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Fixing 404

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Abstract. While debate persists as to whether the costs of Sarbanes-Oxley's Section 404 regulations exceed their benefits, there is far broader consensus that the rule's first year implementation was inefficient. In the words of the PCAOB's former chairman, "the first round of internal control audits cost too much." Second year 404 costs appear to have declined. Significant dispute remains, however, over the magnitude of the decline, and concern persists that Section 404 continues to impose inefficient costs.

Two distinct factors contribute to Section 404's cost-inefficiency. First, the terms "material weakness" and "significant deficiency" reside at the core of the implementing regulations and are easily interpreted to legitimize audits of controls that have only a remote probability of causing an inconsequential effect on the issuer's financial statement. As a quantitative matter, the literature suggests that a control with a remote probability of causing an inconsequential effect on a financial statement would have an effect of approximately five one-hundredths of one percent of the firm's revenues. To the extent that auditors have, in fact, looked to these core definitional terms to drive their control audit practices, it is not difficult to understand how and why the process is inefficient.

Second, the economic and political environments in which the 404 rules are implemented generate a powerful tropism for inefficient hyper-enforcement. Auditors have been broadly criticized for a rash of audit failures and restatements, and do not want to be criticized for implementing Section 404 with insufficient vigor. Auditors thus naturally interpret the rules' ambiguities to support a more detailed process that can deflect criticism for not taking the rules seriously. Auditors are also subject to significant uninsurable litigation risk. Section 404 allows auditors to externalize a portion of that risk by forcing clients to absorb greater precautionary costs that redound to the auditors' benefit by reducing the probability of an audit failure. Auditors also make money selling 404 services to audit and non-audit clients alike. The mechanism at work thus bears a strong similarity to the frequent complaints over the inefficiencies of defensive medicine.

To address these concerns, the Commission and PCAOB should amend Auditing Standard No.2 to incorporate many of the observations found in their later Policy Statements and Reports, and to redefine the objective of the control audit process so as to reduce auditors' incentive to examine controls that are unlikely to have a material effect. The PCAOB should also audit the auditors for evidence of cost-inefficient 404 practices and appropriately sanction violators. There is reason to doubt, however, that the PCAOB can, given its predominant institutional incentives, effectively discipline auditors who are excessively vigilant in the audit process.

Fixing 404

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I. Introduction.

It's time to fix the rules that implement Section 404 of the Sarbanes Oxley Act of 2002.[1]

While there is substantial debate over the costs and benefits of Section 404 as implemented by PCAOB Statement No.2,[2] there is far greater consensus that those rules are not cost effective. Put another way, regardless of whether Section 404's social benefits exceed its social costs, a very large portion of Section 404's benefits can be generated while imposing substantially lower costs on the economy. Consistent with this view, the head of the PCAOB has stated that "it is …clear to us that the first round of internal control audits cost too much."[3]

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[1] There is an important political point to be made here. There is nothing inherently wrong with the language of Section 404 as enacted by Congress. Section 404 is a delegation of authority to the Commission to "prescribe rules" governing management's internal control reports, and to the PCAOB to "set standards for attestation engagements" relating to management's reports. The difficulties arise primarily as a consequence of the specific language employed by the PCAOB in its Statement No. 2, which defines the standards for attestation referenced in the statutory text. It is therefore entirely plausible for strong supporters of Sarbanes-Oxley, the law as enacted by Congress, to be vigorous opponents of Section 404 as implemented by the PCAOB and the SEC through Statement No. 2. The remedies described in this paper therefore do not require Congressional action and can all be implemented at the administrative level by the PCAOB and the Commission.

[2] For a recent summary of the argument that the Sarbanes-Oxley Act in general, and that Section 404 in particular, have imposed heavy burdens on the economy, see, e.g., Henry N. Butler and Larry E. Ribstein, The Sarbanes-Oxley Debacle: How to Fix It and What We've Learned, Address at the American Enterprise Institute: The Liability Project (Mar. 13, 2006) (transcript and related materials available at www.aei.org/events/eventID.1273,filter.all/event_detail.asp). For a strong assertion that the Sarbanes-Oxley Act as a whole, and that Section 404 in particular, are "the principal factor in increased costs" faced by publicly traded firms and generate a situation in which the "costs of regulation clearly exceed its benefits for many corporations", see William J. Carney, *The Costs of Being Public After Sarbanes-Oxley: The Irony of "Going Private*,*"*55 EMORY L.J. 141, 141-42 (forthcoming 2006), *available at* http://ssrn.com/abstract=896564. For an example of the opposing view, suggesting that "Sarbanes-Oxley, for all its reputation as a hard-hitting law, fails to correct a crucial accounting system weakness: the potential for . . . 'moral seduction' of outside auditors", see Don A. Moore, *Sarbox Doesn't Go Far Enough: Further Rules are Needed to Counter Auditors' Natural Bias in Favor of Their Clients*, BUSINESS WEEK, Apr. 18, 2006*see also* Don A. Moore et al., *Conflicts of Interest and the Case of Auditor Independence: Moral Seduction and Strategic Issue Cycling*, Harvard Bus. Sch., Working Paper No. 03115, 2005), *available at* http://ssrn.com/abstract=667363.

[3] *PCAOB Issues Guidance on Audits of Internal Controls* (Pub. Co. Accounting Oversight Bd., Washington, D.C.), May 16, 2005, http://www.pcaobus.org/News/Releases/Pages/05162005_AuditsInternalControl.aspx (quoting Chairman William J. McDonough). As a technical matter, it is valuable to recognize that optimal Section 404 regulations would equate.

There is also a general consensus that the cost of these rules came as a great surprise to the very regulators who put them in place. Indeed, a recent study finds that the average direct cost of implementing Section 404 in its first year averaged about $8.5 million for companies with market capitalizations in excess of $700 million, and about $1.2 million for issuers with market capitalizations of $75 million to $700 million.[4] The Securities and Exchange Commission, however, initially estimated that the average cost of complying with Section 404 would be approximately $91,000.[5] First year implementation costs for larger companies were thus 93 times larger than the SEC had estimated, and 13 times larger than estimated for smaller companies. The regulators thus underestimated the costs of implementing Section 404 not by 50% or 100%, but by almost two orders of magnitude for larger companies and by more than an order of magnitude for smaller companies.

This observation raises additional questions about the fundamental cost-benefit calculus underlying Section 404's implementing regulations. If regulators thought that their Section 404 regulations would generate benefits in excess of their projected costs, did they also think that the benefits would be twice or three times the expected costs? If so, simple arithmetic combined with the power of hindsight suggest that the costs actually incurred have far exceed the benefits that were anticipated - - unless regulators expected that their rule's benefits would be roughly ten to one hundred times larger than their rule's costs. The record is silent as to any such regulatory or legislative expectations.

The actual cost-benefit calculus as it relates to Section 404 is, however, more complicated than this simple ratio test suggests. Section 404 compliance involves large start up costs and lower subsequent maintenance costs. One would also expect that the first year adoption benefits of Section 404 would also be greater than benefits in subsequent years. A proper analysis would thus consider the full life-cycle costs and benefits of the Section 404 rules.

Indeed, while Section 404 start up costs were quite high and second year costs appear to be lower, there is significant dispute over the magnitude of second year cost declines. Data generated in a study supported by the audit industry suggest that average second year Section

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the marginal benefit of compliance with the marginal cost of compliance. It is therefore entirely possible for one to believe that Section 404 generates benefits that, in the aggregate, exceed its costs, but that Section 404 is nonetheless socially wasteful because it forces expenditures beyond the level at which marginal benefit equals marginal cost. Society and investors would then benefit from amendments to Section 404 rules that did a better job of equating the rules' marginal costs to their marginal benefits. The amendments would rationally cut back on those aspects of the Section 404 rules that force large expenditures relative to the benefits generated. The proposal described in this paper can be thought of as presenting just such a set of recommendations.

[4] *The Trial of Sarbanes-Oxley*, THE ECONOMIST, Apr. 22, 2006, at 22.

[5] *Id.*; *see also* Sec. and Exch. Comm'n, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 68 Fed. Reg. 36636, 36657 (June 18, 2003) [hereinafter Management's Report] ("Using our PRA [Paperwork Reduction Act] burden estimates, we estimate the aggregate annual costs of implementing Section 404(a) of the Sarbanes-Oxley Act to be around $1.24 billion (or $91,000 per company)."). To be sure, this estimate relates only to Section 404(a), and not to Section 404(b), but it is hard to conceive that the stand-alone costs of Section 404(b) compliance would dramatically change the basic analysis described in the text.

404 compliance costs in 2005 were $860,000, or 31% less than first year implementation costs, and that compliance costs for larger companies averaged $4.7 million, or 44% less than first year implementation costs.[6] In contrast, a study by Financial Executives International suggests that second year cost savings are roughly half the percentage estimated by the audit-industry backed study. The FEI study finds that "total average cost for Section 404 compliance … during fiscal year 2005 [was] down 16.3 percent from 2004," and further suggests that these reductions were only "about half of what were anticipated."[7]

While news of lower 404 compliance costs is no doubt welcome, the simple observation that costs have declined hardly addresses the core cost-benefit and cost-efficiency concerns raised by the Section 404 rules. In particular, just as first year implementation costs would reasonably be expected to exceed longer term compliance costs, the first year benefits of implementation would also be expected to exceed the longer term benefits of implementation. Thus, relying on the audit-industry data which suggest the largest second year cost decline, if the second year benefits of compliance are, on average, less than 69% (100% - 31%) of first year benefits, then the cost-benefit ratio for Section 404 compliance is, in its second year of implementation, even worse than in its first year. The possibility therefore arises that even though aggregate compliance costs are down, the rules are even less cost-efficient than in their second year of implementation than in their first. The available surveys do not, however, to the best of my knowledge attempt to quantify first year benefits in comparison with second year benefits, so the facts could be precisely to the contrary and cost effectiveness may have improved measured as a percentage of total 404 expenditures. The question of whether Section 404's cost effectiveness in its second year is better or worse than in its first thus remains a mystery.

Further, assuming that the audit industry estimates of cost declines are correct, while an average cost decline of 31% for the average firm, and of 44% for the larger firm, is certainly significant, these declines comes off of a very high base. Second year compliance costs for the average firm now run about 9.5 times as large as the Commission had initially estimated, and for larger firms second year compliance costs now run about 52 times the Commission's initial expectations. Evidently, a wide gap continues to persist between initial cost expectations and the observed lower second year implementation costs.

Thus, just as it is widely appreciated that "the first round of internal control audits cost too much," it follows that there is a high likelihood that the second round of internal control audits cost too much, and that unless there is fundamental reform of the internal control audit process the third, fourth, and fifth rounds will also cost too much, *ad infinitum*.

How and why did such a gap arise between expected and actual Section 404 costs, and what, if anything, can be done to make Section 404 more cost-effective? The response to both questions calls for a detailed examination of the substantive definition of the terms "significant deficiency" and "material weakness" that lie at the core of the rules that implement Section 404,

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[6] David Reilly, *Internal-Control Help Becomes Less Costly*, WALL STREET JOURNAL, Apr. 19, 2006, at C31.

[7] PR Newswire Ass'n, *FEI Survey: Sarbanes-Oxley Compliance Costs are Dropping; Average Compliance Costs are $3.8 Million, Down 16% from Prior Year; Reductions About Half of What Were Anticipated*, Apr. 6, 2006, http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/04-06-2006/0004335523&EDATE=.

as well as a nuanced appreciation of the procedural and litigation environment in which these rules were adopted and enforced.

From a substantive perspective, the root cause of Section 404's cost inefficiency resides in the PCAOB's definitions of the terms "significant deficiency" and "material weakness," combined with the pre-existing definition of the term "remote likelihood" as applied to the 404 process. Simply put, these definitions force auditors and registrants to spend a great deal of time and money worrying about issues that are highly unlikely ever to cause a material misstatement. As explained below, by creating an incentive for auditors to examine processes that arise at the borderline of the remote and inconsequential, Statement No.2 creates an incentive for auditors to concern themselves with processes that have an expected value impact of only 5 one-hundredths of one percent of company revenues. Indeed, the technical definition of "significant deficiency and "material weakness" helps explain how and why Section 404 compliance costs have mushroomed out of control, and so far beyond the Commission's initial aggregate $1.2 billion cost estimate.[8] Therefore, unless and until these core definitions are amended to draw auditors' and registrants' attention out of the weeds and to force them to focus on processes that are more likely to cause a material difference in the firm's financial statements, the Section 404 process will continue to be unnecessarily wasteful.

From a procedural perspective, it is important to recognize that the audit industry has four distinct incentives to push Section 404 compliance to a point of socially inefficient hyper-vigilance. First, the audit industry has been broadly criticized for a rash of audit failures and restatements. The industry does not want to be criticized for failing to implement Section 404 with sufficient vigor. The rule's ambiguities will therefore naturally be interpreted in an expansive manner so as to require more heightened forms of vigilance. Second, many of the rules implementing Section 404 are remarkably vague and susceptible of multiple interpretations. This deep and pervasive ambiguity only amplifies the audit profession's natural and understandable proclivity to interpret Section 404 rules so as to require greater expenditures. Third, auditors are subject to significant litigation risk, much of which is uninsurable. Section 404 provides the audit profession with an opportunity to externalize a portion of that risk by forcing their clients to absorb greater precautionary costs that redound to the auditors' benefit by reducing the probability of an audit failure. Put another way, by forcing clients to spend more money on Section 404 compliance, auditors can reduce the risk that they will be sued. Fourth, auditors make money selling 404 services to audit clients and to non-audit clients. All other factors equal, the more onerous the requirements of Section 404, the more money the audit profession can earn by selling Section 404 services to audit and non-audit clients alike.

None of this is intended to criticize the audit profession as being unique in any material respect because the profession's conduct can be viewed as a natural and rational response to the environment in which it operates. Indeed, many professions can be criticized

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[8] *See* Management's Report, *supra* note 5, at 36657 ("Using our PRA [Paperwork Reduction Act] burden estimates, we estimate the aggregate annual costs of implementing Section 404(a) of the Sarbanes-Oxley Act to be around $1.24 billion (or $91,000 per company).").

on quite similar grounds: doctors, for example, are accused of practicing unnecessarily expensive defensive medicine because of the litigation environment in which they operate and the audit profession's reaction to the Section 404 rules can be likened to a form of defensive medicine. The natural "defensive medicine" forces set in place by Section 404 cannot, however, be constrained unless the PCAOB in its own inspection process makes it clear to the audit profession that auditors will be penalized for overly aggressive and wasteful Section 404 implementations just as they will be penalized for insufficiently attentive Section 404 implementations. In all candor, however, given the institutional incentives that confront the PCAOB, I am not optimistic that Section 404 cost control will rise to the top of PCAOB's inspection agenda.

By combining these two distinct "fixes" through a substantive and fundamental redefinition of the nature of the control process failures that are the core of the Section 404 exercise and, to the extent possible, a vigorous enforcement program designed to deter "hyper-compliance," the SEC and PCAOB should be able to reduce the cost inefficiency currently embedded in the Section 404 compliance process.

II. The Substantive Fix.

As an introductory matter, it is essential to observe that while the goal of the 404 audit process is to obtain reasonable assurance that no material weaknesses exist as of the date of management's assessment, the definitions applied by Statement No.2 require that auditors also assess the presence of "significant deficiencies" in order to assure that no material weaknesses arise. The rules therefore have an embedded incentive that drives or legitimizes the search not only for material weaknesses, but also for less important "significant deficiencies," notwithstanding exhortations by the PCAOB that auditors should focus on material weaknesses. Further, given the standards that are commonly applied by the audit profession, it is not unreasonable to approximate the lower limit of a "significant deficiency" as being triggered by a value that can be measured as five one-hundredths of one percent of the company's revenues. I do not suggest that every 404 audit has actually pursued the search for significant deficiencies that reside at this extreme of remoteness and inconsequentiality. The observation is, instead, that the very definitions that constitute the core of Standard No.2 have this incentive embedded deeply at their core and that, unless and until these definitions are changed or until Standard No.2 is otherwise amended, a root problem that drives the process' inefficiencies will not be fixed.

A. A Precise Definition of the Problem.

PCAOB Statement No.2 requires that auditors search for significant deficiencies and that they issue adverse opinions if they identify material weaknesses.

A significant deficiency is defined as "[a] control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or

interim financial statements that is more than inconsequential will not be prevented or detected." PCAOB Statement No.2 at ¶ 9

A <u>material weakness</u> is defined as a "significant deficiency or combination of significant deficiencies that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected." Id. at ¶ 10.

The term "inconsequential" as used in the definition of significant deficiency has been further defined by the audit profession as relating to "potential misstatements equal to or greater than 20% of overall annual or interim financial statement materiality," subject to the proviso that even smaller amounts can be considered as more than inconsequential "as a result of the consideration of qualitative factors, as required by AS2."[9]

Thus, if one begins with the assumption that a 5% change in revenue is a common and clear metric of materiality, then the audit industry's definition of "inconsequential" suggests that a 1% change (which amounts to 20% of 5%) in an annual or interim financial statement line item would define the dividing line between consequential and inconsequential - - subject, of course, to the proviso that items can certainly be material at levels lower than 5% and that items can also be consequential at levels lower than 1%. Accordingly, the 1% test would seem to define the upper bound of inconsequentiality.

The term <u>remote likelihood</u> is defined "to have the same meaning as the term used in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No 5, Accounting for Contingencies ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

> "When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range as follows:
>
> (a) Probable – The future event or events are likely to occur.
> (b) Reasonably possible – The chance of the future event or events occurring is more than remote but less than likely.
> (c) Remote – The chance of the future event or events is slight."

Therefore, the likelihood of an event is "more than remote" when it is "either reasonably possible or probable." PCAOB Statement No. 2 at ¶ 9 quoting FAS no. 5 at ¶ 3.

The profession appears not to suggest any quantitative probability measures that would correspond to the subjective characteristics of events as probable, reasonably probable, or remote. Indeed, the PCAOB has expressly stated that "the terms "probable," "reasonably possible," and "remote," should not be understood to provide for specific

[9] *A Framework for Evaluating Control Exceptions and Deficiencies, Version 3*, at 15 (White paper, Dec. 20, 2004), *available at* http://www.deloitte.com/dtt/cda/doc/content/us_assur_Framework-Version3%281%29.pdf.

quantitative thresholds. Proper application of these terms involves a qualitative assessment of materiality. Therefore, the evaluation of whether a control deficiency presents a "more than remote" likelihood of misstatement can be made without quantifying the probability of occurrence as a specific percentage."[10] I put aside for the moment that probabilities are unavoidably mathematical constructs that are bounded over the closed interval spanning zero and one and must therefore correspond to some quantitative value or range of values. People may therefore implicitly assign different quantitative values to the phrases "reasonably possible" or "remote," but if they assign no corresponding quantitative values then they are talking about feelings rather than probabilities. The lack of quantification in this respect can therefore also add to the difficulties generated by the definitions at the core of Standard No. 2.

The inescapable implication of these definitions is that, in order to determine whether a company's controls suffer from significant deficiencies, auditors must search for controls at the margin between those that (a) raise a more than remote likelihood of an immaterial but more than inconsequential misstatement of the company's financial statement, and (b) those that raise a less than remote likelihood of an inconsequential misstatement. If we then import into this analysis the prior observation that the borderline between consequentiality and inconsequentiality is no more than 1%, then these two statements indicate that auditors must search for controls at the margin between those that (c) raise a more than remote likelihood of an immaterial but more than 1% misstatement of the company's financials, and (d) those that raise a less than remote likelihood of a 1% misstatement.

Further, if we assume for sake of argument only, and without any supporting literature, and against the PCAOB's direct instructions, that a probability of 5% or less would constitute a less than remote probability, then the quantifiable implication of the preceding articulation of the definition of significant deficiencies implies that auditors have cause to search for and audit control processes with a 5% probability of a 1% implication for a firm's financial statements. The expected value of a 5% probability of a 1% impact is, however, only 0.0005, or five hundredths of one percent. This is, by any standard, a low threshold of sensitivity for triggering an audit requirement.

This is where the game is immediately lost and where massive inefficiencies become hard-wired into the system. It is impossible for an auditor to determine whether the probability of an event is more or less than remote (say 5%), or whether the consequence of any failure is more or less than inconsequential (1%), unless the auditor dives deeply into the weeds of process controls in search of the elusive border that distinguishes "more than remote events with sub-material but more than inconsequential implications" from events that are too remote or inconsequential to be categorized as a significant deficiency.

Unless and until these definitions are amended the prospects for meaningful and efficient reform are quite limited because all other modifications or interpretations of Statement No. 2 will relate to a process by which auditors are still required to search for low-probability, low-magnitude events with which they probably shouldn't be bothering in the first instance. Absent

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[10] Public Company Accounting Oversight Board, Report on the Initial Implementation of Auditing Standard No. 2, PCAOB Rel, No. 2005-023 (Nov. 30, 2005) at 17.

such reform, it becomes inevitable that the 404 audit exercise generates exceptionally large costs as it addresses a wide range of processes that will never have a material effect on the company's financial statements. As SEC Commissioner Glassman has observed, the idea of a company having 40,000 "key controls" is an oxymoron and making Section 404 compliance a "check the box" exercise is "inefficient and ineffective."[11] Yet, that result seems an almost inescapable consequence of the definitions inherent in PCAOB Statement No. 2.

The problems caused by the Statement's approach to materiality is, moreover, compounded by several additional features of the rule, three of which were recently underscored in a Wall Street Journal article by Bob Pozen.[12] First, Pozen observes that the Commission has defined internal structures and procedures for financial reporting to include "more items of information with more details than those ordinarily included in the financial reports of public companies."[13] Internal controls must therefore provide assurances that "receipts and expenditures of the company are being used only in accordance with authorization of management and directors of the company."[14] The result, as Pozen properly observes, is that "by unlinking "internal controls" from "financial reporting" in Section 404, the SEC encourages management and auditors to scrutinize detailed procedures for controlling ordinary expenses ... even when they are clearly immaterial to the company's financial reports."[15]

Pozen also observes that Standard No. 2 states that "an auditor must apply materiality "in an audit of internal controls over financial reporting at both the financial-statement level and at the individual-balance level." This "tends to lead management and auditors to incur tremendous expense by examining controls over balances that are not financially significant for the company as a whole - - for example, reserve balances in a minor subsidiary, or inventory balances in a small factory."[16]

Third, Pozen observes that Standard No.2 states that ""There is no difference in the level of work performed" by the auditors when attesting to management's assessment of the company's internal controls, versus when the auditors express an opinion directly on the effectiveness of the company's internal controls." This aspect of Statement No. 2 forces redundancy in the testing process because "management must test all of the company's internal controls" but the auditors can rely on management's testing "only for the less important areas of internal controls."[17]

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[11] *Glassman Says that 404 Rules Aimed at Holding Management Accountable*, 37 Sec. Reg. & L. Rep. (BNA), No. 41, at 1738 (Oct. 17, 2005).

[12] Robert C. Pozen, *Why Sweat the Small Stuff?*, WALL STREET JOURNAL, Apr. 5, 2006, at A20.

[13] *Id.*

[14] *Id.*

[15] *Id.*

[16] *Id.*

[17] *Id.*

B. A Proposed Solution.

The problem generated by the rule's incentive to search for low probability - low magnitude events can be addressed by amending Statement No. 2 so that auditors should be required to test only for material weaknesses (and not for significant deficiencies) where the definition of a material weakness is restated as a weakness that creates a reasonable possibility (to be defined as a probability that is meaningful more than "remote") that a material misstatement will not be prevented or detected. The various policy statements and other exhortations by the Commission and PCAOB, discussed in greater detail below, are insufficient as long as the rules themselves are so hard wired with definitions that can easily be used to rationalize processes that test the fringe of remoteness and inconsequentiality.

This proposed standard would raise the probability threshold above the level of remoteness and the materiality level above the level of inconsequentiality that now triggers the search for significant deficiency while still pursuing inquiries that would catch reasonably possible material failures. The point at which a material failure becomes reasonably possible, and not just remotely possible, is an entirely rational point at which to begin the inquiry as to the adequacy of controls.

The controls that would no longer be subject to audit under this modified standard are those where it is not reasonably possible that they will lead to a material misstatement. Expenditures on these remote and sub-material controls can be a significant contributing factor to 404 compliance costs. By eliminating the need to address those remote and sub-material controls, compliance costs can be reduced while focusing auditor attention on the reasonable risk of a material misstatement - - which is where the auditors' attention belongs in the first instance. Such a re-definition would also be consistent with the PCAOB's own repeated exhortations that the purpose of the audit is only to obtain a reasonable assurance that no material weaknesses exist as of the date specified in management's assessment.

The PCAOB and the SEC can, without any Congressional action, implement these amendments because they could simply exercise the authority already delegated to them by Congress.

III. The Procedural Fix.

A Precise Definition of the Problem. Whatever the substantive definition of the requirements imposed by Section 404, simple economic analysis suggests that the audit industry, acting rationally and a manner similar to that which would be followed by any other profession subject to analogous economic and social forces, has a powerful incentive to force their clients to over-invest in Section 404 compliance. Four distinct factors contribute to this powerful tendency.

First, the audit profession has been thrashed before Congress, in the media, and in the courts for a range of accounting frauds and restatements. Section 404 requirements create a new set of audit related demands as to which the industry can be criticized, and as to which it can be

saddled with additional liability, if it proves too lax in compliance. The easiest way to avoid such criticism and liability is to be quite demanding when it comes to Section 404 compliance and to interpret any ambiguity in the rules so as to require the investment of additional resources.

Second, the Section 404 rules adopted by the PCAOB and SEC are ambiguous in the extreme. Although some degree of ambiguity is inevitable whenever a complex set of new regulations are adopted, the Section 404 rules were not only ambiguous in their own right, they were also interpreted in a manner that precluded audit clients from obtaining clear guidance from their auditors about procedures that would be appropriate in implementing Section 404. Ambiguity was therefore magnified and compounded in a manner that amplified the profession's incentive to promote a larger number of expensive procedures around Section 404.

Third, the threat of class action securities fraud litigation creates great financial risk for the profession, and a large portion of this risk is uninsurable. It is, however, reasonable for auditors to calculate that the larger the amount that they can force clients to spend on 404 control processes, the lower probability that an audit will result in a litigation claim. Auditors therefore have an incentive to require that clients continue to spend on Section 404 compliance up until the point where the marginal benefit to the auditor (not to the client or to society) equals the marginal cost to the auditor, which could well be zero. The net result is a surfeit of detailed compliance processes that auditors can claim are consistent with Section 404's ambiguous requirements and that reduce auditors' litigation exposure, but that, at the margin, are hugely wasteful to society.

These three mechanisms are alone sufficient to explain the audit industry's tropism toward hyper-vigilant Section 404 compliance. It is impossible, however, to ignore the possibility that Section 404 also acts as a meaningful profit center for the audit industry. There is little doubt that Section 404 has significantly increased the number of hours billed by the audit profession and reports suggest that the first full year of Section 404 compliance was highly profitable for auditors as well as for other providers of Section 404 services. To the extent that the audit profession is also able to increase its profitability by adopting an expansive view of Section 404's requirements, it would be contrary to human nature to suggest that such incentives are irrelevant to the profession's actual conduct.

A Proposed Solution. The PCAOB is the only organization reasonably positioned to constrain the audit profession's natural and unavoidable tendency to push clients to over-invest in Section 404 compliance efforts. The PCAOB should therefore not only inspect firms for the possibility that they have failed to be sufficiently diligent in reviewing Section 404 compliance, but should also investigate whether the firms have, in their dealings with audit and non-audit clients, recommended procedures that were not reasonably necessary in order to comply with Section 404. The PCAOB's ability to conduct such inspections will be constrained until it develops a less ambiguous set of Section 404 rules because, under the current environment which rationalizes the search for processes that have only a remote possibility of having an inconsequential effect on the financial statement, it will be difficult to criticize an auditor for suggesting just about any form of process review, particularly during the first cycle of the 404 process.

It follows that the recommended procedural reform - - aggressive inspection of audit firms for evidence of overly-intrusive Section 404 procedures - - cannot be cleanly separated from the recommended substantive reform - - a redefinition of the term "material weakness" so as to encompass only those weaknesses that create a reasonable possibility or probable likelihood that a material misstatement will not be prevented or detected, combined with a requirement that Section 404 apply only to material weaknesses.

Again, the PCAOB and the SEC can, without any Congressional action, implement these amendments. That said, I am far from optimistic that the PCAOB will, given its institutional incentives, aggressively monitor over-zealous enforcement of Section 404 requirements. The PCAOB's primary mission is, after all, to assure that auditors are being sufficiently aggressive and thorough in their audits of their own clients.

IV. The Small Company Problem

All of these observations arise without regard to the size of the issuer. It is, however, well understood that Section 404 imposes significant fixed costs and that these fixed costs impose particular burdens on smaller publicly traded issuers. These costs have led to calls for a size-based exemption from Section 404 requirements[18] that have in turn fired up opposition from critics who observe that a disproportionate percentage of enforcement actions and restatements are generated by the smaller companies that some would seek to exempt from Section 404 compliance requirements. [19] The call for a size-based exemption has also stoked a debate as to whether the Commission has the legal authority adopt such an exemption.[20]

The small company problem is, however, more fundamental than the broader Section 404 debate suggests. If Section 404 rules are rationalized to become more cost-effective for all issuers, then the 404 compliance cost problem for smaller issuers would be ameliorated, but not eliminated. The essential difficulty for the smaller company is that, even in a world with a perfectly crafted set of Section 404 rules of general applicability, there will be a very substantial fixed cost compliance component that can render compliance uneconomic for a smaller firm. This fixed cost component is far higher today than it was before Section 404's adoption. It follows that small companies that were rationally traded in the public markets prior to Section 404 now find that the regulatory burdens of being publicly traded exceed the benefits of access to the public markets - - all through no fault of the small company itself.

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[18] *See, e.g.*, ADVISORY COMM. ON SMALLER PUB. CO., FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE U.S. SECURITIES AND EXCHANGE COMMISSION (2006) [hereinafter FINAL REPORT], *available at* http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

[19] *See, e.g.*, *Michael Rapoport, SEC Panel to Turn In Report on Sarbanes Debate*, WALL STREET JOURNAL, Apr. 17, 2006, at C3 (quoting Damon Silvers, associate general counsel of the AFL-CIO, stating that "the exemption from [the 404] rules would create a kind of free-fire zone on investors").

[20] For a summary of this debate, see, e.g., *AFL-CIO: SEC Has No Power to Exempt Firms From SOX Internal Controls Provision*, 38 Sec. Reg. & L. Rep. (BNA), No. 3, at 101 (Jan. 16, 2006); *Oxley, Baker Tell SEC Agency Has Power to Mitigate SOX Provisions*, 38 Sec. Reg. & L. Rep. (BNA), No. 11, at 449 (Mar. 13, 2006); *Sarbanes Defends SOX, Lauds Letter Saying SEC Lacks Power for 404 Exemptions*, 38 Sec. Reg. & L. Rep. (BNA), No. 13, at 539 (Mar. 27, 2006).

There are two effective solutions to this problem that can avoid the debate over whether the Commission has the authority to adopt a small company exemption from Section 404 requirements. The first is to provide these companies with an efficient means of de-listing from the public markets. It is wasteful and not in shareholders' best interests for these companies to continue to be saddled with socially inefficient compliance costs. Publicly traded companies can be rid of the obligation to comply with Section 404 and other Sarbanes Oxley obligations either by going private or by "going dark." In a going private transaction, the company's shares are acquired by a privately held or publicly traded entity and, as a consequence of the acquisition, the company ceases to be a publicly traded entity. When a company "goes dark" it reduces the number of its shareholders to less than 300 and continues to trade on the "pink sheets" in a market that is generally less liquid than the NASDAQ or NYSE. "The process of "going dark" through termination of reporting under the securities laws is said to impose a liquidity penalty of about ten percent upon announcement."[21] A regulatory initiative designed to facilitate going private or going dark transitions by companies that have been trapped in this regulatory phase shift, combined with an initiative designed to improve the functioning of the pink sheet markets, would constitute one approach to this problem.

A second solution is not to provide a formal exemption from the Section 404 rules, but to write a second set of rules that would apply only in situations where the company is sufficiently small that the Commission can conclude that the costs of compliance would likely exceed the benefits. These "404-lite" rules would be designed to impose minimal costs on small company issuers over and above the costs that would in any event have to be incurred in order to obtain a competent audit.[22] Further, in considering the thresholds that might trigger the application of "404-light" the Commission might wish to consider revenue triggers as well as market capitalization triggers. There exist situations in which issuers with relatively low revenues have high market capitalizations and in which the cost efficient control environment would be more aptly described by the "404-lite" rules. A test based exclusively on market capitalization would not address these situations. The Section 404 problem is, however, only a fraction of the regulatory dilemma faced by the small publicly traded firm. The fixed costs of being a publicly traded firm have also increased as a result of all of Sarbanes-Oxley's other provisions, combined with the costs imposed by additional regulations adopted by the Commission, tighter listing standards implemented by the exchanges, and heightened legal and accounting costs.[23] The benefits of being a publicly traded firm have also been constrained by the stock market analyst settlement which has made it more difficult for smaller companies to obtain analyst coverage

The result of this sudden and significant increase in compliance costs and reduction in analyst coverage is two-fold. First, there now exists a cadre of smaller firms that rationally entered the public markets at a time when compliance costs were lower and that, given today's cost and risk environment, would rationally decide not to be publicly traded for a multitude of

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[21] Carney, *supra* note 2, at 143, (citing Claudia H. Deutsch, *The Higher Price of Staying Public*, N.Y. TIMES, Jan. 23, 2005, § 3 at 5).

[22] *See* FINAL REPORT, *supra* note 18.

[23] For a detailed examination of many of these factors, see Carney, *supra* note 2.

reasons separate and distinct from Section 404.[24] Second, the probability that a new start-up firm will be able successfully to go public is materially lower today than in the past because the minimum scale required of a new start-up has increased significantly.[25] As a consequence, venture capitalists and other backers of private, start-up firms, should expect lower rates of return from entrepreneurial investing activities than they would otherwise observe. If the Commission is concerned about the potential adverse effects of Section 404 requirements on entrepreneurial companies seeking to go public in the United States, then the Commission might also want to consider a variation on the "404-lite" rules that would ramp up the obligations imposed on new issuers as a function their vintage as well as of their market capitalization and revenues.

It should also be observed that foreign issuers face challenges that are quite similar to those faced by smaller public issuers, and that the Commission also has proceeding under way to facilitate delisting by foreign issuers who find themselves "trapped" by Sarbanes-Oxley's additional regulatory costs.[26]

V. SEC and PCAOB Policy Statements and Reports

The PCAOB and SEC are well aware of the broad outcry stimulated by Statement No.2, and through a series of policy statements have attempted to address many of these concerns. For example, the SEC's May 16, 2005 Policy Statement explained:

"Although it is not surprising that first-year implementation of Section 404 was challenging, almost all of the significant complaints we heard related not to the Sarbanes-Oxley Act or to the rules and auditing standards implementing Section 404, but rather to a mechanical, and even overly cautious, way in which those rules and standards apparently have been applied in many cases. Both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance."[27]

In a parallel statement issued on the same day, the PCAOB urged auditors to:

"• exercise judgment to tailor their audit plans to the risks facing individual audit clients, instead of using standardized "checklists" that may not reflect an allocation of audit work

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[24] Carney, supra note 2..

[25] See, e.g., Rebecca Buckman and Kara Scannell, Do U.S. Regulations Drive Away Start-Ups?. Wall St. J., Apr. 27, 2006, at C5.

[26] Termination of a Foreign Private Issuer's Registration of a Class of Securities Under Section 12(g) and Duty to File Reports Under Section 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 53,020, 70 Fed. Reg. 77,688 (Dec. 23, 2005).

[27] Commission Statement on Implementation of Internal Control Reporting Requirements, Release No. 2005-74 (May 16, 2005), *available at* http://www.sec.gov/news/press/2005-74.htm.

weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);

"•use a top-down approach that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and use the risk assessment required by the standard to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement; [and]

"• take advantage of the significant flexibility that the standard allows to use the work of others."[28]

Five months later, in its Report on the Initial Implementation of Auditing Standard No. 2, issued on November 30, 2005, the PCAOB "found that both firms and issuers faced enormous challenges in the first year of implementation, arising from the limited time frame that that issuers and auditors had to implement Section 404; a shortage of staff with prior training and experience in designing, evaluating and testing controls; and related strains on available resources." [29] Accordingly, "audits performed under these difficult circumstances were often not as effective or efficient as Auditing Standard No. 2 intends…."[30] Among the "most common reasons that audits were not as efficient as the Board expects them to be" were the findings that "some auditors did not effectively apply a top down approach; … did not alter the nature, timing, and extent of their testing to reflect the level of risk [and] [a]s a result, some auditors appear to have expended more effort than was necessary in lower-risk areas…."[31]

The November 30 Report also attempted to clarify and reinforce the meaning of some of the text of Statement No. 2 by observing that "the objective of an audit of internal control is to obtain reasonable assurance as to whether any material weaknesses exist. An important corollary to this fundamental principle is that the standard does <u>not</u> require auditors to search for deficiencies other than material weaknesses. Further, the standard does not redefine materiality for the purposed of auditing internal control…. This means that the auditor should plan and perform the audit of internal control using the materiality measures as the auditor uses to plan and perform the annual audit of the financial statements."[32] Notwithstanding these observations, the November 30 Report recognized that "anecdotal claims have suggested that some auditors

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[28] *PCAOB Issues Guidance on Audits of Internal Controls*, *supra* note 3.

[29] Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, Pub. Co. Accounting Oversight Bd. Release No. 2005-023, at 1 (Nov. 23, 2005), *available at* http://www.pcaobus.org/Inspections/Documents/2005_ 11-30_Release_2005-023.pdf.

[30] *Id.*

[31] *Id.* at 2-3.

[32] *Id*. at 16 (emphasis in original).

have applied a more stringent threshold to the evaluation of control deficiencies than the definitions in Auditing Standard No. 2 require."[33]

The difference between the Policy Statements and Reports issued by the SEC and PCAOB (hereinafter referred to as "The 404 Commentaries") and the text of Standard No. 2, is quite striking in many respects. The 404 Commentaries suggest a sensible approach to the audit of control systems in which auditors avoid processes that are unlikely to be material. The text of the Standard, however, is rife with language that gives license to audit procedures that test the boundaries of the inconsequential and remote.

If it is the Commission's and PCAOB's objective to have The 404 Commentaries govern practice, then the most prudent step would be to amend and reissue the Standard itself so that it incorporates the cautionary language that dominates the Commentaries. Indeed, unless and until the Commission and PCAOB reissue the Standard with a new set of directions that makes clear the limits of the control audit process, the audit profession can reasonably look to the language of the Standard itself as governing over the later adopted Commentaries, and cost-inefficient 404 audits will continue to be common features of the audit landscape.

[33] *Id*. at 17.