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Study shows Section 404 pays off in increased share prices if a company fixes problems

Critics of Sarbanes-Oxley (SOX) argue that the cost of complying with its Section 404 internal controls requirement is too onerous, but a new study suggests that shareholders benefit when companies perform checks on their internal controls.

The report from research firm Lord & Benoit shows companies whose houses are in order enjoy market gains in their share price. Conversely, the stocks of companies with weak internal controls underperform the market.

Further, the process of checking on internal controls, even if the checks turn up problems, can lead companies' shares to outperform if the companies act on the problems, according to the study.

The study surveyed the share-price performance over two years of 2,481 companies that have had to follow SOXâ€™s internal-controls rules. The study's release coincides with the SEC and PCAOB roundtable meeting this week assessing internal-controls requirements, particularly their effect on smaller public companies.

An SEC small-business advisory group has previously recommended that regulators scrap the internal-control rules for companies whose market value is less than $128 million. The advisory group also recommended that companies with a market value of up to $787 million shouldn't be required to have an auditor sign off on their internal controls, as the rules now require, although management should still have to attest to the quality of their controls.

The Lord & Benoit report didn't assess the performance of the smallest companies the SEC advisory panel is looking to exempt. That's because companies with a market value of less than $75 million don't have to comply with the requirements until next year.

Among larger companies that already are reporting on their internal controls, the study found that those reporting no problems in either 2004 or 2005 showed an average share-price gain of 27.7 percent between 2004 and 2006. Companies that reported internal-control deficiencies in both 2004 and 2005 saw an average share-price decline of 5.7 percent.

Markets rewarded companies that reported problems with their internal controls in 2004, but shaped up in 2005. The 264 companies that fell into this category saw an average share price gain over the two-year survey period of 25.7 percent, just slightly below those that didn't have any problems and well above the broad market.

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