

**Securities and Exchange Commission Historical Society**  
**Fireside Chat: Sarbanes-Oxley Section 404**  
**October 16, 2007**

**THERESA GABALDON:** Good afternoon, and welcome to the final broadcast of the 2007 season of Fireside Chats of the Securities and Exchange Commission Historical Society on [www.sechistorical.org](http://www.sechistorical.org). I am Theresa Gabaldon, Lyle T Alverson Professor of Law at The George Washington University School of Law and moderator for the Fireside Chats. As our listeners may know, the SEC Historical Society preserves and shares the history of the U.S. Securities and Exchange Commission and of the securities industry through its virtual museum and archive at [www.sechistorical.org](http://www.sechistorical.org). The museum's collections are free and accessible worldwide at all times. The virtual museum and archive as well as the Society are separate and independent of the SEC and receive no federal funding. We thank ASECA - The Association of SEC Alumni, Inc. and Pfizer Inc. for their generous sponsorship of the entire 2007 Fireside Chat season. Their support, along with gifts and grants from many other institutions and individuals, makes possible the growth and outreach of the virtual museum and archive.

Today's Fireside Chat looks at the Sarbanes-Oxley Act of 2002 and specifically Section 404, which states the management must have tested the fact that they are internal controls and that an auditor must have tested the adequacy of those controls. Last March, during our first Fireside Chat of the season, which focused on Congress and the SEC, Dean Shahinian, one of our panelists, expressed surprise that SOX and Section 404 still stoke controversy. In July, at a gathering on the fifth anniversary of the signing of the act, former Congressman Michael Oxley noted that Sarbanes-Oxley continues to be blamed for just about everything. And visitors to the virtual museum and archive this month can listen to "The Sarbanes-Oxley Blues," written and performed by Dave Maney, well worth the visit for that opportunity alone. From a historic perspective I can attest there are not many legislative acts which inspire musical responses.

To discuss why the Sarbanes-Oxley Act might make people blue, I am delighted to welcome Kurt Schacht, Managing Director of The CFA Institute Center for Financial Market Integrity, and Herbert Wander, Partner in the Chicago office of Katten Muchin Rosenman LLP. Herbert is also a founding member of the Society's Board of Advisors. The remarks of our guests today are solely their own and are not representative of the Society. Our speakers can not give legal or investment advice. Kurt and Herbert, welcome.

**KURT SCHACHT:** Thank you.

**HERBERT WANDER:** Thank you very much.

**THERESA GABALDON:** Our focus today is Section 404 of the Sarbanes-Oxley Act of 2002. That gives us the what at least but we are still missing the who, when and why. Starting in general terms, what does Section 404 require?

**KURT SCHACHT:** As you alluded to in your opening comments, the Sarbanes-Oxley Act of 2002 was enacted in response to what was really a growing crisis in market confidence, exemplified by Enron and WorldCom. What SOX 404 is has been described as really the heart and soul of Sarbanes-Oxley. It is the portion of SOX that's really designed to create a reasonable assurance for users of financial statements, including investors, that the financial reports are free from any material error. That, in a nutshell, is what SOX 404 is all about.

**THERESA GABALDON:** Who does it serve and why?

**HERBERT WANDER:** It would apply to companies that are registered with the Securities and Exchange Commission; in other words, publicly held companies.

**THERESA GABALDON:** You already alluded to the why - Congress seemed to be reacting to the Enron and the WorldCom situations – and gave a semi-indication of what it was trying to achieve. I have a question that relates to something that came up in the Fireside Chat last month on the Foreign Corrupt Practices Act: what exactly is the relationship between Section 404 of Sarbanes-Oxley and the FCPA, how are they the same, and how are they different?

**HERBERT WANDER:** They are not really that different. The Foreign Corrupt Practices Act was designed in 1977 to stop the so-called bribery in political payments and payments under the table. It also included a provision that required publicly held companies to have internal controls that are designed to provide a reasonable basis for thinking that the financial statements were accurate and reflective of all the transactions of the company. But it was not self enforcing. While I was preparing for this Fireside Chat, I really couldn't think of anybody who violated books and records and of not having internal controls from 1977 on through 2002.

About 10 years prior to 2002, a provision was added to the effect that financial institutions that are regulated by the Federal Government are required to have their accounting firm test their internal controls to ensure that they are adequate enough to give them a reasonable basis for believing that their financial statements were sound and accurate. But that test or report never had to be published and it was not that difficult to comply with.

When Congress passed SOX, it included a provision that said you will have internal controls and have them attested to by your outside auditing firm. Congress thought that would not add much in terms of cost and that every audit included an audit of internal controls, but they neglected to really think about a Pandora's Box they opened by establishing the PCAOB as part of SOX. The PCAOB became the regulating entity for accounting firms. Accounting firms were no longer going to be self regulated but regulated by the PCAOB, and the PCAOB was the one who adopted the standards for accounting firms to follow when conducting the internal control audit.

**KURT SCHACHT:** That's a wonderful summary. I am not much of an expert in the Foreign Corrupt Practices Act, but the requirement to have internal controls in place then shows how little attention was being paid to that by both the management and the auditor in practice. That was one of the things that led to the problems we had in 2001-2002 and really the source for Sarbanes-Oxley.

**THERESA GABALDON:** There is a theory that Congress really didn't intend to change much, but merely wanted to look as though it were doing something for purposes of building investor confidence.

**HERBERT WANDER:** Congress had to act because the market was falling dramatically every day, primarily after WorldCom, and the lack of confidence, as Kurt said, was extremely important. Congress is a political animal. When it stepped in, there was the debate on whether it should really study the subject or not, but the fact is that it stepped in and enacted a whole panoply of laws. Not only did it establish the PCAOB, but it furthered regulation of audit committees, prohibited loans to executive officers and for profits made by the CEO and the CFO from faulty financial statements caused by improper conduct that had to be restated. There were

lot of different provisions, but the one that I think everyone has focused on the most is Section 404.

**KURT SCHACHT:** I think any suggestion that Congress really didn't intend much just glosses over the fact and circumstances of the time. It was a very real crisis. It was a very comprehensive package, as Herb has pointed out. Clearly it was reviewed and it was implemented through the normal Congressional process, but was certainly an expedited process, which I think is another reflection of how important people thought it was to get something done. I think the question continues and that there are a lot of people who feel this, that this was an over-reaction to the Enron era and that there wasn't much attention paid specifically to the provisions of Section 404. There is not much legislative history in terms of that being discussed, but I think what happened was that people were thinking that the Foreign Corrupt Practices Acts were actually working and didn't really understand the degree to which controls had fallen by the wayside in terms of their being reviewed and booked by both management and audit, so the level of the repair that was needed was great. We underestimated and I think that it was certainly not something that they would realize it at the time, but the amount of auditor zeal that went into looking at internal controls post-Enron and post-WorldCom really changed the dynamic dramatically.

**HERBERT WANDER:** In addition to that, the PCAOB adopted what is called AS2, Accounting Standard Number Two, which was how the auditors were supposed to conduct the attestation for the internal control review and issue their report. I think by virtue of the substitution of AS5 this year for AS2, most people would agree that AS2 was very heavy and very complicated. Accountants are now being extremely cautious because of the liability concern and the PCAOB process of inspecting accounting firms. Some companies told us that under AS2 they identified 10,000, 20,000 key accounts and when you look back at that time, I think even though who are strongly in favor of the 404 provisions would agree that was just going off the cliff.

**THERESA GABALDON:** Does legislative history or your own analysis give us any insight into what kind of controls Enron and WorldCom actually lacked or give us any sense that if controls had been in place things would have turned out differently?

**HERBERT WANDER:** It's hard to tell. I think at WorldCom, you had management override which is something that internal controls are very concerned with, but it's very difficult under the best of circumstances to detect the senior management override, which is what happened. There is a chance it wouldn't have been caught because management override is difficult to tackle. One of the other things in 404's favor is that not only do you want to produce accurate financial statements but you want to find errors on a more timely basis. Perhaps you would have caught Enron and maybe WorldCom earlier than you would have by virtue of the fact that you now have this 404 attestation. Kurt, would you agree or do you have different sort of feeling that?

**KURT SCHACHT:** I agree management overrode the key aspects of what was missing. I think the other quite significant change, had this been in place, would be the level of auditor's independence and whether or not auditors were actually looking at these things in an independent matter as opposed to more of a discussion with management. But, as you said, it is very difficult to guess at this point whether things would have turned out differently. We like to think that stronger controls would have prevented the activities of Skilling, Lay and Fastow, but it's difficult to guess what might have happened.

**THERESA GABALDON:** What do you think about the state-of-the-art guidance that has come from the SEC and the PCAOB in recent months? Is there now enough guidance for people to feel relatively comfortable that they know what's expected?

**KURT SCHACHT:** I think most people are cautiously optimistic that AS5 is a much simplified version. AS5 also mandates a top down approach, so that you pick out the biggest risks and make sure those are covered by your internal controls rather than look at 20,000 separate key accounts. I think it's much simplified. I still think it's a little heavy handed in the sense that they don't give the auditing firms enough room for judgment. I think AS5 could have chosen a better definition of materiality. I don't think the definition is essentially changed from that in AS2, but it is an improvement. I think, when they talk about scale-ability for smaller public companies, no one knows what means. It is still not very well fleshed out, so we will have to see when smaller public companies start becoming subject to 404 in the coming years, but it is an improvement. Then the SEC adopted this management standard which was lacking. I think it is simplified and hopefully it will produce more efficient and accurate orders as what we are looking for. I would just add that there is some specific mention in AS5 about how smaller firms can actually tailor their internal control structure to fit those principles. I think that's good, on the management side, the information is coming down from the SEC in terms of how you create that framework and being able to use some risk based judgment in terms of what controls are important and what the most risky areas are and then carrying through the management assessment of those controls, allowing them to really focus and be more thorough on the risk areas and spend less time and less money hopefully on looking at the minor controls of the company. It will be interesting to see how this plays through in the first cycle but I think the expectation of this will be a significant improvement for those who are already online as well as those are about to come online for SOX reviews.

**HERBERT WANDER:** It still depends a lot on how the accounting firms will implement it and how the PCAOB inspections of the accounting firm will come out. PCAOB has made one of its four principal points that it will have inspections that look to make sure the accounting firms are efficient and effective, but that remains to be seen.

**THERESA GABALDON:** I think I have heard you saying here that small issuers are not exempt. Are foreign issuers treated the same way as domestic issuers?

**KURT SCHACHT:** I think all U.S. filers are going to be treated the same. There are some differences. They have to comply with the management report fees and the outside audit fees whether they are a foreign filer, small firm or IPO.

**HERBERT WANDER:** That's essentially the case. Eventually, everybody who is publicly held in the U.S. will be subject to it.

**THERESA GABALDON:** Bearing down a bit more specifically on the effect of Sarbanes-Oxley on foreign issuers, one reads that SOX is keeping them away from offerings in this country. Is the evidence on this that is anything more than anecdotal?

**HERBERT WANDER:** I think there are a whole host of factors that you have to consider. Other markets are getting better, money is available in other places but I think one would conclude that it's a factor. I think it's a factor that probably does hurt but to the extent that it does hurt, I don't know if anybody is measuring accurately. We certainly hear a lot about whether IPOs have been affected as well as whether foreign listings have been affected. We think that the suggestion that SOX itself is the leading culprit is sort of a stretch of the facts. There are all

sorts of reason as to why this dynamic is. We have global competition going on, we have home country buyers, we have underwriting cost and I think certainly regulatory complexity is an issue, but whether the piece of regulatory complexity related to Sarbanes-Oxley is the principal cause, I think is really a suspect argument. There have been several studies recently of the consequences of the dispersion of capital that is going on in global market places. Everybody wants to own Wall Street. They see the prosperity here, they want that prosperity and for so many years the competitive position of our markets has really dominated. That dominance has been deep and it has been long. It's only natural in the global environment that the gap is going to narrow over time. I think that's a lot of what's happening.

There was an interesting article at the beginning of the year looking at the delisting of foreign companies on Wall Street, from 2000 through January of 2007. The percentages of foreign delistings were actually lower in the United States according to that of the developing markets, whether you are looking at Germany or even the UK, which is always pointed to as to where all of these listings were going. They lost ground in terms of foreign listings. So, I think that have some concern of whether Sarbanes-Oxley has really that kind of impact.

There are two other factors. I think foreigners do not like our litigious atmosphere, and I do think that, at least in my own opinion, is a very serious factor. In fact, five law professors recently wrote the SEC to ask the Commissioners to engage in a very detailed study about the effect of litigation on the promotion of business and job creation in building our economy. So litigation is very big. The other one I have heard and I don't know how true it is but I suspect that there is some truth to it: foreigners worry about what laws we might pass after the next market collapse; they think we are too quick triggered in that respect.

**THERESA GABALDON:** That's interesting because in light of the SEC's move towards easing registration for foreign issuers, that seem to give them a safety valve.

**HERBERT WANDER:** It's hard to get out. I had a client whose company left the United States and they charged my client, the shareholder, a substantial transfer tax. It was a large amount of money and they didn't waive or pay it for the shareholder. So, we make enemies when companies leave and they don't necessarily want to leave.

**KURT SCHACHT:** I think there are still some concerns and some sensitivity to the fact there is legacy - investors that are left behind. They rely on the public filings at these companies, and there should be some balance with respect to that, but I think we have made it easier.

**HERBERT WANDER:** We made it easier here, but that doesn't alter the fact that they had to pay English taxes on their de-registration effort in the United States.

**THERESA GABALDON:** To stick with the foreign theme for just a bit longer, I have read in the not too distant past something about the fact that someone is making the argument that it was necessary to subject foreign issuers to the requirements of SOX because they were already subject to similar requirements in their home jurisdictions. Is there anything to that argument?

**HERBERT WANDER:** I personally don't think so. Kurt and I discussed that prior to the program. For example, Canada specifically has said that it would like management to test their internal controls but the outside auditor does not have to, and I think that's common around the world. Every other country has different listing standards and different cultures, so I really don't think you can compare the two.

**THERESA GABALDON:** I would like you to pretend that I am on the board of the smallest issuer that might be affected by Section 404, and then tell me what our compliance program would be like.

**KURT SCHACHT:** We are not giving legal advice, but I honestly think that the advice you would give the board of directors relative to this issue would be the same whether it is a small company or a large company. You would want to give the advice to the audit committee and you want to make sure that you had a competent audit committee that was able to understand and ask management the right questions about the design of controls. For example, how have the controls been implemented, whether in fact the controls are effective, what sort of testing did they do. Ask staff to explain that what are some of the most important risk areas of the company are controls in place to cover those high risk areas, and whether they had any significant deficiencies or material weaknesses and full explanations as to why those weren't covered. Also, as we had talked earlier, I think one of the more important questions to ask as a director is how do you handle the management override issue, what protections do you have in place and what assurance do you have that those are actually working.

**HERBERT WANDER:** I am going to elaborate a little bit. If you are really small, I would tell you you shouldn't be public. By really small, I am talking less than a 100 million in total market cap. You are not going to attract large investors in these companies any more because they have billions of dollars to invest and they just don't have the time and the resources to invest in these smaller companies.

But once you go public, you have a whole disclosure arrangement, including proxy statements and quarterly statements with unaudited financial statements. You have yearly 10-K reports with audited financial statements, you have current reports on 8-K, you have to comply with Regulation FD which regulates disclosure. You cannot tip anybody. Insiders are subject to Section 16, the insider reporting and short swing profit provisions. Then you are going to have to set up a disclosure committee and an internal disclosure committee to make sure that the procedures are in place to ensure that your controls are working and that your disclosures are right.

And then we haven't mentioned that the New York Stock Exchange and NASDAQ have changed their listing requirement and so the listing requirements now require you to have a majority of independent directors, so hopefully issuers are going to have quality and experienced independent directors. You are going to have three committees, including an audit committee as Kurt talked about. But you are also going to have to have a compensation committee and a nominating committee made up entirely of independent directors except for some few exceptions where you control the company. You are going to have to have hot lines or whistle blowers. Insiders are not going to be able to freely trade their shares whenever they want subject to the '33 Act and Rule 144; they are also subject to the anti fraud provision. You are going have to adopt an insider trading policy and you are going to have to recapture short swing profits, which involve purchases or sales that take place in every six month period.

Then you have the cost of auditing, legal costs, director fees and their education, and the insurance cost for D&O insurance and costs for experts for the committees. The committees are entitled to hire their outside experts. One of the things that I say to companies that are thinking about going public is that you are going have to have experienced staffing. You might find it difficult to do with a CFO, for example, who came up through the financial world rather than the accounting world. The issuer needs to have adequate staffing. You will have to advise the company, by the way, you will be subject to liabilities under the federal securities laws, both

the '33 Act and the '34 Act, as well as state fiduciary law. So it's a daunting task. Many companies do it, but I think that you find it if you look at the size of IPOs today, as versus seven or eight years ago, they are much, much larger companies going public to support this superstructure.

**KURT SCHACHT:** I agree with much of that. I would say that we are probably a little bit more optimistic about the benefits of being a public company and the ability to access public capital. Small companies become big companies and you need to go through that process, there is no doubt about it. It's different being a public company, but it offers the benefits of accessing unlimited basic capital, which I think is a very attractive thing for lots of issuers regardless of their size.

**HERBERT WANDER:** When you have your stock price doing well, that's great. When your stock price isn't, your shareholders don't want to issue additional stock. So you are subject to a market that in many respects you really do not have any control over. I agree that if you need a lot of money and you don't want to over-leverage the company, the public markets are a great vehicle, but that's when things are going great. When things aren't great, that's when it becomes very expensive.

**THERESA GABALDON:** Do you think that you've changed your line on this in any regard post-Sarbanes-Oxley or is this the same decision that you held in 2000?

**HERBERT WANDER:** No, I think we have to advise our clients on all these problems. For example, if you are a small company, almost any contract becomes major. I had clients who decided that they could not take that kind of exposure. They were dealing with the giants and the giants said you can't disclose the contract with me even though it's a big supply contract for the smaller company. What has changed over the last 10 years is the governance system. If you went public 10 years ago, you needed two independent directors. Now you need a majority of independent directors. Let's assume you have been a founder of the business and you've run the business for 40 years, 30 years, 20 years; that's a cold shower. You have to make sure that the client, before it put its foot in the water, understands the process and how it will be affected by this going forward.

**KURT SCHACHT:** The other piece of this is with that with public listing comes the responsibility for investor protections. These financial reporting and securities rules are not just complex to be complex, they are complex for a reason and I think that's reflected in a lot of the studies that show the cost of capital in our markets because of the complexity and because of a lot of the resulting investor protection is actually lower here. So, there are some positive benefits to that complexity.

**HERBERT WANDER:** We also tell people that once you start taking other people's money, as Kurt says, you become a keeper of that money for them and you owe them the disclosure and the transparency that they are entitled to receive. If you don't think you can measure up, you shouldn't go public.

**KURT SCHACHT:** Do you think that SOX and Section 404 have added on a significant layer of complexity in terms of being public?

**HERBERT WANDER:** Based on my experience, we are finding it harder and harder to find really qualified accounting staff. You can't do it with a one or two person staff; you definitely got

to have really qualified staff. The job market in Chicago or New York job market is a lot different than if you are Madison, Wisconsin or Jasper, Indiana.

You have to look at this from a broader perspective. I would caution people that staffing is very important. If you don't get a passing grade on your internal audit, you have a material weakness, and you have to describe the material weakness. I think a large percentage of the material weaknesses are caused by the fact that they don't have adequate accounting personnel.

**THERESA GABALDON:** I was curious about whether 404 compliance was a question of adding people and where they would go in any organizational chart, or whether it was just a question of adding something to existing job descriptions. It sounds to me that you are suggesting that there does need to be additional personnel and at least some of them should be in the accounting department.

**HERBERT WANDER:** Yes, by all means.

**KURT SCHACHT:** I think there is a mixed way to that approach. Investors are very concerned about the level of expertise and the understanding of financial reporting and the complexities that some of these standards bring, particularly Sarbanes-Oxley. It's a matter of having some experience, whether you do that through new staff or whether you go out and hire consulting and that becomes another issue of cost. It's clearly important enough and complex enough that there is some concern about the level of expertise, particularly with regard to a lot of smaller companies that are going through their first cycle of Sarbanes-Oxley. It also becomes more critical as we talk through those two new standards, both the SEC guidance and the PCAOB's AS5, that require a pretty significant ability to understand what the risky areas are and understanding how you would formulate effective control. I think that raises the bar in terms of the confidence and experience that you have to have.

**THERESA GABALDON:** Can you give me an example of an area of risk for some type of company?

**KURT SCHACHT:** I think that you have to have accurate and complete records of all the transactions that end up making their way onto the financial statement. The information is accurate, complete and protected. That a process, policies and procedures are in place to make sure that the unauthorized use of company assets is something that is either detected and/or prevented as part of that process. So those are the two that are commonly identified as the types of internal controls that are risk-based.

**HERBERT WANDER:** Let me go dig just a little deeper. Take the area of revenue recognition. As we have seen from vast number of re-statements, there were both manipulative and innocent errors. Revenue recognition is an area that to many companies is very risky. Derivative accounting is another; many companies have had problems with derivative accounting because the book is 480 pages long.

**KURT SCHACHT:** Deferred taxes.

**HERBERT WANDER:** Deferred taxes, yes. The market has had problems with leaseholder interests. All the retailers found out they had to reinstate because we've been interpreting this wrong for the last 30 years. There is a whole study - enterprise risk management - which people are going to be paying more and more attention to, which covers not simply the

accounting but also covers the entire business area. People are going to have to focus on what keeps the CEO up at night, what is he or she really worried about? I recently had this discussion with one of my clients. They had a few large clients, and we disclosed this as a risk factor that said the loss of a client could be very material. That's not an accounting risk; we will know when we lose the account. But how do you protect against that? Give good service, right?

**KURT SCHACHT:** It is really a case-by-case analysis now with both the SEC guidance and the AS5 guidance. There is some risk based judgment that you don't have to just go through and have every conceivable control in place because that's what previously would be audited under AS2. But there really is a focus on the most important areas of the company, the top down look at what are the key areas and what are the key risks. I think that's sort of a blessing and a curse. It gives you the flexibility but then you have to have the experienced staff, in order to identify those key controls and key areas that are necessary.

**HERBERT WANDER:** Going back to staffing, one of the areas where I see people getting into difficulty, again into restatements or material weaknesses, is they don't have enough analytics once the results are in. They don't therefore spot problems that have occurred. Why am I so far off budget here? Is it just business or is it somebody on my own staff cheating me? So you have to have enough staff so that you do that top down view on what are the key drivers of the business: am I performing the way I should, and if not, why not?

WorldCom was the reverse. They were performing so well that they drove AT&T crazy. How can we compete with them?

**THERESA GABALDON:** Certainly you've referred to competent in-house staff. Is this also an area where people turn to outside specialists? In addition of course there are outside auditors but tell us what the state of the art is to which they can be compared and found lacking? Or can, could someone just try and do whatever they think is reasonable under the circumstances?

**HERBERT WANDER:** I think it would be very dangerous just to do what you think is reasonable unless you really understand this. You need professional guidance, whether it be accounting, legal, software, IT. You can't just operate saying I think it's reasonable but I don't know whether you agree with me.

**KURT SCHACHT:** I agree. We talked earlier that this will evolve to a point where we will have a state of the art process that would get developed in terms of how a company would assess, given all the options for internal controls and the potential risk. They will assess what's appropriate for their companies and perhaps those software programs already exist. But this will continue to evolve and I think get refined, particularly as the smaller firms go through one or more cycles of 404. They are going to find some of these will help in terms of creating the internal structure and be quite useful.

**HERBERT WANDER:** There is a whole cottage industry on compliance that has grown up. The American entrepreneurial system is working at its best. A day doesn't go by where I don't get 10 blogs and advertisements for either a seminar or a software system or a "come and listen and I'll teach you how to do this and that." The problem is I think that much of this is conflicting, isn't very well thought out, and you really have to be smart enough to sift through and get the best that you can.

**THERESA GABALDON:** I wonder if anyone is yet offering degrees in SOX compliance. If not, it's probably a coming thing. Now, everything we've been talking out here obviously comes at a price. How much on average are companies spending on 404 compliance?

**HERBERT WANDER:** It's actually more difficult to really do that because now it's called an integrated audit; you get the audit and the SOX together as one. The figures that are reported in the proxy statements are one figure, the regular audit and SOX, and that just covers what you're spending on your outside audit. It doesn't include what you're spending internally and it doesn't include all the consultants that you've hired. The numbers were astronomical the first few years. I think they haven't been as high as that and we will see whether the new AS5 and the SEC's guidance will, let me put it this way, reduce the fees or at least keep them from increasing. I think that's a dream world; whether the steep incline of their increases will moderate. Let's see.

**KURT SCHACHT:** I think that the observation that Herb and I heard, many, many times, is the cost of compliance for large firms as it relates to overall revenues was actually a drop in the bucket in many cases. A lot of the larger firms that were consulted on this actually lauded the SOX 404 process, thinking that it was very important process for them to refine the quality and the accuracy of their financial reportings. This really boils down to a cost issue for the small issuer or in terms of how it relates to their revenues and I don't think anybody disagrees with the notion that internal controls are important and there should be some level of management reporting on those. We're quite optimistic that this new guidance, that allows this to be a risk based scaled approach for smaller firms, is going to at least lower the initial costs of the implementation as well as subsequent cycles of Sarbanes-Oxley. The cost is never going to go away; it's never going to be 0. The question is how quickly they go up given the demand on services.

**HERBERT WANDER:** I go back to talking about staffing. If you have good systems in place, the auditors under AS5 can rely more heavily on your internal audit. So you can do things to help yourself to reduce the cost and make the process more efficient. That's again why you need really good, competent, experienced staff.

**THERESA GABALDON:** Are you aware of anyone who actually is trying to conduct some sort of survey to find out how much is being spent or is this another area that's mostly anecdotal?

**HERBERT WANDER:** Everybody does. THE FEI does.

**KURT SCHACHT:** The FEI not too long ago looked at 200 firms that had at least \$6 billion in revenues. I think the average costs for SOX compliance was something in the range of \$3 million. That's again scaling that for the small issuer. Some cost anywhere from 300 to a million and subsequent declines in succeeding cycles of the examination.

**THERESA GABALDON:** So there is a learning curve?

**KURT SCHACHT:** There is very definitely a learning curve.

**HERBERT WANDER:** There are a lot of studies. The accounting firms put out studies; you have to be a statistician to really understand them.

**THERESA GABALDON:** What do you think your bottom line is, Herb? Are investors better or worse off with 404? And then, Kurt I'll ask you the same question.

**HERBERT WANDER:** I would have hoped to see a better model for the modern public company. I know there's some basis for saying that in the smaller ones, the audit itself catches most of the problems and that you don't have to have a separate audit for internal controls. As you grow larger, as you grow more complex; maybe not even larger but maybe more complex, there is a strong feeling that the internal controls are good for business. I would have hoped that there would have been more definitive scaling for the smaller public companies. But we're going to have to live with it and do the best job we can and hopefully continue to improve both the regulation and the accounting structure and the company's own internal control.

**KURT SCHACHT:** I would say that investors have benefited in significant ways with respect to SOX 404. I think it's revealed a lot of deferred maintenance, as people have called it, from the Foreign Corrupt Practices days and in terms of getting that internal control structure up to snuff, it's resulted in many restatements that I think are a reflection of how poorly some of these internal controls were designed and maintained. We had something over 1500 material weaknesses in these statements just last year, 2006. That number will tend to come down in subsequent cycles. So there's a process by which it improves the quality of the financial reporting. I think that's very effective investor protection.

We've created the PCAOB. Herb and I have a different view of the value of the PCAOB, but we now have an independent fully funded organization that has the enforcement ability to use with respect to the accounting community. I think it's increased the independence of accounting firms, which is a wonderful thing in terms of investor protection. We've added some whistle blower protections and I think that it's primarily refocused on both management and the board of directors on the importance of accurate finance reporting like nothing else in the past.

**THERESA GABALDON:** Have you been in any enforcement actions brought for violations of Section 404? That is, you're telling me that it's working, people are doing their restating to reveal things they should have been revealing in the past but this is a different question.

**HERBERT WANDER:** You do the audit of internal controls and if you have a material weakness then you have to disclose that material weakness. Essentially, the company has to disclose that it has a material weakness. It could have the following effects and here's what I'm doing to remediate it. It's not something where the government will say, "you didn't comply, you must go to jail or you get fined." It's just the fact that you haven't passed; you must tell the investing public that you haven't passed. Here is why and here is what I'm doing to change it.

**KURT SCHACHT:** I think its utility as a tool of a prosecution has probably been limited. The one noted case is the Health South case in which Richard Scrushy actually got off in that circumstance. There have been 400 to 500 cases under the DOJ's Corporate Frauds Sweep since 2002 and very few of them have led to convictions. SOX has not been instrumental with respect to these, so it's not been particularly necessary in terms of prosecuting corporate fraud.

**HERBERT WANDER:** There's been very few civil cases. The real question is, are my financial statements accurate; do I have reasonable internal controls? One of the members of our advisory committee made that point repeatedly to us. You won't find people civilly liable to other parties for failure of having an adequate internal control. In fact, what happens is you have an audit and the auditor issues an opinion on the financial statements. If a company has a material weakness, the auditor will have to do additional testing and whatever is necessary to make sure that the auditor is comfortable with the financial statements.

**THERESA GABALDON:** I'm very interested in hearing each of you forecast where you think we'll be in 5 years with respect to Section 404.

**HERBERT WANDER:** I'm not as sanguine that it's going to cure all evils. I think we will have scandals from time to time. Just because banks are robbed because there's money there, we will have scandals because people take unfair advantage. I think people will learn to live with it. Maybe we'll continue to see a lot of these restatements for a variety of other reasons, not because of lack of internal control. I guess it'll balance this year. We're going to have to live with it. And if it does provide additional investor confidence, I think that's a plus.

**KURT SCHACHT:** I think, as Herb says, this is going to be part and parcel of the fabric of being a public company. It's going to be fully accepted. It's going to predicate being public. I think it's going to be modeled more closely in jurisdictions around the world because there's going to be significant accounting frauds in a number of those markets.

There's some pretty interesting challenges though. The question is whether the audit firms are going to be comfortable with an audit process that requires a scaled approach given what they've come from. Will boards actually be able to put their foot down and stand their ground in terms of what their risk judgments are and what their top down judgments are for the internal control structure and thinking that that's going to be adequate? So there's going to be some give and take on this effectiveness versus efficiencies. Corporations want to be efficient in terms of cost. Audit firms will want to be effective in terms of the audit process. And that's going to be an interesting dynamic. The whole issue and circumstance of how SOX came about plays into the work our organization continues to look at, with respect to business and financial services and integrity. And we hope to avoid situations like Sarbanes-Oxley that industry has able to identify these problems and solutions before a meltdown so you don't have a heavy handed formal regulation that has to be in place. Maybe that's wishful thinking. Maybe people will try to get away with whatever they can get away with until they can't. But we're optimistic that this is sort of a model for what to avoid in the future.

**THERESA GABALDON:** Kurt and Herb, thank you for your insightful comments and perspectives on why Sarbanes-Oxley and especially Section 404 continue to stir controversy. I do think this would be interesting to reprise this discussion in another 5 years to better judge the long-term effects off SOX. Will folks still be singing the blues or might there be someone in more cheerful tune?

I would also like to thank ASECA - the Association of SEC Alumni Inc. and Pfizer Inc. for helping to make possible our 2007 Fireside Chat season. We broadcast discussions on Congress and the SEC, the Courts and the SEC, insider trading, the accounting aspects of the Foreign Corrupt Practices Act, and today's chat on Section 404.

Today's Fireside Chat, along with previous chats from our 2004 through 2007 seasons, is now archived in audio format in the virtual museum, so you can listen again to the discussion at any time. A transcript of the discussion as well as the audio in mp3 format will be accessioned in the Online Programs section in the coming months.

This is the conclusion of our 2007 Fireside Chat season but it's not the end of the SEC Historical Society's online programs this year. Please plan to tune in to [www.sechistorical.org](http://www.sechistorical.org) on Thursday, November 1<sup>st</sup> at 12 noon Eastern Time to listen to, 'Keeping the Markets Open: Lessons Learned from 1987 Market Break,' with Brandon Becker, Andrea Corcoran, SEC Chairman Christopher Cox, William Johnston, Richard Ketchum, David Ruder and SEC Division

of Market Regulation Director Erik Sirri. "Keeping the Markets Open" is the first in the series of SEC Historical Society online programs to commemorate the upcoming 75<sup>th</sup> anniversary in 2009 of the founding of the U.S. Securities and Exchange Commission.

I'll return next spring for the 2008 Fireside Chat season, which will also help commemorate this anniversary, looking at the work of some of the major divisions and offices of the SEC. Please join me next March 11<sup>th</sup> at 3 pm Eastern Time for our first Fireside Chat of 2008, looking at the Office of the General Counsel. My guests will former General Counsels Daniel Goelzer and Giovanni Prezioso.

Thank you again for being with us today.