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How Much for SOX?

Five years after Sarbanes-Oxley, the compliance costs remain huge.

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What impact has the Sarbanes-Oxley Act had on compliance costs for public companies? Substantial, it turns out, even five years after it became law.

The Sarbanes-Oxley Act was enacted in mid-2002 to improve corporate financial reporting after the Enron, WorldCom, and other accounting scandals. Opinions vary widely on its success in preventing fraud and increasing investor confidence, as well as on whether its benefits justify the costs. But virtually everyone agrees that the compliance costs associated with Sarbanes-Oxley have been, and continue to be, extraordinarily high—even five years after Congress passed the sweeping law.

In 2003, Foley & Lardner began an annual study of the costs of Sarbanes-Oxley and other corporate governance reforms. Over the five years the study has been conducted, one element has remained constant: Corporate governance reform comes with a heavy financial burden. Since 2001, public companies of all sizes have experienced a significant increase in compliance costs. Most of the increase comes from Section 404 of Sarbanes-Oxley, which requires the outside firm that audits the company's financial statements to attest to and report on the company's internal control structure and procedures for financial reporting.

High Costs Continue

In 2007, our fifth annual study found that companies are still paying millions to comply with the law and related reforms. The average annual cost for companies with less than $1 billion in annual revenue is $2.8 million, an increase of more than $1.7 million since 2002. This represents a 171 percent overall increase in compliance costs between fiscal years 2001 and 2006.

This year's study found only a slight increase (1 percent) in overall corporate governance compliance costs in fiscal year 2006 for companies with annual revenue less than $1 billion. This minor increase followed a 19 percent decrease in fiscal year 2005. The 2005 decrease primarily resulted from a 46 percent decrease in lost productivity reported in fiscal year 2005. Lost productivity decreased another 48 percent in fiscal year 2006.

Other studies have found that internal efficiencies after the initial phase-in of Section 404 in fiscal year 2004 have driven costs down. The reductions in lost productivity in 2005 and 2006 are consistent with that conclusion. But these decreases in lost productivity in 2005 and 2006 have not reversed the extraordinary increases in lost productivity seen in 2002 (102 percent), 2003 (72 percent), and 2004 (556 percent). Average lost productivity attributed to corporate governance compliance in fiscal year 2006 was $290,000, a 530 percent increase from $46,000 in fiscal year 2001.

Although internal efficiencies in Section 404 compliance have driven costs down for fiscal year 2006 and corporate governance compliance costs seem to have reached a plateau, these costs remained extraordinarily high in fiscal year 2006 compared to fiscal year 2001, the year before the initial phase-in of Sarbanes-Oxley's reforms.

Despite the decrease in internal costs for Section 404 compliance during 2006, out-of-pocket costs continued to rise at double-digit rates between fiscal years 2005 and 2006. Out-of-pocket costs for corporate governance compliance were up 13 percent in fiscal year 2006 from fiscal year 2005 for public companies with annual revenue of less than $1 billion. They rose 12 percent over the same period for public companies with annual revenues exceeding $1 billion. The increases in audit fees, board compensation, and legal fees were the primary drivers of these increases.

More External Fees

External audit fees continued to increase and are significant. Some experts predicted that external audit fees would decrease after the initial implementation of Section 404 audits, as auditors became more familiar with their clients' accounting controls and conducted more efficient audits.

Our study has shown, however, that external audit fees are the only corporate governance cost to increase each year since Sarbanes-Oxley was enacted. Audit fees alone now represent more than 47 percent of out-of-pocket corporate governance compliance costs for companies with less than $1 billion in annual revenue, and 60 percent for companies with at least $1 billion in annual revenue.

Average audit fees increased by double-digit percentages each year from 2002 through 2004, with the increase particularly dramatic in 2004 (a 110 percent increase for public companies with less than $1 billion in revenue). The study attributes the 2004 increase to the substantial costs associated with the required Section 404 financial control audit, which phased in for domestic public companies with market capitalizations exceeding $75 million beginning with their first fiscal year ending after Nov. 15, 2004.

In 2005 and 2006, percentage increases in audit fees continued at less dramatic levels than those seen in fiscal years 2002 through 2004. Unlike the early years after Sarbanes-Oxley, audit fees have reached a relative plateau over the past two years for companies of all sizes.

Although year-over-year increases in 2005 and 2006 are relatively modest compared to 2002, 2003, and 2004, audit fees remain at extraordinarily high levels compared to before Sarbanes-Oxley. On average, between 2001 and 2006, external audit fees increased 311 percent for Standard & Poor's small-cap companies, 251 percent for S&P mid-cap companies, and 189 percent for S&P 500 companies.

In addition to increased audit fees, public companies spend increasing amounts to attract and retain qualified directors. Annual director fees have consistently increased for each category of company analyzed. On average, annual director fees have increased 70 percent for S&P small-cap companies, 98 percent for S&P mid-cap companies, and 93 percent for S&P 500 companies between 2001 and 2006.

Public company directors are now much more involved, and they expect compensation for the additional time required. Furthermore, changes in accounting rules requiring the expensing of stock options have contributed, because many corporations reduced directors' stock options and increased cash compensation after these rules were phased in during 2006.

Expenses Phasing In

Our survey of public companies asked respondents how corporate governance and public-disclosure reforms have affected their company's overall administrative expenses. The number of respondents who said corporate governance reforms affected administrative expenses "a great deal" remained consistent from our 2006 (54 percent) to 2007 (52 percent) surveys. Responses to these surveys were similar to those in our 2004 survey (54 percent).

In 2005, however, 70 percent of respondents said Sarbanes-Oxley affected their administrative expenses "a great deal." We attribute the 2005 results to the Section 404 phase-in at the end of 2004.

Over the five years of this study, responses to this question generally have reflected the phases in which Sarbanes-Oxley provisions were implemented. In 2003, which reflects results from fiscal year 2002, only 33 percent of respondents said Sarbanes-Oxley affected their administrative expenses "a great deal." This can be attributed to the phase-in of CEO/CFO certificates in 2002, a relatively low-cost item for most public companies. In 2004 (reflecting 2003 costs), 54 percent reported "a great deal" of impact. New audit committee rules and NYSE/Nasdaq listing standards accounted for the bulk of administrative expenses and, for some companies, early preparations for the Section 404 phase-in also contributed.

In 2005 (reflecting 2004 costs), the full impact of the Section 404 phase-in was realized by public companies with market capitalizations exceeding $75 million, which accounted for the increase to 70 percent in those responding that administrative expenses were affected "a great deal." In 2006, cost increases returned to a relative "steady state," demonstrating that compliance costs were still significant but no longer increasing at the 2005 rates. Fifty-four percent reported "a great deal" of impact for 2006. The steady state was reinforced by the 2007 data, with 52 percent reporting "a great deal" of impact.

What to Do?

This year's survey also asked respondents to report if their company was considering selling, going private, or merging. Consistent with previous years, nearly one in four respondents said they are considering going-private transactions because of corporate governance reforms.

An interesting development in the 2007 survey is the slight increase in respondents who are considering selling their company (16 percent) or merging with another company (14 percent). In the 2006 survey, 8 percent said they were considering merging, and 10 percent said they were considering selling. The fact that companies are considering alternatives to going private is driven by the increased awareness of the attractive prices private equity funds paid in 2006 and early 2007 in the mergers-and-acquisitions market.

For the third year, a majority (84 percent) of respondents said governance and public disclosure reforms are "too strict." This is up from 55 percent in 2003 and 67 percent in 2004. Thus, the feeling that the reforms are "too strict" rose steadily through 2005 and has since plateaued.

Executives who participated indicated a desire for modification of Sarbanes-Oxley and other reforms. Sixty-eight percent of respondents agreed that smaller companies should be exempted from Section 404.

In fiscal year 2006, complying with Sarbanes-Oxley cost public companies with less than $1 billion in revenue $2.8 million, and companies with more than $1 billion in revenue $12.5 million. Five years after enactment, the law remains a substantial financial burden.

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