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THE NUMBERS  
GUY

By CARL BIALIK



## How Much Is It Really Costing To Comply With Sarbanes-Oxley?

June 16, 2005

Public companies have been complaining about the costs of complying with the Sarbanes-Oxley corporate-reform law since its passage in 2002. The outcry has intensified with the departure of Securities and Exchange Commission Chairman William Donaldson, as companies hope for new rules that might ease what they say is a financial burden.

Putting a dollar figure on how much Sarbanes-Oxley has cost corporate America is extremely difficult, though that hasn't stopped many from trying. Often-cited estimates range from \$1.6 million to \$4.4 million per company each year. Meanwhile, one researcher estimated \$1.4 trillion in stock-market losses due to the bill's passage. But some of the estimates on Sarbanes-Oxley are as questionable as the cooked financial books that led to the measure's passage.

Alan Beller, director of the SEC's division of corporation finance, [questioned some estimates](#) in a speech last July in Boston.

Certainly, the increased auditing and record-keeping required by Sarbanes-Oxley has been costly for some companies, especially for small businesses. But few companies have disclosed how much compliance has cost them. Instead, most numbers in the debate come from surveys, where biases and methodology can skew the results.

One study of audit costs -- mentioned in the Washington Post, San Francisco Chronicle and elsewhere -- comes from Financial Executives International, a professional association based in Florham Park, N.J. In a [series](#) of three surveys from

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## ABOUT THIS COLUMN



**The Numbers Guy** examines numbers and statistics in the news, business, politics and health. Some numbers are flat-out wrong, misleading or biased. Others are valid and useful, helping us to make informed decisions. As the Numbers Guy, I will try to sort through which numbers to trust, question or discard altogether. And I'd like to hear from you at [numbersguy@wsj.com](mailto:numbersguy@wsj.com). I'll post and respond to your letters. WSJ.com subscribers can [sign up](#) to receive email when new columns are published (nonsubscribers [click here](#) to sign up), and you can read more columns at [WSJ.com/NumbersGuy](http://WSJ.com/NumbersGuy).

## ABOUT CARL BIALIK

Carl, a former technology reporter for the Online Journal, is a freelance writer living in Brooklyn, N.Y. In addition to the Numbers Guy, he also co-writes [The Daily Fix](#), a sports column that appears each weekday morning on WSJ.com, and oversees some free-content initiatives at the Online Journal. Carl has a degree in mathematics and physics from Yale University. He welcomes your letters at [numbersguy@wsj.com](mailto:numbersguy@wsj.com).

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January 2004 to March 2005, FEI asked contacts at each of 4,000 public companies to estimate the amount of time spent

on Sarbanes-Oxley compliance for 2004. FEI used an hourly cost of \$50, equivalent to an annual salary and benefits of \$100,000 spread over 2,000 hours, to come up with the internal cost to companies. Chris Allen, vice president of communications for FEI and a co-director of the survey, said the dollar figure is "somewhat arbitrary." (FEI also asked companies directly for their costs in audit fees and external costs like consulting and software.)

With each survey, the estimates rose. The first survey found annual costs of \$2 million per company; by the following March, costs were up to \$4.4 million a year. But with each survey, the response rate fell: 321 companies responded to the first survey, but just 217 of 4,000 responded to the most recent one. Survey response rates below 10% can indicate a bias in who has chosen to respond.

"We generally felt it was pretty representative," Mr. Allen told me. Nonetheless, he added, "There's bound to be some response bias. That's who you're going to hear from: the people who are more agitated about [Sarbanes-Oxley]."

FEI itself has a bias, which Mr. Allen readily acknowledges. The group supported much of the Sarbanes-Oxley bill, but opposed a part that required external auditors to provide a separate report on a company's internal controls. "We thought it was duplicative," Mr. Allen said. "That has created most of the costs." The survey results are linked from the "advocacy" section of the FEI Web site.

The American Electronics Association, a trade group, used the FEI numbers to estimate that the cost of compliance for all U.S. companies totaled \$35 billion in 2004. Those findings were released in [a report](#) in February. How did the AEA arrive at the frequently cited \$35 billion figure? In a footnote, the group says the number was derived "from FEI's July survey as well as extensive discussions we have had with many CFOs." A spokesman for AEA didn't reply to my phone and email messages.

Another frequently cited [study](#), released by the law firm Foley & Lardner last May, reported that average costs for companies with annual revenue below \$1 billion had increased by \$1.6 million to \$2.9 million in 2003 from two years earlier. (The most-cited number from the survey wasn't a cost figure, but the finding that 21% of public companies were considering going private or selling the company "as a result of new corporate governance and disclosure reforms.") But the response rate was only 115 out of 9,000 surveys, creating an even greater potential for bias in favor of respondents who most fiercely oppose Sarbanes-Oxley. A Foley & Lardner spokeswoman didn't respond to a request for comment about the response rate. The firm plans to issue an updated survey on costs Thursday.

Companies' cost estimates in SEC filings are more reliable, but disclosing the costs is voluntary. A.R.C. Morgan, a Dutch consultancy focused on Sarbanes-Oxley, reviewed filings in this year's first quarter and found that among those companies reporting costs, compliance cost an average of \$1.8 million for every \$1 billion in sales. However, A.R.C. couldn't extrapolate this to the larger market because it was based on just

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280 companies, the vast majority of which had annual sales under \$2 billion.

FEI's Mr. Allen points out that other studies -- including Foley-Lardner's, executive recruiter [Korn/Ferry's](#), [Business Roundtable's](#) and one from the University of Nebraska analyzing a change in audit fees for Fortune 1000 companies in 2004 -- corroborate FEI's findings of high compliance costs. It could turn out that Sarbanes-Oxley is as costly as the studies have found, or even costlier. But the available data aren't a solid basis for drawing conclusions about the law. It also remains unclear whether companies will succeed in lowering costs in future years as they get better at compliance, as the bill's advocates have suggested.

Whatever the true cost of compliance, a larger debate looms as to whether the measures have been beneficial to investors. The bill's co-sponsor, Rep. Michael Oxley (R., Ohio), [said](#) in a March speech at Georgetown University that the bill generates goodwill with investors, and will continue to do so.

Yet a study from a graduate student from the University of Rochester, which gained notice after it was [mentioned](#) last month by the Economist and in an opinion column in The Wall Street Journal, stated that U. S. financial markets sank by a total of \$1.4 trillion as a result of the bill's passage, apparently reflecting investors' concerns about the costs public companies would incur in complying with the bill.

But two earlier studies of the same question -- how the market responded to key legislative and rulemaking actions in the development of Sarbanes-Oxley -- found entirely different results: Stock markets rose as a result of the bill. The differences show how sensitive this kind of analysis is to seemingly small choices by researchers.

These studies use what's called event analysis -- attempting to isolate market movements around events believed to be driving investor gains or losses. In order to isolate the effect of Sarbanes-Oxley developments like votes in Congress and SEC rulemaking, researchers look at stock-market movements in the day before, of and after the events, and seek to exclude other potentially confounding factors, like major economic reports.

The math gets quite complicated; my impression is that Rochester accounting graduate student Ivy Xiyang Zhang was meticulous in her analysis. (You can download a copy of a draft of her paper [here](#); it has been submitted for publication at peer-reviewed accounting journals.) However, she had to decide which developments were significant and which weren't.

The \$1.4 trillion in market losses she identifies came almost entirely during three periods, all in July 2002: the Senate's debate of the bill from July 8-12, during which time President Bush delivered a speech backing corporate reforms; a period from July 18-23 when the House and Senate wrangled over competing versions of the bill; and a period from July 24-26 when the Senate and House reached agreement. The market tanked in that second period, reflecting about three-quarters of Ms. Zhang's estimated losses.

Yet in an earlier, also unpublished [work](#), University of Iowa accounting professor Morton Pincus interpreted the events of that period differently. He argued that stocks fell because investors feared the bill wouldn't be passed, and not, as Ms. Zhang suggested, because of indications the bill would be passed and would be tougher than expected. As Dr. Pincus told me in an email message, this represents the "basic difference in the results of the two studies." (Another unpublished [study](#), from the University of Memphis, agrees with Dr. Pincus.)

We may never fully know the tenor of discussions between the House and Senate during the period in question. We'll surely never know what investors were thinking as they bought and sold stocks at the time, as Ms. Zhang readily acknowledges. "It's hard to say all of these \$1.4 trillion [in losses] are directly related to Sarbanes-Oxley," she told me. (On July 23, the Journal [attributed](#) the market plunge to several possible factors, none of them the bill.)

Even if we could look into investors' minds during that week of legislative activity, all we would learn is

what they thought three years ago, before the SEC even set rules based on the legislation. The very best market-event study captures only a snapshot of investor sentiment at a moment in time. With so much posturing on both sides, it's safe to say that even today's investors still don't have very good information about the costs of Sarbanes-Oxley.

\* \* \*

My [column](#) last week on hurricane forecasts provoked the following letter, edited for space and clarity:

*I grew up on the East Coast, so I'm used to being inundated with Hurricane Hysteria. Now that I'm in the Midwest, I get Tornado Tantrums. I think a lot of this hysteria and forecasts of gloom and destruction are just the result of ratings wars, but like the Coast Guard, I don't worry about it until I see the storm actually show up. Unfortunately, I still have to deal with lines of people who insist on buying everything at the grocery store in anticipation of doomsday. In my profession I routinely deal with parts-failure data, and inventory-stockage rates. Upon occasion, I find myself dealing with statisticians who create detailed models that are, for the most part, far less accurate than my simple moving averages. Thank you so much for helping me to feel like I may not be so far out in left field as I thought.*

--Paul McBride, BearingPoint

\* \* \*

Blogger Felix Salmon was suspicious when he spotted a statistic in an anti-counterfeiting bill, that counterfeiting costs the U.S. \$200 billion annually. So he dug deeper, and [the result](#) is a classic numerical wild-goose chase: "every time you think you're getting one step closer to a real survey, or real data, the purported source of the information turns out simply to be citing someone else." One expert told him that the likely basis for the \$200 billion stat was "lost in the mists of time."

Write to me at [numbersguy@wsj.com](mailto:numbersguy@wsj.com). I'll post and respond to selected letters here soon. WSJ.com subscribers can also [sign up](#) to receive an email notice when new Numbers Guy columns are published (nonsubscribers can sign up by [clicking here](#)). Read other columns at [WSJ.com/NumbersGuy](http://WSJ.com/NumbersGuy).



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