The Continued Costs Of Being A Public Company

by Thomas E. Hartman

After the huge initial investments required to comply with Sarbanes-Oxley, we could assume that costs would decline as compliance became more routine. Indeed, SOX startup investments were huge—but the costs of compliance have continued to rise year after year, and now smaller public companies are facing the same outlays.

In January of 2003, Foley & Lardner LLP began an annual study of the costs associated with the corporate governance reforms imposed since the adoption of the Sarbanes-Oxley Act, a then-new phenomenon in the business world that has since become a household name. While our methodology evolved over the years as we learned how best to gather and analyze our data, one element remained constant: corporate governance reform comes with a heavy financial burden for today's public companies.

Even now, more than five years after SOX's initial implementation, costs associated with corporate governance compliance continue to rise. The question "corporate governance at what cost?" remains as relevant as ever.

What we have found in the fifth year of our study is that companies are still paying millions of dollars to comply with the Act and related governance reforms. Specifically, the 2007 edition of our study determined that the average cost of compliance for companies with under $1 billion in annual revenue has increased more than $1.7 million, to approximately $2.8 million since the enactment of Sarbanes-Oxley. This represents a 171 percent overall increase between 2001 and 2006.

Notwithstanding the large cumulative increase since 2001, this year's study found only a slight increase in overall corporate governance compliance costs (one percent) in fiscal year 2006. This slight increase followed a 19 percent drop in fiscal 2005.

The 2005 decrease resulted primarily from a 46 percent decline in lost productivity. Lost productivity decreased another 48 percent in fiscal year 2006. Other studies have concluded that the realization of internal efficiencies after the initial phase-in of Section 404 in 2004 have driven down costs. The reductions we have seen in lost productivity in 2005 and 2006 are consistent with that conclusion.

Nevertheless, these improvements in 2005 and 2006 have not reversed the extraordinary increases in lost productivity seen in 2002 (102 percent increase), 2003 (72 percent) and especially 2004 (556 percent). Lost productivity in fiscal year 2006 was $290,000, a 530 percent increase from $46,000 in fiscal year 2001—Sarbanes-Oxley.

The costs of SOX compliance have indeed plateaued, but related out-of-pocket costs for public companies still increased between 2005 and 2006.

While overall costs associated with Sarbanes-Oxley Act compliance have "plateaued," the out-of-pocket costs facing public companies increased between fiscal year 2005 and fiscal year 2006. Out-of-pocket costs associated with corporate governance compliance were up 13 percent in 2006 from 2005 for public companies with annual revenue of under $1 billion, and up 12 percent for those with revenues over $1 billion. The increased cost of audit fees, board compensation and legal fees has driven these out-of-pocket increases.

External audit fees have continued to increase and represent a significant expense for public companies. Some experts predicted that audit fees would

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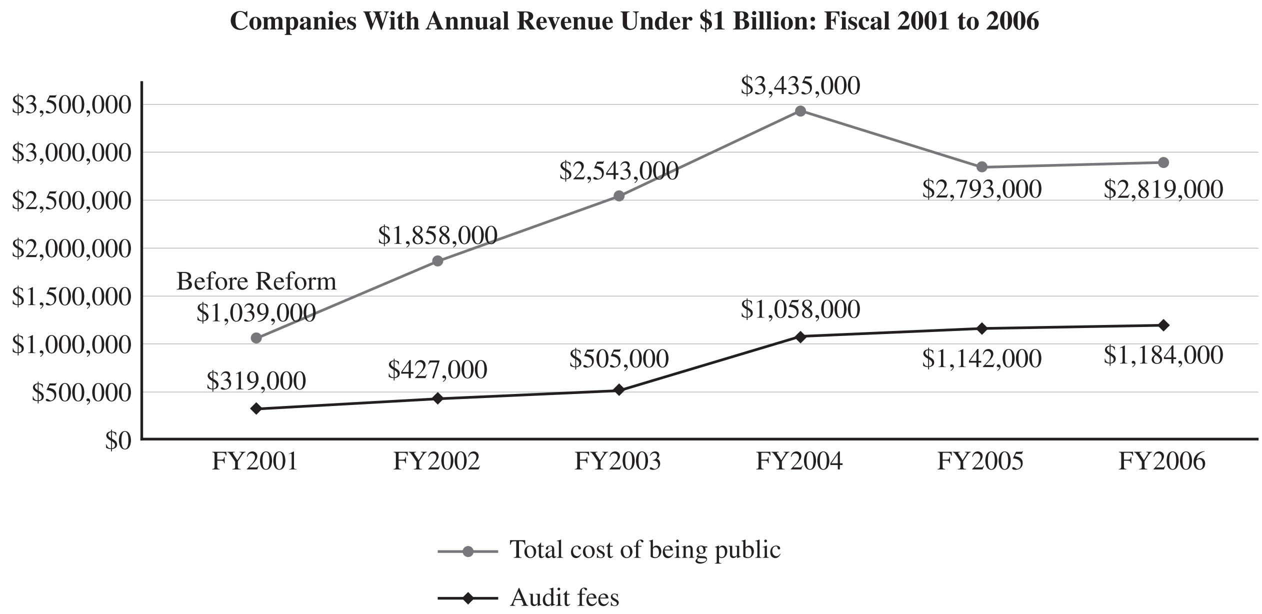
Higher And Higher
No SOX Relief In Sight



decrease after the initial implementation of Section 404 audits as external auditors became more familiar with their client's accounting controls and, therefore, more efficient in conducting their audits.

However, external audit fees have been the only cost we have seen increase every year since the Sarbanes-Oxley Act was passed. Audit fees alone now represent more than 47 percent of out-of-pocket costs associated with corporate governance compliance for public companies with under $1 billion in annual revenue. This reaches 60 percent for companies with $1 billion and over in annual revenue.

Average audit fees increased by double-digit percentages each year from the enactment of Sarbanes-Oxley in 2002 through 2004, and increased dramatically in fiscal year 2004. We attribute this to the substantial costs associated with the financial control audit required under Section 404 of SOX. Section 404 phased in at the end of 2004 for domestic public companies.

In fiscal year 2005, increases continued, though at less dramatic levels. For S&P mid-cap and S&P 500 companies, these percentage increases were the smallest since the enactment of Sarbanes-Oxley.

Audit fees reached a relative steady state in fiscal year 2006 for companies of all sizes with relatively modest year-over-year increases. In fiscal 2006, the percentage increase in average audit fees was relatively consistent for all companies analyzed. There was a five percent increase for small-caps, a four percent increase for mid-cap companies and a six percent rise for the S&P 500.

While the year-over-year increases in 2005 and 2006 are relatively modest, on average external audit fees increased 271 percent between fiscal years 2001 and 2006 for companies with under $1 billion in revenue, and remain a significant expense for companies of all sizes.

The number of respondents in our study who felt that Sarbanes-Oxley had impacted administrative expenses "a great deal" remained consistent between our 2006 survey (54 percent) and 2007 (52 percent). Responses in our 2006 and 2007 surveys were similar to those seen in 2004 (54 percent). In 2005, 70 percent of the respondents to our survey felt Sarbanes-Oxley added to their administrative expenses "a great deal." We attribute the 2005 results to the Section 404 phase-in that occurred at the end of 2004.

In the five years we have conducted this study, responses to questions on administrative expenses have generally reflected the phases in which the Sarbanes-Oxley Act was implemented. In 2003, the first year of our study (reflecting results from fiscal year 2002), only 33 percent of respondents indicated SOX impacted their administrative expenses "a great deal." We attribute this to the phase-in of CEO/CFO certificates in 2002, a relatively low-cost item for most companies.

By 2004, we believe new audit committee rules and NYSE/NASDAQ listing standards accounted for the bulk of administrative expenses, supplemented for some companies by early preparations for Section 404 phase-in. Some 54 percent of respondents reported "a great deal of impact." In 2005, the full impact of Section 404 phase-in was realized by domestic companies with market capitalizations over $75 million. This accounted for the increase to 70 percent in those responding that administrative expenses were impacted "a great deal."

In 2006, cost increases hit a "steady state" in which the costs of compliance are still significant but are no longer increasing at the earlier rates, and 54 percent report "a great deal" of impact. In 2007, the steady state concept was reinforced by the data, with 52 percent reporting "a great deal of impact."

Sarbanes-Oxley continues to increase administrative expenses. It also makes it more expensive to attract and retain qualified directors.

While respondents continue to believe that Sarbanes-Oxley affects administrative expenses, it also continues to be increasingly expensive for companies of all sizes to attract and retain qualified directors. Annual director fees also increased steadily and consistently for each category of company analyzed.

Overall, annual director fees have increased an average of 70 percent for S&P small-cap companies, 98 percent for S&P mid-caps and 93 percent for the S&P 500 between fiscal 2001 and 2006. We believe changes in the accounting rules requiring the expensing of stock options contributed to this trend. Many corporations reduced their grants of stock options to directors and increased cash pay after these rules phased-in in 2006.

This year's study found nearly one in four survey respondents (23 percent) are considering going-private transactions as a result of corporate governance and public disclosure reforms. This is consistent with respondents from previous years. Additionally, respondents continued to explore other options, including selling the company (16 percent) and merging with another company (14 percent). We believe this is driven by increased awareness among the business community of the attractive prices being paid in 2006 and early 2007 by private equity funds in the mergers and acquisitions market.

For the third straight year, a vast majority (84 percent) of respondents felt that corporate governance and public disclosure reforms are too strict. In 2005 and 2006, 82 percent responded similarly.

There is a significant outcry for the modification of corporate governance and corporate disclosure reform. Responses included statements such as:

- ☐ "Revisit disclosure requirements and accounting principles from the point of view of the user of financial statements. What is meaningful and of value to them as opposed to what the regulators want or think is of value?"
- ☐ "Set up different compliance standards. For example, Grades A, B & C. If you want to be an "A" company (like a GE), you have the most stringent standards you have to meet. If you are comfortable being labeled a "C" company and have the market treat you accordingly, you will not have as stringent requirements as an "A" or "B" company."
- ☐ "Provide for clear, meaningful disclosure and let stockholders decide by investing or not investing—not by giving them rights to run the corporation."
- ☐ "Don't impose the same requirements on all companies regardless of size. Consider the benefit of the cost we incur."

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A majority of respondents (68 percent) feel that smaller public companies should be exempted from Section 404 of the Sarbanes-Oxley Act. Respondents were also relatively aggressive in their definition of "smaller" public companies, with 59 percent of the respondents believing the threshold should be set at $250 million or more of market cap. Responses from executives on offering such relief from Section 404, and the most appropriate method to do so, included:

☐ "Get rid of it."

☐ "[Section] 404 does serve to ensure appropriate processes and controls, but a more rational approach is needed. In particular, there needs to be coordination of the PCAOB auditing standards and the PCAOB inspections. We have found the inspection standards driving our independent auditor's requirements more than the auditing standards."

☐ "Provide for a meaningful analysis of internal controls and not what amounts to a tally sheet of minutiae that in reality are meaningless to the operation and results of the corporation and serve no benefit for investors."

☐ "The repetition of testing controls performed over and over must be considered in a more sensible and realistic light and eliminated. In addition, too much time is spent on non-high risk areas. It is very expensive and serves little or no purpose other than to drive investment capital off shore."

☐ "*Total repeal*—as a 30-year partner in a Big-4 accounting firm who now sits on public company boards, I am intimately familiar with controls, etc. [Section] 404 has become a 'check the box' exercise where inexperienced people go through lots of motions with minimal return on investment. The verifications the CEO and the CFO make are the most important aspects. To make these verifications the enterprise needs to have appropriate processes and controls in place. I believe this is the most powerful component of SOX."

In response to the continued significant Sarbanes-Oxley compliance costs which public companies are facing, one respondent noted: "The disclosures have become so detailed and immaterial that the burden on companies is large and the ability of investors to understand what is truly material compromised. Quantity is currently overshadowing quality."

In 2006, SOX compliance was costing public companies with under $1 billion in revenue $2.8 million annually, and those over $1 billion an average of $12.5 million annually. SOX remains a substantial financial burden for all public companies five years after its enactment. ■

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