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COMMENTARY

Balancing the Costs and Benefits of Auditing and Financial Reporting Regulation Post-SOX, Part I: Perspectives from the Nexus at the SEC

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INTRODUCTION

From August 2006 through July 2008, while on leave from the University of Southern California, I served at the Securities and Exchange Commission (SEC) as Deputy Chief Accountant for Professional Practice in the Office of the Chief Accountant (OCA). OCA has three groups: Accounting, International, and Professional Practice. Professional Practice mostly focuses on audit-related issues, although many projects are multi-faceted so the groups often work together.

The Professional Practice Group (PPG) was created by former Chief Accountant Don Nicolaisen in the aftermath of the Sarbanes-Oxley Act of 2002 (SOX). PPG plays a significant role in leading and coordinating the Commission's oversight of all the Public Company Accounting Oversight Board (PCAOB) activities and the Commission's work with respect to auditor independence; it works alongside other offices and divisions within the Agency to provide perspective and input on a variety of audit-related issues; and it consults with audit firms and registrants on audit matters. Nicolaisen envisioned an academic—someone "independent" of audit practice, yet knowledgeable about auditing and public policy issues related to the accounting profession—as advantageous for the PPG deputy position. He asked Emeritus Professor Andy Bailey to serve as the first deputy of the Group; then Chairman Cox asked me to serve as the second.

When I first walked into the SEC building next to Union Station in Washington, D.C., I was greeted by a display reminding: "The mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." I quickly internalized this mission as it informs day-to-day decision-making at the SEC. Investor protection, in particular, is the

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touchstone. This is so for all decisions—whether large or small and regardless of the background, experience, or prior beliefs of any individual member of the Commission or its staff. While the ubiquity of "investor protection" in speeches and press releases from the SEC can give it the appearance of a marketing slogan, in fact, investor protection does reflect the mindset at the SEC.

The Federal securities laws recognize financial reporting with full and fair disclosure as a critical component of the SEC's mission. Importantly, these laws likewise recognize that having such reports audited by knowledgeable, objective, independent accountants is a bedrock principle that enhances the credibility and reliability of the financial information provided to the capital markets. The staff in OCA works day-in and day-out to maintain and improve the quality of financial reporting and auditing.

Before joining the staff at the SEC, I spent more than two decades thinking, writing, and talking about the quality of financial reporting and auditing. However, as a professor, I had the luxury of considering issues of my choosing, from afar—as my time and inclination permitted. Congressional oversight, media scrutiny, concerned market participants, and pending rule-making had no import—except occasionally to help motive my research. Moreover, I had few confidentiality constraints or non-negotiable deadlines. As a professor, my workload was pretty predictable and mostly controllable. None of these characterized my life at the SEC. Yet, the PPG's "think tank" environment, team-work approach, and highly expert staff facilitated a transition between the two different worlds of a university professor and an SEC deputy.

This commentary shares some experiences and offers insights on some of the initiatives in which I was involved during my time at the SEC. My primary intent in doing so is twofold: (1) to provide perspective on some important public policy issues in accounting and auditing and (2) to assess what seems to be working well and what needs improvement in the regulation of the practice of accounting and auditing. As such, I hope this commentary will help inform your research and teaching.

In addition, I hope to encourage academics to take advantage of the opportunities that present themselves for public service and input on public policy issues. For example, based on my experience, PPG significantly benefited from the involvement of Professors David Plumlee, Bill Kinney, and Roger Martin, who served as Academic Fellows in the Group, and I know that each of these three significantly benefited from their time at the SEC.

This commentary appears in two parts. During my time at the SEC, much effort focused on improving the implementation of SOX Section 404. Akin to a case study, Part I provides background, overviews the problems, describes the efforts of the SEC and PCAOB to correct these problems, and suggests some lessons to take-away from the 404 "saga." In turn, Part II discusses a number of other SEC initiatives and activities and assesses the state of regulation of public company audits post-SOX.

THE SAGA OF SOX SECTION 404

Background

When I arrived, the SEC was working to improve the implementation of SOX Section 404, and this initiative continued for some time as a focus for PPG. Based on its number of words, Section 404 represents a very small part of SOX. Nonetheless, Section 404 had become the poster-child for costly new regulation enacted under a "fire-alarm" approach (Kinney 2005). Moreover, it was contributing to a general questioning of the cost-benefit balance for SOX as a whole.[1] For example, during this time, one theme I heard constantly was that "SOX, especially Section 404, put U.S. businesses at a competitive disadvantage."

[1] Those who describe the last decade as one of deregulation largely neglect SOX and the ensuing SEC regulations implementing SOX.

Both informal and formal feedback to the Commission from a variety of sources, such as SEC roundtables and reports by the U.S. Government Accountability Office (GAO 2006) and an SEC Advisory Committee on Smaller Public Companies (ACSPC 2006), emphasized the unexpectedly high cost of complying with Section 404, including escalating audit fees. Even the President and Congress were asking the SEC to fix the 404 problem. Especially concerning was the potential costs to smaller public companies (i.e., non-accelerated filers)[2] who had not yet had to comply with Section 404 under the SEC's staged implementation approach. In response, and spearheaded by the efforts of John White, the newly appointed Director of the Division of Corporation Finance (DCF), in May of 2006, both the Commission (SEC 2006) and the PCAOB (2006) announced roadmaps outlining actions each planned to take to improve the implementation of Section 404.

Purpose of Section 404

Before discussing these actions, let me pause and consider Section 404. First, it is useful to keep in mind what 404 does not do. SOX Section 404 does not establish a requirement to have adequate internal controls. Rather, the importance of having adequate internal controls, which provide reasonable assurance regarding the reliability of financial reporting, is long-recognized and was actually reinforced back in 1977 under the Foreign Corrupt Practices Act for companies of all sizes.

SOX Section 404 adds a requirement for annual *disclosures* to investors about whether the internal controls that a company has put in place are effective at providing the requisite reasonable assurance about the reliability of its financial reporting.[3] Under the SEC's 404(a) implementation rules, management discloses its assessment—that is, its conclusion on whether the company's internal control over financial reporting (ICFR) is effective at fiscal year-end.[4] Management cannot disclose that ICFR is effective when it has concluded that the condition of the controls is such that there is a reasonable possibility of a material misstatement in the financial statements—that is, any material weaknesses.[5]

SOX Section 404(b) requires the issuer's audit firm (which must be registered with the PCAOB) to attest to, and report on, the ICFR assessment made by management in accordance with standards adopted by the PCAOB. Often overlooked is SOX Section 103, which likewise speaks to auditor responsibilities with regard to ICFR and, in turn, complicated the implementation of audit requirements related to ICFR.[6] Also, Section 404(b) states that "any such attestation shall not be the subject of a separate engagement." Some interpreted this phrase to mean that audit

[2] Non-accelerated filers are companies with less than $75 million of public float.

[3] Control frameworks such as that of the Committee of Sponsoring Organizations of the Treadway Commission (COSO 1992) explain what is required of a system to achieve reasonable assurance. In turn, the SEC's 404 implementation rules specify that management's annual assessment must be made in accordance with a suitable control framework's definition of effective internal control. COSO is one such suitable framework and the most widely used by issuers.

[4] Under the SEC's implementation rules, ICFR means "internal control structure and procedures for financial reporting" as used in SOX Sections 404 and 103. ICFR overlaps but does not coincide with disclosure controls and procedures (DCPs), which are defined as controls and procedures designed to ensure that information required to be disclosed is disclosed, within the time periods specified in the SEC's rules and forms. Under Section 302 (for U.S. companies), management is responsible for evaluating and disclosing the effectiveness of DCPs at the end of each quarter. Finally, SOX and the SEC's implementation rules also require management to disclose quarterly any changes in ICFR that have materially affected, or are reasonably likely to materially affect, ICFR.

[5] Not only must management disclose any material weaknesses, but management should consider including in this disclosure: the nature of each material weakness; the impact on the company's financial reporting and ICFR; and current plans, if any, or actions already undertaken for remediating the material weakness.

[6] SOX Section 103 requires that audit reports describe: (1) the scope of the auditor's testing under 404(b); (2) the findings of the auditor from such testing; (3) an evaluation of whether the internal control structure and procedures (ICFR) include "maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer" and "provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles (GAAP), and that

fees should not increase with the addition of an ICFR audit—perhaps mistakenly conflating ICFR audits with internal control-related requirements under generally accepted auditing standards (GAAS) for financial statement audits that help auditors determine the nature, extent, and timing of substantive tests and specify necessary internal communications (then defined as reportable conditions under Statement of Auditing Standards [SAS] No. 60, *Communication of Internal Control Related Matters Noted in an Audit*).[7]

Problems with the Initial Implementation of Section 404

Implementing SOX Section 404 represents a fascinating public policy case study on the challenges of asking market participants to absorb significant new financial reporting regulation, which has implications for other accounting and auditing public policy initiatives, including the adoption of international financial reporting standards (IFRS). Plus, SOX 404 offers more general lessons for regulatory reform. For example, setting aside financial institutions,[8] prior to SOX, only a small number of public companies voluntarily reported publicly on the effectiveness of their internal control, in accordance with a control framework such as COSO, and almost none had auditor attestation on effectiveness (McMullen et al. 1996).[9] Thus, Section 404 appears unlike the requirements for financial statement audits imposed by the Securities Acts in the 1930s, which followed widespread voluntary demand and supply (Wallace 1980; Chow 1982; Watts and Zimmerman 1983). In other words, Section 404 was imposed "top-down" by fiat; it was not "bottom-up," i.e., market-driven or emergent (Brown and Palmrose 2005).

Still, management reporting and auditor attestation on internal control by public companies was not a new idea either. For example, the 1987 *Report of the National Commission on Fraudulent Financial Reporting* (the Treadway Commission) specifically recommended that the SEC require management reporting to shareholders on the effectiveness of internal control. A special report by the Public Oversight Board (POB 1993) recommended the SEC require both management and auditor reporting on the effectiveness of internal control. The GAO agreed and in its 1996 report, *The Accounting Profession*, urged the SEC to move forward on this important issue. As a member of the POB Panel on Audit Effectiveness from 1998–2000, I can recall this being one of the few public policy issues that the SEC and audit firm representatives *both* urged the Panel to support.[10] Then, in 2002, the POB, chaired by Charles Bowsher formerly head of the GAO, published its final annual report that stated: "Management of public corporations should be required to prepare an annual statement of compliance with internal controls to be filed with the SEC. The corporation's chief financial officer and chief executive officer should sign this attestation and the auditor should review it" (POB 2002, 59).

Not only did issuers and auditors have limited experience prior to SOX with internal control effectiveness reporting and attestation, but the implementation of Section 404 occurred during the

receipts and expenditures of the issuer are being made only in accordance with authorization of management and directors of the issuer;" and (4) at a minimum, material weaknesses in such controls and any material noncompliance found on the basis of such testing.

7 In addition, experiences with internal control reporting requirements in the context of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) by management and independent auditors of large financial institutions may have influenced cost expectations for issuers generally.

8 The internal control effectiveness reports with auditor attestation by large financial institutions since 1993 under FDICIA were filed with regulators and only available to the public upon request (Panel on Audit Effectiveness 2000, 31).

9 One exception was Enron. Enron provided a management report on the effectiveness of controls, with auditor attestation thereon, in the late 1990s and 2000.

10 The Panel declined to do so. Instead, the Panel's Final Report (2000, 33) included a recommendation to the SEC that, *if* management is required to report to shareholders on the effectiveness of internal control, the SEC require either the external auditor report on internal control or that management explicitly state the external auditors do not express an opinion on internal control, to avoid investors drawing unwarranted inferences about the nature of the auditor's responsibilities or work performed in regards to internal control.

aftermath of the financial reporting scandals that led to the passage of SOX. This contributed to a more conservative regulatory and reporting environment, which impacted the behavior of regulators, auditors, and issuers (including audit committees). Moreover, Section 404 was implemented as the PCAOB, the new SOX-created apparatus for federal regulation of public company audits, was being installed and the PCAOB was setting the tone and tenor for its oversight. At the time, PCAOB Chairman McDonough talked about "tough love" (CFO Staff 2004).

In addition, the PCAOB made another crucial decision—it decided to write its own standards for public company audits. The Board decided not to delegate audit standard-setting to any professional group of accountants as provided for under SOX Section 103. While the PCAOB adopted many GAAS standards promulgated by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) as PCAOB Interim Auditing Standards, "interim" was the operative word. The PCAOB intended to rewrite GAAS for public company audits. Meanwhile, as its first major standard, the PCAOB drafted and released guidance for performing integrated audits of the financial statements and ICFR (PCAOB Auditing Standard No. 2 [AS No. 2; PCAOB 2004]) in March 2004,[11] which was approved by the Commission in June 2004.

Unfortunately, from a public policy perspective, AS No. 2 proved to be poorly calibrated for ICFR attestations, both cross-sectionally and over time. AS No. 2 exemplifies a very prescriptive standard. It was not perceived to be risk-based or judgment focused. Instead, AS No. 2 provided specificity for auditors around the many considerations for scope and conduct of ICFR attestations on integrated audits. Specificity involved everything from walkthroughs to multi-location coverage. Plus, AS No. 2 constrained the auditor's use of knowledge obtained from previous audits, and it constrained the auditor's use of the work of others.

Another problem ensued from AS No. 2, which came to be known as the "40's paragraphs" problem. These paragraphs in AS No. 2 required auditors to understand and evaluate management's process for assessing the effectiveness of ICFR. This requirement contributed to auditors actually driving management evaluation processes. Adding to the confusion and reinforcing this result, AS No. 2 required that auditors express two opinions—one with respect to management's report on its assessment and another on the effectiveness of ICFR itself. As to the former, it was not until a June 2006 staff speech that the PCAOB publicly clarified that auditors, issuers, and others simply misunderstood if they believed AS No. 2 required the auditor to express an opinion on management's assessment (evaluation) *process* (Hamilton 2006).

This problem gained added importance because the SEC did not issue any guidance to management on such matters as the conduct of the ICFR evaluation process, the evidence needed to support management's assessment, or the documentation needed to be maintained.[12] So, in the face of these uncertainties, management turned to AS No. 2—the auditing standard—for guidance. Moreover, by letting the PCAOB define key terms, the SEC only reinforced the need for management to consider AS No. 2. For example, the SEC's initial 404 implementation rules refer management to the auditing literature for definitions of a material weakness and a significant deficiency. Further, AS No. 2 listed factors for auditors that indicate at least a significant deficiency and provide a strong indicator of a material weakness in ICFR, and these became the de facto indicators for management, too.

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[11] In keeping with the PCAOB's commitment to writing its own standards, AS No. 2 did not rely on or reflect a draft standard for ICFR attestations under SOX 404(b) developed post-SOX by a task force of the ASB.

[12] As Chief Accountant, Don Nicolaisen asked COSO to provide some guidance to management for evaluating ICFR, especially management of smaller companies, which COSO issued in July 2006 (COSO 2006). Even though the PPG staff evangelized its usefulness (e.g., SEC publications and staff presentations reference it), this guidance never seemed to gain much traction as a public policy response to the 404 problems.

It was no wonder that when asked during a meeting of the PCAOB's Standing Advisory Group (SAG) in June 2006 why the PCAOB was planning to revise AS No. 2 against the advice of some SAG members, a PCAOB staff member quipped: "To keep it from collapsing under its own weight." To address these problems, the SEC (2006) and PCAOB (2006) roadmaps anticipated that the Commission would issue guidance to management "to assist in its performance of a top-down, risk-based assessment of ICFR" and the PCAOB would similarly amend AS No. 2.

Improving the Implementation of Section 404

When I arrived on the scene, the SEC had already issued a concept release seeking public comment on the issues to be addressed in subsequent guidance for management on how to assess ICFR. After considering comment letters on the concept release and other input, the Commission issued a proposing release (an exposure draft in non-SEC parlance) in December 2006. Then, after once again considering comment letters and other input, in May 2007, the Commission held an open meeting and approved interpretive guidance for management (SEC 2007) in conducting its required evaluation under Section 404(a). Further, the Commission amended its rules to define material weakness and significant deficiency.

While working with other offices and divisions, in particular DCF and the Office of the General Counsel (OGC), PPG led much of the Commission's process to rationalize the implementation of Section 404—which included summarizing and considering comment letters; drafting guidance, rule amendments, and releases for Commission action; revising staff guidance in frequently asked questions; making numerous presentations to various interested parties; and updating Congressional staffers on progress. In addition, PPG's 404-related efforts included working with the Board and staff of the PCAOB as they developed, drafted, exposed, and finalized a new standard, Auditing Standard No. 5 (AS No. 5; PCAOB 2007a), to replace AS No. 2.

SOX requires the Commission approve all PCAOB rules and professional standards in order for them to become effective. So, once rules or standards are adopted by the Board, the PCAOB files them with the Commission. The Commission then generally publishes the proposed rule or standard in the *Federal Register* for public comment. After considering public comments, the Commission votes on whether to approve the rule or standard. If approved, the text of the Commission order is printed in the *Federal Register* and the rule or standard becomes effective in accordance with its terms. Once approved by the Commission, PCAOB rules also become enforceable by the Commission.

Given this SOX requirement, there is a natural inter-play between the SEC and PCAOB.[13] Indeed, exercising oversight helps defend the constitutionality of the PCAOB under the provisions of Title I of SOX. During my time at the SEC, to facilitate the Commission's oversight responsibilities, PPG staff met regularly with the PCAOB staff to discuss and provide input on the PCAOB's standard-setting activities. Moreover, with the high profile and widespread interest in rationalizing the implementation of Section 404, SEC and PCAOB interactions were elevated and included some special features, such as what came to be known as "404-Day" at the Commission.

On April 4, 2007 (4-04, get it?), the Commission held a rare open meeting. To clarify, open meetings are not rare; the rarity of this one was its purpose. This meeting was not held to take any action that required a Commission vote, such as on proposed or final rule-making. Rather, the purpose of this meeting was for the Commission to consider the staff's approach to and progress on working with the PCAOB on revising AS No. 2. (Under the Sunshine Act [Pub L. 94–409], for

[13] I appreciate that views may differ on the appropriate oversight role of the SEC, and others may have different perspectives on the process of replacing AS No. 2 with AS No. 5, including PCAOB board members at the time (Whitehouse 2008). In this regard, the PCAOB roadmap PCAOB 2006 called for amending and clarifying AS No. 2 mostly consistent with previously issued PCAOB guidance (e.g., PCAOB 2005), *not replacing* AS No. 2.

all five Commissioners to meet together and advise the staff on a matter such as this one, they had to do so publicly.[14]) Following presentations by the Chairman of the PCAOB and a representative from GAO, the Commission and staff publicly discussed such issues as alignment of the Commission's proposed management guidance and the PCAOB's proposed audit standard as to overall approaches and terminology, scaling the audit for smaller companies, the use of judgment by auditors, and more principles-based guidance for auditors on considering and using the work of others in an audit.

"404-Day" also provided an important opportunity for transparency on process, which helped reassure investor representatives, in particular, that rationalization of 404 did not mean retrenchment. Much of the dialog on improving the implementation of Section 404 revolved around improving the efficiency of both managements' evaluation process and the audit process. The final guidance issued by the SEC (2007) and PCAOB (2007a) surely did allow management and auditors to take stock of their respective 404 efforts and eliminate costs that did not contribute to improving the reliability of financial reporting. Nonetheless, during the open meeting, the staff and Commission discussed how improving the *effectiveness* of both processes was the overarching goal. The staff explained that in evaluating the many suggestions for crafting guidance, proposals perceived to involve gains in efficiency at the expense of effectiveness were not supported by the staff. Rather, proposals needed to involve gains in both efficiency and effectiveness or be effectiveness neutral with gains in efficiency to garner staff support.[15] Finally, the open meeting allowed Commissioners to signal boundaries to guide the staff in finalizing guidance for the Commission to consider. For example, one boundary for several Commissioners was any additional change to the definition of material weakness from that proposed for public comment.

Bifurcating and Deferring Implementation for Smaller Companies

Much of the SEC and PCAOB efforts to improve the implementation of Section 404 were motivated by and mindful of making the process cost-benefit effective for smaller companies. From an investor protection perspective, Section 404 reflects the notion that investors in both small and large companies are entitled to the same (minimum) level of credible and reliable disclosures about the effectiveness of ICFR. Still, PPG also tried to alleviate some of the anxiety felt by non-accelerated filers by simplifying and distilling the message. For example, PPG presentations asked non-accelerated filers to recognize that, at the core, the SEC's guidance for conducting the ICFR evaluation suggests certifying officers ask themselves two questions: (1) Do my employees know what they need to do to get the financial statements right (i.e., to prepare reliable financial statements)?; and (2) How do I know they did these things? Answering these two questions, in particular in a smaller company, should not have to be costly or complex, and PPG explained that the SEC's guidance does not make them so.

To ease smaller companies into 404 and work out any kinks beforehand using the experiences of larger companies, the SEC adopted a staged and eventually bifurcated implementation. U.S. accelerated filers had to begin complying with both Section 404(a) and (b) for annual reports for fiscal years ending on or after November 15, 2004. However, non-accelerated filers had to first comply with Section 404(a) in annual reports for fiscal years ending on or after December 15, 2007. Until recently, Section 404(b) was scheduled to apply to non-accelerated filers in annual reports for fiscal years ending on or after December 15, 2009. This represents several deferrals, including one from December 15, 2008 where the intent to do so was first announced by Chairman

[14] As an aside, regulatory reform could include reassessing the usefulness and limitations, in this day-and-age, of the Sunshine Act restriction constraining more than two Commissioners from meeting for business without notice.
[15] Jones (2007) discusses how the SEC's final Interpretive Guidance for Management (2007) improves the effectiveness of managements' 404 evaluation processes.

Cox in testimony before the House Small Business Committee in December 2007. Such continuing deferrals are not without controversy. For example, some view them as akin to an exemption and argue that only Congress, not the SEC, has the authority to exempt non-accelerated filers from Section 404(b). While these are matters for lawyers to debate, it is noteworthy that Congress in SOX Section 405 did exempt investment companies from Section 404. Given this exemption, the argument goes that Congress did not intend to exempt others such as non-accelerated filers.

Having brought non-accelerated filers into the "404(a) fold," from 2007 on attention continued to focus on the costs (versus benefits) of auditor attestation of ICFR for smaller companies with much speculation as to whether the Commission would yet again defer non-accelerated filers from the requirements of Section 404(b). Further complicating this matter was the conflation of such a deferral with the conduct of a cost-benefit study.

Studying the Costs and Benefits of Section 404

During testimony before the House Small Business Committee in June 2007, Chairman Cox announced that the SEC's Office of Economic Analysis (OEA) would conduct a cost-benefit study on 404. The timing of this announcement and the Commission's subsequent deferral of 404(b) for non-accelerated filers undercut the momentum of the PCAOB's efforts around implementing AS No. 5 for audits of smaller companies. For example, the PCAOB committed to issuing guidance to build-out the application of AS No. 5 on integrated audits of smaller, less complex companies and to address other challenges that might arise in audits of those companies. Although it was proposed in October 2007 this guidance was not issued until January 2009.[16] In addition, the PCAOB created the position of Director of Technical Policy Implementation and appointed an associate chief auditor well-versed in AS No. 5 to fill it. The Director implemented a robust process for training PCAOB inspectors on AS No. 5 and conducting outreach to others, including it as part of the PCAOB's very useful forums on auditing in the small business environment, before leaving the PCAOB in April 2008 having served in this new role for less than eight months.

In December 2007 testimony, again before the House Small Business Committee, the Chairman elaborated that the OEA study was expected to have two parts—a web-based survey of companies that are subject to Section 404 and in-depth interviews with a subset of companies including those that are newly compliant. According to this testimony, the study would focus on identifying trends and provide a comparison to costs under the old auditing standard. Plus, the study would pay special attention to those small companies complying with Section 404 for the first time. The Chairman said that the study would be available no earlier than June 2008.[17] It was finally released in October 2009. Because the study was so delayed, at the same time, the Commission announced another deferral for non-accelerated filers from Section 404(b) until annual reports with fiscal years ending on or after June 15, 2010 (SEC 2009). However, Chairman Schapiro also stated that there will be no further Commission extensions.

The OEA study (SEC 2009) provides some evidence indicating that the Commission's 2007 efforts to rationalize the implementation of Section 404 are working and so 404(b) requirements can now be extended to smaller companies, which allowed a new Chairman and Commission to declare victory and finalize the implementation of 404. Nonetheless, there were some unfortunate

[16] The January 2009 guidance was issued as Staff Views, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies.*

[17] See testimony by Christopher Cox on "Sarbanes-Oxley Section 404: New Evidence on the Cost for Small Companies," before the U.S. House of Representatives Committee on Small Business (December 12, 2007) at http://www.sec.gov/news/testimony/2007/ts121207cc.htm. Also, see SEC press release announcing "SEC Begins Small Business Costs and Benefits Study of Sarbanes-Oxley Act Section 404 and Commission Proposes One-Year Extension of Financial Compliance Requirements for Smaller Companies While Study Underway" (February 1, 2008) at http://www.sec.gov/news/press/2008/2008-8.htm.

aspects to this chapter in the 404 saga. First, the SEC does not generally conduct these sorts of studies, which are complicated by detailed federal regulations. Plus, way too much pressure was put on this study. Research can inform policy-making, but no single study can provide definitive evidence, especially one so constrained.

The primary focus of the study was on Section 404(b) for non-accelerated filers who had not yet implemented it. However, rather than solicit evidence on this issue with careful methodological crafting (e.g., see Kinney and Shepardson 2009), OEA decided to use a web-based survey open to all issuers. This gives the study the appearance of a poll. But, setting aside this problem and regardless of response rate, questions arise as to sample representativeness and reliability. Many of these are acknowledged upfront in the study in a series of caveats (SEC 2009). For example, OEA recognized that survey respondents were not constrained to only those individuals with requisite knowledge within the responding companies. This represents a non-trivial matter because *neither* cost nor benefit data are quantified, observable, or readily available at the company level. By nature, the data are subjective and perceptual; they involve estimates. Even on the cost side most companies do not segregate and track actual costs of their 404(a) effort, and the audit fees for 404(b) encounter similar issues on integrated audits (both conceptually and practically). On the benefit side, to supplement issuer perceptions, the study includes evidence from interviews (with assistance from OCA) of a limited number of market participants.

The Final Chapter?

So, in the midst of trying to recover from perhaps the worst economic crisis in 75 years and more than seven years after the passage of SOX, smaller companies have been given what is characterized as the Commission's final decision on bringing them under the requirements of Section 404. Still, the 404 controversy continues and Congress has reentered the fray with various proposals.[18] Meanwhile, PPG has integrated an ICFR perspective into its work, and this perspective continues to inform the Group's activities.[19]

LESSONS LEARNED FROM THE 404 EXPERIENCE

Undermining the Voice of the Profession

Before concluding the discussion of SOX Section 404, it seems important to consider any lessons learned from the experience. From my perspective, there are a few essential ones. First, setting aside the benefits of management and auditor reporting on the effectiveness of ICFR,[20] the unexpectedly high costs of the 404 effort coupled with the perception that auditors were behind these costs—whether by driving management evaluation processes or by driving up audit fees—continue to disadvantage auditing and the accounting profession in a public policy setting. Regu-

[18] For example, in October 2009, a bill called the "Small Business SOX Relief Act" was introduced in the House to permanently exempt small companies from Section 404(b). Further, in November 2009 as part of H.R. 4173, the Wall Street Reform and Consumer Protection Act of 2009, the House Financial Services Committee passed the Garrett-Adler amendment that would permanently exempt non-accelerated filers from Section 404(b) and require the SEC and the Comptroller General to conduct a study to determine how the SEC can reduce the burden of complying with Section 404(b) for accelerated filers whose market capitalization falls between $75 and $250 million. The study would have to consider whether reducing the compliance burden or a complete exemption for such companies would encourage companies to list on U.S. exchanges in their initial public offerings.

[19] For example, Panucci (2008) and Besch (2009) provide observations on ICFR disclosures and discuss how the current environment may impact management's annual assessment and the external audit of the effectiveness of ICFR and management's quarterly evaluation of DCPs. In addition, Gaynor (2006) discusses evaluating ICFR in the context of accounting estimates, including fair value estimates, and fraud risk assessments.

[20] Discussions of the cost of implementing SOX Section 404 should also recognize the role of costs companies *elected* to incur to improve their controls, which include the costs of addressing so-called "deferred maintenance" issues.

lators helped reinforce these perceptions by putting the onus on audit firms for inefficiencies and over-auditing rather than defending the firms for adhering to the requirements of AS No. 2.

The profession's push for and strong support of Section 404 has come to be viewed as self-serving given the ensuing revenue stream it produced for audit firms. In turn, this has tainted the ability of the accounting profession to credibly support important public policy issues post-SOX, such as converting financial reporting by U.S. companies to IFRS. Because of market participant experiences implementing Section 404, skeptics quickly focus on economic motives and incentives and see the profession's endorsement of IFRS as simply supporting a new opportunity for generating revenues—a new "golden goose" like 404. (One irony here is that the need for discipline over controls as embodied in Section 404 becomes especially critical under more judgment-based regimes, such as IFRS [Palmrose 2009, 287]).

Questioning the Benefits of Auditor Attestation

But the public policy implications for auditing and the accounting profession are even broader and more nuanced. For example, during my time at the SEC, the 404 experience helped create resistance to mandating any attestation requirements as part of the SEC's interactive data (XBRL) initiative for tagging GAAP financial statements.[21] To illustrate this mindset, during a 2007 roundtable on interactive data when the subject of requiring external assurances came up, the Chairman interjected that doing so would be "one good way to make sure that this entire effort suffers crib death."[22]

PPG's educational efforts were unsuccessful in overcoming these perceptions—cemented by the 404 experience.[23] Concerns that the SEC should not risk having issuers provide financial information in XBRL that was not of equal credibility and reliability to that filed or furnished under extant requirements did not translate into mandated assurances for XBRL financials.

Similar perceptions influenced an SEC Federal Advisory Committee. The Final Report of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR 2008) discusses XBRL and the issue of assurance, but does not include any recommendation. However, CIFiR does suggest that the SEC's XBRL initiative should include a voluntary program in which companies obtain assurance on their interactive data-tagged financial statements (CIFiR 2008, 107). Among the small set of companies in the SEC's pilot program, which started using interactive data in financial statement filings in 2005 and led up to the SEC's final rules issued in early 2009, more than one company voluntarily had its external audit firm provide such assurances.[24]

[21] The SEC's XBRL initiative might not have been possible without the support of the large audit firms. The firms directly funded XBRL-U.S. and contributed staff time to developing and reviewing a taxonomy for tagging U.S. GAAP financial statements.

[22] Further, Chairman Cox stated that assurance was unnecessary because XBRL was "almost akin to the choice of financial printer." See transcript (amended June 18, 2007) for the "SEC Interactive Data Roundtable: Creating Interactive Data to Serve Investors" (March 19, 2007) on the SEC website.

[23] On the other hand, exceptions now appear. For example, the SEC's final rule on *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers* (Release Nos. 33-9072 and 34-60813), posted on October 13, 2009, states: "The Commission believes that an auditor's attestation to a company's disclosure of its assessment on the effectiveness of the company's internal control is an important safeguard" (p. 4). Further, in response to the Madoff fraud, in May 2009, the Commission proposed for public comment new rules for *Custody of Funds or Securities of Clients by Investment Advisers* (Release No. IA-2876; File No. S7-09-09) that would require advisers to engage an independent audit firm to conduct an annual surprise examination and, in certain circumstances, to produce an internal control opinion by an independent public accountant registered with, and inspected by, the PCAOB. However, a number of comment letters expressed concerns that OEA cost estimates in the SEC proposal (of, on average, $8,100 for surprise audits and $250,000 for internal control reports) were greatly understated. To their credit, even large audit firms suggested that the SEC should consider other more cost-benefit effective approaches (Lumb 2009).

[24] The PCAOB staff provided questions and answers to address issues on *Attest Engagements Regarding XBRL Financial Information Furnished Under the XBRL Voluntary Financial Reporting Program on the EDGAR System* (May 25, 2005). Plumlee and Plumlee (2008) discuss the limitations of this guidance for SEC mandated XBRL financials.

Regulators Focusing on Audit Efficiency

Finally, in my view, a misstep in the 404 saga was for the PCAOB and SEC to use the terms "audit efficiency" to characterize their focus. For example, the PCAOB (2006) roadmap committed to "reinforce auditor efficiency through PCAOB inspections." And, in turn, the SEC committed to inspecting the PCAOB in this regard. The SEC (2006) roadmap stated: "The PCAOB announced on May 1, 2006, that it would focus its 2006 inspections on whether auditors have achieved cost-saving efficiencies in the audits they have performed under AS No. 2, and on whether auditors have followed the guidance that the PCAOB issued in May and November 2005 urging them to do so. As part of the Commission's oversight of the PCAOB, the Commission staff inspects aspects of the PCAOB's operations, including its inspection program. Among other things, upon completion of the PCAOB's 2006 inspections, the staff will examine whether the PCAOB inspections of audit firms have been effective in encouraging implementation of the principles outlined in the PCAOB's May 1, 2006, statement." These notions were subsequently extended and applied in the context of AS No. 5.

Improving the implementation of Section 404 was essential. Even so, it is likewise essential for regulators to maintain audit effectiveness and audit quality as the "true north" on their compasses. Audit efficiency is primarily the purview of the market; post-SOX, it is the concern of auditors and audit committees. Sure, everyone wants "just right" auditing. Promulgating cost-benefit effective auditing standards to guide auditor performance is very important. But, post-SOX, it has become a trickier proposition.

Unlike the SEC, which must explicitly consider costs and benefits in its rule-making, SOX does not require the PCAOB to weigh the costs versus benefits of its rules and standards before adopting them. However, PCAOB Board members have said they do so anyway (Palmrose 2006a; Glover et al. 2009). Still, given that Board members are not practicing auditors and most have no audit experience, this seems a difficult challenge for them. For example, in the case of AS No. 2, the Board received many comments that the costs would out-weigh the benefits of what was being proposed in the exposure draft, which the Board failed to appreciate in finalizing the standard.

Nonetheless, once promulgated, auditing standards represent a floor, not a ceiling, for auditor performance (Palmrose 2006b). Because of the nature of the audit process and uncertainties that arise in the acquisition and evaluation of audit evidence, auditors must be allowed to do "too much" work, when considered from an *ex post* perspective, with audit firms and audit committees sorting through the compensation for such work.

By committing to focus on "audit efficiency" in the context of 404, regulators opened the door to pressures to address more general concerns with "over-auditing," including that the PCAOB should inspect for audit efficiencies on both parts of integrated audits (i.e., audits of ICFR *and* the financial statements). Otherwise, for example, it was suggested that the PCAOB establish a clear policy against over-auditing of internal controls including a fine schedule against auditors, if necessary (NASDAQ 2007).[25] Luckily, that one went nowhere.

Even so, in helping fill the SEC observer role on SAG, I likewise heard various SAG members encourage the PCAOB to rewrite auditing standards to eliminate unnecessary and costly audit efforts. Further, in testimony before the Department of the Treasury Advisory Committee on the Auditing Profession, the Senior VP and Chief Auditor of NASDAQ said: "An important concern

[25] It was also suggested that the PCAOB establish an ombudsman office to serve as an advocate for issuers who feel their internal controls are being over-audited (NASDAQ 2007). Legislation passed by the House of Representatives in December 2009—H.R. 4173, The Wall Street Reform and Consumer Protection Act of 2009—includes a provision that requires the PCAOB to appoint an ombudsman to act as a liaison between the Board and any registered public accounting firm or issuer with respect to issues or disputes concerning the preparation of any audit report or resulting from regulatory activities of the Board, particularly with regard to the implementation of SOX Section 404.

in the global marketplace is that U.S. listed companies are over audited enduring needless cost. Any measurement [of audit quality] should include determining how [audit] firms can control this increasingly costly problem" (O'Malley 2008, 3).

In my opinion, regulators could have side-stepped this entire problem by avoiding terms like "audit efficiency," and reframing the 404 regulatory focus around an objective of promoting a common understanding, among both auditors and PCAOB inspectors, on the meaning of the standard's requirements—whether AS No. 2 or AS No. 5. Indeed, a review of the PCAOB's findings from inspections on the second-year implementation of AS No. 2 reveals areas of confusion on the intent of the standard (PCAOB 2007b). Based on discussions with practitioners, Glover et al. (2009, 228) provide further insights on the difficulties auditors encountered in understanding AS No. 2 and the need for them to elicit clarifications on its requirements from the PCAOB. Further, it would have been helpful for the PCAOB to simply say "mea culpa"—we miscalibrated—rather than maintain that auditors misunderstood AS No. 2.

However, importantly, the PCAOB did not carry notions of "over-auditing" into inspections of the financial statement side of integrated audits. During my time at the SEC, the PPG staff exercised similar caution. Finally, it is noteworthy that the PCAOB now appears to have refocused on effectiveness in ICFR audits. For example, the PCAOB (2009) report on overall findings from inspections of the first-year implementation of AS No. 5 primarily, albeit not entirely, discusses effectiveness.

CONCLUDING REMARKS

In conclusion, Part I of this commentary has provided a "case study" of the SEC efforts to improve the implementation of SOX Section 404. During my time at the SEC, these efforts included the Commission issuing interpretive guidance for management (SEC 2007) and working with the PCAOB as they replaced AS No. 2 with AS No. 5. Part I has also included some lessons that I took away from being involved in the 404 experience.

The Professional Practice Group in OCA, with a small but very dedicated staff, was at the forefront of the Commission's efforts to improve the implementation of Section 404. The Group accomplished a great deal in a relatively short period of time. In doing so, it skillfully reasoned through a large amount of input that often included very different points of view.

Finally, in reflecting on these accomplishments, I have come to appreciate the wisdom of one of the many colorful quips from Professor Joe Grundfest of the Stanford Law School and a former SEC Commissioner. When once chided for being part of a public policy initiative that produced few recommendations, he replied: "Oh, but you also must judge us by the mischief we kept from happening." In keeping the quality of financial reporting and audit effectiveness uppermost in mind, PPG measured very well by this standard, too.

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