

## **SUPPORTING STATEMENT REGARDING STUDY OF THE COSTS AND BENEFITS OF COMPLIANCE WITH THE RULES IMPLEMENTING SECTION 404 OF THE SARBANES-OXLEY ACT OF 2002**

This submission pursuant to the Paperwork Reduction Act of 1995, 44 U.S.C. Section 3501 et. seq., constitutes a request for approval of a study to be conducted by staff in the Commission's Office of Economic Analysis with the assistance of a contractor to the Commission and support from other members of the Commission's staff, including staff in the Office of the Chief Accountant and the Division of Corporation Finance.

### **A. Justification**

#### **1. Necessity of Information Collection**

On June 5, 2003, the Commission adopted several amendments to its rules and forms to implement Section 404 of the Sarbanes-Oxley Act of 2002. Among other things, the amendments require companies, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting and an accompanying auditor's report, and to evaluate, as of the end of each fiscal quarter, or year in the case of a foreign private issuer filing its annual report on Form 20-F or Form 40-F, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Larger reporting companies, known as large accelerated filers and accelerated filers, have been complying with the Section 404 requirements for the past three years. Smaller reporting companies, known as non-accelerated filers, have just recently been required to start complying with the rules implementing Section 404(a) of the Sarbanes-Oxley Act (the rules that require management to conduct an evaluation of, and report on, the effectiveness of a company's internal control over financial reporting). The Commission has granted several deferrals of the date by which non-accelerated filers must begin to comply with Section 404(b) of the Sarbanes-Oxley Act (the rules that require companies to include an auditor's attestation report regarding the effectiveness of the company's internal control over financial reporting). In February 2008, the Commission proposed to defer the Section 404(b) compliance date until a non-accelerated filer must file an annual report for a fiscal year ending on or after December 15, 2009.

Both the Commission and the Public Company Accounting Oversight Board have taken a series of steps since initial adoption of the rules implementing the Section 404 requirements, including deferring the compliance dates for non-accelerated filers, to improve implementation of the internal control over financial reporting requirements. Other actions have included issuance by the Commission of interpretive guidance for management to assist management in complying with the Section 404 requirements, the PCAOB's replacement of its Auditing Standard No. 2 with Auditing Standard No 5, development of implementation guidance for auditors of smaller companies, and the PCAOB's hosting of forums on audits of internal control over financial reporting in the

small business environment. In addition, the Commission and PCAOB have held roundtables on implementation of the Section 404 requirements.

The Office of Economic Analysis of the Commission (OEA) has been asked to undertake a study to determine whether the Section 404(b) auditor attestation requirement is being implemented in a manner that will be cost-effective for smaller reporting companies. Members of the Senate and House small business committees have expressed concern about the orderly and efficient implementation of the Section 404 requirements and have encouraged the Commission to undertake its own cost and benefits study.

To inform its analysis, the OEA staff plans to undertake a web-based survey of all companies to which Section 404 applies. Participation in this survey will be voluntarily on the part of the approximately 10,000 candidate respondents. To test and ensure the reliability of statistical evidence obtained from this survey, the OEA staff also plans to do a follow-up survey that will be targeted to a selected (random) sample of approximately 500 of the 10,000 companies. Finally, the staff will undertake in-depth interviews of approximately 75-100 interested parties, including representatives of 404-affected companies, to inform the design and interpretation of the follow-up survey. The empirical evidence and inferences from all of this will be reported to the Commission in a report by the OEA staff. We expect to complete the study in the fall of 2008.

2. Purposes of, and Consequences of Not Requiring, the Information Collection

The Office of Economic Analysis will use the information that it obtains through the proposed communications as an essential element in its preparation of a report to the Commission on the costs and benefits of rules under Section 404, focusing on Section 404(b). The primary objective of the study is to inform the Commission, PCAOB, public companies (and their auditors and investors), members of Congress and other interested parties on the costs and benefits of Section 404, leading to an evaluation on the part of the Commission and its staff as to whether the Section 404(b) auditor attestation requirement is being implemented in a manner that will be cost-effective for smaller reporting companies, the non-accelerated filers. Without the information to be collected, the OEA staff would have inadequate data with which to conduct the study, and the Commission's evaluation of the efficiency and effectiveness of Section 404 implementation would be severely hampered.

3. Role of Improved Information Technology and Obstacles to Reducing Burden

Most of the information will be collected using a web-based survey. Technology may not significantly assist us in conducting in-depth interviews of interested parties or focus group interviews of individual investors.

4. Efforts to Identify Duplication

The information to be collected through the proposed survey and interviews is not otherwise available. A search of the previous literature by OEA staff has revealed numerous academic studies of 404 implementation and a number of non-academic surveys. None of these presents evidence of sufficient scope, or is of a recent enough date, to serve the needs of the Commission. Nor are prior surveys sufficiently well-documented to extrapolate from the sample of companies that responded to the survey to the population of companies to which Section 404 applies. (A key objective of the planned survey is to enable OEA staff to evaluate any response bias that might cause the responses to over-represent the experiences of a particular sub-sample of companies, as opposed to the companies that are affected by Section 404 more generally). Moreover, none of the previous surveys have sought information that is sufficient for our purposes to evaluate whether the Section 404(b) auditor attestation requirement is being implemented in a manner that will be cost-effective for smaller reporting companies, the non-accelerated filers. The planned survey is designed to elicit information on the cost-benefit implications of recent actions that the Commission and PCAOB have taken to improve implementation.

5. Effect on Small Entities

Any entity's participation in the study is entirely voluntary. The SEC staff and its assigned contractor personnel may seek to conduct interviews with companies that Commission rules categorize as smaller reporting companies.

6. Consequences of Less Frequent Collection

The proposed interviews and inquiries are intended to be one-time events, with the potential for follow-up arising only as needed to ensure the quality and reliability of the study. To limit the burden on the population of 10,000 companies that are invited to respond to the web-based survey, the study design allows for those companies to receive general announcements of the survey but limited in-person contact from the staff. To address any possible sample selection bias that might arise from this less burdensome approach of limiting the staff's individual contact with the target population, the study design includes a plan for a possible follow-up survey of a restricted, random sample of 500 companies. Those companies will be identified at random from the 10,000 companies by OEA staff and contacted to elicit their responses to the follow-up survey. Efforts to reach out to this restricted sample of 500 companies will impose a one-time burden of follow-up on those companies, yet permit the OEA staff to conduct a more reliable analysis of the efficiency of Section 404(b) implementation and the potential to reduce its year-by-year burden on the 10,000 companies to which it applies. Finally, in-depth interviews with 75-100 respondents will be limited to smaller numbers of different types of interested parties, including companies, investor groups and audit firms.

7. Inconsistencies with Guidelines in 5 CFR 1320.5(d)(2)

Not applicable.

8. Consultations Outside the Agency

We did not receive any comments on the 60-day Federal Register Notice associated with this submission. The rulemaking to implement the Section 404 requirements was subject to the notice and comment process.

9. Payment or Gift to Respondents

We may reimburse expenses incurred by study participants, if there are any expenses.

10. Assurance of Confidentiality

Potential survey respondents will be notified that the purpose of the survey is to gather information for use by Commission staff relating to its evaluation of the consequences of rules relating to Section 404 of the Sarbanes-Oxley Act, and that there is no other intended purpose. They will be further notified that the Commission will seek to keep private to the extent allowable under applicable laws: (i) the identity of all respondents and (ii) any data which would identify the respondent. Survey responses that do not identify the respondent and the various aggregate statistical findings of the study may be made public by the SEC or its staff.

11. Sensitive Questions

Not applicable.

12. Estimate of Respondent Reporting Burden

We estimate that up to 10,000 companies will respond to the web-based survey at an estimated one hour per response, for a total burden of 10,000 hours. In addition we estimate that about 500 companies, selected at random, may be the subject of a follow-up web-based survey that poses the same questions as the initial survey yet is brought to the attention of the potential respondents through targeted outreach by the SEC staff and assigned contractor personnel. Finally, 75-100 interested parties will be the subject of in-depth interviews, including interviews of audit committee members, audit firms, investors and other interested investors will participate in in-depth interviews at an estimated two hours per interview, for a total burden of 1,000 hours. The aggregate estimated burden total for the study is 1,100 hours. The decision whether to participate in the survey or interview will be wholly voluntary.

13. Estimate of Total Annualized Cost Burden

Not applicable.

14. Estimate of Cost to the Federal Government

The estimated cost of conducting the study is approximately \$700,000.

15. Explanation of Change in Burden

Not applicable.

16. Information Collection Planned for Statistical Purposes

The information collection would employ statistical methods.

17. Explanation as to Why the Expiration Date Will Not be Displayed

An expiration date will not be displayed because the information collection that is the subject of the request will not appear in a Commission rule or form.

18. Exception to Certification

Not applicable.

B. Collection of Information Employing Statistical Methods1. Description of potential respondent universe and any sampling or other respondent selection method to be used.

The universe of potential respondents includes approximately 10,000 public companies subject to the Section 404 requirements and no more than 100 other interested parties, such as audit firms and investor groups. Sample selection will occur in three distinct parts. First, all 10,000 companies will be invited by general solicitation to participate in the web-based survey, to be offered over the SEC website. Second, as many as 500 companies will be invited through targeted outreach to participate in a follow-on web-based survey, also to be offered over the SEC website and potentially using the same survey instrument. Finally, 75-100 interested parties – including representatives of public companies, will be invited through active outreach to participate in in-depth interviews. At each stage, sample selection will occur through the OEA staff's identification of the sample of target respondents – 10,000 companies, 500 companies, or 75-100 respondents – and the choice of the target respondent whether to participate in the survey or interview.

See Appendix A for the survey instrument in draft form. The survey instrument will be updated through a process of extensive pre-testing before being delivered over the SEC website. Potential respondents will earn of the survey through general solicitation, and the SEC will provide live support for the survey through a 1-800 number.

See Appendix B for the in-depth interview scripts in draft form. The interview scripts will be updated through a process of pre-testing before being delivered over the telephone (or, in some instances, in person) to the selected sample of respondents.

The statistical processes for sample selection and analysis will be more rigorous for the survey than for the interviews, as explained below.

To evaluate the costs and benefits of the Commission's rules under Section 404, representatives of companies subject to these rules will be invited to participate in a web-based survey, to be posted on the SEC website. Thus, representatives of about 10,000 companies will be invited to participate in the voluntary-response survey, which will serve as a key source of data for the OEA staff's empirical analysis of the costs and benefits of Section 404 implementation to date.

A review of the evidence of response rates from past 404-related surveys of public companies reveals that response rates have varied markedly, such as from 0.93% and 21.87%, depending on the survey. The OEA staff's evaluation of this information is that response rates tend to vary with size and other factors, including survey sponsorship. Since these factors might also be related to 404 costs, there is a risk that respondents may not report costs representative of the general population of 404-compliant companies. This is known as "sample selection bias." As a result, we will conduct a follow-up survey of as many as 500 companies sampled at random – and thus less subject to selection bias – from the initial sample of 10,000 companies. Evidence from a comparison of the factors that affect sample selection in the initial and follow-up surveys will inform the OEA staff's analysis of the applicability of the responses from the initial voluntary-response survey to the population of all 404-compliant companies generally.

Turning to the in-depth interviews, the interview subjects will be drawn at random (and, in some instances, through self-selection of volunteers) from the universe of all companies to which Section 404 applies, as well as from the universe of individuals who represent knowledgeable audit firms and investor groups. The 75-100 interviews will be distributed across these different types of interested parties, in contrast with the web-based survey, which is designed to obtain response data from the companies whose financial reporting practices are the subject of Section 404. We expect the evidence collected from the in-depth interviews to be largely anecdotal. The objective of the in-depth interviews is to facilitate the preliminary testing of survey questions and to give the staff timely access to qualitative information with which to enrich its interpretation of the quantitative survey findings.

## 2. Describe the procedures to be used for the collection of information.

Data on survey responses will be collected through a web-based survey instrument, to be posted on the SEC website and supported live through a 1-800 number.

For purposes of the follow-up survey, the OEA staff will select at random a sample of companies from the universe of companies to which the Section 404 rules apply. The number of companies from which responses will be actively solicited is likely not to exceed 500, with the ultimate number depending on the response rate from the initial survey, the statistical properties of the response data, and other factors.

For the in-depth interviews, the OEA staff will select as candidate respondents a random sample of companies and audit firms for inclusion in the interview sample. Among companies and audit firms, the targeted number of actual participants has been set at 75-100, so the number of candidate respondents that the OEA staff identifies by statistical methods will exceed this number by an amount that includes the extent to which respondents become known entirely through self-selection (by volunteering).

3. Describe methods to maximize response rates and to deal with issues of non-response.

The OEA staff will attempt to maximize response rates and deal with issues of non-response through a variety of methods. General outreach by senior SEC personnel will help to increase awareness of the survey and its practical value, thereby encourage responses. The survey instrument will be delivered over the SEC website. Live support to respondents will be provided over a 1-800 line that potential respondents can call in order to obtain additional information regarding questions. In the case of the follow-on survey, outreach by the SEC staff and assigned contractor personnel will be directed to the specific companies that are selected at random for the follow-on survey, and to specific personnel within those companies. The sizes of the target samples for the follow-on survey and interviews will be adjusted to factor in a cushion for non-responses. Other methods to be used by the SEC staff and assigned contractor personnel to maximize response rates and deal with issues of non-response will include making multiple contacts with each company, including headquarters and local offices, as necessary; contacting companies by letter describing the research, followed by a telephone call and additional follow-up calls as needed to schedule interviews; and, as appropriate, choosing office locations and facilities for any in-depth (or focus group) interviews that are undertaken in person, so as to offer ample potential for recruiting each category of participants.

4. Describe any tests of procedures or methods to be undertaken.

The OEA staff will engage in the express testing of procedures and methods in areas that include the following. First, the staff will extensively pre-test the wording and sequencing of questions to be included in the survey instrument and interview scripts, some of which reflect questions from previous 404-related surveys. Pre-testing will lead to modification of the survey questions before they are delivered through the SEC website.

Second, the staff will undertake tests of the sample selection properties of the survey response data relative to the underlying population of all companies to which Section 404 applies. This will include univariate and multivariate analysis of the response types and frequencies, and the application of standard statistical methods to illuminate and, as appropriate, adjust for any factors that are found to be correlated with those survey outcomes in a way that affects the usefulness of the survey evidence to the staff's ultimate objective of evaluating the costs and benefits of Section 404 implementation

more generally. Standard statistical methods will be considered in evaluating the extent to which corrections for response bias are suitable, and any implemented corrections will be made transparent in any reports that are produced using these data.

5. Name and telephone of individual consulted on statistical aspects of the design.

The OEA staff designed the statistical aspects of the study and will collect and analyze the information for use in its report to the Commission. The project leader is Dr. Cindy R. Alexander (202-551-6602), and project technical staff includes Dr. Scott Bauguess, Dr. Kathleen Weiss Hanley and Dr. Yoon-Ho (Alex) Lee, all staff members of the Office of Economic Analysis. All research and analysis within the Office of Economic Analysis occurs under the supervision of Dr. James A. Overdahl (202-551-6644), Chief Economist, Securities & Exchange Commission.