reasons Cited by Companies for Going Private, 1998-2005, by Percent

	Direct costs	Indirect costs	Market/liquidity issues	Private company benefits	Critical business issues	Other	No reason
1998	12.3	5.3	14.0	26.3	15.8	3.5	54.4
1999	33.3	12.2	33.3	42.2	8.9	3.3	37.8
2000	20.0	11.1	32.2	37.8	20.0	5.6	38.9
2001	32.2	13.3	31.5	23.8	20.3	3.5	49.0
2002	44.4	13.9	35.4	22.9	16.0	1.4	45.1
2003	57.8	27.5	38.5	21.3	19.7	0.8	31.6
2004	52.7	25.7	28.6	15.9	15.5	1.2	38.4
2005 Q1	62.2	28.9	28.9	8.9	12.2		27.8

Source: GAO analysis of SEC filings and relevant press releases.

Note: See appendix II for a more detailed description of the categories and limitation for this analysis. Because companies were able to cite more than one reason for going private, the percentages may add up to more than 100 for each year.

Further, the benefits of public company status historically appeared to have been disproportionately smaller for smaller companies, companies

[22]See appendix II for full description of each reason.

[23]Consistent with our findings, a number of research reports also find that companies most often cited cost savings from not having to comply with SEC regulations as a benefit of going private. For example, see C. Luez, et al., "Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations," Wharton School Working Paper, University of Pennsylvania, September 2004, and S. Block, "The Latest Movement to Going Private: An Empirical Study," *Journal of Applied Finance*, 14 (1): 2004.

with limited need for external funding, and companies whose public shares were traded infrequently or in low volume at low prices.[24] As a result, issues unrelated to the Sarbanes-Oxley Act, such as market and liquidity issues and the benefits of being private, are also major reasons for companies going private. From 1999 to 2004, more companies cited market and liquidity issues than the indirect costs associated with maintaining their public company status. Companies in this category cited a wide variety of issues related to the company's publicly traded stock such as a lack of analyst coverage and investor interest, poor stock market performance, limited liquidity (trading volume), and inability to use the secondary market to raise additional capital.[25] Smaller companies also have cited advantages of private status such as greater flexibility, freedom from the short-term pressures of Wall Street, belief that the markets had consistently undervalued the company, and the ability to avoid disclosures of information that might benefit their competitors (see app. II).

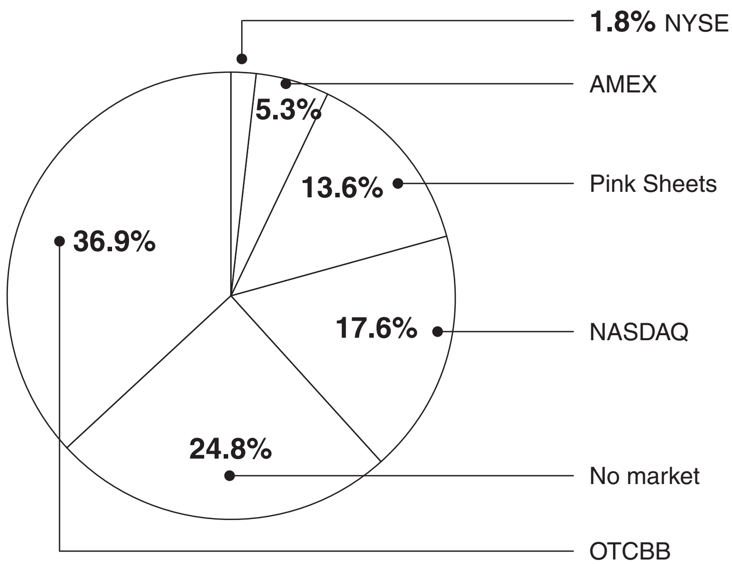
Companies that elect to go private reduce the number of financing options available to them and must rely on other sources of funding. In aggregate, equity is cheaper when it is supplied by public sources, net of any costs of regulatory compliance. However, in some circumstances, private equity or bank lending may be preferable alternatives to the public market. Statistics suggest bank loans are the primary source of funding for U.S. companies that rely on external financing. Some companies with insufficient market liquidity had little opportunity for follow-on stock offerings and going private would not have fundamentally altered the way they raised capital. We found that almost 25 percent of the companies that deregistered from 2003 through the end of the first quarter of 2005 were not trading on any market at all (see fig. 3). Approximately 37 percent of the companies that went private during this period were traded on the Over-the-Counter Bulletin Board (OTCBB); the general liquidity of this market is significantly less than major markets traded on the NASDAQ

[24]In general, public companies will differ in the costs incurred and benefits obtained as a result of their public company status because of differences in size, industry, or other factors.

[25]Well before the passage of the Sarbanes-Oxley Act, analysts noted that a decline in analyst and research coverage of smaller companies and other challenges had resulted in a large number of smaller companies with extremely low valuations and limited trading volume and investor interest. For example, research in 2003 suggested that, while 95 percent of all companies with market capitalization greater than $1 billion were covered by an analyst, 21 percent of companies with market capitalization between $25-50 million were covered by an analyst, and just 3 percent of companies below $25 million market capitalization were covered.

Stock Market, Inc. (NASDAQ) or the New York Stock Exchange (NYSE).[26] Additionally, 14 percent were traded in the Pink Sheets and, therefore, were most likely closely held and traded sporadically, if at all. Pink Sheets LLC is not registered with SEC, has no minimum listing standards, does not require quoted companies to provide detailed information to its investors, and is regarded as high-risk by many investors. As a result, trading on the Pink Sheets may produce negative reputational effects that can further reduce liquidity and the market value of the company's stock, thereby increasing the cost of equity capital.[27]

Figure 3: Where Companies Traded Prior to Deregistration, July 2003-March 2005



Source: GAO analysis of SEC data.

[26]The OTCBB is an electronic quotation system for equity securities not traded or listed on any of the national exchanges or NASDAQ. Generally, issuers of securities quoted on the OTCBB are smaller companies.

[27]Although National Association of Securities Dealers, Inc. (NASD) oversees the OTCBB, the OTCBB is not part of the NASDAQ Stock Market. SEC has found that fraudsters often claim that an OTCBB company is a NASDAQ-listed company to mislead investors into thinking that the company is bigger than it actually is (see Microcap Stock: A Guide for Investors: http://www.sec.gov/investor/pubs/microcapstock.htm). Pink Sheets LLC has no affiliation with NASD and its activities are not regulated by SEC.

It Is Too Soon to Determine How Sarbanes-Oxley Affected Access to Capital for Smaller Public Companies

As previously discussed, a large number of smaller public companies have not fully implemented all the requirements of the Sarbanes-Oxley Act, notably non-accelerated filers (public companies with less than $75 million in public float). As a result, it is unlikely that the act has affected access to the capital markets for these companies. Moreover, the limited time that the act's provisions have been in force would limit any impact on access to capital, even for the companies that have implemented section 404. For instance, more than 80 percent of the smaller public companies that responded to our survey indicated that the act has had no effect or that they had no basis to judge the effect of the act on their ability to raise equity or debt financing or on their cost of capital.

There are indications that the Sarbanes–Oxley Act at a minimum has contributed to some smaller companies rethinking the costs and benefits of public company status. For example, more than 20 percent of the smaller companies that responded to our survey also stated that the act encouraged them to consider going private or deregistering. In contrast, a number of the smaller public companies that responded to our survey cited positive effects associated with the implementation of the act, notably positive impacts on audit committee involvement (60 percent), company awareness of internal controls (64 percent), and documentation of business processes (67 percent).

SEC and PCAOB Have Been Addressing Smaller Company Concerns Associated with the Implementation of Section 404

SEC and PCAOB have taken actions to address smaller public company concerns about implementation of Sarbanes-Oxley Act provisions, particularly section 404, by giving smaller companies more time to comply, issuing or refining guidance, increasing communication and education opportunities, and establishing an advisory committee on smaller public companies. In particular, SEC has extended deadlines for complying with section 404 requirements several times since issuing its final rule in 2003 (see table 3). In its final rulemaking on section 404 requirements, SEC stated that it was sensitive to concerns that many smaller public companies would experience difficulty in evaluating their internal control over financial reporting because these companies might not have as formal or well-structured a system of internal control over financial reporting as larger companies. In November 2004, SEC granted “smaller” accelerated filers an additional 45 days to file their reports on internal control over financial reporting out of concern that these companies were not in a position to meet the original deadline. SEC granted non-accelerated filers two additional extensions in March 2005 and September 2005, with the latter extension giving non-accelerated filers until their first fiscal year after July 2007 before having to report under section 404. SEC also considered the particular challenges facing smaller companies when granting these extensions. Further, SEC noted that there were other small business initiatives underway that could improve the effectiveness of non-accelerated company filers' implementation of the section 404 reporting requirements.

Table 3: SEC Extensions of Section 404 Compliance Dates

Action	Date	Description
Final rule	June 5, 2003	*SEC's rationale* SEC adopted an extended transition period for compliance so that companies and their auditors would have time to prepare and satisfy the new requirements. The transition period would provide additional time for PCAOB to develop the new auditing standard for internal control over financial reporting. *Compliance dates* An accelerated filer (generally, a U.S. company that has public equity float of more than $75 million and has filed at least one annual report with SEC) was required to comply for its first fiscal year ending on or after June 15, 2004. A non-accelerated filer was required to comply for its first fiscal year ending on or after April 15, 2005.
Final rule; extension of compliance dates	February 24, 2004	*SEC's rationale* The extension would minimize the cost and disruption of implementing a new disclosure requirement. The extension would provide companies and their auditors with a sufficient amount of time to perform additional testing or remediation of controls based on the final auditing standard. *Compliance dates* An accelerated filer was required to comply for its first fiscal year ending on or after November 15, 2004. A non-accelerated filer was required to comply for its first fiscal year ending on or after July 15, 2005.
Exemptive order	November 30, 2004	*SEC's rationale* SEC was concerned that many smaller accelerated filers were not in a position to meet the compliance dates. *Compliance dates* Subject to certain conditions, a smaller accelerated filer (generally, a U.S. company with public float of less than $700 million) was granted an additional 45 days to comply. The compliance dates for non-accelerated filers did not change.

Action	Date	Description
Final rule; extension of compliance dates	March 2, 2005	*SEC's rationale* In December 2004, SEC established an advisory committee to, among other things, assess the impact of the Sarbanes-Oxley Act on smaller public companies. The extension was intended to give the committee additional time to conduct its work. In January 2005, COSO established a task force to provide guidance on how the COSO framework could be applied to smaller companies. The extension would give smaller public companies time to consider the new COSO guidance, which COSO intended to publish during the summer of 2005. *Compliance dates* The compliance dates for accelerated filers did not change. A non-accelerated filer was required to comply for its first fiscal year ending on or after July 15, 2006.
Final rule; extension of compliance dates	September 22, 2005	*SEC's rationale* The extension was warranted due to ongoing efforts by the COSO task force and SEC's advisory committee. In August 2005, the advisory committee recommended that SEC extend section 404 compliance dates for non-accelerated filers. The extension was consistent with the advisory committee's recommendation. *Compliance dates* The compliance dates for accelerated filers did not change. A non-accelerated filer is required to comply for its first fiscal year ending on or after July 15, 2007.

Source: GAO analysis of SEC regulatory actions.

While SEC's final rule serves as basic guidance for public company implementation of section 404 requirements, PCAOB's Auditing Standard Number 2 provides the auditing standards and requirements for an audit of the financial statements and internal control over financial reporting, as part of an integrated audit. It is a comprehensive document that addresses the work required by the external auditor to audit internal control over financial reporting, the relationship of that work to the audit of the financial statements, and the auditor's attestation on management's assessment of the effectiveness of internal control over financial reporting. The standard requires technical knowledge and professional expertise to effectively implement.

While both SEC regulations and the PCAOB standard refer to COSO's internal control framework, many companies were unfamiliar with or did not use this framework, despite the fact that public companies have been required by law to have implemented a system of internal accounting controls since 1977. According to SEC, smaller public companies and their auditors had expressed concern that the COSO internal control framework was designed primarily for larger public companies and smaller companies lacked sufficient guidance on how they could use COSO's internal control framework, resulting in disproportionate section 404 implementation costs. As a result, SEC staff asked COSO to develop additional guidance to assist smaller public companies in implementing COSO's internal control framework in a small business environment. In October 2005, COSO issued a draft of the guidance for public comment, and anticipated issuing final guidance for smaller public companies in early 2006. The draft guidance outlined 26 principles for achieving effective internal control over financial reporting and provides examples on how companies can implement them. The draft guidance states that the fundamental concepts of good internal control over financial reporting are the same whether the company is large or small. At the same time, the draft guidance points out differences in approaches used by smaller companies versus their larger counterparts to achieve effective internal control over financial reporting and discusses the unique challenges faced by smaller companies. While intended to provide additional clarity to smaller companies for implementing an internal control framework, the guidance has received mixed reviews with some questioning whether it will significantly change the disproportionate cost and other burdens for smaller public companies associated with section 404 compliance.[28]

In December 2004, SEC announced its intention to establish its Advisory Committee on Smaller Public Companies to assess the current regulatory system for smaller companies under the securities laws, including the impact of the Sarbanes-Oxley Act. In addition to granting companies more time to meet the act's requirements, SEC has been considering how its section 404 guidance and overall approach to implementation might be revised. SEC chartered the advisory committee on March 23, 2005. The committee plans to issue its final report to SEC by April 2006.

On March 3, 2006, the committee published an exposure draft of its final report for public comment that contained 32 recommendations related to securities regulation for smaller public companies.[29] Due to the number of recommendations, the advisory committee refers to its 14 highest priority recommendations as "primary recommendations." One of its primary recommendations is an overarching recommendation calling for a "scaled"

[28]On January 20, 2006, we submitted a comment letter to COSO on its draft guidance that contained specific recommendations on areas where we felt the guidance could be improved.

[29]See 71 *Federal Register* 11090 (Mar. 3, 2006).

approach to securities regulation, whereby smaller public companies are stratified into two groups, “microcap” and “smallcap” companies. Under this recommendation, microcap companies would consist of companies whose common stock in the aggregate make up the lowest 1 percent of U.S. equity market capitalization. The advisory committee estimates, based on data from SEC’s Office of Economic Analysis, that the microcap category would include public companies whose individual market capitalization is less than $128 million, approximately 53 percent of all U.S. public companies. For the smallcap category, the advisory committee estimates that the category would include public companies whose individual market capitalization is less than $787 million and greater than $128 million, and would encompass an additional 26 percent of U.S. public companies and an additional 5 percent of U.S. market capitalization. Taken together, the categories of microcap and smallcap companies, as defined by the advisory committee draft recommendations, would include approximately 79 percent of all U.S. public companies and 6 percent of market capitalization, according to the advisory committee’s analysis of SEC data. The recommendation calling for a scaled approach for securities regulation based on company size was also incorporated into the committee’s preliminary recommendations related to internal control over financial reporting.

While acknowledging that some have questioned whether smaller public companies’ problems with section 404 have been overstated, the advisory committee concluded that section 404, as currently structured, “represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed.”[30] In part, the advisory committee based its conclusion on a belief that smaller public company compliance with section 404 has resulted in disproportionate costs and less certain benefits.

The advisory committee’s primary recommendations related to internal control over financial reporting address regulatory relief from section 404 for a subset of the microcap and smallcap categories described above by the inclusion of revenue criteria.[31] Specifically, the committee’s preliminary recommendations are that:

[30] 71 *Federal Register* 11090, 11098.

[31] SEC staff told us that they had not conducted a legal analysis of the preliminary recommendations to determine if SEC has authority to issue exemptions from section 404.

- Unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs, provide exemptive relief from all of the requirements of section 404 of the Sarbanes-Oxley Act to microcap companies with less than $125 million in annual revenue and to smallcap companies with less than $10 million in annual product revenue.[32]

- Unless and until a framework for assessing internal control over financial reporting for smallcap companies is developed that recognizes the characteristics and needs of those companies, provide exemptive relief from section 404(b) of the act—the external auditor involvement in the section 404 process—to smallcap companies with less than $250 million but greater than $10 million in annual product revenues and microcap companies with between $125 million and $250 million in annual revenues.

By including the revenue criteria, the committee's recommendations regarding section 404 cover a subset of the public companies included within its microcap and smallcap definitions. The committee estimated that, after applying the revenue criteria, 4,641 "microcap" public companies (approximately 49 percent of 9,428 public companies identified in data developed for the advisory committee by SEC's Office on Economic Analysis) may potentially qualify for full exemption from section 404 and another 1,957 "smallcap" public companies (approximately 21 percent of the SEC-identified public companies)—a total of 70 percent of SEC-identified public companies—may potentially qualify for exemption from the external audit requirement of section 404(b).[33] It is likely that a number of public companies that would qualify

[32]The exposure draft of the Advisory Committee on Smaller Public Companies uses the term "product revenue" as one of the criteria for categorizing smallcap companies for the purposes of its recommendations. However, the exposure draft did not contain an explanation of the term "product" revenue. As a result, it was not possible to analyze how a $10 million "product" revenue filter might affect the number of smallcap companies that would become eligible for the full exemption from section 404 otherwise limited to microcap companies under the Advisory Committee's preliminary recommendations. *See* 71 *Federal Register* 11093, 11104, and 11105.

[33]The 9,428 public companies identified by SEC included U.S. companies listed on the New York and American Stock Exchanges (NYSE and AMEX, respectively), the NASDAQ Stock Market, and the OTC Bulletin Board. However, data prepared for the Advisory Committee by SEC's Office of Economic Analysis noted that the 9,428 public companies do not include approximately 3,650 U.S. public companies whose stock trades on the Pink Sheets. The omission of Pink Sheet companies results in an understatement of the number and percentage of public companies that would be affected by the committee's recommendations calling for section 404 regulatory relief for smaller public companies.

for exemptive relief under the committee's recommendations have probably already complied with both sections of 404(a) and (b), based on their status as accelerated filers.

If adopted, these recommendations would effectively establish a "tiered approach" for compliance with section 404, "unless and until" a framework for assessing internal control over financial reporting is developed for microcap and smallcap companies. Under the tiered approach, larger public companies that do not meet the committee's size criteria for exemption would continue to be required to comply with both section 404(a)—management's assessment of and reporting on internal control over financial reporting—and section 404(b)—the external auditors' attestation on management's assessment and the effectiveness of the company's internal control. "Smallcap" public companies that meet the revenue criteria would be exempt from complying with section 404(b), but the companies would still be required to comply with section 404(a). "Microcap" and some "smallcap"companies that meet the revenue criteria would be entirely exempt from both section 404(a) and (b).[34] The committee's two primary recommendations related to regulatory relief from section 404 for smaller public companies also include additional requirements that affected public companies apply additional corporate governance provisions and report publicly on known material internal control weaknesses.[35]

In its next primary recommendation on internal control over financial reporting, which is premised on the adoption of the recommendation for microcap companies described above, the committee acknowledged that SEC might conclude, as a matter of public policy, that an audit requirement is necessary for smallcap companies. In that case, the committee recommended SEC provide for the external auditor to perform an audit of only the design and implementation of internal control over

[34]Under the committee's recommendations, "smallcap" companies with annual product revenues below $10 million would receive the same treatment as microcap companies and be exempted from having to comply with both sections 404(a) and (b).

[35]The specified corporate governance provisions included (1) adherence to standards relating to audit committees in conformity with Rule 10A-3 under the Securities Exchange Act and (2) adoption of a code of ethics with the meaning of Item 406 of Regulation S-K applicable to all directors, officers, and employees and compliance with further obligations under Item 406(c) relating to the disclosure of the code of ethics. Additionally, the committee recommended that management continue to be required to report on any known material weaknesses, including those uncovered by the external auditor and reported to the audit committee.

financial reporting, which by its nature would be more limited than the audit of the effectiveness of internal control over financial reporting required by section 404(b) and PCAOB's Auditing Standard No. 2, and that PCAOB develop a new auditing standard for such an engagement. While this recommendation is based on the view that having the external auditor perform a review of the design and implementation of internal control over financial reporting would be more cost-effective than the work otherwise required under Auditing Standard No. 2, the committee's report does not address the extent to which costs for such a review would be lower than that required under Auditing Standard No. 2 and whether the lower costs would be worth the reduced assurances provided by reduced scope of the external auditors' work on internal control over financial reporting.

While not specifically focused on small business issues, SEC also conducted a public "roundtable" in April 2005 that gave public companies, accounting firms, and others an opportunity to provide feedback to SEC and PCAOB on what went well and what did not during the first year of section 404 implementation. GAO also participated in this roundtable. Following the roundtable, the SEC and PCAOB Chairmen noted the importance of section 404 requirements but acknowledged that initial implementation costs had been higher than expected and noted the need to improve the cost-benefit equation for small and mid-sized companies. Both agencies issued additional guidance in May 2005 based on findings from the roundtable. PCAOB's guidance clarified that auditors (1) should integrate their audits of internal control over financial reporting with their audits of the client's financial statements, (2) exercise judgment and tailor their audit plans to best meet the risks faced by their clients rather than relying on standardized "checklists," (3) use a top-down approach beginning with company-level controls and use the risk assessment required by the standard, (4) take advantage of the work of others, and (5) engage in direct and timely communication with their audit clients, among other matters. Guidance by SEC and its staff emphasized the need for reasonable assurance, risk-based assessments, better communication between the auditor and client, and clarified what should be in material weakness disclosures. Representatives of the smaller public companies that we interviewed indicated that the additional guidance that SEC and PCAOB issued was helpful. SEC and PCAOB plan to hold a second roundtable in May 2006 to discuss companies' second year experiences with implementing section 404. Both chairs of SEC and PCAOB have said that they would consider additional guidance if necessary.

On November 30, 2005, PCAOB also issued a report on the initial implementation of its auditing standard on internal control over financial reporting.[36] The report included observations by PCAOB—based in significant part, but not exclusively, on its inspections of public accounting firms, which in the 2005 cycle included a review of a limited selection of audits of internal control over financial reporting—on why the internal control audits were not as efficient or effective as the standard intended. PCAOB also amplified the previously issued guidance of May 2005, discussing how auditors could achieve more effective and efficient implementation of the standard.

Further, PCAOB has held a series of forums nationwide to educate the small business community on the PCAOB inspections process and the new auditing standards. The goal of the forums was to provide small accounting firms and smaller public companies an opportunity to discuss PCAOB-related issues with Board members and staff. PCAOB also established a Standing Advisory Group to advise PCAOB on standard-setting priorities and policy implications of existing and proposed standards. The Standing Advisory Group has considered ways to improve the application of its internal control over financial reporting requirements—Auditing Standard No. 2—with respect to audits of smaller public companies.

Finally, both SEC and PCAOB have acknowledged the challenges that smaller public companies faced and continue to face in implementing section 404 and have begun to address those challenges. SEC also has emphasized that smaller companies need to focus on the quality of their internal control over financial reporting. Data provided by SEC's Office of Economic Analysis and other studies have pointed to the increased level of restatements as an indicator that the Sarbanes-Oxley Act—section 404 in particular—has gotten companies to identify and correct weaknesses that led to financial reporting misstatements in prior fiscal years. For example, according to recent research conducted by Glass, Lewis and Co., the restatement rate for smaller public companies was more than twice the rate for the largest public companies (9 percent for companies with revenues of less than $500 million and 4 percent for companies with more

[36] PCAOB Release No. 2005-023, *Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (Washington, D.C.: Nov. 30, 2005).

than $10 billion).[37] SEC staff also noted that smaller public companies had a disproportionately higher rate of material weaknesses in internal control over financial reporting during the first year of implementing section 404. Our discussions with accounting firms confirmed that smaller public companies have had a higher rate of reported material weaknesses in internal control over financial reporting than larger public companies.

A major challenge in considering any regulatory relief from section 404 is that the overriding purpose of the Sarbanes-Oxley Act is investor protection. Investor confidence in the integrity and reliability of financial reporting is a critical element for the efficient functioning of our capital markets. The purpose of internal control over financial reporting is to provide reasonable assurance over the integrity and reliability of the financial statements and related disclosures. Market reactions to financial misstatements illustrate the importance of accurate financial reporting, regardless of a company's size.

Given the anticipated regulatory changes, particularly those relating to section 404's internal control reporting requirements, smaller public companies may be limiting or not taking definitive actions to improve internal control over financial reporting based on a perception that they could become exempt from section 404. Further, PCAOB officials noted that such a perception may have limited smaller business involvement in PCAOB forums.

[37]See Glass Lewis & Co., "Restatements – Traversing Shaky Ground," *Trend Alert*, June 2, 2005. The restatement rate calculation only included companies with available financial data. The lack of financial data and, therefore, exclusion of these companies, may lead to a slight bias in the restatement rate for all companies (with a slightly larger impact on the rate for smaller companies).

Sarbanes-Oxley Act Requirements Minimally Affected Smaller Private Companies, Except for Those Seeking to Enter the Public Market

While the act does not impose new requirements on privately held companies, companies choosing to go public realistically must spend additional time and funds in order to demonstrate their ability to comply with the act, section 404 in particular, to attract investors.[38] This may have been a contributing factor in the reduction of the number of initial public offerings (IPO) issued by small companies since 2002. However, other factors—stock market performance and changes in listing standards—likely also have affected the number of IPOs. While a number of states proposed legislation with provisions similar to the Sarbanes-Oxley Act, three states[39] actually enacted legislation requiring private companies or nonprofit organizations to adopt requirements similar to certain Sarbanes-Oxley Act provisions. Finally, some privately held companies have been adopting the act's enhanced governance practices because these companies believe these practices make good business sense.

Sarbanes-Oxley May Have Affected IPO Activity; however, Other Important Factors also Influence Entry into the Public Market and Access to Capital

Small businesses that are not public companies typically rely on a variety of sources to finance their operations, including personal savings, credit cards, and collateralized bank loans. In addition, small businesses can use private equity capital sources such as venture capital funds—private partnerships that provide private equity financing to early- and later-stage high-growth small businesses—to fund their growth. Small businesses may also issue equity shares to other types of investors to finance further growth. These shares may be sold through private placements where shares are sold directly to investors (direct placement) or through a public offering where the shares are sold through an underwriter (going public).[40] In addition, some small companies issue equities that trade on smaller markets such as the Pink Sheets.[41] For those private companies desiring to enter the public market, the IPO process has always been recognized as a time-consuming and expensive endeavor.

[38]Section 404's requirements only apply to annual reports required by section 13(a) or section 15(d) of the Securities Exchange Act of 1934.

[39]Illinois, Texas, and California.

[40]For more information on small business equity capital formation, see GAO, *Small Business: Efforts to Facilitate Equity Capital Formation*, GAO/GGD-00-190 (Washington, D.C.: Sept. 29, 2000).

[41]Pink Sheets LLC, a privately held company, does not require companies to be registered with SEC; therefore, many of these companies do not make available the kind of detailed financial disclosures that SEC-registered companies must provide.

However, venture capitalists and private company officials told us that, as a result of the act and other market factors, many private companies have been spending additional time, effort, and money to convince investors that they can meet the requirements of the act. For example, investors have become more cautious and demanding of the private companies in which they invest. Consequently, private companies have hired auditors and additional staff to make substantial changes to their financial system and data-reporting capabilities, document internal controls and processes, and review or change accounting procedures.

According to venture capitalists and private company officials with whom we spoke, a private company's ability to meet the Sarbanes-Oxley Act's requirements can significantly decrease some of the investment risk associated with becoming a public company. For example, both groups told us that companies with well-documented internal control and governance policies were more attractive and able to secure investor funding at a much lower cost. Moreover, they noted that underwriters expected private companies to consider and comply with the act well in advance of going public. If a private company were unable to meet the act's requirements, venture capitalists would want the company to show evidence of a plan for becoming compliant as soon as the company became public. If not, venture capitalists noted that they would be less likely to invest in such a company and look elsewhere for investment opportunities.

These new expectations may have served to increase the expenses associated with the IPO process through changes in the professional fees charged by auditors and potentially other costs as well. Specifically, we found that there has been a disproportionate increase for the smallest companies when IPO expenses were viewed as a percentage of revenue. As shown in table 4, the direct expenses (excluding underwriting fees) associated with the IPO represented a significant portion of a small company's revenues, relative to larger companies, from 1998 through the second quarter of 2005. These expenses have increased disproportionably since 2002 for small companies going public—especially for the smallest of these companies ($25 million or less in revenues). While Sarbanes-Oxley Act requirements could explain some of this increase, legal, exchange listing, printing, and other fees unrelated to the act could also account for this increase. Moreover, other market factors also could explain the increase in IPO expenses paid to auditors.[42]

Table 4: IPO Direct Expenses as a Percentage of Company's Revenues, by Size

	$25 million or less	$25 -100 million	$100-250 million	$250-500 million	$500 million-1 billion	Greater than $1 billion	All companies
1998	12.5	3.0	1.2	0.6	0.3	0.2	0.9
1999	17.6	3.7	1.8	0.7	1.2	0.1	0.9
2000	21.3	3.3	1.9	0.8	0.3	0.1	0.6
2001	14.3	3.0	1.1	0.8	0.5	0.1	0.2
2002	10.6	3.1	1.1	0.6	0.3	0.1	0.1
2003	17.5	5.0	1.5	0.7	0.4	0.5	0.9
2004	25.9	4.9	2.2	1.5	0.4	0.3	1.3
2005 (Q1-Q2)	28.1	5.3	1.5	1.2	0.6	0.3	1.0
1998 – 2005 Q2	18.2	3.8	1.7	0.9	0.5	0.1	0.4

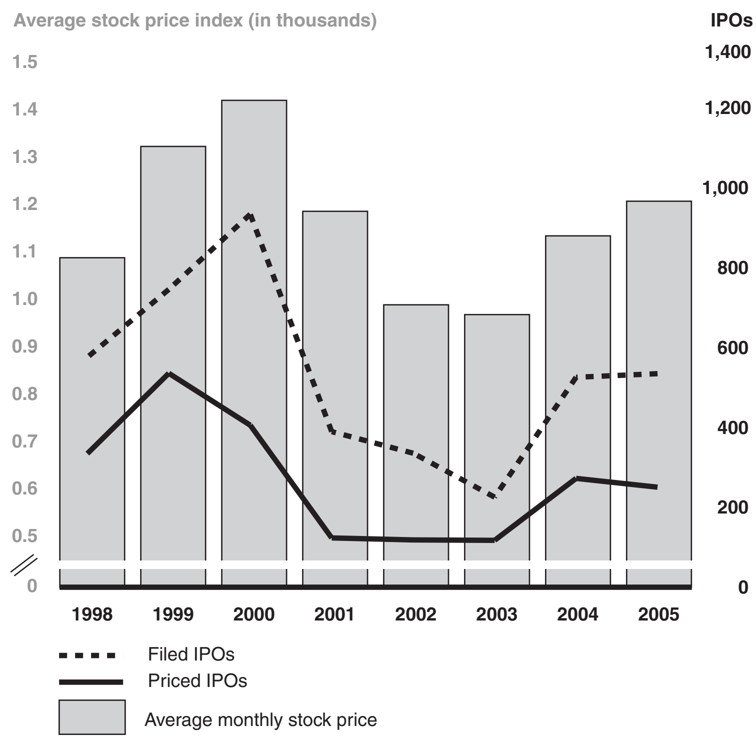
Source: GAO analysis of data from SEC filings.

Note: Includes only companies with financial data available. In some cases, pro forma or un-audited revenue data were used. There can be significant lag between the dates when a company initially files for an IPO and when the stock of the company is finally priced (begins trading). The number of priced IPOs only includes those companies that initially filed for an IPO after November 1, 1997. See appendix I for more details.

In addition to the requirements of the Sarbanes-Oxley Act and the general increase in direct expenses, other important factors likely have influenced IPO activity. To illustrate, the downward trend in IPOs occurred before the passage of the Sarbanes-Oxley Act in mid-2002. It is widely acknowledged that IPO filings and pricings tend to be closely associated with stock market performance. As shown in figure 4, companies generally issued (priced) significantly more IPOs when stock market valuations were higher.

[42]Cost increases associated with concentration in the accounting industry are one of these potential factors. Some companies and their investment banks would consider only a large accounting firm when preparing for an IPO. In 2003 and 2004, over 80 percent of the companies completing the IPO process used a large accounting firm.

Figure 4: IPO and Stock Market Performance, 1998-2005



Source: GAO analysis of SEC data.

Note: The number of priced IPOs only includes those companies that initially filed for an initial public offering after November 1, 1997. For more information, see appendix II.

Companies with smaller reported revenues now make up a smaller share of the IPO market. The number of IPOs by companies with revenues of $25 million or less decreased substantially, from 70 percent of all IPOs in 1999 to about 48 percent in 2004 and 31 percent during the first two quarters of 2005. Venture capitalists told us that, on average, a private company had to demonstrate at least 6 quarters of profitability before it could go public and hire an auditor to carry it through the IPO process. According to the venture capitalists, an increasing number of small and mid-sized private companies have been pursuing mergers and acquisitions as a means of growing without going through the IPO process, which now typically costs more than a merger or acquisition.

Potential Spillover Effects of the Sarbanes-Oxley Act on Private Companies Have Been Minimal

While the Sarbanes-Oxley Act has increased corporate governance and accountability awareness throughout business and investor communities, our research and discussions with representatives of financial institutions suggest that financiers are not requiring privately held companies to meet Sarbanes-Oxley Act requirements as a condition to obtaining access to capital or other financial services. For example, the representatives said they emphasize utilization of credit scoring to make decisions and may make lending decisions using "personal guarantees" in lieu of audited financial statements and reported cash flow on financial statements for the smallest private companies. For larger private companies, the representatives stated that they require audited financial statements and cash flow information, but that their lending requirements existed well before the Sarbanes-Oxley Act and have not changed as a result of its passage. Overall, they noted that they do not believe that the act has affected the way financial institutions and lenders conduct business with private companies. They also noted that financial institutions and lenders have always enjoyed the freedom to obtain virtually any information about a potential borrower and to inquire about the company's financial reporting process and corporate governance practices. For example, if it were considered necessary to help determine a company's ability repay a debt, a lender could ask the company to provide copies of any corporate governance guidelines, business ethics policies, and key committee charters that the company had adopted.

Immediately following the act's passage, several states proposed legislation to enact corporate governance and financial reporting reforms for private companies and nonprofit organizations. Specifically, several state legislatures proposed instituting requirements similar to those in the Sarbanes-Oxley Act for privately held state-registered companies. Subsequently, three states—Illinois, Texas, and California—passed legislation that mandates corporate governance and accountability requirements that resemble certain provisions of the Sarbanes-Oxley Act. For example, Illinois passed legislation in 2004 that requires enhanced disclosures for certain nonpublic companies and additional licensing requirements for certified public accountants and, in 2003, Texas passed legislation that imposes strict ethics and disclosure requirements for outside financial advisors and service providers, public or private, that provide financial services to the state government. On September 29, 2004, California adopted the Nonprofit Integrity Act of 2004, becoming the first state in the nation to require nonprofit organizations to meet requirements that resemble some provisions of the Sarbanes-Oxley Act. For instance, nonprofits with gross revenues of $2 million or more operating within the state of California currently are required to have independent auditors and, in the case of charitable corporations, audit committees. Further, two other states—Nevada and Washington—have passed legislation that require accounting firms to retain work papers for 7 years for audits of both public and private companies. Furthermore, based on our research and discussions with representatives from the National Association of State Boards of Accountancy, we found that some state boards made changes to regulations that focus on key governance and accountability issues similar to those mandated by the Sarbanes-Oxley Act. For example, New Jersey adopted enhanced peer review requirements and Tennessee instituted additional work paper retention requirements for certified public accountants.

Based on our discussions with private equity providers and private company officials, it appears that some privately held companies increasingly have incorporated certain elements of the Sarbanes-Oxley Act into their governance and internal control policies. Specifically, they have adopted practices such as CEO/CFO financial statement certification, appointment of independent directors, corporate codes of ethics, whistleblower procedures, and approval of nonaudit services by the board. According to these officials, some private companies have reported receiving pressure from board members, auditors, attorneys, and investors to implement certain "best practice" policies and guidelines, modeled after the requirements of the act. They noted that the act has raised the bar for what constitutes best practices in corporate governance and for expectations regarding internal control. Additionally, the officials told us that some private companies may have chosen to voluntarily adopt certain practices that resemble Sarbanes-Oxley Act provisions to satisfy external auditors and legal counsel looking for comparable assurances to reduce risk, increase confidence, and improve credibility with many stakeholders. Based on our research, we found that many of the aspects of corporate governance reform currently being adopted by private companies were those relatively inexpensive to implement, but information on the specific costs associated with adopting these provisions was not available.

Smaller Companies Appear to Have Been Able to Obtain Needed Auditor Services, Although the Overall Audit Market Remained Highly Concentrated

Since the enactment of the Sarbanes-Oxley Act, smaller public companies have been able to obtain needed auditor services; however, auditor changes suggest smaller companies have moved from using the services of a large accounting firm to using services of mid-sized and small firms. Some of this activity has resulted from the resignation of large accounting firms from providing audit services to small public companies. Reasons for these changes range from audit cost and service concerns cited by companies to client profitability and risk concerns cited by accounting firms, including capacity constraints and assessments of client risk. In recent years, public accounting firms have been categorized into three categories—the largest firms, "second tier" firms (mid-sized), and regional and local firms (small).[43] From 2002 to 2004, 1,006 companies reported auditor changes involving a departure from a large accounting firm. Over two-thirds of these companies reported switching to a mid-sized or small accounting firm. Most of the companies that switched to a mid-sized or small accounting firm were smaller public companies with market capitalization or revenues of $250 million or less. Overall, mid-sized and small accounting firms conducted 30 percent of the total number of public company audits in 2004—up from 22 percent in 2002. Despite client gains for mid-sized and small firms, the overall market for audit services remained highly concentrated, with mid-sized and smaller firms auditing just 2 percent of total U.S. publicly traded company revenue.[44] In the long run, mid-sized and small accounting firms could increase opportunities to enhance their recognition and acceptance among capital market participants as a result of the gains in public companies audited and operating under PCAOB's registration and inspection process.

[43]In addition to the four largest and four mid-sized firms, there were roughly 800 small and mid-sized accounting firms that issued audit opinions for U.S. companies in 2002 and approximately 600 that issued audit opinions in 2004.

[44]The term "revenue" is used interchangeably with the term "sales" used in the *Who Audits America* database. See appendix I for more detail.

Smaller Companies Found It Harder to Keep or Obtain the Services of a Large Accounting Firm, but Overall Access to Audit Services Appeared Unaffected

Our limited review did not find evidence to suggest that the Sarbanes-Oxley Act has made it more difficult for smaller public companies to obtain needed audit services, but did suggest that smaller public companies may have found it harder to retain a large accounting firm as a result of increased demand for auditing services, largely due to the implementation of section 404 and other requirements of the act, and the capacity limitations of the large accounting firms. Of the 2,819 auditor changes from 2003 through 2004 that we identified using Audit Analytics data, 79 percent were made by companies that represented the smallest of publicly listed companies (companies with $75 million or less in market capitalization or revenue).[45] Although fewer mid-sized and small accounting firms conducted public company audits in 2004 because some firms did not register with PCAOB or merged with other firms, the market appears to have absorbed these changes effectively, with other firms taking on these clients.

Recent Auditor Changes Resulted in Small Accounting Firms Gaining Clients

Our analysis showed that 1,006 of the 2,819 changes, or 36 percent, involved departures from a large accounting firm. Of the 1,006 auditor changes, less than one-third (311 or 31 percent) resulted in the public company moving to another large accounting firm, and slightly under two-thirds (651 or 65 percent) retained a mid-sized or small accounting firm (see table 5).[46]

[45]We analyzed auditor change data using the Audit Analytics database, excluding foreign filers, funds and trusts without market data, and benefit plans. We grouped public companies into five size categories based on their respective market capitalization: (1) up to $75 million, (2) greater than $75 million to $250 million, (3) greater than $250 million to $700 million, (4) greater than $700 million to $1 billion, and (5) greater than $1 billion. If market capitalization data were not available, revenue data were used as relevant proxies for company size. Companies without market capitalization or revenue data were not included in the analysis (643 companies).

[46]Forty-four companies (less than 1 percent) reported not finding a new auditor as of December 2004. Some of these companies may have deregistered, gone bankrupt, merged with or been acquired by another company, or otherwise ceased business activity.

Table 5: Companies Changing Accounting Firms, 2003-2004

	Went to large accounting firm	Went to mid-sized accounting firm	Went to small accounting firm	No auditor reported as of December 2004	Total departures
Exiting large accounting firm	**311**	**298**	**353**	**44**	**1,006**
Average market capitalization	$1,829,869,346	$172,173,323	$52,108,359	-	
Average revenue	$1,291,589,676	$138,816,527	$50,765,823	-	
Exiting mid-sized accounting firm	**18**	**30**	**147**	**21**	**216**
Average market capitalization	$1,285,735,282	$59,822,406	$38,111,445	-	
Average revenue	$1,044,690,777	$53,694,660	$22,789,900	-	
Exiting small accounting firm	**41**	**49**	**1,446**	**61**	**1,597**
Average market capitalization	$213,223,882	$78,923,135	$18,441,598	-	
Average revenue	$92,138,114	$28,518,987	$5,039,327	-	
Total gains[a]	59	347	500	126	
Total losses[b]	(695)	(186)	(151)		
Net gain (loss)	**(636)**	**161**	**349**	**126**	

Source: GAO analysis of Audit Analytics data.

Note: Average market capitalization and revenue figures are based only on those companies with available relevant financial data.

[a]Total gains represent the sum of companies that went to that particular category of accounting firm (large, mid-sized, or small) from another category (cells highlighted in grey for the particular column). For example, large accounting firms gained 59 companies from 2003 to 2004 (18 from mid-sized firms and 41 from small accounting firms).

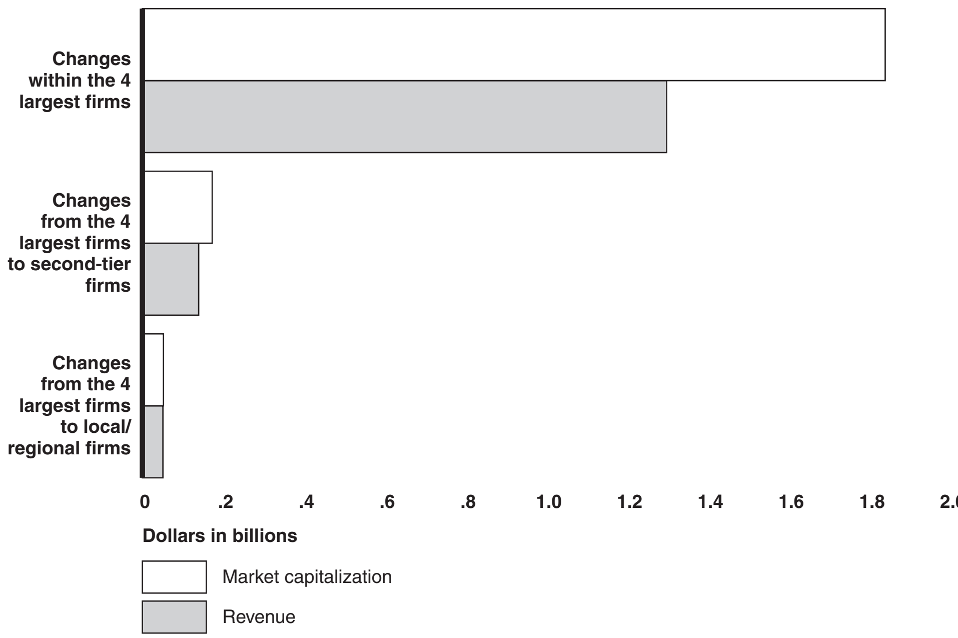
[b]Total losses represent the sum of companies that left that particular category of accounting firm (large, mid-sized, or small) for another category of firm plus those for which there was no auditor reported as of December 2004 (cells highlighted in grey for that particular row). For example, large accounting firms lost 695 companies from 2003 to 2004 (298 went to mid-sized firms, 353 went to small-sized firms, and 44 that had no auditor reported as of December 2004).

Over the same period, mid-sized and small accounting firms lost fewer public company clients to the large accounting firms; as a result, mid-sized and small firms experienced a net increase of 510 public company clients—a net gain of 161 and 349 companies for mid-sized and smaller firms, respectively. Because we had no data on companies' selection processes, we could not determine whether mid-sized and small firms competed for these clients with other large accounting firms or if they received these clients by default with no competition from the other large accounting firms. According to *Who Audits America*, small and mid-sized accounting firms increased their percentage public company audit from 22 percent in 2002 to 27 percent in 2003, and by 2004 they audited 30 percent of all U.S. publicly traded companies.[47] Small and mid-sized firms audited over 38 percent of all public clients in 2004 according to Audit Analytics data, which include, in addition to publicly traded companies, other SEC reporting companies including foreign registered entities, registered funds and trusts, and registered public companies that are not publicly traded.

The majority of the clients the mid-sized and small firms gained were smaller companies with market capitalization or revenues averaging $200 million or less. As shown in table 5 and figure 5, the companies leaving a large accounting firm and retaining another large firm tended to be very large—with average market capitalization (or revenue) of more than $1 billion. However, the average market capitalization (or revenue) of companies leaving a large accounting firm and retaining a mid-sized accounting firm was less than $175 million and the capitalization (or revenue) of companies retaining a small firm was significantly smaller—less than $53 million. Similarly, companies leaving smaller and mid-sized firms that retained a large accounting firm tended to be much larger than those that retained another mid-sized or small firm.

[47]These figures do not include foreign companies or companies that did not trade on NYSE, NASDAQ, AMEX, OTCBB, or the Pink Sheets. See appendix I for data reliability.

Figure 5: Average Size of Companies Changing Auditors, 2003-2004, by Type of Accounting Firm Change



Source: GAO analysis of Audit Analytics data.

Note: This figure includes only those companies with available relevant financial data.

Reasons for Auditor Changes May Have Included Costs Related to the Act and Risk Assessments

While the reasons for the movement of smaller public companies to mid-sized and small accounting firms may be somewhat speculative at this point, the Sarbanes-Oxley Act may have contributed to this shift. Some smaller companies may have preferred a large firm because of the perception that large accounting firms—by virtue of their reputation or perceived skills—can help attract investors and improve access to capital.[48] Workload demands placed on the large firms by larger public companies, which represent the overwhelming majority of their clients, have increased with section 404 and other Sarbanes-Oxley Act implementing regulations. The resulting increases in workload and audit

[48]In a previous report, *Public Accounting Firms: Mandated Study on Consolidation and Competition*, GAO-03-864 (Washington, D.C.: July 2003), we noted that public companies wishing to demonstrate their worthiness for debt and equity investments might continue to employ a large accounting firm to increase their credibility among potential lenders and investors and that some companies and boards of directors have been reluctant to consider small firms.

fees appear to have constrained smaller companies' access to large accounting firms—either because smaller companies were unable to afford a large accounting firm or because large accounting firms resigned from smaller clients. According to Audit Analytics, the largest accounting firms resigned from three times as many clients in 2004 as in 2001, and three-quarters of those were companies with revenues of less than $100 million.

Beyond resignations by large accounting firms in response to increased demand for audit services, the act may have caused large accounting firms to reevaluate the risk in their aggregate client portfolios by increasing the responsibilities and liability of auditors, leading them to shed smaller public companies. According to the large accounting firms with whom we spoke, they did not have enough resources to retain all of their clients after the Sarbanes-Oxley Act and cited risk as a significant factor in choosing which clients to keep.[49] Moreover, the largest audit firms could be applying stricter profitability guidelines in selecting their clients, eliminating those engagements where profit margins are smaller.

While former clients of large accounting firms may represent opportunities for mid-sized and small accounting firms, they also represent some risks. For example, we found that a disproportionate percentage of the companies that left a large accounting firm for a small firm had accounting or risk issues. Overall, about 69 percent of the companies that left a large accounting firm switched to a mid-sized or small accounting firm. However, 92 percent of the companies that received a going concern qualification went to a mid-sized or small accounting firm.[50] In addition, about 81 percent of the companies with at least one accounting issue (such as restatement, reportable condition, scope limitation, management

[49]Many of the public accounting firms with whom we talked had a significant number of accelerated filers for 2004 and noted that the additional work challenged the firm's capacity. While the firms expanded and supplemented their capacity to handle the additional work, these firms also acknowledged that they took the workload and capacity issues into account in conducting their ongoing client acceptance and retention reviews. Many of the firms—particularly the large accounting firms—acknowledged that since 2002, their review and retention processes have resulted in a reduction of their public company audit client base to better match workload capacity.

[50]Ninety-four percent of the companies changing auditors that had going concern opinions had market capitalization of $75 million or less (or, if no market capitalization data were available, $75 million or less in revenues). A going concern opinion is issued by an auditor if the auditor has doubts about the company's ability to generate or raise enough resources to stay operational (to continue as a "going concern").

found to be unreliable, audit opinion concerns, illegal acts, or SEC investigation) went from a large to a mid-sized or small accounting firm. In contrast, 63 percent of the companies with no going concern qualification or any additional "risk" issues went to mid-sized and small firms. We also found that, if a large accounting firm resigned as the auditor of record, the company was more likely to switch to a mid-sized or small accounting firm. Roughly 85 percent of the smallest companies that were dropped by one of the largest accounting firms retained a smaller audit firm.

Mid-sized and Small Accounting Firms Continued to Operate in a Highly Concentrated Market

Although mid-sized and small accounting firms gained clients in 2003 and 2004, they continued to operate in a market dominated by large accounting firms. The market for audit services in 2004 changed little from the market we described in our 2003 report.[51] For example, mid-sized and small accounting firms increased their share of all public company revenues by 1 percentage point in 2002–2004. The market for audit services remained highly concentrated—a tight oligopoly, where in 2004 the four largest firms audited 98 percent of the market and the remaining firms audited 2 percent—and the potential market power was significant.[52]

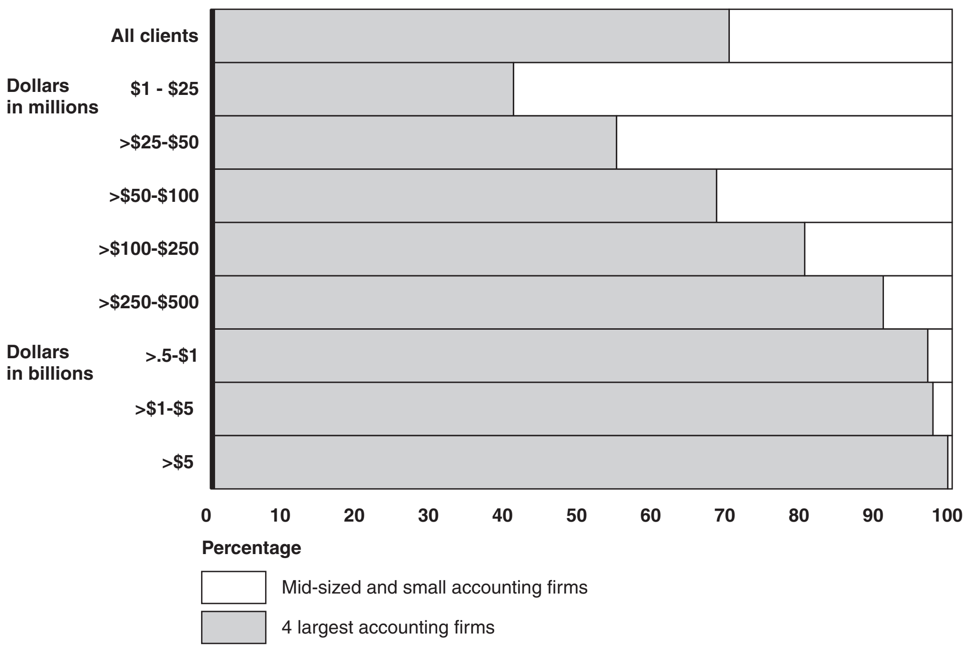
The market for smaller public company audits was much more competitive than the overall and large public company market. As shown in figure 6, while the market for audit services for large company clients remained dominated by large accounting firms, the market for the smallest public company clients appeared to indicate healthy competition. Mid-sized and small firms audited 59 percent of all public company clients with revenues of $25 million or less, 45 percent of all clients with revenues greater than $25 million up to $50 million, and 32 percent of all clients with revenues greater than $50 million up to $100 million. When these revenue categories were combined, the large accounting firms combined with the mid-sized firms audited 75 percent of companies with revenues of $100

[51]See GAO-03-864.

[52]These concentration statistics suggest a Hirschman-Herfindahl Index (HHI) of 2,505, which is equivalent to the index calculated for 2002 (2,566). The HHI is calculated by summing the squares of the individual market shares of all the participants. An HHI above 1,800 indicates a highly concentrated market in which firms have the potential for significant market power. While concentration ratios and the HHI are good indicators of market structure, these measures only indicate the potential for oligopolistic collusion or the exercise of market power and can overstate the significance of a tight oligopoly on competition. See GAO-03-864 for further discussion of the HHI.

million or less, while the small firms audited the remaining 25 percent.[53] As noted in our 2003 report, as companies expanded operations around the world, the large audit firms globally expanded through mergers in order to provide service to their international clients.[54]

Figure 6: Percentage of Clients Audited by Revenue Category, 4 Largest Accounting Firms versus Mid-sized and Small Accounting Firms, 2004



Source: *Who Audits America 2004.*

Note: Does not include companies that did not trade on the major exchanges or over-the-counter markets, foreign companies, or bankrupt companies. Figures omit certain small accounting firms that held a very small share of the market.

More recently, mid-sized and small accounting firms gained more large clients. In 2004, these accounting firms audited approximately 3 percent of

[53]As such, the four-firm and eight-firm (large accounting firms plus second-tier firms) concentration ratios are 0.55 and 0.75 respectively for this particular section of the market. These ratios are consistent with an HHI below 1,000. As a general rule, an HHI below 1,000 indicates a market predisposed to perform competitively, while an HHI above 1,800 indicates a highly concentrated market. See GAO-03-864.

[54]See GAO-03-864.

the companies with revenues greater than $500 million, up from 2 percent in 2002. However, as shown in table 5, the average revenue of the clients lost to the largest accounting firms was $1.1 billion while the average revenue of the client gained from the largest accounting firms was $138.8 million. Overall, mid-sized and small accounting firms conducted 30 percent of the total number of public company audits in 2004—up from 22 percent in 2002. While these companies make up just 2 percent of total public company revenue, they are a large segment of the market of publicly traded clients.[55]

Sarbanes-Oxley Act May Impact the Continuing Competitive Challenges Faced by Mid-Sized and Small Accounting Firms

According to some experts, competitive challenges related to the ability of mid-sized and small firms to compete for public companies such as capacity, expertise, recognition, and litigation risks may have been strengthened since the passage of the Sarbanes-Oxley Act.[56] For example, in a recent American Assembly report, a number of industry professionals indicated that large accounting firms' facility with new requirements was seen as increasingly important as audits have become more complex and time-consuming and the financial consequences of noncompliance more severe.

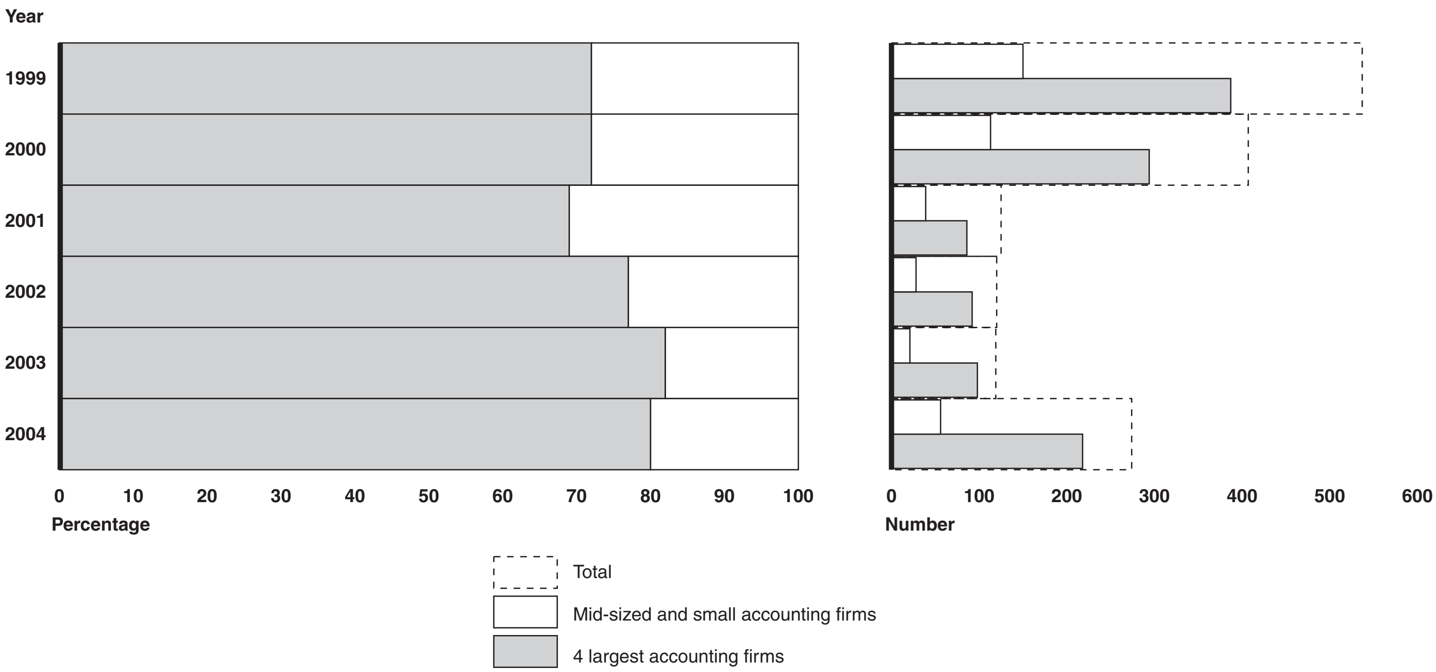
Additionally, even though some experts believe that large accounting firms' regulatory competence has been overstated, a perception may exist among many large and some small U.S. companies as well as other market influencers and stakeholders that only the large accounting firms can

[55]Based on a large sample analyzed from Audit Analytics, when we broadened the market to include SEC reporting companies that do not publicly trade, funds and trusts, the 600 small and mid-sized firms we identified audited over 4,400 domestic public clients.

[56]As we noted in our 2003 report, mid-sized and small accounting firms face challenges in effectively competing for large national and multinational public company audits. The challenges include lack of staff resources, experience, technical expertise, and global reach necessary to audit large multinationals; establishing recognition and credibility with larger companies and market participants to counter the perception that only large firms can provide the required auditing services; increased litigation risk and insurance costs associated with auditing public companies; and difficulty in raising capital to expand infrastructure to compete with large accounting firms. Also, at a recent conference on auditor concentration organized by The American Assembly, experts generally agreed that significant challenges restrict the ability of mid-sized accounting firms to increase their market share and present a major alternative to the large accounting firms. "The Future of the Accounting Profession: Auditor Concentration," which was held on May 23, 2005, was a follow-on to the Assembly's November 2003 meeting where 57 business leaders, academics, journalists, and regulatory officials discussed the challenges the accounting profession faced. For more information, see http://www.americanassembly.org/index.php.

provide the required auditing services necessary to meet the requirements of the act. For example, the venture capital industry representatives that we spoke with stated that this perception has been especially prevalent for companies issuing IPOs. As shown in figure 7, companies large and small tended to use large accounting firms for IPOs.

Figure 7: Total Number of IPOs, by Size of Accounting Firm, 1999–2004



Source: GAO analysis of SEC data.

Over the long run, the Sarbanes-Oxley Act could ease some of these challenges. For example, mid-sized and small accounting firms have continued to confront the perceptions of capital market participants that only large firms have the skills and resources necessary to perform public company audits. These perceptions have constrained firms from obtaining or retaining many clients that the firms believed were within their capacity to audit. However, the increase in public company audits performed by mid-sized and small accounting firms has given these firms additional opportunities to enhance their recognition and acceptance among more public companies and capital market participants. Also, as smaller public companies begin complying with section 404 in 2007, small accounting firms will gain additional experience with the implementation of the act. Taking on additional clients will provide an important growth opportunity. Effectively matching company size and needs with accounting firm size and capabilities could allow smaller public companies to find the best combination of quality, service value, and reach.

In addition, the PCAOB registration and inspection process and the establishment of attestation, quality control, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports could provide increased assurance of the quality of small accounting firm audits. Similarly, as more information will become available through PCAOB's ongoing inspection program, small accounting firms could establish a "track record," allowing for additional opportunities for recognition and acceptance among analysts, investment bankers, investors, and public companies.

Conclusions

The Sarbanes-Oxley Act was a watershed event—strengthening disclosure and internal control requirements for financial reporting, establishing new auditor independence standards, and introducing new corporate governance requirements. Regulators, public companies, audit firms, and investors generally have acknowledged that many of the act's provisions have had a positive and significant impact on investor protection and confidence. Yet, for smaller public companies and companies of all sizes that have complied with the various provisions of the Sarbanes-Oxley Act, compliance costs have been higher than anticipated—with the higher cost being associated with the internal control over financial reporting requirements of section 404.

There is widespread agreement that several factors contributed to the costs of implementing section 404 for both larger and smaller public companies. Few public companies or their audit firms had prior direct experience with evaluating and reporting on the effectiveness of internal control over financial reporting or with implementing the COSO internal control framework, particularly in a small business environment. This was despite previous requirements, dating back to 1977, that public companies implement a system of internal accounting controls. The first year costs were exacerbated because many companies were documenting their internal control over financial reporting for the first time and remediating poor or nonexistent internal controls as part of their first-year implementation efforts to comply with section 404, both of which could be viewed as a positive impact of the act. In addition, the nature, timing, and extent of available guidance on establishing and assessing internal control over financial reporting made it more difficult for most public companies and audit firms to efficiently and effectively implement the requirements of section 404. As a result, management's implementation and assessment efforts were largely driven by PCAOB's Auditing Standard No. 2, as guidance at a similar level of detail was not available for management's implementation and assessment process. These factors, in conjunction with the changed environment and expectations resulting from the act, contributed to a considerable amount of "learning curve" activities and inefficiencies during the initial year of implementation. Auditing firms and a number of public companies have stated that they expect subsequent years' compliance costs for section 404 to decrease. This is not unexpected given the significance and nature of the changes and a preexisting environment that did not place enough emphasis on effective internal control over financial reporting.

Consistent with the findings of the Small Business Administration on the impact of regulations generally on smaller public companies, it is reasonable to conclude that smaller public companies face disproportionately greater costs, as a percentage of revenues, than larger companies in meeting the requirements of the act. While facing the same basic requirements, smaller public companies generally have more limited resources, fewer shareholders, and generally less complex structures and operations. Again, this is to be expected given the economies of scale and differing levels of corporate infrastructure and resources. However, some of the unique characteristics of smaller companies can create opportunities to efficiently achieve effective internal control over financial reporting. Those characteristics include more centralized management oversight of the business, more involvement of top management in the business operations, simpler operations, and limited geographic locations.

The ultimate impact of the Sarbanes-Oxley Act on the majority of smaller public companies remains unclear because the time frame to comply with section 404 of the act was extended until fiscal years ending after July 2007 for the approximately 5,971 public companies with less than $75 million in public float. Recognizing the challenges that smaller public companies have faced in meeting the requirements of the act, particularly section 404, SEC formed an advisory committee on smaller public companies to analyze the impact of the act and other securities laws on smaller public companies. The advisory committee has issued an exposure draft of its final reporting stating that certain smaller public companies need relief from section 404, "unless and until" a framework for assessing internal control over financial reporting is developed that recognizes the characteristics and needs of smaller public companies. The exposure draft contains specific recommendations that would essentially result in a "tiered approach" for compliance with section 404 requirements, where larger public companies would continue to be required to fully comply with all requirements of section 404, while smaller public companies consisting of "microcap" and "smallcap" companies would be granted differing levels of exemptions until an adequate framework was in place.

We have two specific concerns regarding the advisory committee's recommendations. First, the recommendations propose relief "unless and until a framework for assessing internal control over financial reporting" for smaller companies is developed that "recognizes the characteristics and needs of those companies." While the recommendations hinge on the need for a framework that recognizes smaller public company characteristics and needs of smaller public companies, they do not address what needs to be done to establish such a framework or how such a framework should take into consideration the characteristics and needs of smaller public companies. Many, if not most, of the significant problems and challenges encountered by large and small companies in implementing section 404 related to problems with implementation, rather than the internal control framework itself. In addition to having a useful internal control framework, appropriate implementation of a framework by public companies must be based on risk, facts and circumstances, and professional judgment. We believe that sufficient guidance covering both the internal control framework and the means by which it can be effectively implemented is essential to enable large and small public companies to implement a framework which would enable effective and efficient assessment and reporting on the effectiveness of internal control over financial reporting.

Our second concern relates to the ambiguity surrounding the conditional nature of the "unless and until" provisions of the recommendations and its potential impact on a large number of companies that would likely qualify for the proposed exemptions. If resolution of small public company concerns about a framework and its implementation results in an extended period of exemption, then large numbers of public companies would potentially be exempted for additional periods from complying with this important investor protection component of the act. The categories of microcap and smallcap companies, as defined by the advisory committee recommendations, cover 79 percent of U.S. public companies and 6 percent of the U.S. equity market capitalization when combined. Although the categories of microcap and smallcap have been further refined by the advisory committee through the addition of a revenue size filter for purposes of its primary recommendations on section 404, it appears that a large number of companies, up to 70 percent of all U.S. public companies, would be potentially exempted. Specifically, the committee estimates that, after applying the revenue criteria, 4,641 "micro cap" public companies (approximately 49 percent of 9,428 public companies identified in data developed for the advisory committee by SEC's Office on Economic Analysis) may potentially qualify for the proposed full exemption from section 404 and another 1,957 "smallcap" public companies (approximately 21 percent of the identified public companies) may potentially qualify for the proposed exemption from the external audit requirement of section 404(b). These estimates do not include those public companies trading on the Pink Sheets that would be covered by the Advisory Committee's preliminary recommendations. In addition, it is likely that a number of public companies qualifying for exemptive relief under the committee's recommendations are likely to have already complied with both sections of 404(a) and (b) of the act under the current category of accelerated filers.

Also, regarding the committee's third primary internal control recommendation calling for a review of the design and implementation of internal control if SEC concludes, as a matter of public policy, that the external auditor's involvement is required, it is not clear from the committee's report the extent to which, particularly in the present environment, such a review would result in lower costs than those being associated with the implementation of PCAOB's Auditing Standard No. 2. Any lower costs that might result must be considered in light of the reduced independent assurances on the effectiveness of internal control over financial reporting that would result and the potential for confusion on the part of users of the public company's financial statements and audit reports.

Until sufficient guidance is available for smaller public companies, some interim regulatory relief on a limited scale may be appropriate. However, given the number of public companies that would potentially qualify for relief under the recommendations being considered, we believe that a significant reduction in scope of the proposed relief needs to occur to preserve the overriding investor protection purpose of the Sarbanes-Oxley Act. The purpose of internal control over financial reporting is to provide reasonable assurance over the integrity and reliability of the financial statements and related disclosures. Public and investor confidence in the fairness of financial reporting is critical to the effective functioning of our capital markets. Market reactions to financial statement misstatements illustrate the importance of accurate financial reporting, regardless of a company's size. SEC staff and others have pointed to the increased level of restatements as an indicator that the Sarbanes-Oxley Act—section 404 in particular—has prompted companies to identify and correct weaknesses that led to financial reporting misstatements in prior fiscal years.

Indicators also show that in some respects, smaller companies have a higher risk profile for investors. For instance, smaller public companies have higher rates of restatements generally and showed a disproportionately higher rate of reported material weakness in internal control over financial reporting during the initial year of section 404 implementation. Over time, having the effective internal control over financial reporting envisioned by the act can reduce some aspects of the higher risk profile of smaller public companies.

When SEC receives and considers the final recommendations of SEC's small business advisory committee, it is essential that SEC consider key principles, under the umbrella principle of investor protection, when deciding whether or to what extent to provide smaller public companies with alternatives to full implementation of the section 404 requirements. These principles include (1) assuring that smaller public companies have sufficient useful guidance to implement, assess, and report on internal controls over financial reporting to meet the requirements of section 404, (2) if additional relief is considered appropriate, conducting further analysis of small public company characteristics to significantly reduce the scope of companies that would qualify for any type of additional relief while working to ensure that the Sarbanes-Oxley Act's goal of investor protection is being met, and (3) acting expeditiously such that smaller public companies are encouraged to continue improving their internal control over financial reporting.

First, it is critical that SEC carefully assess the available guidance, including that being developed by COSO, to determine whether it is sufficient or whether additional action needs to be taken, such as issuing supplemental or clarifying guidance to smaller public companies to help them meet the requirements of section 404. Our analysis of available research and discussions with smaller public companies and audit firms indicate that public companies and external auditors have had limited practical experience with implementing internal control frameworks in a smaller company environment and that additional guidance is needed. Moreover, it is critical that SEC coordinate its actions with PCAOB, which is responsible for establishing standards for the external auditor's internal control attestations, to ensure that external auditors are using standards and guidance on section 404 compliance that are consistent with guidance for public companies and that they are doing so in an effective and efficient manner. As SEC considers the need for additional implementation guidance, it will be important that the guidance and related PCAOB audit standards be consistent and compatible. Also, it will be important for the PCAOB to continue to identify ways in which auditors can achieve more economical, effective, and efficient implementation of audit-related standards and guidance.

Second, as SEC considers whether and to what extent it might be appropriate to provide additional interim relief to some categories of smaller public companies, it will be important to balance the needs of the investing public with the concerns expressed by small businesses. In doing so, it is important to determine whether there are unique characteristics, in addition to size, that could influence the extent that some regulatory accommodation might be appropriate in order to arrive at a targeted and limited category of companies being provided with potential exemptions. For example, if these companies were closely held or have a higher rate of insider investors, regulatory relief may raise less of an investor protection concern. These investors may be more knowledgeable about company operations and receive fewer benefits from section 404's enhanced disclosures. For companies that are widely traded, regulatory relief would raise more concerns about investor protection and relief would appear less appropriate. Furthermore, although the "insider" shareholder owners may not have the same need for investor protection as investors in broadly held companies, minority shareholders who are not insiders may need such protection. For other purposes, certain provisions of SEC's securities regulations and the Employee Retirement Income Security Act of 1974 regulations condition different types of relief, in part, on the nature and/or the financial sophistication of the investor, and SEC may wish to consider whether such approaches would help serve to balance the concerns of small businesses against the needs of investors. The criteria and characteristics used should be linked to the investor protection goals of the Sarbanes-Oxley Act and be geared toward limiting the numbers of companies that would be eligible based on those investor protection goals. In addition, the advisory committee's preliminary recommendations to exempt "smaller public companies" from the external audit requirements of section 404 would include a number of companies that have already complied with section 404, and SEC needs to carefully consider whether it is appropriate to provide regulatory relief on this basis.

Finally, we believe that SEC has an obligation to resolve section 404 implementation requirements for smaller public companies in a way that creates incentives for smaller public companies to take actions to improve their internal control over financial reporting. Rather than delaying implementation, which would likely result in smaller public companies anticipating future extensions or relief, SEC's resolution of these issues would provide needed clarity and certainty over the scope and timing of smaller companies' compliance with section 404 and provide incentives to smaller public companies to begin the process of implementing section 404.

Recommendations

In light of concerns raised by the SEC Advisory Committee on Smaller Public Companies and others regarding the ability of smaller public companies to effectively implement section 404, we recommend that the Chairman of SEC

- assess the guidance available, with an emphasis on implementation guidance for management's assessment of internal control over financial reporting, to determine whether the current guidance is sufficient and whether additional action is needed, such as issuing supplemental or clarifying guidance to help smaller public companies meet the requirements of section 404, and
- coordinate with PCAOB to (1) help ensure that section 404-related audit standards and guidance are consistent with any additional guidance applicable to management's assessment of internal control and (2) identify additional ways in which auditors' can achieve more economical, effective, and efficient implementation of the standards and guidance related to internal control over financial reporting.

If, in evaluating the recommendations of its advisory committee, SEC determines that additional relief is appropriate beyond the current July 2007 compliance date for non-accelerated filers, we recommend that the Chairman of SEC analyze and consider, in addition to size, the unique characteristics of smaller public companies and the knowledge base, educational background, and sophistication of their investors in determining categories of companies for which additional relief may be appropriate to ensure that the objectives of investor protection are adequately met and any relief is targeted and limited.

Agency Comments and Our Evaluation

We provided a draft of this report to the Chairman, SEC, and the Acting Chairman, PCAOB, for their review and comment. We received written comments from SEC and PCAOB that are summarized below and reprinted in appendixes III and IV. SEC agreed that the Sarbanes-Oxley Act has had a positive impact on investor protection and confidence, and that smaller public companies face particular challenges in implementing certain provisions of the act, notably section 404. SEC stated that our recommendations should provide a useful framework for consideration of its advisory committee's final recommendations. PCAOB stated that it is committed to working with SEC on our recommendations and that it is essential to maintain the overriding purpose of the Sarbanes-Oxley Act of investor protection while seeking to make its implementation as efficient and effective as possible. Both SEC and PCAOB provided technical comments that were incorporated into the report as appropriate.

As we agreed with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution of it until 30 days from the date of this letter. At that time, we will send copies of this report to interested congressional committees and subcommittees; the Chairman, SEC; the Acting Chairman, PCAOB; and the Administrator, SBA. We will make copies available to others upon request. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

If you have any questions concerning this report, please contact William B. Shear at (202) 512-8678 or shearw@gao.gov, or Jeanette M. Franzel at (202) 512-9471 or franzelj@gao.gov. Contact points for our Office of Congressional Relations and Public Affairs may be found on the last page of this report. See appendix V for a list of other staff who contributed to the report.

William B. Shear
Director, Financial Markets and
Community Investment

Jeanette M. Franzel
Director, Financial Management
and Assurance

Appendix I: Objectives, Scope, and Methodology

Our reporting objectives were to (1) analyze the impact of the Sarbanes-Oxley Act on smaller public companies in terms of costs of compliance and access to capital; (2) describe the Securities and Exchange Commission's (SEC) and Public Company Accounting Oversight Board's (PCAOB) efforts related to the implementation of the act and their responses to concerns raised by smaller public companies and the accounting firms that audit them; (3) analyze the impact of the act on smaller privately held companies, including costs, ability to access public markets, and the extent to which states and capital markets have imposed similar requirements on smaller privately held companies; and (4) analyze smaller companies' access to auditing services and the extent to which the share of public companies audited by small accounting firms has changed since the enactment of the Sarbanes-Oxley Act.

In arriving at our report objectives, we incorporated nine specific questions contained in your request letter. See table 6 for a cross-sectional comparison of the nine specific questions contained in your letter, the four report objectives, and our findings.

Table 6: Cross-sectional Comparison of Request Letter Questions, Our Report Objectives, and Selected Findings

Request letter question	Report objective	Findings
1. In investigating the effects of the act on small public companies, please assess:		
(a) How requirements in the act and the implementing regulations, as adopted for publicly traded companies, affect small business equity capital formation in both the stock and bond markets.	1. Analyze the impact of the Sarbanes-Oxley Act on smaller public companies in terms of costs of compliance and **access to capital**. 2. Describe SEC's and PCAOB's efforts related to the implementation of the act and their responses to concerns raised by smaller public companies and the accounting firms that audit them.	Because a large number of smaller public companies have not yet implemented all the provisions of the act and the recent and ongoing actions by SEC and PCAOB to address small business implementation issues, it is too soon to determine the act's impact on smaller public companies' access to capital. Along with other market factors, the act may have encouraged some smaller companies to go private. Going private reduces financing options available to those companies, which must rely on potentially more expensive alternatives to public equity capital.

Request letter question	Report objective	Findings
(b) What the detailed costs are that small public companies bear in complying with the act on both a federal and state level.	1. Analyze the impact of the Sarbanes-Oxley Act on smaller public companies in terms of **costs of compliance** and access to capital. 2. Describe SEC's and PCAOB's efforts related to the implementation of the act and their responses to concerns raised by smaller public companies and the accounting firms that audit them.	Our analysis of Audit Analytics data showed that the smallest companies that had fully implemented the act's provisions, particularly section 404, spent a median of 1.1 percent of their revenues on audit fees whereas companies that had not implemented section 404 spent 0.8 percent of their revenue on audit fees. Responses to our survey provided the following detailed costs for first year of implementation: fees to consultants for services related to section 404 ranged from $3,000 to over $1.4 million. To help smaller companies and their auditors develop approaches to implement the act's requirements, SEC established an Advisory Committee on Smaller Public Companies. SEC recently extended the section 404 compliance deadline for non-accelerated filers based on the committee's recommendation, which SEC had previously done on two separate occasions. Currently, a non-accelerated filer must begin to comply with section 404 for its first fiscal year ending on or after July 15, 2007. The advisory committee has several other recommendations under consideration, including providing conditional total section 404 exemptive relief for the very smallest public companies or staggering the 404 requirements based on company size or other characteristics. Both SEC and PCAOB issued additional guidance to help both public companies and accounting firms in implementing section 404, expecting that the additional guidance would help lower public companies' costs of compliance. As the act was a federal law, there were no costs for public companies on a state level.

Request letter question	Report objective	Findings
(c) The challenges small companies face in obtaining access to auditing services in order to comply with the act.	4. Analyze smaller companies' **access to auditing** services and the extent to which the share of public companies audited by smaller accounting firms has changed since the enactment of the Sarbanes-Oxley Act.	Smaller public companies appear to have been able to obtain needed auditing services, although not necessarily from their auditor of choice. However, many smaller companies moved from large accounting firms to smaller accounting firms and paid higher fees for audit services. In particular, smaller firms appear to be taking on a higher percentage of public companies with accounting issues. Furthermore, the act's auditor independence requirements caused smaller companies to seek advice from other sources, which increased costs.
2. In investigating the effects of the act on small private companies, please assess the extent to which:		
(a) Financial institutions require private small companies to comply with the act in order to receive capital financing and financial services.	3. Analyze the impact of the act on smaller privately held companies, including costs, ability to access public markets, and the **extent to which** states and **capital markets have imposed similar requirements on smaller privately held companies**.	The act appears to have increased corporate governance and accountability awareness throughout the business and investor communities. However, it does not appear that the capital markets, notably banks and venture capitalists, are denying private companies access to capital or other financial services because of failure to meet Sarbanes-Oxley Act requirements.
(b) States have or are considering enacting provisions of the act for small privately held companies.	3. Analyze the impact of the act on smaller privately held companies, including costs, ability to access public markets, and the extent to which states and capital markets have imposed similar requirements on smaller privately held companies.	Three states—Illinois, Texas, and California—have passed legislation with corporate governance and accountability requirements that resemble certain provisions of the Sarbanes-Oxley Act. Two other states enacted laws covering auditor work paper retention requirements and some state boards of accountancy have proposed rule changes affecting, among other things, enhanced peer review requirements for CPAs. We are unaware of any states that enacted a version of section 404 on internal control over financial reporting for privately held companies.
(c) Small privately held companies are being denied access to capital or other financial services, because they do not meet the act's requirements.	3. Analyze the impact of the act on smaller privately held companies, including costs, ability to access public markets, and the **extent to which** states and **capital markets have imposed similar requirements on smaller privately held companies**.	Our research and discussions with representatives of financial institutions suggest that smaller private companies have not been denied access to capital or other financial services as a result of the act.

Request letter question	Report objective	Findings
(d) Small private companies are incurring additional costs to comply with any part of the act in order to receive financial services. Please include a detailed list of these compliance and accounting costs.	3. Analyze the **impact of the act on smaller privately held companies, including costs,** ability to access public markets, and the extent to which states and capital markets have imposed similar requirements on smaller privately held companies.	We found no evidence that smaller private companies were incurring additional costs, except for smaller private companies intending to go public or "voluntarily" complying with provisions of the act. However, information on factors that may have encouraged smaller private companies to voluntarily comply with provisions of the act or the specific costs for those smaller private companies was not available.
(e) Compliance with the act has created significant barriers to entry for small privately held companies to reach the public markets.	3. Analyze the **impact of the act on smaller privately held companies, including** costs, **ability to access public markets**, and the extent to which states and capital markets have imposed similar requirements on smaller privately held companies.	We found that smaller private companies wanting to go public were spending additional time, effort, and money to convince investors that they could meet the act's requirements.
3. With respect to small accounting and auditing firms, we request that GAO review whether the market has improved for these firms since GAO's findings outlined in "Mandated Study on Consolidation and Competition," GAO-03-864, as required by Section 701 of the act.	4. Analyze smaller companies' access to auditing services and the **extent to which the share of public companies audited by small accounting firms has changed** since the enactment of the Sarbanes-Oxley Act.	While the number of public companies audited by smaller accounting firms has increased since the passage of the act, large accounting firms continue to dominate the market in terms of the proportion of market capitalization audited. In 2004, large accounting firms audited 98 percent of total revenues.

Source: GAO.

To address our four objectives, we reviewed and analyzed information from a variety of sources, including the legislative history of the act, relevant regulatory pronouncements and related public comment letters, and available research studies and papers. We also interviewed officials at SEC, PCAOB, and the Small Business Administration (SBA). In addition, we held discussions with the chief financial officers (CFO) of smaller public and private companies, representatives of relevant trade associations, accounting firms, market participants, and experts.

Impact of Sarbanes-Oxley Act on Smaller Public Companies

We could not analyze the impact of the act on many smaller public companies because SEC has extended the date by which public registrants with less than $75 million public float (known as "non-accelerated" filers) must comply with Section 404 of the act to their first fiscal year ending on or after July 15, 2007.[1] According to SEC, non-accelerated filers represent about 60 percent of all registered public companies and about 1 percent of total available market capitalization. As a result, we analyzed public data and other information related to the experiences of public companies that have fully implemented the act's provisions. We also compared the information from companies that had implemented the act with information from smaller companies that took the SEC extension to gain some insight into the potential impact of these provisions on the non-accelerated filers.

Audit Fees and Auditor Changes

Audit Analytics, an on-line market intelligence service maintained by Ives Group, Incorporated provides, among other things, a database of audit fees by company back to 2000 along with demographic and financial information. Using this database, we analyzed changes in the audit fees companies have paid by various size categories. Audit Analytics also provides a comprehensive listing of all reported auditor changes, which includes data on the date of change, departing auditor, engaged auditor, whether the change was a dismissal or resignation, whether there was a going concern flag or other accounting issues, and whether a fee dispute or fee reduction occurred. Using this database, we identified 2,819 auditor changes from 2003 through 2004.

We performed several checks to verify the reliability of the Audit Analytics data. For example, we crosschecked random samples from each of the Audit Analytics databases with SEC proxy and annual filings and other publicly available information. While we determined that these data were sufficiently reliable for the purpose of presenting trends in audit fees and auditor changes, the descriptive statistics on audit fees contained in the report should be viewed in light of a number of data challenges. First, the Audit Analytics audit fee database does not include fees for companies who did not disclose audit fees paid to their independent auditor in an SEC filing. Second, some companies included in the database—especially small companies—did not report complete financial data. We handled missing data by dropping companies with incomplete financial data from any analysis involving the use of such data. Therefore, it should be noted that we are not dealing with the entire population included in the Audit

[1]SEC's definition of a non-accelerated filer is based in part on the company's "public float," which is a subset of market capitalization. Market capitalization is defined as the number of shares outstanding multiplied by the price per share. Generally, a company's public float includes shares that are available to the public. Thus, shares held by company insiders such as the CEO or CFO would not be included in public float.

Analytics database but rather a large subset.[2] Because of these issues, the results should be viewed as estimates of audit fees based on a large sample rather than precise estimates of all fees charged over the entire population. It should also be noted that SEC found issues with the data on market capitalization (used largely in our discussion of auditor changes and companies going private) which are being addressed by Audit Analytics.

Deregistrations

To determine the number of companies that have deregistered before and after the implementation of the Sarbanes-Oxley Act, we obtained and analyzed data filed with SEC. From 1998 through April 24, 2005, over 15,000 companies filed SEC Form 15 (Certification and Notice of Termination of Registration). First, we analyzed all the companies to determine whether the company was deregistering its common stock to continue to operate as a privately held company. During this step, we eliminated companies that filed the Form 15 as a result of acquisitions, mergers that were not "going private" transactions liquidations, reorganizations, or bankruptcy filings or re-emergences.[3] We also eliminated duplicate filings and filings by foreign registrants. For the remaining companies, we reviewed their SEC filings and press releases and other press articles to determine their reasons for deregistration. We grouped the reasons into seven categories for our final analysis.

We took a number of steps to ensure the reliability of the database, including testing of random samples of the coded data, 100 percent verification of certain areas of the database, and various other quality control measures. For the initial coding, we found the error rates to be 0.6 percent or lower for all years except 2001 and 1998. Because the initial error rate exceeded 1.5 percent for these 2 years, we performed 100 percent verification and corrected any errors. However, because the error rate for the remaining years was positive, it is unlikely that we captured

[2]In general, when working with any of the financial database, breaking out the number of companies by size will result in the loss of observations because some companies will not have financial data available.

[3]Companies that were merged into, or were acquired by, another company were only included if the transaction was initiated by an affiliate of the company (either the company filed a form Schedule 13E-3 with SEC or GAO analysis found evidence of a "going private" transaction in the case of OTCBB- and Pink Sheet-listed companies).

every company going private in 1998–2005.[4] We also excluded all companies with one or zero holders of record unless that company also filed a Schedule 13E-3 (Going private transaction by certain issuers) with SEC.[5] In doing so, we may have missed some companies going private. However, an outside study found only 12 companies that filed a Form 15 but did not file a Schedule 13E-3 from 1998 through 2003.[6] Additionally, our analysis of the companies that listed more than one holder of record on the Form 15 should have picked up some of these types of firms. As a result, this limitation is minor in the context of this report and does not alter the trends also found by a number of research reports.

Survey of Public Company Views on Implementing the Sarbanes-Oxley Act

To obtain information about public companies' views on implementing Sarbanes-Oxley Act requirements, we conducted a Web-based survey of companies with market capitalization of $700 million or less and annual revenues of $100 million or less that reported to SEC that they had complied with the act's requirements related to internal control over financial reporting. To develop and test our questionnaire, we interviewed officials at 14 smaller public companies. We then pretested drafts of our questionnaire with 10 companies and then discussed their answers and experiences with our social science survey specialists. The pretests were conducted in person and by telephone with company executives in Virginia, Maryland, New York, Connecticut, California, Georgia, and Illinois.

To identify the smaller public companies eligible to participate in the survey, we analyzed company SEC filings from the Audit Analytics database. Our survey universe consisted of 591 companies that met the following five criteria: (1) $700 million or less in market capitalization as of the end of the company's 2004 fiscal year; (2) $100 million or less in revenues as of the end of the company's 2004 fiscal year end; (3)

[4]There may also be additional omissions due to errors on Form 15s or because some Form 15s that were initially listed by SEC were not found or were not available in electronic form. In a few instances, it appeared that the Form 15 was completed incorrectly by the firm. Mistakes included missing fields or an obvious misunderstanding of what information was required.

[5]A test of a random sample of 200 of these companies found that merging, bankrupt, and liquidating firms typically reported one or zero as the number of holders of record. In each case, the companies were found to have either merged with another company or had gone bankrupt or liquidated. See also Marosi and Massoud (2004), "Why Do Firms Go Dark," who used a similar method to exclude mergers and acquisitions.

[6]Leuz et al. (2004).

completed section 404 requirements by filing related reports of management and the company's external auditor as of August 11, 2005; (4) were not foreign companies; and (5) were not investment vehicles such as mutual funds and shell companies. Of the 591, we could not reach 168 within the survey period because we were not able to obtain e-mail addresses for the CFO or other executive. We began our Web-based survey on September 21, 2005, and included all useable responses as of November 1, 2005. We sent follow-up e-mails on three occasions to remind respondents to complete the survey. One hundred fifty-eight companies completed the survey for an overall response rate of 27 percent. Only one respondent indicated that his company was a non-accelerated filer.

The low response rate raised concerns that the views of 158 respondents might not be representative of all smaller public company experiences with the Sarbanes-Oxley Act. While we could not test this possibility for our primary questions (whether the act places a disproportionate burden on smaller companies or compromises their ability to raise capital), we did conduct an analysis to determine whether our sample differed from the population of 591 in company assets, revenue, and market capitalization and type (based on the North American Industrial Classification System code). We found no evidence of substantial non-response bias based on these characteristics. However, because of the low response rate we still could not assume that the views of the 158 respondents were representative of the views of other smaller public companies on implementing Sarbanes-Oxley Act requirements. Therefore, we do not consider these data to be a probability sample of all smaller public companies.

In addition to potential non-response bias, the practical difficulties of conducting any survey may introduce other non-sampling errors. For example, difference in how a particular question is interpreted or the sources of information available to respondents may introduce errors. We took steps to minimize such non-sampling errors in both the data collection and data analysis stages. We examined the survey results and performed computer analyses to identify inconsistencies and other indications of error. A second independent analyst checked all the computer analyses. Further, we used GAO's Questionnaire Programming Language (QPL) system to create and process the Web-based survey. This system facilitates the creation of the instrument, controls access, and ensures data quality. It also automatically generates code for reading the data into SAS (statistical analysis software). This tool is commonly used for GAO studies.

We used QPL to automate some processes, but also used analysts to code the open-ended questions and then had a second, independent analyst review them. (The survey contained both open- and close-ended questions.) We entered a set of possible phrases, called tags, which we identified for each question into QPL. When the analysts reviewed the text responses, they assign the tags that best reflect the meaning of what the respondent has written. The system then compares the tags assigned by the independent reviewers. Multiple tags may be assigned to a single response; thus, it is possible for reviewers to agree on some tags and not on others. Although it is possible to have reviewers resolve their differences until agreement is found, for this survey we only considered tags that were selected by all reviewers on the first pass. Tags assigned by only one reviewer were dropped. This process allowed a quantitative analysis of open comments made by respondents. Finally, we verified all data processing on the survey in house and found it to be accurate.

SEC and PCAOB Efforts to Address Smaller Company Concerns

To address our second objective describing SEC's and PCAOB's efforts related to the implementation of the act and their responses to concerns raised by smaller public companies and the accounting firms that audit them, we interviewed SEC and PCAOB staff on the rulemaking and standard setting processes. We also interviewed public company executives, representatives of relevant trade associations, and market participants for their reaction to the agencies' rules, guidance, and other public announcements.

During the course of our review, both SEC and PCAOB held forums and other open meetings to allow a public discourse on the act's impact on public companies, accounting firms, investors, and other market participants. We attended most of these forums and open meetings and reviewed submitted comments. Specifically, from November 2004 to February 2006, we attended either in person or through a Web cast the following: SEC's Advisory Committee on Smaller Public Companies open meetings; SEC's Roundtable on Implementation of Internal Control Reporting Provisions; SEC's Government-Business Forum on Small Business Capital Formation; PCAOB's Standing Advisory Group Meetings; and PCAOB's forums on auditing in the small business environment. We reviewed the guidance that SEC and PCAOB separately issued on May 16, 2005, as a result of comments received at SEC's section 404 roundtable.

Impact of Act on Smaller Privately Held Companies

To determine the act's impact on smaller privately held companies, we analyzed available research and studies. We also interviewed officials of the National Association of State Boards of Accountancy in states that required or were considering requiring privately held companies to comply with corporate accountability, governance, and financial reporting measures comparable to key provisions in the Sarbanes-Oxley Act.

Further, we analyzed data and interviewed officials on whether lenders, financial institutions, private equity providers, or others were imposing the act's requirements on privately held companies as a condition of obtaining capital or financial services. Finally, we interviewed officials and analyzed available data on whether, as a result of the act, privately held companies were voluntarily adopting key provisions of the act as best practices or whether they had faced challenges in trying to reach the public markets.

To assess the impact of the act on privately held companies trying to reach the public markets, we obtained a sample from SEC's Electronic Data Gathering, Analysis, and Retrieval (EDGAR) system, a database that includes companies' initial public offering (IPO) and secondary public offering (SPO) filings. Our sample contained registration statements, pricings and applications for withdrawal filed with SEC from 1998 through July 2005. We performed various analyses of IPO and SPO activity prior to and after enactment of Sarbanes-Oxley, including analyses of the sizes of companies coming and returning to the market, types and amounts of IPO expenses, and the reasons cited by companies for withdrawing their IPO filing. We analyzed IPO expenses as a percentage of revenue and offering amount for companies in various size categories to determine whether the differences between the groups changed over time and whether the differences were statistically significant when controlling for other determining factors.

SEC's EDGAR database is considered the definitive source for information on IPOs since all companies issuing securities that list on the major exchanges and the OTCBB, as well as those that meet certain criteria listing on the Pink Sheets, must register the securities with SEC. Nevertheless, we crosschecked the descriptive statistics retrieved from EDGAR with NASDAQ's IPO data. However, there was no financial data available on several companies, while others failed to provide information to complete all of the fields. In cases where revenue was left blank, individual filings were reviewed and actual revenue, 9-month revenue or pro-forma data was used to determine the size of the company. In cases were this data was not available we dropped these companies from any analysis involving the use of such data. Additionally, there can be significant lag between the dates a company initially files for an IPO with SEC and when the stock of the company is finally priced (begins trading). Because we had data on IPO filings during the last 2 months of 1997, we were able to include those companies that priced IPOs over the 1998-2005 period that initially filed for an IPO during that time. However, any IPOs that were priced during this time but had an initial filing that occurred prior to November 1, 1997, are not included. For this reason the number of priced IPOs for 1998 (and to an even lesser extent 1999) may understate somewhat the actual numbers of companies coming to the public market during that year. This limitation is insignificant in the context of this report.

Company Access to Auditing Services and Changes in Share of Public Companies That Small Firms Audit

To assess changes in the domestic public company audit market, we used public data—for 2002 and 2004—on public companies and their external accounting firm to determine how the number and mix of domestic public company audit clients had changed for firms other than the large accounting firms. To be consistent with our 2003 study of the structure of the audit market, we used the *Who Audits America* database, a directory of public companies with detailed information for each company, including the auditor of record. Only domestic public companies traded on the major exchanges or over-the-counter with available financial data were included in our analysis of audit market concentration and the results do not include a number of clients of the smallest audit firms. Users of our 2003 study will also note that we used the term “sales” when referring to auditor concentration but use the term “revenue” in this report. Although *Who Audits America* refers to sales, our conversations with the provider of the data, confirmed that although the terms can be used interchangeably, “revenue” is a better term than “sales” in accurately describing the contents of the database.

To verify the reliability of these data sources, we performed several checks to test the completeness and accuracy of the data. Previously GAO crosschecked random samples of the *Who Audits America* database with SEC proxy filings and other publicly available information. Descriptive statistics calculated using the database were also compared with similar statistics from published research. Moreover, academics who worked with GAO in the past also compared random samples from *Compustat*, *Dow-Jones Disclosure*, and *Who Audits America* and found no discrepancies. We also crosschecked the results with estimates obtained using Audit Analytics’ audit opinion database. The results were not significantly different and confirm the finding outlined in the body of the report. However, because of the lag in updating some of the financial information and the omission of a number of small public clients, the results should be viewed as estimates useful for describing the market for audit services.

We conducted our work in California, Connecticut, Georgia, Maryland, New Jersey, New York, Virginia, and Washington, D.C., from November 2004 through March 2006 in accordance with generally accepted government auditing standards.

Appendix II: Additional Details about GAO's Analysis of Companies Going Private

A number of research studies and anecdotal evidence suggest that a significant number of small companies have gone private as a result of costs associated with the increased disclosure and internal control requirements introduced by the Sarbanes-Oxley Act of 2002. To provide a better understanding of companies going private, we analyzed Form 15s filed by companies, related Securities and Exchange Commission (SEC) filings and press releases to determine the total number of companies exiting the public market and the reasons for the change in corporate structure. See appendix I for our scope and methodology. This appendix provides additional information on the construction of our database and descriptive statistics.

Our Database Included Firms That "Went Dark" as Well as Firms That Completely Exited the Public Market

Although there is no consensus on the term "going private," we started with the description used in the "Fast Answers" section of SEC's Web site: a company "goes private" when it reduces the number of its shareholders to fewer than 300 (or 500 in some instances) and is no longer required to file reports with SEC.[1] To reduce the number of holders of record, a company can undertake a number of transactions including tender offers, reverse stock splits, and cash-out mergers. In many cases, the company already meets the requirement for deregistration and therefore the registrant need only file a Form 15 (which notifies SEC of a company's intent to deregister) with SEC to meet this description of "going private." As a result, we use the terms "going private" and "deregistering" interchangeably. However, not all companies that deregister completely exit the public markets; some elect to continue trading on the less regulated Pink Sheets.[2] Companies that deregister their shares with SEC but continue public trading on the Pink Sheets are often considered as having "gone dark" rather than private in the academic literature. However, our final "going private" numbers include companies that no longer trade on any exchange and those that continue to trade on the less

[1]Under certain SEC rules, public companies voluntarily can deregister by filing a Form 15 with SEC if they have fewer than 300 holders of record or fewer than 500 holders of record if the company's total assets have not exceeded $10 million at the end of the company's 3 most recent fiscal years and if the company meets some additional criteria. Many of these companies can have thousands of actual beneficial shareholders. For example, Ced & Co., the nominee of Depository Trust Company would be counted as one certificate holder of record for many thousands of investors served by the brokerage firms that are members of the Depository Trust Company.

[2]The Pink Sheets LLC does not require companies whose securities are quoted upon its systems to meet any listing requirements or require the companies to be registered with SEC.

regulated Pink Sheets ("went dark").[3] It should be noted that SEC does not have rules that define "going dark" and the term is used here as it is used in academic research.

The companies contained in our database include only those companies that deregistered common stock, were no longer subject to SEC filing requirements, and were headquartered in the United States. Moreover, the database excludes most cases where the company was acquired by, or merged into another company; filed for, or was emerging from, bankruptcy; or was undergoing or planning liquidation. We also excluded a significant number of companies that filed for an initial public offering and subsequently filed a Form 15 within a year; filed no annual or quarterly financials between the first filing with SEC and the Form 15; or filed as a result of reorganization where the company remained a public registrant. Based on the information contained on the Form 15, we were able to exclude four types of filers: (1) companies that deregistered securities other than their common stock; (2) companies that continued to be subject to public reporting requirements; (3) companies that were headquartered in a foreign country; and (4) companies for which a Form 15 could not be retrieved electronically.[4]

In addition to SEC filings, we used press releases located through Lexis-Nexis to investigate whether the companies experienced any of the disqualifying conditions (bankruptcy, merger, acquisition, liquidation, etc.). Companies that were merged into, or were acquired by, another company were only included if the transaction was initiated by an affiliate of the company (either the company filed a Schedule 13E-3 with SEC or our analysis found evidence of a "going private" transaction in the case of Over-the-Counter Bulletin Board (OTCBB) and Pink Sheet-quoted

[3]Because we are addressing the potential effects on the access to capital, our database focuses on "going private" from a public disclosure requirement perspective—not necessarily from a trading perspective. Some companies actively trade but are not required to disclose information to SEC via periodic filings—these are considered private; some companies do not trade actively but report to SEC—these are considered public and when they file a Form 15 and cease filing with SEC are considered to have gone private.

[4]In a few cases, we found companies that deregistered their common stock and had other public securities that were still subject to SEC reporting requirements, but later deregistered those securities shortly after the initial Form 15 filing. These types of companies are also included in our final numbers.

companies).[5] Moreover, if the transaction resulted in the company becoming a subsidiary of another publicly traded company or a foreign entity, or if the transaction met any of the other disqualifying conditions, that company was excluded from our final numbers.

Each Form 15 also contained the number of holders of record. We excluded all companies with one or zero holders of record unless that company also filed a Schedule 13E-3 with SEC. A test of a random sample of 200 of these companies found that merging, bankrupt, and liquidating firms typically reported one or zero as the number of holders of record.[6] Because there may have been some companies that went private by way of merger that did not file a Schedule 13E-3, our database may have excluded some companies going private as a result of using this qualifier. However, this limitation is minor in the context of this report (see app. I for additional information on data reliability). In total, these exclusions left us with 1,093 U.S. companies going private from 1998 through the first quarter of 2005 out of the 15,462 Form 15 filings initially provided to us by SEC.[7]

[5]Generally, if the transaction is initiated by an affiliate (an insider) of the company, Rule 13e-3 of the Securities Exchange Act of 1934 requires the affiliate to file a Schedule 13E-3 with SEC. The filing of a Schedule 13E-3 may also be required when affiliated transactions result in a company's publicly held securities no longer being traded on a national securities exchange or an inter-dealer quotation system, such as NASDAQ. The Schedule 13E-3 requires a discussion of the purposes of the transaction, any alternatives that the company considered, and whether the transaction is fair to all shareholders. The schedule also discloses whether and why any of its directors disagreed with the transaction or abstained from voting on the transaction and whether a majority of directors,who are not company employees, approved the transaction.

[6]The companies were found to have either merged with another company or, in some cases, had gone bankrupt or were liquidated. See also Marosi and Massoud (2004), "Why Do Firms Go Dark," University of Alberta, March 2004, who used a similar criterion to exclude companies.

[7]Ten additional companies went private between April 1, 2005, and April 24, 2005, bringing the total to 1,103.

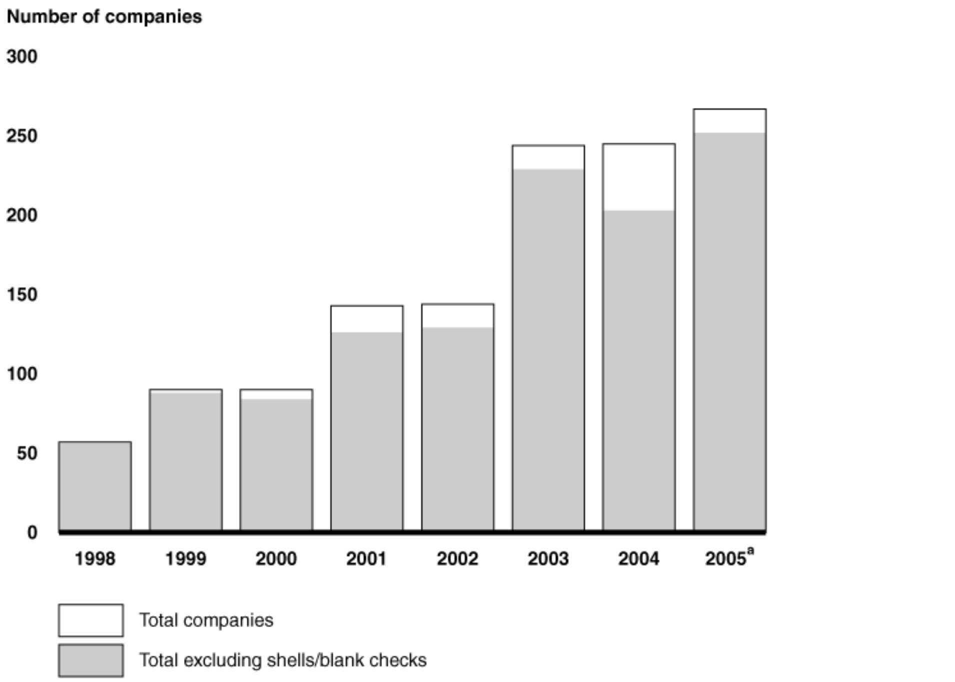
Consistent with Outside Studies, We Found That the Number of Companies That Went Private Increased Significantly from 2001 through 2004

The number of public companies going private increased significantly from 143 in 2001 to 245 in 2004 (see fig. 8). Based on the number of companies going private during the first quarter of 2005, we project that the number of companies going private will increase, to 267 companies by the end of 2005. While these numbers constitute a small percentage of the total number of public companies, the trends we identified suggest that more small companies are reconsidering the cost and benefits of remaining public and raising capital on domestic public equity markets. As figure 8 shows, the number of companies going private increased significantly, whether or not we excluded the types of companies explicitly considered as speculative investments by SEC—blank check and shell companies.[8] Overall, these companies, identified as such by Standard Industry Classification code, represent 17 percent of the companies going private in 2004 but just 2.5 percent of the companies going private during the first quarter 2005 and 8.4 percent of the overall sample.[9]

[8]SEC recently targeted regulatory problems that they identified where shell companies have been used as vehicles to commit fraud and abuse SEC's regulatory processes.

[9]Blank check companies are typically development stage companies that have no specific business plan or purpose or have indicated that their business plan was to engage in a merger or acquisition with an unidentified company or companies, entities, or persons. SEC defines a shell company as a company with no or nominal operations and either no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets. SEC noted that many investors have been victimized in shell company schemes over the years. However, their corporate structures and status as publicly listed entities and fully reporting issuers are features of interest for some small companies with a desire to go public by way of reverse merger. In a reverse merger, a private company merges with a public company and continues as the dominant successor.

Figure 8: Total Number of Companies Identified as Going Private from 1998 to 2005



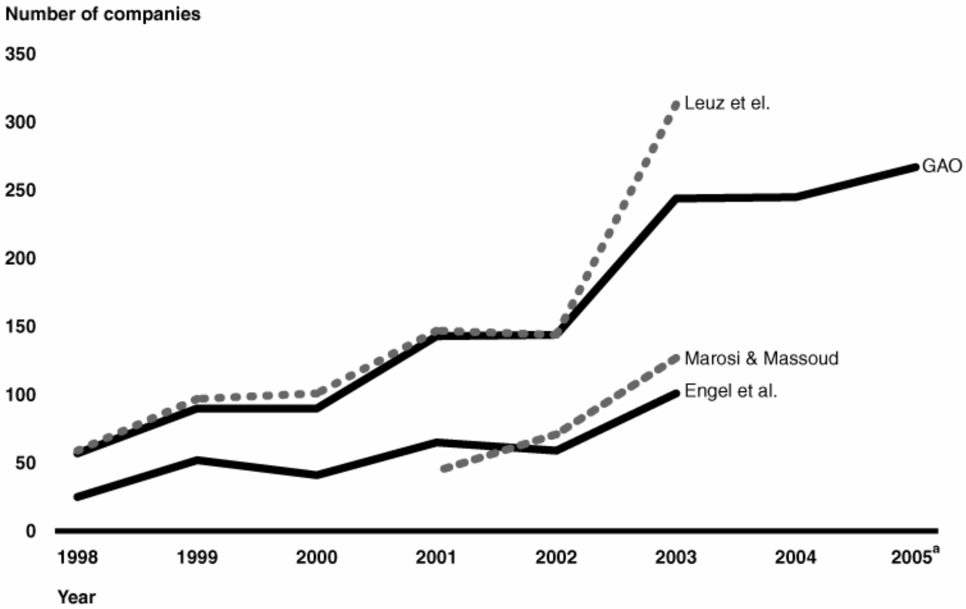
Source: GAO analysis of SEC data.

Notes: Includes companies that deregistered but continued to trade over the less regulated Pink Sheets ("went dark") and public shells and blank check companies. Does not include companies that have filed for, or are emerging from, bankruptcy, have liquidated or are in the process of liquidating, were headquartered in a foreign country or that have been acquired by or merged into another company unless the transaction was initiated by an affiliate of the company and the company became a private entity. The estimate for 2005 is projected based on the number of companies going private in the first quarter and the pattern of deregistration activity found in 2003 and 2004.

[a]Partial year, only includes the first 2 quarters of 2005.

A number of research reports have also found that the number of companies exiting the public market has increased since 2002. Although there are differences in the search methodologies and types of companies included, each study found similar trends and reached similar conclusions (see fig. 9). For example, in Leuz et al. (2004) the number of companies going dark or private increased from 144 to 313 between 2002 and 2003. Moreover the authors found that the bulk of the increase was made up of companies that continued trading on the Pink Sheets after deregistration. Engel et al. (2004), which was based on a smaller subset of deregistering companies, found a statistically significant increase in the rate at which companies went private. Marosi and Massoud (2004) excluded all merger-related transactions and found that the number of companies going dark increased from 71 in 2002 to 127 in 2003.[10]

Figure 9: Companies Going Private or Dark, by Research Study



Source: GAO analysis of SEC data and selected studies.

Note: Leuz et al. data includes going private and going dark companies in 1998–2003. The Marosi and Massoud data only includes companies going dark in 2001–2003. The Engel study includes data on going private transactions based on 13E-3 filings in 1998–2003. Additional differences in the types of companies excluded exist across these samples. GAO's number for 2005 is projected based on the number of companies going private in the first quarter and the pattern of deregistration activity found in 2003 and 2004.

[a]Partial year, only includes the first 2 quarters of 2005.

[10]E. Engel, R. Hayes, and X. Wang, "The Sarbanes-Oxley Act and Firms' Going Private Decisions," University of Chicago Working Paper, May 2004; C. Luez, A. Triantis, and T. Wang, "Why Do firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistration," University of Pennsylvania Working Paper, September 2004; and Marosi and Massoud (2004), "Why Do Firms Go Dark," University of Alberta, March 2004.

We Grouped Reasons for Company Decisions to Go Private into Seven Categories

In analyzing company decisions, we used various sources to determine why the companies included in our database deregistered their common stock. Because companies did not always disclose the reasons for their decision in an SEC filing, we also searched press releases and newswire announcements using the Lexis-Nexis search engine. We then used the reasons given in the various filings and other media to construct seven broad categories, summarized in table 7. Because companies often gave multiple reasons for the decision to deregister (go private) and it was difficult to tell which were the most important, we allowed up to six reasons for each company included in our database.[11] For example, Westerbeke Corporation went private in 2004 and cited the following reasons for the decision: "a small public float," inability to use its stock as currency for acquisitions, benefits the company would receive as private entity such as "greater flexibility," the ability to make "decisions that negatively affect quarterly earnings in the short run," and the costs and time devoted by employees and management "resulting from the adoption of the Sarbanes-Oxley Act of 2002." This company is included in our database with following coded reasons for going private: (1) market/liquidity issues; (2) private company benefits; (3) direct costs; and (4) indirect costs.

[11]It should be noted that these reasons are self reported by the company and are not based on any additional (and more complex) analysis of company behavior. Furthermore, because the Schedule 13E-3 requires a discussion of the purposes of the transaction, any alternatives that the company considered, and whether the transaction is fair to all shareholders, affiliates of the company that are advocating the transaction may list all the pros and cons of going private. As a result, in cases where a company is required to file a Schedule 13E-3 with SEC, cost savings are generally listed as a benefit of going private and therefore captured in our database as one of the reasons for the decision.

Table 7: Reason for Going Private, by Category Descriptions

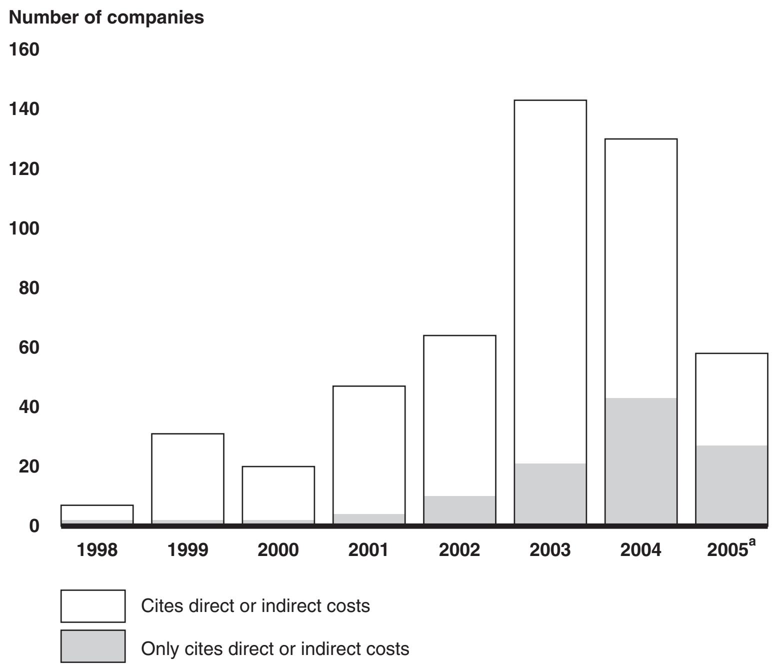
Direct costs	Company cites the costs associated with being a public company. Includes listing costs, regulatory compliance costs, expenses paid for outside advice, audit and attestation requirements, other expenses directly related to the implementation of the Sarbanes-Oxley Act, taxes at the corporate level, and costs related to shareholders and shareholder accounts.
Indirect costs	Company cites the amount of time and effort required to meet periodic reporting requirements, adhere to securities laws, and service shareholders. Includes time and company resources spent on Sarbanes-Oxley-specific requirements instead of regular business activities.
Market/liquidity issues	Company cites thinly traded stock or general illiquidity of company shares, poor market conditions, an undervalued or low stock price, lack of analyst coverage, or disinterest on the part of investors. Includes inability or difficulty in raising capital through follow-on offerings or using stock as currency for mergers, acquisitions, or employee compensation.
Private company benefits	Company cites benefits of becoming a private company including ability to act quickly without market pressure, keep information from competitors, or provide more flexibility in corporate operations. Also includes normal business decisions, changes in strategy, and belief that going private would provide better growth and investment opportunities.
Critical business issues	Company cites negative business prospects or critical issues that could undermine the ability of the company to remain profitable or continue as a going concern. Includes lawsuits, SEC actions, exchange delisting, general bad business, intense competition, or failure of plans that could have made the company more viable.
Other	Company cites reasons not covered by the listed categories.
No reason	Company provides no information on why it decided to deregister. Includes companies that indicated they deregistered simply because they met the requirements to do so.

Source: GAO.

More Companies Have Cited Costs as Reasons for Going Private Since 2002

Although companies go private for a variety of reasons, in recent years, more companies cited the direct costs of maintaining public company status as at least one of the reasons for going private. As shown in figure 10, the number of companies citing costs as at least one reason for going private increased from 64 in 2002 to 143 and 130 in 2003 and 2004. However, the percentage of companies citing cost as the only reason for exiting the market has increased significantly in recent years. While only 21 cited costs and no other reason in 2003 (15 percent of the total citing cost), 43 did so in 2004 (33 percent of the total citing cost). During the first quarter of 2005, nearly 50 percent of the companies mentioning cost, cited costs as the only reason for going private.

Figure 10: Companies Citing Costs as One of the Reasons for Going Private



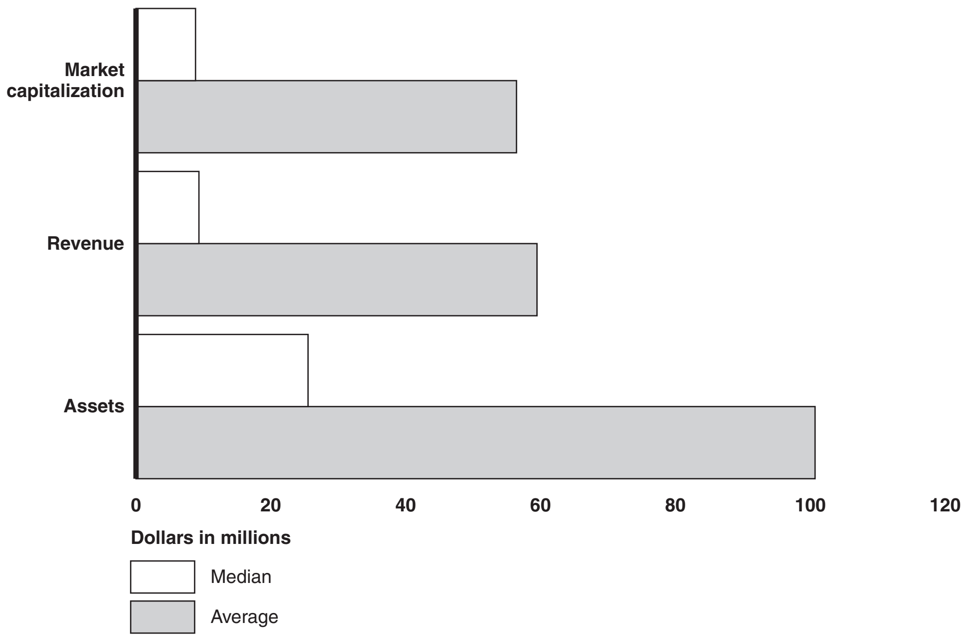
Source: GAO analysis of SEC data.

[a]Partial year, only includes the first 2 quarters of 2005.

Companies Going Private Typically Were among the Smallest of Publicly Traded Companies

By any measure (market capitalization, revenue or assets), the companies that went private over the 2004–2005 period represent some of the smallest companies in the public arena (see figs. 11 and 12). Because these companies were on average very small, they enjoyed limited analyst coverage and limited market liquidity—one of the primary benefits cited for going or remaining public. The median market capitalization and revenue for these companies was less than $15 million.

Figure 11: Average and Median Sizes of Companies Going Private, 2004-2005



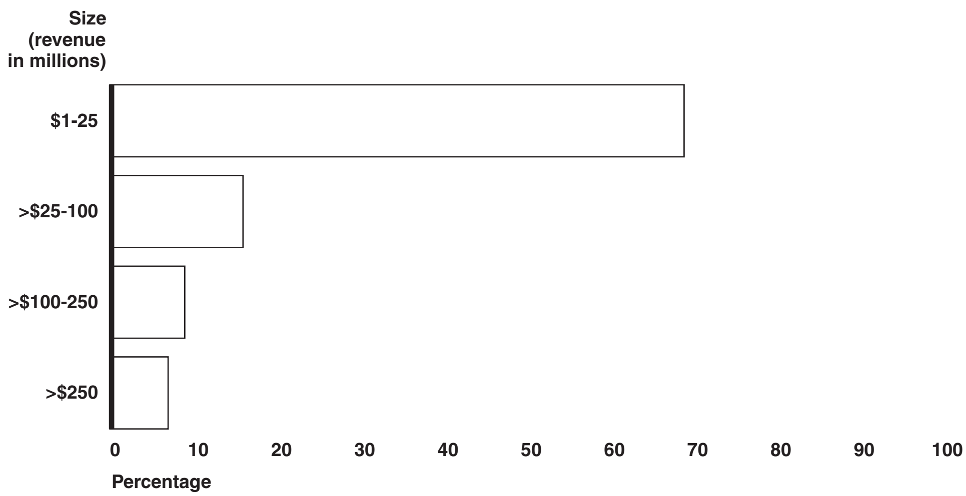
Source: GAO analysis of SEC and Audit Analytics data.

Note: Only includes companies with financial data available.

Figure 12 also illustrates that companies going private were disproportionately small, which reflected that the net benefits from being public likely were smallest for small firms and the costs of complying with securities laws likely required a higher proportion of a smaller company's revenue. For example, 84 percent of the companies that went private in 2004 and 2005 had revenues of $100 million or less and nearly 69 percent had revenues of $25 million or less.[12] We also found that a significant portion of these companies—12.5 percent of those that went private in 2004–2005—had not filed quarterly or annual financial statements with SEC in more than 2 years; therefore, we did not have access to recent financial information.

[12]Given that the financial data are based on the company's last annual filing, these results should be viewed as estimates of company size.

Figure 12: Revenue Categories for Companies Going Private, 2004-2005



Source: GAO analysis based of SEC and Audit Analytics data.

Note: Only includes companies with financial data available.

Appendix III: Comments from the Securities and Exchange Commission

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 31, 2006

Mr. William B. Shear
Director, Financial Markets and Community Investment
United States Government Accountability Office
441 G Street, N.W.
Washington, DC 20548

Dear Mr. Shear:

Thank you for the opportunity to comment on your draft report entitled *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*. We agree with you that the Sarbanes-Oxley Act has had a positive impact on investor protection and confidence, but share your concern that smaller public companies are facing particular challenges in implementing certain provisions of the Act, most notably Section 404.

As you note in your draft report, the Securities and Exchange Commission has undertaken a number of initiatives to assess the costs of compliance with the Sarbanes-Oxley Act, particularly Section 404, and to appropriately balance those costs with the benefits for smaller public companies. The Commission has extended filing deadlines, issued guidance, established the SEC Advisory Committee on Smaller Public Companies, and sponsored a Section 404 roundtable event in April 2005. In addition, the Commission will be conducting a second Section 404 roundtable event on May 10, 2006, which should provide further insight into the experiences of companies and their accountants in the second year of Section 404 implementation. The information gained at the roundtable may be useful to smaller companies.

Your draft report stresses the importance for the Commission, in assessing the final recommendations of the SEC Advisory Committee, of balancing the key principle behind the Sarbanes-Oxley Act—investor protection—against the goal of reducing the regulatory burden on smaller public companies.

The draft GAO report also makes three specific recommendations for the Commission's consideration in reviewing the final report of the Advisory Committee, as it relates to Section 404: (1) assess whether additional guidance is needed to help smaller public companies meet the requirements of Section 404, (2) work with the PCAOB to ensure consistency and efficient implementation of Section 404 guidance and standards, and (3) ensure that the objectives of investor protection are met and that any Section 404 relief granted is targeted and limited.

Mr. William B. Shear
March 31, 2006
Page 2

These recommendations should provide a useful framework for consideration of the Advisory Committee's final recommendations, which are due to the Commission by April 23, 2006. We do not believe, however, that it would be appropriate for us to speculate or comment on the Committee's recommendations in this letter before they are finalized and submitted to the Commission. We wish to emphasize that the Commission continues to support the mission of the Advisory Committee, very much appreciates its work, and looks forward to receiving its final recommendations.

Thank you again for the chance to comment upon your draft report. We appreciate the GAO's attention to these important issues.

Sincerely,

John W. White
Director
Division of Corporation Finance

Scott A. Taub
Acting Chief Accountant

Appendix IV: Comments from the Public Company Accounting Oversight Board

PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

April 7, 2006

William B. Shear
Director, Financial Markets and
Community Investments
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Shear:

We have received and reviewed your draft report entitled Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies. We appreciate your providing the Public Company Accounting Oversight Board with an opportunity to comment on this report.

Among the report's recommendations is for the Securities and Exchange Commission to work with the PCAOB to ensure that Section 404-related auditing guidance is consistent with any additional SEC guidance.

The PCAOB is committed to working with the SEC on GAO's recommendations. We agree that it is essential to preserve the overriding purpose of the Sarbanes-Oxley Act of investor protection while we seek ways to make its implementation as efficient and effective as possible. Technical comments have been provided to your evaluators separately. We do not have any additional comments at this time.

Sincerely,

Bill Gradison
Acting Chairman

Appendix V: GAO Contacts and Staff Acknowledgments

GAO Contacts

William B. Shear (202) 512-8678
Jeanette M. Franzel (202) 512-9471

Acknowledgments

In addition to those named above, Harry Medina and John Reilly, Assistant Directors; E. Brandon Booth; Michelle E. Bowsky; Carolyn M. Boyce; Tania L. Calhoun; Martha Chow; Bonnie Derby; Barbara El Osta; Lawrance L. Evans Jr.; Gabrielle M. Fagan; Cynthia L. Grant; Maxine L. Hattery; Wilfred B. Holloway; Kevin L. Jackson; May M. Lee; Kimberly A. McGatlin; Marc W. Molino; Karen V. O'Conor; Eric E. Petersen; David M. Pittman; Robert F. Pollard; Carl M. Ramirez; Philip D. Reiff; Barbara M. Roesmann; Jeremy S. Schwartz; and Carrie Watkins also made key contributions to this report.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone:	Voice:	(202) 512-6000
	TDD:	(202) 512-2537
	Fax:	(202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548