

FIXING 404

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Although debate persists as to whether the costs of Sarbanes-Oxley's Section 404 regulations exceed their benefits, there is broad consensus that the rules have been inefficiently implemented. Substantive and procedural factors contribute to the rules' inefficiency.

From a substantive perspective, the terms "material weakness" and "significant deficiency" are central to 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 statements. As a quantitative matter, the literature suggests that a control with a remote probability of causing an inconsequential effect has an expected value of only five one-hundredths of one percent of a firm's net income.

Procedurally, the Section 404 rules are implemented in an economic and political environment that generates a powerful tropism for inefficient hyperenforcement. Auditors have been broadly criticized for a rash of audit failures and restatements. They do not want to be further criticized for implementing Section 404 with insufficient vigor. Auditors are also subject to significant uninsurable litigation risk. That provides an incentive to externalize risk by forcing clients to absorb greater precautionary costs that benefit auditors by reducing the probability of an audit failure. Auditors also make money selling Section 404 services to audit and nonaudit clients alike. These three forces combine to create powerful incentives for the audit industry, incentives that contribute to inefficient expenditures on Section 404 procedures much like the forces that drive inefficient expenditures on defensive medical procedures.

To address these concerns, the Securities and Exchange Commission ("Commission" or "SEC") and the Public Company Accounting Oversight Board ("PCAOB") should aggressively redraft the rules implementing Section 404 to eliminate the need to examine controls that are unlikely to have a material effect. At the same time, the PCAOB should monitor audit firms' Section 404 practices and discipline auditors who promote or engage in cost-inefficient procedures.

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We are not confident that these or any other reforms will be sufficient to remedy the problems already created by Section 404. The audit profession has incorporated inefficient Section 404 procedures into its integrated audit framework, and experience suggests that auditors are loathe to weaken processes already in place. While the Commission and the PCAOB should act aggressively to rationalize Section 404 costs, Section 404 as implemented under the current rules may have established an irreversible process that will continue to impose inefficient costs on publicly traded firms for years to come.

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INTRODUCTION

It's time to fix the rules that implement Section 404 of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act" or "Sarbanes-Oxley").¹ Section 404 is a delegation of authority to the Securities and Exchange Commission ("Commission" or "SEC") to "prescribe rules" governing management's internal control reports, and to the Public Company Accounting Oversight Board ("PCAOB") to "set standards for attestation engagements" relating to management's reports.² The difficulties arise not in the text of Section 404 but in the structure of the rules adopted by the PCAOB, and approved by the SEC, implementing Section 404. The specific language of Auditing Standard No. 2 ("AS2"),³ which defines the standards for attestation referenced in the statutory text, was a product of these rules.

An important political point deserves emphasis at the outset. There is nothing inherently wrong with the language of Section 404 as enacted by Congress. It is entirely possible for strong supporters of Sarbanes-Oxley to

1. 15 U.S.C. § 7262 (Supp. IV 2004).

2. *Id.*

3. AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS, Auditing Standard No. 2 (Pub. Co. Accounting Oversight Bd. 2004) [hereinafter AS2], effective pursuant to Order Approving Proposed Auditing Standard No. 2, Exchange Act Release No. 49,884, 69 Fed. Reg. 35,083 (June 17, 2004).

be vigorous opponents of Section 404 as implemented by the PCAOB and the SEC through AS2. This Article's critique is directed entirely at AS2. Resolution of these problems will not require Congressional action because the PCAOB and the Commission can implement all necessary and appropriate amendments at the administrative level.

While there is substantial debate over the costs and benefits of Section 404 as implemented by AS2, there is far greater consensus that the PCAOB's rules are not cost effective in the sense that a very large portion of Section 404's benefits can be generated while imposing substantially lower costs on the economy.⁴ 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."⁵

The cost of Section 404 compliance seems to have surprised the very regulators who put the rules in place. A recent study found that the direct cost of implementing Section 404 in its first year averaged about \$7.3 million for companies with market capitalizations in excess of \$700 million and about \$1.5 million for issuers with market capitalizations of \$75 million to \$700 million.⁶ The SEC initially estimated the average cost of complying with Section 404 at approximately \$91,000.⁷ First-year implementation

4. For a recent summary of the argument that the Sarbanes-Oxley Act of 2002 in general, and Section 404 in particular, have imposed heavy burdens on the economy, see, for example, HENRY N. BUTLER & LARRY E. RIBSTEIN, *THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT* (2006). For a strong assertion that the Sarbanes-Oxley Act in general, and Section 404 in particular, are "the principal factor[s] 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 (2006). For an argument that the implementation of Section 404 has created harmful unintended consequences, see Alex J. Pollock, *Undoing SOX's Unintended Consequences,* TCS DAILY, May 25, 2006, <http://www.tcsdaily.com/article.aspx?id=052506D>. See also Donna Block, *Agency attempts to clarify SOX burdens,* THE DEAL, July 13, 2006 (quoting Representative Tom Feeney as stating that "[t]he high burden of regulation and compliance is outsourcing America's lead in world capital markets," and "[t]he London Stock Exchange is going around the country advertising itself as a 'SOX-free zone'"). 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,* BUS. WK., Apr. 17, 2006, at 112. 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).

5. PCAOB, *PCAOB Issues Guidance on Audits of Internal Control,* May 16, 2005, http://www.pcaobus.org/news_and_events/news/2005/05-16.aspx (quoting Chairman William J. McDonough). As a technical matter, the optimal implementation of Section 404 regulations would equate the rules' marginal social benefit of compliance with their marginal social cost. It is therefore entirely possible for one to believe that Section 404 rules generate aggregate benefits in excess of their costs but that the Section 404 rules are nonetheless socially wasteful because they force expenditures beyond the level at which marginal benefits equal marginal costs. The proposal described in this paper presents just such a set of recommendations. For a more complete treatment of this subject, see Section III, *infra*.

6. CRA INT'L, *SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES: SURVEY UPDATE 5-6* (2005) [hereinafter *SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES*].

7. Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities Act Release No. 8238, 68 Fed. Reg.

costs for larger companies were thus eighty times greater than the SEC had estimated, and sixteen times greater than estimated for smaller companies.

This observation raises additional questions about the fundamental cost-benefit calculus underlying Section 404's implementing regulations. If, at the time of the rules' adoption, regulators believed that AS2 would generate benefits in excess of projected costs, by how much did they expect benefits to exceed costs? Did they believe that benefits would exceed costs by some modest amount, or did they actually believe that AS2's benefits would range from sixteen to eighty times greater than its expected costs? It follows that, unless regulators believed that AS2 would generate benefits enormously in excess of its projected costs—a proposition entirely unsupported by the record—the standard has sorely disappointed its drafters. AS2 may stand as one of the greatest failures of cost-benefit analysis in the history of the Securities and Exchange Commission.

The debate over Section 404's cost effectiveness is not limited to its first-year implementation costs.⁸ While Section 404 start-up costs were quite high and second-year compliance 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 404 compliance costs for smaller companies were \$900,000, or 39% less than first-year costs, and that second-year compliance costs for larger companies averaged \$4.3 million, or 42% less than first-year implementation costs.⁹ In contrast, a study by Financial Executives International found that “total average cost for Section 404 compliance . . . during fiscal year 2005 [was] down 16.3 percent from 2004,” and suggests that these reductions were only “about half of what were anticipated”¹⁰ and about half of the magnitude of the cost declines reported by the audit industry's sponsored study.

While news of reduced Section 404 compliance costs was no doubt welcome, the simple observation that costs have declined addresses neither the core cost-benefit question nor the cost-efficiency concerns raised by the

36,636, 36,657 (June 18, 2003) [hereinafter Management's Reports] (“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 Commission's cost analysis.

8. The actual cost-benefit calculus as it relates to Section 404 is more complicated than this simple ratio test suggests. Section 404 compliance involves large start-up costs and lower subsequent maintenance costs. Similarly, first-year benefits of Section 404 should also be greater than benefits generated in subsequent years. A complete cost-benefit analysis would consider the full lifecycle costs and benefits of the Section 404 rules and would discount those costs and benefits accordingly.

9. SARBANES-OXLEY SECTION 404 COSTS AND IMPLEMENTATION ISSUES, *supra* note 6, at 6–7.

10. *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*, PR NEWswire ASS'N, Apr. 6, 2006, <http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=104&STORY=/www/story/04-06-2006/0004335523&EDATE=>

Section 404 rules. In particular, just as first-year implementation costs would reasonably be expected to exceed second-year costs, first-year implementation benefits would also be expected to exceed second-year benefits.¹¹ The available surveys do not, however, quantify first- or second-year benefits in a form that supports any clear inference as to whether Section 404 is more or less cost effective in its second year than it was in its first.

Further, assuming that the audit industry's more aggressive estimates of cost declines are correct, these declines are from a very high base. The audit industry's estimate of second-year compliance costs for the average firm still runs about 9.5 times greater than the Commission's initial estimate for first-year costs. For larger firms, second-year compliance costs now run about fifty-two times the Commission's initial expectations. These data suggest that Section 404's second-year implementation costs remain quite inefficient in comparison with the SEC's initial expectations. Just as it is widely appreciated that "the first round of internal control audits cost too much,"¹² there is a high likelihood that the second round of internal control audits also cost too much. Absent fundamental reform, the third, fourth, and fifth rounds are also likely to cost too much, *ad infinitum*.¹³

How and why did such a gap arise between expected and actual costs? What, if anything, can be done to bring Section 404 costs more in line with the regulators' own initial expectations? Responding to both questions calls for a detailed examination of the substantive definitions of two terms at the core of the Section 404 rules—"significant deficiency" and "material weakness"—as well as a nuanced appreciation of the procedural environment in which these rules were initially adopted and the litigation environment in which they continue to be 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 Section 404 process. As explained in detail below, these definitions force auditors and registrants to expend a great deal of effort worrying about issues that are highly

11. The rationale underlying this proposition is straightforward. In the first year of Section 404 implementation, registrants would likely encounter and rectify their most serious control issues. The control deficiencies identified in subsequent years would be, in all likelihood, the more modest sorts of deficiencies that were not identified in earlier implementation cycles, and would likely generate lesser benefits. Thus, if costs in Section 404's second year of implementation were only half of first-year costs, but if benefits were only a quarter of first-year benefits, then Section 404's cost-benefit ratio for its second year of implementation could actually be twice as bad as it was in Section 404's first year of implementation.

12. PCAOB, *supra* note 5.

13. Although both the SEC and PCAOB rules are technically concerned with the defined term "internal control over financial reporting," for the sake of brevity this Article refers simply to "internal controls." As a technical matter, "internal control over financial reporting" comprises only that subset of internal controls addressed in the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") report which relates to financial reporting objectives. See Management's Reports, *supra* note 7, at 36,638-41.

unlikely ever to cause a material misstatement. More precisely, AS2 creates an incentive for auditors to examine processes that arise at the borderline of the remote and the inconsequential, processes that have an expected value impact as low as five one-hundredths of one percent of an issuer's net income. Indeed, the technical definitions of "significant deficiency" and "material weakness" produce a rather clear roadmap of how and why Section 404 compliance costs have mushroomed out of control, far beyond the Commission's initial aggregate \$1.2 billion estimate.¹⁴ Until these core definitions are amended to draw auditors' and registrants' attention out of the weeds and to force a focus on processes that are likely to have a material effect on a registrant's financial statements, the Section 404 process will continue to be unnecessarily wasteful.¹⁵

From a procedural perspective, the audit industry is subject to three distinct incentives to push Section 404 compliance to a point of socially inefficient hypervigilance. First, the audit industry has been broadly criticized for a rash of audit failures and restatements¹⁶ and does not want to be further criticized for failing to implement Section 404 with sufficient vigor. As a result, auditors are encouraged to interpret the rules' ambiguities in an expansive manner so as to require more heightened vigilance. Second, the litigation environment has a significant *in terrorem* effect, and auditors are subject to significant uninsurable litigation risk. Section 404 provides auditors the opportunity to externalize a portion of that risk by forcing audit 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 because of an audit failure. Third, auditors make money providing Section 404 audits to audit clients and selling Section 404 services to nonaudit clients. All else being equal, the more onerous the Section 404 compliance efforts, the more money the audit profession can earn.

None of this is intended to criticize the audit profession as being unique in any material respect. Indeed, the profession's conduct can be viewed as a rational response to the environment in which it operates, and many professions can be criticized on quite similar grounds. Physicians, for example, are

14. See *id.* at 36,657.

15. The history of the terms "significant deficiency" and "material weakness" is worthy of consideration. As discussed in greater detail below, both terms were contained in generally accepted auditing standards as they existed prior to enactment of the Sarbanes-Oxley Act, and nothing in the Act required the PCAOB to redefine those concepts. The PCAOB, however, decided that the two concepts should be revised to "promote increased consistency in evaluations." AS2, *supra* note 3, ¶ E78. In light of subsequent experience with the impact of the newly-adopted definitions, the PCAOB may determine that the usage of these terms should once again be modified in order to avoid undue cost and inappropriate attention to immaterial matters.

16. See, e.g., Floyd Norris, *Big Auditing Firm Gets 6-Month Ban on New Business*, N.Y. TIMES, Apr. 17, 2004, at A1; Larry Dignan, *After Andersen, accounting worries stick*, CNET NEWS.COM, June 17, 2002, http://news.com.com/After+Anderson%2C+accounting+worries+stick/2100-1017_3-936813.html; *Enron: Lessons from the External Auditors*, CAE BULL., Dec. 7, 2001, <http://www.theiaa.org/CAE/index.cfm?iid=211>.

often accused of practicing unnecessarily expensive defensive medicine because of the litigation environment in which they operate,¹⁷ and the audit profession's reaction to the Section 404 rules can be analogized to a financial form of defensive medicine. The natural "defensive medicine" forces set in place by Section 404 cannot, however, be constrained unless the PCAOB follows through with its recent public statements and restrains audit firms from pursuing overly aggressive Section 404 implementations, just as it penalizes them for inadequate attention to Section 404.

The SEC and PCAOB can best reduce the cost inefficiency currently embedded in the Section 404 compliance process through a fundamental redefinition of the key terms that are at the core of AS2 combined with a vigorous procedural inspection program designed to deter hypercompliance. This Article develops the argument as follows. Part I summarizes the short but complex historical evolution of Section 404 and its implementing regulations. Part II reviews a set of basic economic concepts relating to cost-benefit analysis that help explain how and why Section 404 has been pushed far beyond the point of economic rationality. Part III describes the issues raised by the core definitional provisions of AS2—"material weakness" and "significant deficiency"—and offers a "substantive fix" for these problems. Part IV describes the issues raised by audit firm incentives in implementing AS2 and offers a "procedural fix" for these problems. Part V expands on the particular problem faced by smaller issuers confronting the relatively high fixed costs imposed by Section 404. We conclude by offering observations about the viability of reforming AS2, including the possibility that it may be impossible to turn back the sands of time and refashion AS2 so that it generates benefits in excess of its costs. While regulators should do all they can in an effort to regain that balance, there is room for skepticism as to whether it can be achieved. If this skepticism proves correct, then Section 404 will be a permanent and unjustified burden on the capital formation process in the United States, and it will continue to impose unnecessary costs on issuers and shareholders alike.

Early versions of this Article were circulated broadly at the SEC and PCAOB. Subsequently, the SEC and PCAOB announced proposed amendments to AS2 that would implement all of this Article's central recommendations. We provide a postscript that describes these more recent developments and briefly discusses the extent to which these developments may in fact help resolve the inefficiencies generated by AS2.

I. THE HISTORY AND EVOLUTION OF SECTION 404

Section 404(a) of the Sarbanes-Oxley Act directed the SEC to promulgate rules requiring companies reporting under the Securities Exchange Act

17. See, e.g., Daniel Kessler & Mark McClellan, *Do Doctors Practice Defensive Medicine?*, 111 Q.J. ECON. 353 (1996); David M. Studdert et al., *Defensive Medicine Among High-Risk Specialist Physicians in a Volatile Malpractice Environment*, 293 J. AM. MED. ASS'N 2609 (2005).

of 1934, as amended (the “Exchange Act”), other than registered investment companies, to include in their annual reports

an internal control report, which shall—(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.¹⁸

Section 404(b) further required the company’s independent auditors to attest to and report on this management assessment. Under this directive, on June 5, 2003, the SEC adopted the basic rules implementing Section 404. These rules were designed to be phased in over several years based predominantly on the size of the issuer. Today, all but nonaccelerated filers are obliged to comply with the requirements of Section 404.¹⁹

On June 17, 2004, the SEC issued an order approving the PCAOB’s AS2.²⁰ This standard, titled “An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements,” established the requirements that apply to an independent auditor when performing an audit of a company’s internal controls.²¹ The rules adopted by the SEC require management to base its evaluation of the effectiveness of internal controls on a suitable, recognized control framework established by a body that has followed certain procedures, including distribution of the framework for public comment. While no particular framework is mandated, the SEC and PCAOB have specifically identified the internal control framework published by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) as suitable,²² and this framework has emerged as the dominant one applied by U.S. companies. The COSO framework identifies the components and objectives of internal control audits, but it does not contain general guidance as to the steps management must follow in assessing the effectiveness of such controls.

Since its well-intended adoption, the actual implementation of Section 404 by companies and their auditors has been characterized by significant cost overruns and intense criticism. For example, on July 6, 2006, SEC Commissioner Paul S. Atkins observed that Section 404 can serve to improve the quality of financial information, but acknowledged that it is also “cited as the law’s most costly provision because of the excessive way in

18. 15 U.S.C. § 7262 (Supp. IV 2004).

19. Nonaccelerated filers are generally defined to mean reporting issuers with an aggregate market value of common equity held by nonaffiliates of less than \$75 million. *Cf.* 17 C.F.R. § 240.12b-2 (2006).

20. Order Approving Proposed Auditing Standard No. 2, Exchange Act Release No. 49,884, 69 Fed. Reg. 35,083 (June 17, 2004).

21. *Id.*

22. AS2, *supra* note 3, ¶ 14.

which accountants and management have implemented it.”²³ And while the actual costs incurred far exceeded those anticipated for companies of all sizes, costs in relation to revenue have been disproportionately borne by smaller public companies.²⁴

The SEC took a number of preliminary steps designed to address the problems encountered during the first year of Section 404’s implementation. On March 23, 2005, the SEC chartered an Advisory Committee on Smaller Public Companies (the “Advisory Committee”) to assess the current regulatory system for such companies under the securities laws and to make recommendations for changes in a number of areas, including internal control assessments and audits.²⁵ On April 13, 2005, the SEC held a roundtable discussion concerning the implementation problems under Section 404. It responded to the feedback received from the roundtable by offering guidance in the form of a policy statement.²⁶ The policy statement included the following observations:

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

23. Paul S. Atkins, Commissioner, SEC, Remarks Before the International Corporate Governance Network 11th Annual Conference (July 6, 2006), <http://www.sec.gov/news/speech/2006/spch070606psa.htm>.

24. ADVISORY COMM’N ON SMALLER PUB. COS., SEC, FINAL REPORT OF THE ADVISORY COMMITTEE ON SMALLER PUBLIC COMPANIES TO THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 32–34 (2006), <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf> [hereinafter FINAL REPORT].

25. See Notice of establishment of the Advisory Committee on Smaller Public Companies, Securities Act Release No. 8514, Exchange Act Release No. 50,864, 69 Fed. Reg. 79,498 (Dec. 16, 2004); Notice of first meeting of SEC Advisory Committee on Smaller Public Companies, Securities Act Release No. 8560, Exchange Act Release No. 51,417, 70 Fed. Reg. 15,699 (Mar. 23, 2005).

26. Press Release, SEC, Commission Statement on Implementation of Internal Control Reporting Requirements (May 16, 2005), available at <http://www.sec.gov/news/press/2005-74.htm>.

27. *Id.*

- 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

Subsequently, 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 timeframe 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 why audits were not as efficient as the Board expects them to be” were the findings that “[s]ome 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 appeared 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 AS2 by observing that

[t]he 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 *not* require auditors to search for deficiencies other than material weaknesses. Further, the standard does not re-define materiality for the purposes of auditing internal control. . . . This means that the auditor should plan and perform the audit of internal control using the same 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 “[a]necdotal claims have suggested that some auditors applied a more stringent threshold to the evaluation of control deficiencies than the defini-

28. PCAOB, *supra* note 5.

29. PCAOB, RELEASE NO. 2005-023, 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 I (2005), available at http://www.pcaobus.org/Rules/Docket_014/2005-11-30_Release_2005-023.pdf [hereinafter PCAOB RELEASE NO. 2005-023].

30. *Id.*

31. *Id.* at 2–3.

32. *Id.* at 15–16 (citations omitted).

tions in Auditing Standard No. 2 require.”³³ More fundamentally, however, the November 30 report failed to confront the reality that AS2 states that a material weakness can arise as the consequence of the cumulative effect of a set of less significant deficiencies³⁴ and that the text of the standard itself therefore compels a search for control deficiencies that are, in and of themselves, submaterial.

The difference between the policy statements and reports issued by the SEC and PCAOB and the text of AS2 is quite striking in many respects. These statements and reports suggest a sensible approach to the audit of control systems in which auditors avoid processes that are unlikely to be material. In contrast, the text of AS2 is rife with language that, as a practical matter, requires audit procedures that test the boundaries of the inconsequential and remote.

Thus far, the additional regulatory guidance has appeared to do little to address the inefficiencies of a Section 404 audit. The perception that the initial regulatory releases and public statements have failed to improve the efficiency of Section 404 audits sets the stage for the later consideration of more significant measures, including the amendment of AS2 itself, as discussed below.

The Advisory Committee issued its Final Report to the SEC in April 2006 after thirteen months of fact finding and deliberation, including oral testimony from a wide variety of market participants and evaluation of hundreds of written comments. The Final Report contained thirty-three recommendations in the areas of capital formation, accounting, corporate governance, disclosure, and internal controls.³⁵ In its discussion of Section 404, the Advisory Committee highlighted the disproportionate costs imposed by AS2 on smaller public companies.³⁶ The Final Report recommended partial or complete exemptions from Section 404 requirements for smaller public companies under specified conditions, including enhanced corporate governance standards, “[u]nless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs.”³⁷

In April 2006, the Government Accountability Office issued a Report to the Senate Committee on Small Business and Entrepreneurship.³⁸ The Report recommended that in considering the concerns of the Advisory Committee, the SEC should assess the available guidance to determine if additional action were needed, noting that implementation and assessment

33. *Id.* at 16.

34. *See* AS2, *supra* note 3, ¶ 10.

35. For a discussion of the definition of smaller public company recommended by the Advisory Committee, see FINAL REPORT, *supra* note 24, at 14–19.

36. *Id.* at 32–35.

37. *Id.* at 43, 48.

38. U.S. GOV'T ACCOUNTABILITY OFFICE, SARBANES-OXLEY ACT: CONSIDERATION OF KEY PRINCIPLES NEEDED IN ADDRESSING IMPLEMENTATION FOR SMALLER PUBLIC COMPANIES 52–53 (2006).

efforts were largely driven by AS2.³⁹ The following month, in testimony before the House Committee on Small Business, Representative Nydia M. Velázquez highlighted the disproportionate burden of Section 404 on small firms, noting that compliance costs approach three percent of revenue for some companies and urging Section 404 relief for small companies.⁴⁰ In May 2006, Congressman Tom Feeney introduced the Compete Act to reduce the burdens associated with the implementation of Section 404.⁴¹ If adopted, the Compete Act would provide an exemption from auditors' internal control assessment requirements for smaller public companies along the lines recommended by the Advisory Committee. The Act would alter the standard for review in internal control audits from a remote likelihood standard to an objective *de minimus* standard of five percent of net profits. And the Act would direct the Commission and the PCAOB to promulgate specific guidelines for measuring the terms "reasonable," "significant," and "sufficient" in the context of internal control audits.

More recently, there has been a flurry of regulatory and other developments intended to address continued criticism regarding the inefficient implementation of Section 404. On May 1, 2006, the PCAOB released a statement announcing that a key area of emphasis in their 2006 inspections of accounting firms' internal control audits would be the efficiency of such audits, defined as whether the objectives of AS2 were being achieved with the least expenditure of effort and resources.⁴² Areas of focus include, among other matters, the degree to which internal control and financial statement audits were performed as a single, integrated process and whether a risk-based approach was used in formulating the audit.⁴³ A few weeks later, the PCAOB announced a four-point plan to improve the internal control audit process that, significantly, included possible amendments to AS2.⁴⁴ One amendment under consideration would "*clarify[]* the definitions of significant deficiency and material weakness in internal control."⁴⁵ These new developments are steps in the right direction. However, if, as we contend, key definitions in AS2 are so flawed as to make the pursuit of the objectives of the standard inherently inefficient, then the SEC and PCAOB must sub-

39. *Id.*

40. *Sarbanes-Oxley Section 404: What is the Proper Balance Between Investor Protection and Capital Formation for Small Public Companies?: Hearing Before the H. Comm. on Small Bus. Democrats*, 109th Cong. (2006), <http://www.house.gov/smbiz/democrats/Statements/2006/st050306.htm> (last visited Feb. 10, 2007) (statement of Rep. Nydia M. Velázquez, Ranking Democratic Member, House Comm. on Small Bus.).

41. Compete Act, H.R. 5405, 109th Cong. (2d Sess. 2006).

42. Press Release, PCAOB, Board Issues Statement Regarding 2006 Inspections (May 1, 2006), available at http://www.pcaobus.org/News_and_Events/News/2006/05-01a.aspx.

43. *Id.*

44. Press Release, PCAOB, Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements (May 17, 2006), available at http://www.pcaobus.org/News_and_Events/News/2006/05-17.aspx.

45. *Id.* (emphasis added).

stantively amend these definitions, rather than merely clarify them, in order to achieve their policy objectives. More specifically, the contemplated amendments must change the fundamental definitions in a way that eliminates the perceived need to test near the levels of remoteness and inconsequentiality.⁴⁶

Also in May 2006, the SEC announced further steps designed to improve the implementation of Section 404. These steps included the issuing of a concept release, discussed below, offering guidance concerning internal control assessments. To ensure that its guidance is helpful to smaller public companies, the Commission intends to make its guidance scalable, as recommended by the Advisory Committee.⁴⁷

The May 2006 announcement and other recent statements by SEC officials make clear that the Commission intends to address the Advisory Committee's recommendation by promulgating a more cost-effective standard rather than through an exemption for smaller public companies. While noting the forthcoming guidance from the SEC, the PCAOB, and COSO concerning Section 404, John White, director of the SEC's Division of Corporation Finance, stated in a speech on May 25, 2006, "that it looks as if the 'unless and until' condition suggested by the Advisory Committee [as an alternative to an exemption] will be met, and the Commission has indicated that it does not intend at this time to extend a permanent exemption to smaller companies."⁴⁸ Mr. White also commented on the need to amend AS2: "After the second [Section 404] Roundtable earlier this month, and consideration of extensive public comments, the Commission and the PCAOB now agree that the PCAOB should amend AS 2 [*sic*], in part to fully reflect the earlier guidance in the standard itself."⁴⁹

On May 16, 2006, COSO released a response to the recommendations of the SEC Advisory Committee suggesting that forthcoming guidance would address the Committee's concerns regarding the inefficiency and lack of

46. For an argument supporting a change in definitions such as that suggested in the Compete Act, see Pollock, *supra* note 4 ("In an essential reform, the Compete Act would direct the SEC and PCAOB to change the audit review standard from 'other than a remote likelihood,' which has caused Sarbanes-Oxley to be everywhere associated with nitpicking and trivial paperwork, to a reasonable 'material weakness' criterion.").

47. Press Release, SEC, SEC Announces Next Steps for Sarbanes-Oxley Implementation (May 17, 2006), available at <http://www.sec.gov/news/press/2006/2006-75.htm>. As foretold by that announcement, the SEC recently postponed Section 404 implementation again for nonaccelerated filers from fiscal years ending on or after July 15, 2007, to fiscal years ending on or after December 15, 2007, with respect to the management assessment; and to fiscal years ending on or after December 15, 2008, with respect to the outside auditor attestation. Press Release, SEC, Further Relief from the Section 404 Requirements for Smaller Companies and Newly Public Companies (Dec. 15, 2006), available at <http://www.iasplus.com/usa/0612sox404sme.pdf>.

48. John W. White, Dir., Div. of Corp. Fin., SEC, Remarks Before the SEC Institute 21st Annual Mid-Year SEC Reporting Forum: Section 404: The Need for Input (May 25, 2006), <http://www.sec.gov/news/speech/2006/spch052506jww.htm>.

49. *Id.*

scalability of current guidance.⁵⁰ The additional COSO guidance was issued in June 2006.⁵¹ While the COSO response is helpful in providing general guidance for smaller public companies in applying the COSO framework, it does not address the root cause of the inefficiencies experienced in implementing Section 404.

The SEC issued its Section 404 concept release on July 11, 2006.⁵² The concept release was intended as a prelude to forthcoming guidance designed to improve the implementation of Section 404⁵³ and defined the general areas likely to be addressed in the course of Section 404 reform, including the use of company-level controls to address risk within an organization, improvement of evaluation procedures, and clarification of documentation requirements. In the press release accompanying the concept release, the SEC's then-acting Chief Accountant, Scott Taub, noted: "The guidance we issue should help companies further improve and streamline their processes for assessing the effectiveness of internal controls. We intend for the guidance to be flexible and scalable, such that it will assist companies of all sizes."⁵⁴ The press release also reiterated the SEC's intention to work with the PCAOB to amend AS2. The concept release discussed this intention further: "[B]ased on feedback received, a number of the implementation issues arose from an overly conservative application of the Commission rules and AS No [sic] 2, and the requirements of AS No. 2 itself, as well as questions regarding the appropriate role of the auditor."⁵⁵

In the concept release, the SEC further expressed the belief that additional guidance following the comment period and revisions to AS2 "may help reduce or eliminate the excessive testing of internal controls by improving the focus on risk and better use of entity-level controls."⁵⁶ Although the concept release did not provide detail on how AS2 might be amended, Question 25 requested public comment on whether guidance would be helpful regarding the definitions of the terms "material weakness" and "significant deficiency."⁵⁷ This Article answers that question in the affirmative but argues that mere guidance will not resolve the inherent inefficiencies resident in the core definitions themselves. More serious surgery is required to accomplish the objective of improving the implementation of Section 404, and the terms

50. See Letter from Larry E. Rittenberg, Chairman, Comm. of Sponsoring Org. of the Treadway Comm'n, to Christopher Cox, Chairman, SEC, & John White, Dir., Div. of Corp. Fin., SEC (May 16, 2006).

51. COMM. OF SPONSORING ORG. OF THE TREADWAY COMM'N, INTERNAL CONTROL OVER FINANCIAL REPORTING—GUIDANCE FOR SMALLER PUBLIC COMPANIES (2006).

52. Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, Exchange Act Release No. 54,122, 71 Fed. Reg. 40,866 (July 11, 2006) [hereinafter Concept Release].

53. Press Release, SEC, SEC Moves Forward on Sarbanes-Oxley 404 Improvements (July 11, 2006), available at <http://www.sec.gov/news/press/2006/2006-112.htm>.

54. *Id.*

55. See Concept Release, *supra* note 52, at 9.

56. *Id.* at 22.

57. *Id.* at 23.

“material weakness” and “significant deficiency” must be dramatically redefined if the Section 404 process is to have any chance of being reengineered to strike a reasonable cost-benefit balance.

The nation’s two major trading markets have also commented on the harm caused by an overly conservative implementation of Section 404. Robert Greifeld, president and CEO of NASDAQ, has written that the “constant refrain I hear [from international entrepreneurs] is that when it comes time to do an IPO, they will be reluctant to list on American markets,” due in large part to Sarbanes-Oxley.⁵⁸ Greifeld has also noted that “[o]ur research has shown that the burden on small companies [from Sarbanes-Oxley], on a percentage of revenue basis, is 11 times that of large companies.”⁵⁹ According to a New York Stock Exchange working group, “[c]urrent implementation of SOX 404 is putting the US capital markets at a competitive disadvantage as the largest capital raising activities are taking place outside the United States due to cumbersome and costly regulations.”⁶⁰ The working group identified the definitions in AS2 as one of the culprits: “The current definition regarding ‘reasonable assurance’ in Accounting Standard No. 2 with the focus on ‘remote likelihood’ is causing auditors to test controls at the lowest of levels with no real benefit being derived.”⁶¹

II. BASIC COST-BENEFIT ANALYSIS

The problems generated by AS2 are readily illustrated by reference to classic cost-benefit analysis. Assume that it is possible to rank order all audit control procedures from most valuable to least valuable—where value is measured in terms of the marginal benefit generated by that control process—and that controls are in fact implemented in sequence from most valuable to least valuable.⁶² “Top-down” planning for control audits, a process that is now strongly advocated by the Commission and the PCAOB, should naturally generate sequences of this sort.⁶³ Assume also that the costs of each of these audit processes can be normalized so that each control is

58. Bob Greifeld, *It's Time To Pull Up Our SOX*, WALL ST. J., Mar. 6, 2006, at A14.

59. *Id.*

60. NYSE Working Group, *Observations and Recommendations to Improve SOX 404*, <http://www.nyse.com/pdfs/RecommendationstoImproveSOX404.pdf>.

61. *Id.*

62. Marginal costs and benefits are measured here from a social perspective, that is, the extent to which the control generates costs and benefits to shareholders and all other stakeholders in the process. By defining costs and benefits in terms of social cost and benefit, the analysis includes effects on constituencies other than the corporation and its shareholders, such as employees who might become unemployed or auditors who might suffer financial losses in the event of a controls-related financial failure.

63. See, e.g., Press Release, SEC, Commission Statement on Implementation of Internal Control Reporting Requirements (May 16, 2005), available at <http://www.sec.gov/news/press/2005-74.htm>; PCAOB, RELEASE NO. 2005-009, POLICY STATEMENT REGARDING IMPLEMENTATION OF AUDITING STANDARD NO. 2, AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS, 2, 8–9 (2005), available at http://www.pcaob.com/Rules/Docket_008/2005-05-16_Release_2005-009.pdf.

composed of a certain number of “control equivalents,” each of which has a constant dollar cost.⁶⁴ The costs generated by the 404 process would then be linear in the number of “control equivalents” implemented through an audit process. By construction, it follows that a graph describing the total benefits generated by the Section 404 process, where controls are implemented in a sequence of declining marginal returns, will show diminishing marginal returns to the number of controls implemented because the control with the greatest marginal benefits will be the first to be implemented. It also follows that a graph describing the costs generated by the Section 404 process will be linear in the number of control equivalents because the total cost of implementing any number of “control equivalents” is a constant function of the number of “control equivalents” being implemented.

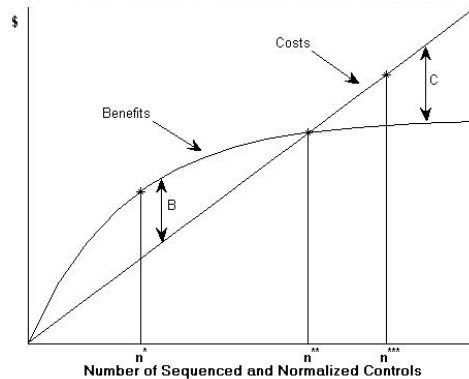
Figure 1 describes just such a set of hypothetical costs and benefits for Section 404 and AS2.⁶⁵ Basic economics teaches that the auditors and the registrant should only implement controls that fall to the left of the point n^* in Figure 1, that is, the point at which the marginal benefit of implementing a control equals its marginal cost.⁶⁶ By construction, every control to the left of this point generates marginal benefits greater than the marginal cost of implementing that control, and every control to the right of this point generates marginal costs that exceed the marginal benefits of implementing that control. The optimal implementation of a Section 404 process would cause controls to be implemented to the point n^* , but no further. Total social benefits of the 404 process at the point n^* are represented by the distance B in Figure 1.

64. For example, if the most valuable control is five times more expensive than the average control, then that control could be described as generating costs equal to five “control equivalents.” A control that is only a tenth as expensive to implement would then be described as generating a tenth of an average “control equivalent.”

65. For a similar graph see W. KIP VISCUSI, JOHN M. VERNON & JOSEPH E. HARRINGTON, JR., *ECONOMICS OF REGULATION AND ANTITRUST* 30 (3d ed. 2000).

66. *See id.* at 29.

FIGURE I
ILLUSTRATIVE COST-BENEFIT PROFILE
FOR SECTION 404 CONTROLS



If the audit process continues to force controls beyond the point n^* , then the marginal cost of implementing each of those controls is, by construction, larger than the marginal benefit generated by those controls. As a consequence, the total social benefit generated by the process will gradually diminish until the number of controls implemented equals the point n^{**} , where the aggregate benefits generated by the Section 404 process will equal its costs. While many commentators argue over whether Section 404 costs exceed benefits, Figure 1 makes clear that if society actually implements Section 404 regulations to the point where the regulations' total costs equal their total benefits, then society *will have already overinvested in the control process* by adopting controls that exceed the optimal arrangement at the point n^* . Simply phrasing the debate over Section 404 in terms of whether its aggregate costs exceed its aggregate benefits biases the outcome toward overinvestment in the Section 404 process.

If auditors have an incentive to force clients to adopt control processes that generate very low levels of marginal benefit, then they may force clients to adopt controls to a point such as n^{***} , where the marginal benefit of the control to the auditor is close to zero. It is only at the point n^{**} that the Section 404 process ceases to generate additional benefits for auditors in terms of potential litigation risk reduction in a manner arguably consistent with the text of AS2. But at that point, the total cost of the Section 404 process exceeds its benefits by the amount C , and society would be involved in a massive overinvestment in internal control processes.

Figure 1 helps illustrate and explain four basic points about the Section 404 debate. First, Figure 1 focuses on a simple economic rule that has been all but forgotten in the *sturm und drang* over implementing Section 404. The Commission and the PCAOB should focus on ensuring that the Section 404 process only implements controls up to the point n^* . However, as we are about to demonstrate, the wording of AS2 and the incentives built into the audit process effectively guarantee that the process will be pushed beyond this point of optimality, possibly even toward a point approaching n^{***} .

Second, while it is entirely understandable that much of the debate has been framed in terms of the total costs and benefits generated by Section 404 and AS2, to conduct the debate on these terms is essentially to concede that the process is already suboptimal because total costs may not equal total benefits until the number of controls implemented exceeds the point at which marginal cost equals marginal benefit.

Third, because the audit profession largely decides the number of controls to be audited, and because the audit profession can apply its own private calculus to the computation of marginal costs and benefits, the audit profession has the ability to drive the number of controls to a point where the private marginal benefits to the profession equal the private marginal costs to the profession. This point can be far beyond the point at which social marginal costs equal social marginal benefits, or even the point at which total social costs equal total social benefits.

Fourth, as the Commission's chairman has recently noted, there is much room for improvement at the Commission in the application of cost-benefit analysis to the rulemaking process.⁶⁷ The challenges encountered with Section 404 may serve as an excellent starting point for self-analysis by the Commission and by the PCAOB as to how both agencies might improve their application of cost-benefit principles to the audit process.

III. THE SUBSTANTIVE FIX

While the goal of the Section 404 process is to obtain reasonable assurance that no material weaknesses exist as of the date of management's assessment, the definitions applied by AS2 require, as a practical matter, that auditors also assess the presence of "significant deficiencies." AS2 asserts that a combination of significant deficiencies can constitute a material weakness. An auditor therefore cannot reasonably conclude that no material weaknesses are present unless the auditor has also searched for significant deficiencies and evaluated those significant deficiencies to determine whether, when aggregated, they constitute a material weakness. Identifying and assessing significant deficiencies, in turn, requires that auditors identify and assess myriad control deficiencies that do not individually constitute significant deficiencies. The result is a cascade downward from the material, through matters that are merely "more than inconsequential," to matters that do not even reach the threshold of inconsequentiality, all in an overzealous effort to identify controls that might, in fact, be material.

The rules thus have an embedded incentive that drives 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.⁶⁸ Further, given the standards that are commonly applied by the audit profession, it is not unreasonable to approximate

67. See Christopher Cox, Chairman, SEC, Remarks Before the Securities Industry Association (Nov. 11, 2005), <http://www.sec.gov/news/speech/spch111105cc.htm>.

68. See *supra* notes 26–31 and accompanying text.

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 a company’s net profits (or of any other quantitative performance measure). We do not suggest that every Section 404 audit has actually pursued the search for significant deficiencies that reside at these extreme borders of remoteness and inconsequentiality. We merely observe that this incentive is deeply embedded in the very definitions at the core of AS2. Unless and until these definitions are changed or AS2 is otherwise amended or superceded, the root problem that drives and legitimizes the process’ inefficiencies is not likely to be fixed.

A. A Precise Definition of the Problem

Auditors must issue adverse opinions if they identify material weaknesses.⁶⁹ AS2 requires auditors to search for material weaknesses, which, as a practical matter, requires that they search for significant deficiencies and, below that threshold, control deficiencies generally.

A *significant deficiency* is defined as

a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, 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.⁷⁰

The definition includes a note clarifying that “[a] misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements.”⁷¹ The import of this language is difficult to overstate. The note expressly explains that unless the auditor can reasonably reach the affirmative conclusion that the potentially *aggregated* misstatements, including the possibility of further undetected misstatements, would *clearly* be immaterial, then a significant deficiency must be found whenever the likelihood is greater than remote. This is, of course, in many instances a difficult conclusion to reach, and experience has shown that this standard can lead to the identification of vast numbers of significant deficiencies.

A *material weakness* is defined as “a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.”⁷² Here again, because material weak-

69. See AS2, *supra* note 3, ¶ 175.

70. *Id.* ¶ 9.

71. *Id.*

72. *Id.* ¶ 10.

nesses can arise through the aggregation of significant deficiencies, auditors must inquire not only at the high level of presumptive materiality but well down into the weeds to ascertain which combination of significant deficiencies might aggregate to have a material effect.

The usage of these terms in the promulgation of AS2 is striking when compared with their usage in generally accepted auditing standards as they existed prior to enactment of the Sarbanes-Oxley Act. AU Section 325 of the American Institute of Certified Public Accountants' Professional Standards ("AU 325"), "Communication of Internal Control Related Matters Noted in an Audit," provided guidance in identifying and reporting conditions relating to an entity's internal controls observed during an audit of financial statements.⁷³ AU 325 employed the concepts of "reportable conditions" and "material weaknesses." Reportable conditions were broadly defined as

matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent *significant deficiencies* in the design or operation of internal control, which could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.⁷⁴

A material weakness was defined as

a reportable condition in which the design or operation of one or more of the internal control components does not reduce *to a relatively low level* the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.⁷⁵

Under the preexisting standards, "reportable conditions" were deficiencies judged by the auditor, in its experience and discretion, to be worthy of reporting to the audit committee, rather than deficiencies that cross the hair-trigger threshold of "more than remote and . . . more than inconsequential," as per the new AS2 concept. Likewise, the preexisting standards set the likelihood threshold for the presence of a material weakness at a "relatively low level," rather than at the more stringent AS2 threshold of "more than remote." AS2 thus introduced a major innovation through its definitional shift away from preexisting auditing standards. Congress did not require this innovation in the Sarbanes-Oxley Act.

The quantitative implications of these definitions also bear close consideration. The audit profession has further clarified the term "inconsequential" as used in AS2's definition of significant deficiency as relating to "[p]otential misstatements equal to or greater than 20% of overall annual or

73. AM. INST. OF CERTIFIED PUB. ACCOUNTANTS, CODIFICATION OF STATEMENTS ON AUDITING STANDARDS (INCLUDING STATEMENTS ON STANDARDS FOR ATTESTATION ENGAGEMENTS) AU § 325 (2001).

74. *Id.* AU § 325.02 (emphasis added).

75. *Id.* AU § 325.15 (emphasis added).

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 AS 2.”⁷⁶

Therefore, if one begins with the common assumption that a 5% change in net income⁷⁷ or in some other quantifiable accounting measure is material, 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 may be 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 “remote likelihood” is defined to have “the same meaning as the term ‘remote’ as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (‘FAS No. 5’).”⁷⁸ Paragraph 3 of FAS No. 5 explains:

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 events [*sic*] or events occurring is slight.⁷⁹

An event is therefore “‘more than remote’ when it is either reasonably possible or probable.”⁸⁰

The PCAOB has expressly stated that

the terms “probable,” “reasonably possible,” and “remote,” should not be understood to provide for specific quantitative thresholds. Proper application of these terms involves a qualitative assessment of probability.

76. A FRAMEWORK FOR EVALUATING CONTROL EXCEPTIONS AND DEFICIENCIES 15 (2004), available at http://www.deloitte.com/dtt/cda/doc/content/us_assur_Framework-Version3%281%29.pdf (version 3).

77. Studies suggest “widespread use of a ‘rule of thumb’ of five to ten percent of net income” as an objective measure of materiality. SEC Staff Accounting Bulletin No. 99, 64 Fed. Reg. 45,150, 45,152 (1999), available at <http://www.sec.gov/interps/account/sab99.htm> (citing FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING CONCEPTS NO. 2: QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION ¶ 167 (1980), available at <http://www.fasb.org/pdf/con2.pdf>). However, SAB 99 rejects exclusive reliance on a quantitative test for determining materiality.

78. AS2, *supra* note 3, ¶ 9.

79. *Id.* (quoting ACCOUNTING FOR CONTINGENCIES, Statement of Financial Accounting Standards No. 5, ¶ 3 (Fin. Accounting Standards Bd. 1975)).

80. *Id.*

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.⁸¹

We put aside for the moment the unassailable fact that probabilities are mathematical constructs and must therefore correspond to some quantitative value or range of values. Due to the absence of quantitative guidance, people will implicitly assign different quantitative values to the phrases “reasonably possible” or “remote” or, alternatively, reduce the analysis to the vagaries of subjective feelings. This variability adds to the difficulties generated by the definitions at the core of AS2.

These definitions inescapably imply that, in order to determine whether a company’s controls suffer from significant deficiencies, auditors are required as a practical matter to evaluate a broad spectrum of controls, all the way down to the border 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) raise a less than remote likelihood of an inconsequential misstatement. Because it will often be impossible for auditors to know, *ex ante*, on which side of that border any particular control or combination of controls might fall, this process can easily require the evaluation of many controls that are ultimately determined to fall below either the remoteness or inconsequentiality thresholds. If we then import into this analysis the prior observation that the borderline between consequentiality and inconsequentiality is no more than 1% of net profit (or of any other objective accounting measure), then auditors must search for controls near the border between (a) those that raise a more than remote likelihood of an immaterial—but more than 1%—misstatement of the company’s financials, and (b) those that raise a less than remote likelihood of a 1% misstatement.

Further, if we assume for sake of argument only, and clearly against the PCAOB’s direct instructions, that a probability of 5% or less would constitute a less than remote probability, then the preceding articulation of the definition of significant deficiencies implies that auditors have cause to search for any 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 only five-hundredths of 1% of net profits, or of any other objective line-item accounting standard that might be selected. This is, by any standard, a low threshold of sensitivity for triggering an audit requirement.

At this point, the game is immediately lost and 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 would be more or less than inconsequential (say 1%), unless the auditor dives deeply into the weeds in search of the elusive border that distinguishes “more than remote events

81. PCAOB RELEASE No. 2005-023, *supra* note 29.

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 AS2 will relate to a process by which auditors are either obligated or encouraged to search for low-probability, low-magnitude events with which they probably should not be concerned in the first instance. Absent such reform, it becomes inevitable that the Section 404 audit exercise will generate 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 former SEC Commissioner Glassman observed, the idea of a company having 40,000 “key controls” is an oxymoron, and a “check the box” exercise for Section 404 compliance is “inefficient and ineffective.”⁸² Yet that result appears to be an inescapable consequence of the definitions inherent in AS2.

Several additional features of the rule compound the problems caused by AS2’s approach to materiality. Bob Pozen underscored three of these features in a *Wall Street Journal* article.⁸³ First, Pozen observed 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.”⁸⁴ Internal controls must therefore provide assurances that “receipts and expenditures of the company are being made only in accordance with authorization of management and directors of the company.”⁸⁵ The result, as Pozen observes, is that “[b]y unlinking ‘internal controls’ from ‘financial reporting’ in Section 404, the SEC encourages management and auditors to scrutinize detailed procedures for controlling ordinary expenditures . . . even in cases where they are clearly immaterial to the company’s financial reports.”⁸⁶

Pozen also observes that AS2 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.”⁸⁷ 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.”⁸⁸

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

83. Robert C. Pozen, *Why Sweat the Small Stuff?*, *WALL ST. J.*, Apr. 5, 2006, at A20.

84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.*

Finally, Pozen observes that AS2 states that “[t]here 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.”⁸⁹ This aspect of AS2 forces redundancy in the testing process because “[m]anagement must test all of the company’s internal controls” but the auditors can rely on management’s testing “only for less important areas of internal controls.”⁹⁰

Taken together, Pozen’s observations suggest that the text of AS2 contains provisions that amplify the rules’ tendency to force a focus on obscure and immaterial process controls and provide a rationale for applying insufficient processes to audit those controls. This is hardly a recipe for a cost-efficient regulatory process.

B. A Proposed Solution

The problem generated by the rules’ incentive to search for low-probability/low-magnitude events can be addressed by amending AS2 so that auditors are required to test only for material weaknesses and not for significant deficiencies. The definition of a “material weakness” should be restated as a weakness that creates a likelihood that a material misstatement will not be prevented or detected at a probability threshold that is meaningfully greater than “remote”—for example, to return to the terminology of AU 325, where there is more than a relatively low level of risk of material misstatement of the financial statements. If, and to the extent that, AS2 maintains the concept that the aggregation of significant deficiencies can lead to the existence of a material weakness, then a revision to the likelihood threshold for material weaknesses should also be combined with a restatement of the definition of the term “significant deficiency.” A significant deficiency should then be understood as a control deficiency that creates a likelihood that a misstatement will not be prevented or detected at a probability threshold that is meaningfully more than “remote” and with a magnitude meaningfully greater than inconsequentiality. The various policy statements and other exhortations by the Commission and PCAOB are insufficient as long as the rules themselves are 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 deficiencies while still pursuing inquiries that would catch reasonably possible material failures. This is an entirely rational point at which to begin the inquiry into the adequacy of controls.

89. *Id.*

90. *Id.*

The controls that would no longer be subject to audit under this modified standard are those where the risk of a material misstatement falls beneath a relatively low level. Expenditures on these low-likelihood, sub-material controls can be a significant contributing factor to Section 404 compliance costs. By eliminating the need to address these 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 redefinition 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.⁹¹

IV. THE PROCEDURAL FIX

A. 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 in a manner similar to that which would be followed by other professions subject to analogous economic and social forces, has a powerful incentive to force their clients to overinvest in Section 404 compliance. Three 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.⁹² Section 404 requirements create a new set of audit-related demands that can form the basis for further criticism and additional liability if the audit industry proves too lax in compliance. The easiest way for the industry 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 as requiring the investment of additional resources by audit clients.

Second, the new federal enforcement climate and the threat of class action securities fraud litigation create great personal and financial risk for the profession. A large portion of this financial risk is uninsurable. It is reasonable for auditors to calculate that requiring clients to purchase additional Section 404 control processes can reduce the 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 point to as consistent with Section 404's ambiguous requirements. These processes can reduce auditors' litigation exposure but can be hugely wasteful to society.

91. See *supra* note 32 and accompanying text.

92. See *supra* note 16 and accompanying text.

Third, Section 404 can act as a profit center for the audit industry. 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.⁹³ To the extent that the audit profession can also increase its profitability by adopting an expansive view of Section 404's requirements, it would ignore human nature to suggest that these incentives are irrelevant to the profession's actual conduct.

In addition to these three incentives, a fourth factor must also be considered in crafting an effective solution to the Section 404 implementation problem: the inertia of established practices and policies that have evolved as part of the integrated audit. AS2 encourages integration of the financial statement audit and the internal control audit.⁹⁴ In an integrated audit, the auditor designs and executes procedures that accomplish the objectives of both audits.⁹⁵ According to the PCAOB, most auditors were unable to integrate their first-year audits under AS2, due largely to timing constraints.⁹⁶ Because of the PCAOB inspection process and client pressure to reduce costs, the trend towards the integrated audit has continued to gain momentum, and there is evidence to suggest that such integration may be partially responsible for the decline in second-year costs.⁹⁷ Although integration of the two audits is intended to enhance process efficiency, integration also raises the possibility that the level of review currently required under AS2 has been "hard-wired" into existing processes. If so, it may be very difficult to reduce Section 404 compliance costs through amendments to AS2 because AS2 will no longer apply to a discrete component of the audit process and the entire integrated audit process will have to be reworked in order to achieve the necessary efficiencies. The inefficiencies propounded by Section 404's early implementation may already be so well entrenched in the integrated audit process that there is little meaningful hope that an amendment of AS2, no matter how well crafted, can return the system to a point where the marginal costs of compliance equal the marginal benefits.

B. 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 overinvest in Section 404 compliance efforts. The PCAOB should not only

93. See, e.g., Amy Gunderson, *Can't Find an Accountant?*, INC., Aug. 2005, at 19; Mark Jaffe, *Sarbanes-Oxley a Boon for Auditors*, N.Y. SUN, Nov. 5, 2004, available at <http://www.nysun.com/article/4372>; Thomas E. Hartman, *The Cost of Being Public in the Era of Sarbanes-Oxley* (June 16, 2005), http://www.fei.org/download/foley_6_16_2005.pdf.

94. PCAOB, *supra* note 5.

95. See PCAOB RELEASE NO. 2005-023, *supra* note 29.

96. *Id.* at 8.

97. See SEC, Roundtable Discussion of Second-Year Experience with Internal Control Reporting and Auditing Provision (May 10, 2006) (transcript available at <http://www.sec.gov/spotlight/soxcomp/soxcomp-transcript.txt>).

inspect firms for the possibility that they have failed to be sufficiently diligent in reviewing Section 404 compliance, but it should also investigate whether the firms, in their dealings with audit and nonaudit clients, have recommended procedures that were not reasonably necessary to comply with Section 404. As noted earlier, the PCAOB has recently stated that it will emphasize efficiency in connection with its 2006 inspections.⁹⁸ However, the PCAOB's ability to deter inefficient Section 404 audits will be constrained until the core definitions that shape Section 404 audits are substantively amended. Under the current scheme, which rationalizes the search for processes at the edge that might have a remote possibility of having an inconsequential effect on the financial statements, it will be difficult to criticize an auditor for suggesting almost any level of process review.

It follows that the recommended procedural reform, which will require aggressive inspection of audit firms for evidence of overly intrusive Section 404 procedures, cannot be cleanly separated from the recommended substantive reform, which will require a redefinition of the term "material weakness" to encompass only those weaknesses that create more than a relatively low level of risk that a material misstatement will not be prevented or detected. Again, the PCAOB and the SEC can, without any Congressional action, implement these amendments. We recognize that there is reason to question whether the PCAOB can successfully strike the difficult balance between its primary mission of ensuring that auditors are sufficiently aggressive when auditing clients and its newly articulated goal of preventing overzealous application of Section 404 requirements.

An additional procedural fix would be to amend AS2 to increase auditors' ability to place reasonable reliance on the work of others, in particular on the work of a registrant's internal audit function. As currently written, AS2 provides that "when the auditor uses the work of others, the auditor is responsible for the results of their work."⁹⁹ Without incorporating the concept of reasonable reliance, this is in effect a strict liability standard—if the other party got it wrong, the auditor pays.¹⁰⁰ Under those circumstances, it is little wonder that auditing firms are reluctant to use the work of others. A more balanced and appropriate allocation of responsibility would provide protection for the auditors as long as their reliance on the work of others was reasonable under the circumstances.

98. See *supra* notes 42–43 and accompanying text.

99. AS2, *supra* note 3, ¶ 111.

100. Other passages from AS2 that might similarly tend to have an inhibitory effect on auditors' willingness to rely on the work of others are ¶ 122, which speaks only of "using the work of internal auditors to a limited degree," *id.* ¶ 122, and ¶ 126, which, as to information technology general controls, speaks only of using "the work of others to a moderate extent" and only "so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level." *Id.* ¶ 126.

V. THE SMALL COMPANY PROBLEM

The foregoing suggestions have been made without regard to the size of the issuer. Nevertheless, it is widely recognized that Section 404 imposes significant fixed costs and that these fixed costs impose particular burdens on smaller publicly traded issuers.¹⁰¹ The Advisory Committee has described these burdens as follows:

[B]ecause of their different operating structures, smaller public companies have felt the effects of Section 404 in a manner different from their larger counterparts. With more limited resources, fewer internal personnel and less revenue with which to offset both implementation costs and the disproportionate fixed costs of Section 404 compliance, these companies have been disproportionately subject to the burdens associated with Section 404 compliance. Moreover, the benefits of documenting, testing and certifying the adequacy of internal controls, while of obvious importance for large multinational corporations, are of less certain value for smaller public companies, who rely to a greater degree on “tone at the top” and high-level monitoring controls, which may be undocumented and untested, to facilitate accurate financial reporting. The result is a cost/benefit equation that, many believe, diminishes shareholder value, makes smaller public companies less attractive as investment opportunities and impedes their ability to compete.¹⁰²

As discussed previously, the disproportionate costs incurred by smaller public companies prompted the Advisory Committee to call for a size-based exemption from Section 404 requirements unless and until a more scalable, cost-effective framework is developed.¹⁰³ In opposition to suggestions to exempt certain classes of issuers from Section 404, critics contend that a disproportionate percentage of enforcement actions and restatements are generated by smaller public issuers.¹⁰⁴ The call for a size-based exemption has also stoked a debate over whether the Commission has the legal authority to adopt such an exemption.¹⁰⁵

The small company problem is 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 Section 404 compliance cost problem for smaller issuers would be ameliorated but not eliminated. Even assuming that a perfectly crafted set of Section 404 rules of general applica-

101. See FINAL REPORT, *supra* note 24, at 32–35.

102. *Id.* at 23–24.

103. See *id.* at 32–34.

104. See, e.g., Michael Rapoport, *Outside Audit: SEC Panel to Turn In Report on Sarbanes Debate*, WALL ST. J., Apr. 17, 2006, at C3 (quoting Damon Silvers, associate general counsel of the AFL-CIO, stating, “The exemption from [the Section 404] rules would create a kind of free-fire zone on investors”).

105. For a summary of this debate, see, for example, *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).

bility can be developed, the smaller company will still face a very substantial fixed cost compliance component that can render compliance uneconomical. This fixed cost component of the public company audit is far higher today than it was before Section 404's adoption.¹⁰⁶

Further, the Section 404 problem is only part 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 Sarbanes-Oxley's other provisions, additional regulations adopted by the Commission, tighter listing standards implemented by the exchanges, and heightened legal and accounting costs.¹⁰⁷ The stock market analyst settlement has also constrained the benefits of being a publicly traded firm because the settlement makes it more difficult for smaller companies to obtain analyst coverage.¹⁰⁸

The result of this sudden and significant increase in compliance costs and reduction in analyst coverage is twofold. First, one cadre of smaller firms rationally entered the public markets at a time when compliance costs were lower and, given today's cost and risk environment, would rationally decide not to be publicly traded for a multitude of reasons separate and distinct from Section 404.¹⁰⁹ Second, the probability that a new start-up firm will be able to go public successfully is materially lower today than in the past because the minimum scale required of a new start-up has increased significantly.¹¹⁰ As a consequence, venture capitalists and other backers of private, start-up firms should expect fewer liquidity events through initial public offerings and lower rates of return from entrepreneurial investing activities than they would otherwise observe.

Three potential solutions to the small company problem are available. The first is to provide already-public companies with an efficient means of delisting from the public markets as recommended by the Advisory Committee.¹¹¹ 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 eliminate 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

106. See, e.g., Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies, Securities Act Release No. 8666, Exchange Act Release No. 53,385, 71 Fed. Reg. 11,090 (Feb. 28, 2006); Amy Feldman, *Surviving Sarbanes-Oxley*, INC., Sept. 2005, at 132; Gunder-son, *supra* note 93; Jaffe, *supra* note 93; Deborah Solomon, *Corporate Governance (A Special Report)*; *At What Price? Critics say the cost of complying with Sarbanes-Oxley is a lot higher than it should be*, WALL ST. J., Oct. 17, 2005, at R3; FIN. EXECUTIVES INT'L, FEI SPECIAL SURVEY ON SARBANES-OXLEY SECTION 404 IMPLEMENTATION EXECUTIVE SUMMARY (2004), available at <http://www.404institute.com/docs/SOXSurveyJuly.pdf>; Hartman, *supra* note 93.

107. For a detailed examination of many of these factors, see Carney, *supra* note 4.

108. See FINAL REPORT, *supra* note 24, at 72 (recommending adoption of policies that encourage and promote the dissemination of research on smaller public companies).

109. *Id.*

110. See, e.g., Rebecca Buckman & Kara Scannell, *Venture Capital: Do U.S. Regulations Drive Away Start-Ups?*; *Sarbanes-Oxley Deters IPOs, Say Venture Capitalists, Who Seek Changes in Law*, WALL ST. J., Apr. 27, 2006, at C5.

111. See FINAL REPORT, *supra* note 24, at 91.

are typically acquired by a privately held entity or control group 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, terminates its reporting obligations under the Exchange Act, 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.”¹¹² One approach to this problem would be a regulatory initiative designed to facilitate going private or going dark transitions by companies that have been caught in this regulatory phase shift combined with an initiative designed to improve the functioning of the pink sheet markets.

Foreign issuers face challenges that are quite similar to those faced by smaller public issuers. The Commission recently repropose a rule to facilitate termination of Exchange Act reporting obligations by foreign issuers where the average daily trading volume of the issuer’s securities in the United States was no greater than five percent of such trading volume in its primary trading market over a recent twelve-month period.¹¹³

A second solution is to provide further and continued exemptions as recommended by the Advisory Committee.¹¹⁴

A third solution is to write a separate set of rules only applicable in situations where the company is sufficiently small that the Commission concludes that the costs of compliance would likely exceed the benefits even under an amended, more cost-effective AS2 regime.¹¹⁵ These “404-lite” rules would be designed to impose minimal costs on small company issuers over and above the costs incurred to obtain a competent audit. Further, in considering the thresholds that might trigger the application of 404-lite, the Commission might wish to consider revenue triggers as well as market capitalization triggers as the Advisory Committee has recommended.¹¹⁶ Issuers with relatively low revenues sometimes have high market capitalizations, and a cost efficient control environment would be more aptly addressed by the 404-lite rules. A test based exclusively on market capitalization would not address these situations.

Following the receipt of its Advisory Committee’s recommendations, the Commission has taken a number of meaningful and encouraging steps to address the plight of the smaller public company in the context of Section 404. As noted above, the Commission has recently proposed extending

112. Carney, *supra* note 4, at 143, (citing Claudia H. Deutsch, *The Higher Price of Staying Public*, N.Y. TIMES, Jan. 23, 2005, § 3, at 5).

113. 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. 55,005, 72 Fed. Reg. 7 (Dec. 13, 2006).

114. See FINAL REPORT, *supra* note 24, at 43, 48.

115. See *id.* at 50 (discussing a proposal along the lines recommended by the Advisory Committee).

116. See *id.* at 44.

again the Section 404 compliance date for nonaccelerated filers, and it has provided relief for issuers undertaking initial public offerings such that Section 404 compliance will not be mandated until the issuer has filed at least one annual report with the Commission.¹¹⁷

CONCLUSION

Tinkering around the edges will not remedy the problems caused by Section 404 as implemented by AS2. As now drafted, AS2 guarantees a compliance regime in which the marginal costs of compliance far exceed the marginal benefits, causing the waste of billions of dollars on inefficient implementations of Section 404 controls. As a necessary first step to reform, the PCAOB and the SEC should amend AS2's core definition of "material weakness" and consider eliminating the requirement to focus on "significant deficiencies." These definitional changes will help force auditors to focus exclusively on controls that have a reasonable probability of causing a material misstatement or omission in a financial statement. This amendment to AS2's substantive requirements must also be complemented by aggressive PCAOB oversight designed to counteract the understandable tendency in the audit profession to cause overinvestment in Section 404 controls.

We are not confident that these or any other reforms will be sufficient to undo the problems caused by Section 404. The audit industry has already, in accordance with PCAOB recommendations, incorporated current Section 404 practices into integrated audit procedures applied in connection with non-404 audits. Unless the steps taken by the SEC and PCAOB are powerful enough to cause a significant reengineering of the integrated audit process, any effort at bringing Section 404's costs more into line with its benefits will have limited success at best.

Fixing 404 will not be easy. AS2 will have to be reengineered from the bottom up, and the PCAOB will have to adopt a monitoring style that runs counter to its primary mission. The Commission and the PCAOB must not show any timidity at all in addressing these problems, particularly because they will be required to act in the face of the predictable opposition of groups with a vested interest in preserving a rigorous Section 404 compliance environment without regard to the cost-benefit tradeoffs involved in implementing Section 404. Absent such reform, America's shareholders will have to resign themselves to a future in which publicly traded corporations

117. See White, *supra* note 48. On September 29, 2006, SEC Chairman Christopher Cox reiterated the Commission's support of the Advisory Committee's Section 404 recommendations:

Finally, I want all who are listening to this to know that the Commission is working to implement the important recommendations from the SEC Advisory Committee on Smaller Public Companies last April. In particular, we have adopted the Committee's recommendation on Sarbanes-Oxley Section 404, that unless and until a framework for assessing internal control over financial reporting for smaller companies is developed that recognizes their characteristics and needs, smaller companies will get relief from Section 404.

Christopher Cox, Chairman, SEC, Speech to the SEC Government-Business Forum on Small Business Capital Formation (Sept. 29, 2006), <http://www.sec.gov/news/speech/2006/spch092906cc.htm>.

are systematically forced to waste billions of dollars on control processes that simply don't generate marginal benefits in excess of their marginal costs, and in which start-up firms will find it less attractive to list their shares on public markets and foreign firms less appealing to cross-list their shares in U.S. markets. The choice is for the Commission and PCAOB to make, but the evidence in favor of fundamental reform seems powerful indeed.

POSTSCRIPT

Early drafts of this Article were broadly circulated within the PCAOB and SEC, and, in a set of December 2006 releases, both agencies suggested that they would be taking steps consistent with this Article's recommendations. Most notably, the PCAOB announced that it was seeking comment on a new Auditing Standard No. 5 that would supersede its Auditing Standard No. 2.¹¹⁸ The proposed new standard would, among other matters, be a "[r]e-articulation of the definition of material weakness to exclude significant deficiency."¹¹⁹ The PCAOB explained that this amendment was desirable because reference to the notion of significant deficiency within the definition of material weakness "has raised concern that auditors may be performing their audits at a level of detail necessary to ensure that their procedures identify all significant deficiencies, rather than only material weaknesses."¹²⁰

The PCAOB also recognized that defining a significant deficiency as a control deficiency "that has a more than remote likelihood of resulting in a misstatement that is more than inconsequential"¹²¹ can cause companies and auditors to "spend excess time identifying, discussing and fixing deficiencies that are not sufficiently important to the company's overall system of internal control."¹²² It therefore proposes to "replace[] the term 'more than inconsequential' with the term 'significant' and define[] 'significant' as 'less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting.'"¹²³

Much in the same vein, the PCAOB observed that reliance on the phrase "more than remote" may have caused some auditors and issuers to "misun-

118. PCAOB, RELEASE NO. 2006-007, PROPOSED AUDITING STANDARD, AN AUDIT OF INTERNAL CONTROLS OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS 1 (2006), available at http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No_2006-007.pdf [hereinafter PCAOB RELEASE No. 2006-007]. In drafting Accounting Standard No. 5, the PCAOB also attempted to address all of the points in Recommendation III.S.1 of the Advisory Committee's report relating to improving internal control auditing. Audio file: PCAOB, Open Board Meeting Webcast (Dec. 19, 2006), <http://www.connectlive.com/events/pcaob>.

119. PCAOB RELEASE No. 2006-007, *supra* note 118, at 10.

120. *Id.*

121. *Id.*

122. *Id.*

123. *Id.*

derst[and] the term ‘more than remote’ to mean something significantly less likely than a reasonable possibility. This, in turn, may have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended.”¹²⁴ To deter this form of behavior, the PCAOB proposes to replace the reference to “more than remote likelihood” with “reasonable possibility” within the definitions of both material weakness and significant deficiency.¹²⁵ The PCAOB calculates the impact of this change as follows:

To the extent that the term ‘more than remote’ has resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, this change should significantly improve the evaluation of deficiencies such that material weaknesses, when they are identified, are indeed the deficiencies that are most important.¹²⁶

The proposed new standard would also permit auditors to increase their reliance on knowledge obtained during previous audits and to avoid replicating procedures to the extent that they may have already occurred.¹²⁷ It would also reduce the barriers to having auditors rely on the work of others and eliminate the separate requirement to evaluate management’s annual evaluation process.¹²⁸

As for concerns about Section 404’s effects on smaller issuers, the proposed new rule includes an exhortation that “the auditor should scale the audit so that it is appropriate for the company’s size and complexity,” but does not otherwise articulate a distinct set of audit requirements that would apply to smaller issuers.¹²⁹ In the PCAOB’s view, no distinct standards are necessary because “the proposals’ reliance on principles rather than detailed instruction [will] require auditors to consider each company’s unique facts and circumstances before determining how to apply the standard.”¹³⁰ This individual attention, combined with changes in the standard that focus “the auditor on the most important controls . . . should together make the audit more scalable for any company.”¹³¹

The SEC also recognized that there has been an “overly conservative application of the Commission rules and PCAOB Auditing Standard No. 2.”¹³² The Commission therefore proposed to provide guidance to management conducting reviews of the internal controls over financial reporting.

124. *Id.* at 9.

125. *Id.*

126. *Id.*

127. *Id.* at 18–20.

128. *Id.* at 14, 21–25.

129. *Id.* at 29.

130. *Id.* at 28.

131. *Id.*

132. Management’s Report on Internal Control Over Financial Reporting, 71 Fed. Reg. 77,635, 77,637 (proposed Dec. 20, 2006) (to be codified at 17 C.F.R. pts. 210, 240, 241), available at <http://www.sec.gov/rules/proposed/2006/33-8762.pdf>.

The guidance emphasizes “a top-down, risk-based approach that allows for the exercise of significant judgment so that management can design and conduct an evaluation that is tailored to its company’s individual circumstances”¹³³ and is organized around two broad principles. The first emphasizes the need to focus on whether a control issue “adequately address[es] the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner.”¹³⁴ Control issues that are not material need not be a focus of attention. “The second principle is that management’s evaluation of evidence about the operation of its controls should be based on its assessment of risk”¹³⁵ in a manner that should allow management to use “more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high risk areas.”¹³⁶

As was the case with the PCAOB, the Commission adopted no special rules for smaller issuers. Instead, the Commission observed that its broader interpretive position should benefit “companies of all sizes and complexities”¹³⁷ and “encourage smaller public companies to take advantage of the flexibility and scalability of [the Commission’s new] approach to conduct an efficient evaluation of internal control over financial reporting.”¹³⁸

In all, these proposed amendments are highly responsive to this Article’s substantive proposals and suggest that the PCAOB and SEC are likely to adopt an analysis essentially identical to ours. These new releases are, however, silent about the vigor with which the PCAOB intends to pursue evidence that auditors have engaged in inefficient processes. As a practical matter, it will probably be impossible to form any view as to the PCAOB’s commitment to fight wasteful implementations absent a few years of practical experience in the field. Thus, to the extent that efficient implementation of Section 404 requires vigilant oversight by the PCAOB combined with a new set of core definitions, it is premature to conclude that the PCAOB’s and SEC’s proposals will be sufficient to resolve the efficiency problems created by the Section 404 implementing regulations.

133. *Id.* at 77,639–40.

134. *Id.* at 77,639.

135. *Id.*

136. *Id.*

137. *Id.*

138. *Id.* at 77,640.