Sarbanes-Oxley Section 404:
The 'Section' of Unintended Consequences and its Impact on Small Business

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SARBANES-OXLEY SECTION 404:
THE 'SECTION' OF UNINTENDED CONSEQUENCES AND ITS IMPACT ON SMALL BUSINESS

AeA, ADVANCING THE BUSINESS OF TECHNOLOGY

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ABOUT AeA

AeA, founded in 1943 by David Packard, is the largest high-tech trade association in the United States with nearly 3,000 companies, representing all segments of the industry and 1.8 million employees. Currently, AeA has 18 offices in and around the United States, as well as offices abroad in Brussels and Beijing. Our primary purpose is helping our members' top and bottom lines by providing the following services: Access to Investors; State, Federal & International Lobbying; Insurance Services; Government Procurement; Business Networking; Foreign Market Access; Select Business Services; and Executive Education.

AeA's unique grassroots network promotes and represents the business interests of America's technology industry. We provide competitive products and services to our members and lead in education and advocacy on a variety of high-tech business issues. They include: Sarbanes-Oxley Section 404 reform; RFID initiatives; broadband deployment; preventing harmful Internet privacy legislation; making the research and development tax credit permanent; seeking updated export controls legislation; working with U.S. trade negotiators to achieve high-tech industry negotiating objectives within new international trade agreements; limiting the government's regulation and taxation of the Internet; promoting education reform; lowering capital costs for emerging technology companies; and supporting human resource and immigration policies that ensure access to the most qualified and highly educated workers.

From the well known giants of the high-tech world to the next generation of dynamic, smaller companies, AeA's members create products that promote innovation and efficiency in virtually every industry and business sector in the United States and throughout the world. The impact of high-tech products on people's everyday lives is immeasurable. High-tech products keep people safer and healthier, enable them to be more productive at home and on the job, and contribute to a better quality of life. Whether it is medicine or national security, education or agriculture, environment or entertainment, the high-tech industry is omnipresent and is inextricably linked to the advancement of modern society.

For information about AeA and the high-tech industry, please visit our website at www.aeanet.org. And for more information about our grassroots Sarbanes-Oxley Section 404 initiative please visit www.aeanet.org/SOX.

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EXECUTIVE SUMMARY

Section 404 of the Sarbanes-Oxley Act (the Act)[1] is having a devastating impact on AeA's small and medium-sized member companies. Skyrocketing implementation costs have put high-tech companies in the position of having to delay major projects at a time when many are struggling to compete with low-cost competition from Asia. Section 404 implementation is the quintessential example of the law of unintended consequences, with the biggest victim being small business.

AeA member companies, particularly its small and medium-sized companies, were so alarmed at the problems of Section 404's implementation that they requested we establish a national Section 404 committee. To allow a broader group of companies to participate, AeA first established a Section 404 working group in each of our 18 councils around the country and received feedback from approximately 125 companies. These working groups were comprised primarily of chief financial officers (CFOs) and other senior executives, and their intent was to convey to the powers that be that: Section 404 is not achieving the intent of its legislative authors; it is disproportionately expensive to smaller companies; and it is negatively impacting the ability of companies to compete.

There is no doubt that the Act contains many reforms that are in fact improving corporate governance. The vast majority of the Act's provisions are:

- positive;
- easy to understand;
- improving corporate governance;
- cost effective; and
- consistent with the objective of reducing financial fraud.[2]

Unfortunately, the many positive reforms are being overshadowed by one section that is imposing high costs with little return in terms of fraud detection. Although well intentioned, the most onerous provision of the Act is Section 404. The legislation itself is not even the problem. Section 404's guidance has not differentiated between large and small companies, and as a result, auditors have been applying a one-size-fits-all approach to implementation. This is having a devastating impact on small business.

Section 404's implementation has resulted in many unintended consequences, and the current guidance needs to be reevaluated and modified by the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) to prevent permanent damage to the competitiveness of small and medium-sized businesses that are the job growth engine of the U.S. economy. In addition, Congress must exert its oversight authority by holding hearings on the implementation of Section 404. Congressional intent clearly is not being served by the current implementation process, and Congress also needs to do its part to stop this train wreck.

Section 404 has become problematic because:

- The cost burden amounts to a major regressive tax on small business.
- It is extremely burdensome and, as evidence suggests, it will not be effective in detecting corporate fraud.
- External auditors have adopted a "one size fits all" approach to Section 404. This means that a small company with $16 million in revenue and a relatively simple organizational structure essentially is being held to the same standard as a large multi-billion dollar company with a very complicated organizational structure.

- It gives investors a false sense of security.
- The expense and awkward bureaucratic mechanisms it creates hurts U.S. competitiveness.
- The huge increase in compliance costs has some foreign companies considering whether to withdraw from U.S. financial markets.
- The implementation cost is approximately $35 billion – more than 20 times greater than the SEC estimated in 2003.[3]
- The SEC believed there would be "a direct correlation between the extent of the burden and the size of the reporting company, with the burden increasing commensurate with the size of the company." The opposite appears to be true.[4]

Section 404's costs have skyrocketed because this section is being conservatively interpreted by external auditors and companies now are being forced to pay external auditors approximately $200 per hour to examine controls that provide little value. Examples of the frivolous actions that companies must take and then pay an auditor to prove include:

- requiring an auditor to attend a meeting to prove it took place;
- having the technical support "help desk" document every call it receives from employees;
- proving that all of the physical keys to an office in Europe have been accounted for since it opened in 1995;
- examining how the power supply to computer facilities is secured;
- requiring people to respond to thousands of e-mails to prove they received them; and
- ensuring that every employee has a personnel performance evaluation.

Smaller companies neither require, nor can they afford, the same level of investment in internal controls as much larger companies. Understanding the detrimental impact that implementation is having on smaller companies, on December 16, 2004, the SEC announced the creation of an advisory panel that will evaluate the Act's impact on smaller public companies.[5]

- This action is a necessary one; however, AeA is concerned with the planned timing for the report from this advisory panel, which is being tasked to report its results in January 2006. AeA believes that this timeline is too long to provide effective relief for small and medium-sized businesses in 2005.

- AeA recommends that the advisory panel be tasked to submit a preliminary report by May 1, 2005, so that the most obvious and expensive problems with the current implementation of Section 404 can be corrected in 2005.

AeA's goal is simple – we would like to improve Section 404, not to roll back the Act. To address our members' concerns, AeA formed working groups around the country to examine the impact of Section 404, and in that process, our companies outlined the primary problems with Section 404 and have created a list of recommendations/solutions to improve its implementation.

This paper is the result of our working groups' work, and it lays out a series of specific recommendations/solutions designed to improve the efficiency of the Act's implementation in a manner that is consistent with the legislation's intent.

BACKGROUND

Section 404 of the Act states that the SEC shall prescribe rules requiring each annual report to contain an internal control report that must:

> (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 effectiveness of the internal control structure and procedures of the issuer for financial reporting.[6]

With respect to the internal control assessment, Section 404 requires:

> [E]ach registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.[7]

What does this mean and how does it differ from the Section 302 certifications already in force?

Section 302 certifications, which now have been in force for more than a year, require the CEO and CFO to certify that they have made certain disclosures, based on their most recent evaluation of internal controls over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions). The key difference is that although Section 302 requires management to evaluate a company's internal controls, Section 404 is being interpreted to mean that management must prove that its internal controls are effective, a very expensive and time-consuming task, the results of which do little to prevent or detect fraud.

As part of the Act, Congress created the PCAOB, a quasi-governmental agency, to oversee the audits by public accounting firms. The PCAOB is charged with the responsibility of establishing auditing standards for public company audits, subject to SEC approval.[8]

Financial and Information Technology (IT) Control Frameworks: The frameworks being used for the implementation of Section 404 are split into two primary areas – financial controls and IT related controls. In practice, the standards being implemented by the PCAOB and the "Big 4"[9] do not differentiate between the stages of a company's development, resulting in a massive and disproportionate burden for small companies.

The Treadway Commission's Committee of Sponsoring Organizations (COSO) published "Internal Control – Integrated Framework," an internal controls framework that has been identified as suitable for Section 404 purposes – even though published in 1992. Similarly, the IT Governance Institute's "Control Objectives for Information and Related Technology" (COBIT) has been adopted for IT controls. Both are frameworks for evaluating internal controls and are geared towards a large multi-billion dollar company with a very high standard of mature and comprehensive internal controls. Although these frameworks have been around for over 10 years, the vast majority of financial executives had never heard of them before implementation of Section 404.[10]

In addition to the controls around the financial applications, COBIT mandates standards for areas such as physical security of data centers, network security, web security, backup policy, etc. Applying Section 404 to all areas of IT is akin to Congress's allowing the police to mandate that all home owners in America must install a major security system to protect their homes regardless of the cost, or the value of the home and contents. Then they must hire an expensive consultant to prove to the police that they have maintained and verified the operation of the system.

MAJOR FLAWS WITH SECTION 404

The primary concerns with Section 404 implementation stem from the following:

(1) Evidence suggests that the COSO/COBIT frameworks being used to implement Section 404 will not be effective in stopping fraud.
(2) The cost serves as a major regressive tax on small and medium companies because the cost is not directly proportionate to revenue.
(3) The cost of implementation is more than 20 times greater than the SEC estimate in June 2003.
(4) The costs will remain very high in years two and three.
(5) The expense and bureaucratic mechanisms created by Section 404 hurt U.S. competitiveness.
(6) Section 404 is pushing a number of smaller public companies to go private or consider doing so.
(7) Section 404 results in such a huge increase in compliance costs that some foreign companies now are considering withdrawing from U.S. financial markets.

(1) Evidence suggests that the COSO/COBIT frameworks being used to implement Section 404 will not likely be effective in stopping fraud.

Although AeA supports in principle the importance of strong internal controls for transparency and accuracy, we believe there are limits to the efficacy of internal controls. It has long been recognized by leading authorities in the auditing and fraud prevention area that internal controls are not effective at detecting and preventing fraud. They are especially ineffective at preventing and detecting fraud caused by collusion between senior company officials. This is exactly the type of fraud that is reported to have caused the demise of Enron, WorldCom, Tyco, and others.

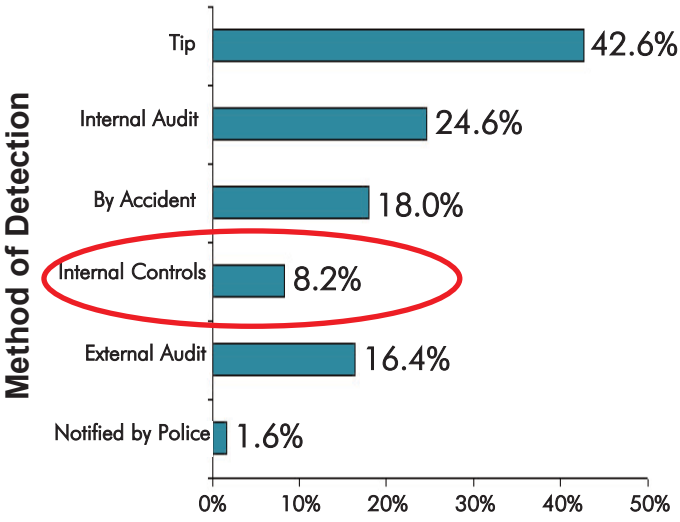
Why do internal controls fail to detect collusion? The answer is very simple. The essence of internal controls is that person A performs a function and person B checks it. If person A and person B get together to commit fraud, then this internal control will not be effective. Of the large investor losses suffered as a result of fraud, this is almost always the problem.

The Association of Certified Fraud Examiners, a recognized authority on preventing and detecting fraud, published the "2004 Report to the Nation on Occupational Fraud and Abuse," a study that highlights the ineffectiveness of internal controls in detecting fraud by executives and in high dollar amount cases of fraud.

In its discussion of detecting fraud by executives, the report states:

> Although the data from our survey strongly supports Sarbanes-Oxley's call for the establishment of anonymous reporting mechanisms, the information we gathered did not provide the same measure of support for the significant burden SOX (particularly Section 404) places on the internal controls as a fraud detection tool.[11]

Detection Method for Million-Dollar Schemes



Source: Association of Certified Fraud Examiners[12]

As the chart above highlights, in cases of fraud causing $1 million or more in losses, internal

controls only detected fraud approximately eight percent of the time. Fraud was caught by accident more often.

Investors will not be any better protected from fraud than before implementation of Section 404. The best protection from fraud would be to increase the efforts to support whistler-blower provisions and to increase prosecution efforts. Those provisions will be far more successful at preventing investor losses than Section 404, and they are dramatically more cost effective.

(2) **The cost serves as a major regressive tax on small and medium companies because the cost is not directly proportionate to revenue.**

In addition to the huge aggregate cost, Section 404 has another major flaw in that contrary to the SEC's expectation, its cost is not directly proportional to the size of the company. This is because small and medium companies effectively are being held to the same standards as very large companies.

> **"This has turned into a check-the-box process. The work is being done by individuals — often only 22 to 26 years old — with very little business knowledge. They just don't know where to begin."**
>
> **— CFO, $76 million company**

What became clear during our companies' discussions on Section 404 is that the cost burden for smaller companies as a percentage of revenue is far greater than for large companies. For multi-billion dollar companies, the cost may run at approximately 0.05 percent of revenue, but for small companies with revenues below $20 million, the costs can rapidly approach three percent of revenue.

The chart to the right highlights the expected cost of Section 404 compliance as a percentage of revenue. These results appear consistent with data received from AeA's working groups.

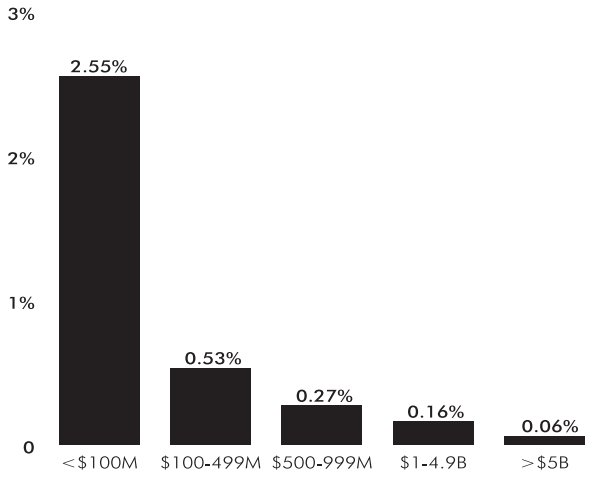
> **"The Big Four are effectively regulating the IT operations of every public company in the United States."**
>
> **— CFO, $500 million company**

Another important way to examine this is to assess the cost relative to the number of employees in a company. Anecdotal evidence from AeA's member companies reveals that for a large company the cost of Section 404 is approximately $400 per employee, whereas, for small companies, the cost in many instances approaches $4,000 per employee. We even heard from one company that is spending $15,000 per employee.

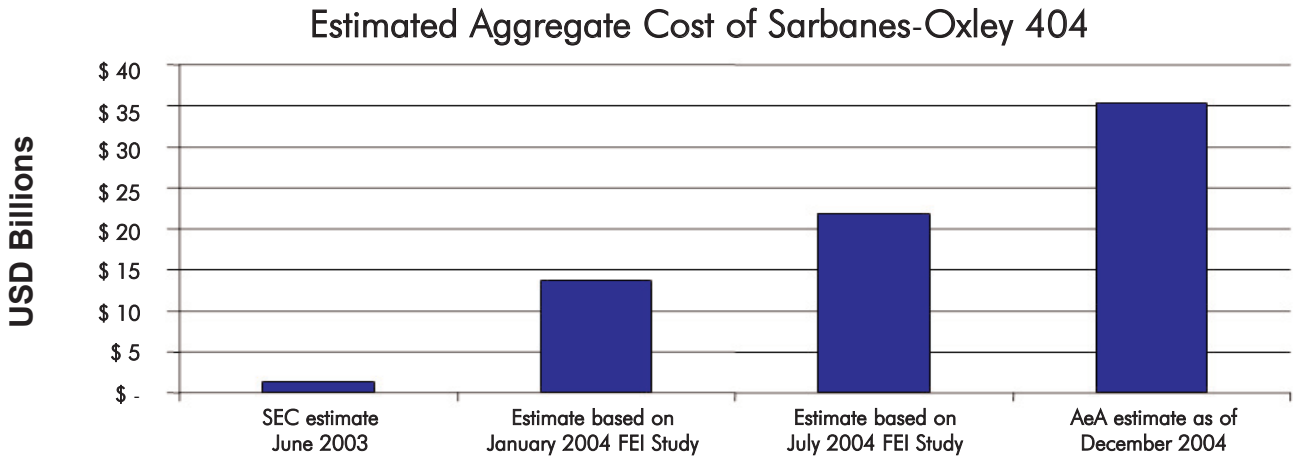
This is a major burden for small companies at a time when many are struggling to compete with low-cost competition from Asia and with escalating medical costs.

In essence, Section 404 is a very high regressive tax on small and medium companies, businesses that are serving as the job growth engine of the U.S. economy. This is the primary reason behind our recommendation to temporarily suspend Section 404 for all companies with revenues less than $1 billion.

Section 404 Costs as a Percent of Revenue



Source: Based on data from the Financial Executives International study and AeA's Section 404 working groups' estimates



Source: Based on data from the Financial Executives International studies and AeA's Section 404 working groups' estimates[16]

Who pays the cost? Although companies will pay the cost of compliance, other interested parties will also be impacted.

- The U.S. Treasury will lose revenue as a result of reduced corporate tax receipts.
- Employees will pay for this through reduced raises, reduced benefits, and lost jobs. Companies will have to make up the cost and they will have to do that by cutting other costs and by moving more jobs offshore. This is especially true for small companies.
- Shareholders will also be impacted by reduced profits.

Where does the money go? In the last year, a whole industry has sprouted around Section 404. We estimate that approximately 27 percent of the cost will go to pay the external auditors.[13] We estimate the remaining costs will be split in half between internal resources, such as bigger internal audit departments, and third party consultants who will assist in the work.

(3) The cost of implementation is more than 20 times greater than the SEC estimate in June 2003.

In June 2003, the SEC estimated the aggregate cost of implementing Section 404 on all registrants at approximately $1.24 billion, or $91,000 per registrant.[14] This amount, a huge sum in and of itself, is proving to be a massive understatement. Since June 2003, that cost literally has sky rocketed.

Calculating the cost: In January 2004, Financial Executives International (FEI) completed a survey of the cost of Section 404 for its members. The study found that the average costs associated with compliance during the first year could exceed $4.6 million per company for the largest U.S. companies.[15] A study conducted just months later revealed that the cost would be approximately 62 percent greater than previously anticipated because of a "109 percent rise in internal costs, a 42 percent jump in external costs and a 40 percent increase in the fees charged by external auditors."[17]

AeA estimates that the final average cost likely will approach $5,000,000 per large registrant, with smaller companies being disproportionately burdened and often spending well over $1 million in compliance costs – and not $91,000 per registrant as the SEC predicted in 2003. Instead, we predict Section 404 will cost approximately $35 billion – more than 20 times the SEC's estimate in June 2003.[18]

(4) The costs will remain very high in years two and three.

It would appear that we should expect a reduction in the cost for year two, and that is what most CFOs want. Many of the CFOs we have consulted, however, anticipate the cost of Section 404 to increase in year two, because regulators and the "Big 4" now have the resources to do the extra work, and they are unlikely to scale down their organizations immediately in 2005.

(5) The expense and bureaucratic mechanisms created by Section 404 hurt U.S. competitiveness.

Instead of taking a principles-based approach, COSO and COBIT provide a super-checklist for all companies, set a cookie-cutter approach for how one must run a business, and they create a limitless necessity to document, document, document, rather than to do, do, do.

A specific example of the damage that this does relates to new IT productivity projects. The only way that U.S. companies successfully can compete with companies based in low-cost countries is to be more efficient. The key to greater efficiency is to invest in new and improved IT and automated systems. Because COSO requires an internal control to be "mature" to be considered effective, it is not practical to implement major new IT systems in the third and fourth fiscal quarters because the control will not be mature. Additionally, with new systems there are always post-implementation bugs to be fixed, and if they are implemented late in the year, then there will not be enough time to remediate any bugs that are discovered, and have the new control mature before year end.

As a result, many companies are delaying new system implementations until the first half of the new fiscal year. This increases the cost and delays the productivity benefits, reducing U.S. competitiveness.

> **"I am spending almost three times more on this than I am on healthcare for my employees."**
>
> **— CEO, $19 million company**

(6) Section 404 is pushing a number of smaller public companies to go private or consider doing so.

According to a study conducted by the law firm Foley & Lardner,[19] the average cost of being a public company with sales under $1 billion increased by $1.6 million in 2003 due to Section 404. The Foley study found that 20 percent of companies surveyed were considering going private to avoid Sarbanes-Oxley costs.[20] Generally, companies go public in order to raise capital through public markets; however, the costs associated with Section 404 have caused some companies to consider going private because the costs associated with being a public company outweigh the benefits.

> **"Tech firms with 500 employees or less say they're particularly hard hit because they run fast and lean. They warn of added bureaucracy and stifled innovation."**
>
> **— Carrie Johnson, *Washington Post*, December 1, 2004**

These developments not only restrict the ability of small companies to raise capital, but they weaken the U.S. capital markets by discouraging smaller companies from going public.

(7) Section 404 results in such a huge increase in compliance costs that some foreign companies are now considering withdrawing from U.S. financial markets.

The huge increase in the regulatory burdens being placed on U.S. registrants naturally is making U.S. capital markets a much less attractive option for non-U.S. companies. British and German business groups have begun a push to urge the SEC to make changes that would make it easier for companies to delist from U.S. markets because many foreign companies are considering delisting as a result the Act.[21] In fact, on January 25, 2005, SEC Chairman William Donaldson addressed the concerns of foreign private issuers and said in a speech at the London School of Economics that he expects "the SEC to consider whether there should be a new approach to the deregistration process for foreign private issuers if they do not feel prepared to meet the U.S. requirements."[22]

The departure of international companies from U.S. capital markets would significantly weaken those markets and increase the cost of raising capital for all U.S. public companies. Additionally, it would strengthen European and Asian markets, creating increased future competition for the U.S. markets. This departure would have a very negative impact on job growth in the U.S. financial sector.

Reasons for the excessive cost:

a) Holding small companies to standards appropriate to very large companies.

b) Requirement to document all controls, instead of just key controls, thus tripling the work.

c) Requirement to certify as of year end creates the need to test controls four times and creates a large fire drill of work at year end.

d) Requirement that all key controls, regardless of their risk level, must be tested every year. Essentially the process must start fresh each year without taking account of the results of the prior year's testing and the relative risk of controls.

This goes against the accepted and effective audit risk assessment process where it is logical to consider the results of the prior year's activities in assessing the relative risk of various controls and the frequency with which they should be tested. This results in an audit that is only very marginally more effective, but is massively more expensive. AeA is not aware of any major loss suffered by investors because of the use of appropriate audit rotation procedures.

e) The requirement that only the registrant's external auditor can perform the Section 404 attestation.

Given that the Big 4 audit 99 percent of U.S. public companies in terms of revenue,[23] and that the Government Accountability Office (formerly the General Accounting Office) has determined that the Big 4 accounting firms represent an oligopoly with significant anticompetitive market power, this mandate has significantly reduced any real competitive bidding for the work. If the SEC's estimate that approximately 27 percent of the cost of Section 404 is paid to external auditors is accurate, then this work, according to our estimate, will amount to over $9 billion of new revenue for the Big 4. It also appears that in general, the hourly rate being billed to registrants for this Section 404 attestation work by their external auditors is significantly higher than the average billing rate for their external audit work in 2003.

CONCLUSION

Improved corporate governance is an achievable and worthy goal. The executives who participated in AeA's working groups welcomed the benefits of many of the Act's provisions. Unfortunately, the benefits are being overshadowed by one section that is causing an enormous amount of work and expense with little return in terms of fraud detection. Section 404 compliance is not simply a nuisance that companies would prefer to avoid. It is having a very real and significant negative impact on companies, and in particular, small and medium-sized companies.

Section 404's implementation should be re-examined immediately in order to address the disproportionate impact it is having on smaller companies. The SEC has begun the process of examining Section 404 as it relates to smaller companies, and this is a positive development that is long overdue. The timeline laid out by the SEC for this project, however, is too long to provide effective relief for small and medium-sized companies in 2005, and AeA recommends that the Advisory Committee be tasked to submit a preliminary report that addresses the most obvious problems with Section 404 implementation.

We believe the recommendations set forth in this paper will alleviate many of the unintended consequences that have resulted from implementation of Section 404. We urge the SEC and PCAOB to adopt these recommendations to make Section 404 more effective and equitable in a manner that does not regressively tax smaller companies that are the growth engine of the U.S. economy.

SECTION 404 PROBLEMS AND SOLUTIONS

Now that we have discussed the primary problems involving Section 404, this section of the paper provides specific solutions that address the problems inherent with Section 404, both in terms of the guidance and its implementation. We intend for these solutions to improve Section 404 and make it congruent with the intent of its legislative authors. To understand the solutions we propose, it is necessary to first understand the underlying problems and the impact they are having on companies.

(1) The PCAOB has not provided sufficient detailed guidance as to what constitutes key controls.

Impact: External auditors are requiring companies to document and test controls that do not impact the financial statements. For example, many companies are now required to document every call that their help desks receive for technical support and auditors are now ensuring that every employee has a personnel performance evaluation. Having those procedures in place may be good business practice, but they do not ensure the accuracy of a company's financial statements.

The all-inclusive approach applied by external auditors to IT controls has resulted in massive cost for little value. It is clear that in the area of IT controls, auditors have spent most of their time on controls that have a very tangential, if any, impact on the financial reporting process and have focused on business risk decisions that do not impact the accuracy of the financial statements.

Solution: The PCAOB should provide more detailed guidance as to what does and does not constitute a key control over financial reporting, especially in the area of IT. The scope of Section 404 financial and IT compliance efforts then should be limited to those key controls that are needed to ensure the integrity of the financial statements, eliminating the documentation and validation requirement for non-key controls.

The guidance from the PCAOB also should make it very clear that companies do not need to test key controls, where an effective and tested compensating control exists.

(2) Redundant Section 404 testing.

Impact: The point in time opinion requires both the company and the external auditors to perform testing of controls twice, once during the year and once towards the end of the year to facilitate the updating of testing for the fiscal year end. This results in a significant amount of redundant work with controls being tested four times.

Solution: We recommend that the "point in time" opinion of the auditors be modified to a "period in time" opinion so that the testing can occur in a more linear distribution throughout the year.

(3) There is a lack of competition for Section 404 certification work.

Impact: The Government Accountability Office (GAO) has determined that the Big Four accounting firms audit 99% of the revenues of U.S. public companies. As such, the GAO has concluded that the Big Four are an oligopoly with a significant amount of anti-competitive market power. This lack of competition is significantly increasing the costs of Section 404 certification.

Solution: Allow Section 404 certification work to be completed by any qualified firm. This would

improve the independence of the process and would allow competition to emerge for the external attestation work, reducing the effective cost without reducing the effectiveness of the provision.

(4) Significant new IT projects and system changes are being delayed six to nine months due to - practical issues with respect to Section 404.

Impact: Many companies are delaying the implementation of significant IT projects by six to nine months solely because of the documentation and testing requirements of Section 404. They also expect this problem to persist, and predict that they will be able to make major systems changes only in the first half of their fiscal years going forward. As as result, Section 404 requirements are significantly inhibiting business operations and having an impact on the competitiveness of companies.

Solution: Allow registrants to exclude significant new IT projects and systems changes from that year's Section 404 certification.

This exclusion would be similar to the one that currently allows companies to exclude new acquisitions completed late in the year from the Section 404 certification. This exception was provided to avoid the very damaging consequence of preventing companies from making acquisitions in the second half of their fiscal year.

Under the exception for new acquisitions, companies that make acquisitions late in the fiscal year are allowed to note in their certification that the attestation of the effectiveness of internal controls does not cover the internal controls of the new acquisition. They then are required to disclose the details of the acquired company's financials so that investors can assess the materiality of the new acquisition to the company. Similarly, under a proposed exception for new IT projects, the company would disclose the system for which the qualification is being made, including details of its specific functions and the proportion of specific income statement and/or balance sheet items that are controlled by the new system and also details of compensating controls in place during the interim period to ensure the accuracy of the financial statements.

(5) A company must test each of its controls each year.

Impact: An enormous amount of work will be repeated from scratch each year, driving up costs.

Solution: As with the standard audit process, allow companies to rotate the testing of key controls based on a reasonable assessment of the risk related to each material account and the risk related to each control. Each year a company would evaluate its risk areas and then, based on the risk and past results, the company would decide to test some controls only periodically, perhaps every two years.

This would eliminate the need to start the testing process from scratch each year regardless of the results of the previous year's testing. Under the current system, companies basically throw out the results of previous year's work and start again. An example of a low risk account would be the cost paid for a building. This should be on the books and not change each year so there would be a very low risk of its being wrong.

(6) External auditors have stopped providing their clients with accounting advice.

Impact: In the past, when a company had a complex accounting question, it would draw on the considerable technical expertise of the big accounting firms to help it decide the correct course of action. In the current environment, companies are required to do this research independently, and then if they decide on an incorrect course of action, they are deemed by the external auditor to have a "deficiency" because of a lack of accounting expertise.

Solution: Amend the rules around auditor independence to allow companies to rely on their audit firms for accounting and internal controls related advice.

Some common sense needs to be applied to this issue. Most companies cannot afford to hire the host of specialist accountants that the big accounting firms have available. Preventing companies from getting accounting advice will result in a greater number of accounting errors, a significant increase in the number of companies deemed to have "ineffective" accounting departments, and a significant increase in cost.

(7) Companies have not been provided with sufficient time to comply with Section 404 guidance.

Impact: The PCAOB has been issuing guidance as companies work to meet Section 404 deadlines. In some instances, companies and their auditors have had to go back and redo work already completed based on recently issued guidance, which has increased the total cost and burden of Section 404 compliance.

Solution: PCAOB guidance, including interpretive guidance, should in most cases be issued in a manner consistent with the generally accepted practice followed by other standards setting bodies, *i.e.*, that of issuing exposure drafts, allowing a comment period, and then issuing final guidance that allows registrants sufficient time for efficient implementation. This would allow companies to understand what they are being asked to do and would give companies and auditors time to interpret and comply with the guidance.

(8) Small and medium-sized companies are often impacted by regulations differently.

Impact: The lack of input by smaller companies and the lack of consideration of the unique attributes of smaller companies in the development of guidance often results in unintended consequences.

Solution: Expand the Board of the PCAOB to include a representative from a small or medium-sized company.

AeA believes that it is essential that some of the Board members have enough experience with small and medium-sized business to estimate the impact of PCAOB regulations on small and medium-sized businesses adequately. These businesses make up the majority of registered companies and, given the excessive costs of Section 404 relative to the SEC's expectation, it is clear that more expertise in this area is needed on the Board.

(9) Public company auditors are not conducting integrated audits. PCAOB's Auditing Standard No. 2 "*An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*" states than an audit of internal controls over financial reporting should be integrated with the audit of the financial statements.

Impact: The audit costs for small and medium-sized companies have increased dramatically from the previous year, anywhere from two to six times the prior year's cost. Most member companies going through the Section 404 audit are not seeing a well conducted integrated audit being performed by the auditors. As a result, there ends up being two separate audits being performed, massively increasing the fees from the previous year's financial statement audit.

Solution: Require auditors to conduct an integrated audit by using work done for the internal controls attestation to be considered as evidence for the financial statement audit.

(10) A 10 million dollar company is treated the same as a 10 billion dollar company under Section 404 guidance.

Impact: Smaller companies are disproportionately harmed because the cost is effectively much greater for them than for larger companies.

Solution: Temporarily suspend the current requirements of Section 404 for all registrants that had revenues of less than $1 billion in their last annual filing with the SEC. This suspension should last until the PCAOB provides appropriate and specific guidance for small and medium-sized companies, such that the cost of implementing Section 404 for these companies approximates the cost estimated by the SEC in June of 2003.

These companies would disclose to investors in their SEC filings that they are under the threshold and have not performed the Section 404 internal review process. This would be voluntary, and any company wishing to could choose to get the certification.

Why use revenue as the metric? We have chosen to use revenue as the key metric because:

1. the need for more sophisticated internal controls scales with the size of a company;
2. the COSO/COBIT frameworks are targeted to the needs of very large companies; and
3. the data show that the cost impact of Section 404 compliance is very clearly correlated to the size of the company as measured in revenues.

Why choose a cut-off level of $1 billion? We have chosen $1 billion because:

1. Our research shows that above the level of $1 billion in revenue, the annual cost of Section 404 drops below 0.2 percent of revenue. Although we still think that this amount is too high, it at least is reaching a level where it does not fundamentally affect a company's strategic investments and employee benefits.
2. The aggregate market value of companies with more than $1 billion in revenue is equal to 85 percent of the aggregate market capitalization of all U.S. public companies. This means that 85 percent of the "risk" to investors still will be covered by Section 404.
3. We estimate that limiting the Section 404 requirements to only those companies with revenues greater than $1 billion will reduce the aggregate cost to approximately $12 billion, reducing the cost by almost two thirds. This still will be 10 times the SEC's original estimate.

Using a cut-off level of $1 billion will result in 85 percent of the market value of U.S. public companies being included under the provisions of Section 404.

We believe that this cut-off level strikes a reasonable balance between reducing investors' risk of corporate fraud and the reduced profits investors see through the burden of Section 404.

Another factor in favor of a revenue cut-off is that investors currently apply this type of filter to companies in assessing their investment choices. Investors understand that smaller companies have different risk profiles than larger companies. Examples of the different risks are lower trading volume, lower economies of scale, less sophisticated IT and financial systems, more risk of being disrupted by larger competitors, etc. Investors will be able to understand these criteria easily.

APPENDIX 1

The Act's Cost-Effective Provisions:

Given the intent of the Act — transparency and accountability — the following provisions are cost-effective measures.

1. Umbrella Whistle-Blower Protection Provision: The Act requires that all registrants establish an anonymous reporting method for employees anonymously to report concerns directly to the audit committee.

AeA believes that this provision will be the most effective provision of the Act in deterring and uncovering fraud. This provision is inexpensive to implement and AeA believes that it will do more to achieve the goals of the Act than the estimated $35 billion being spent on Section 404.

2. Quarterly and Annual Section 302 Certifications by CEOs and CFOs: This Section requires the CEO and CFO to certify to the best of their knowledge that the company's internal controls are adequate to ensure the accuracy of the financial statements.

This provision does a good job of raising the awareness of internal controls with senior management and helps the commitment to invest in their maintenance.

3. Audit Committee Requirements: All Audit Committee Members must be independent and one member should be a financial expert. The Audit Committee (not management) is responsible for the appointment of the outside auditor and the pre-approval of all non-audit services.

4. Officer or Director Bars and Penalties: The SEC may bar individuals from serving as directors and officers if the SEC proves the individual is unfit to serve.

This raises the penalties for improper conduct by corporate officers and serves as a deterrent for committing fraud.

5. Mandatory Codes of Ethics for Senior Financial Officers: The Act requires publicly traded companies to disclose if they have a code of ethics for senior financial officers, and if not, why not. The Act describes the standards of compliance that should be contained within the code of ethics.

This also raises awareness of good ethical standards.

6. Corporate Officer and Director Real Time Section 16 Reporting: The Act requires officers and directors to disclose their purchases or sales of the company's equity securities on an accelerated basis.

This also provides investors with better information.

7. Auditor "Revolving Door" Prohibition and Audit Partner Rotation Requirement: Under this Section, an accounting firm may not provide audit services to any company whose CEO, controller, CFO, chief accounting officer, "or [other] person serving in an equivalent position" worked for the accounting firm in the past year. The Act also requires accounting firms to rotate the lead audit partner at least every five years.

This also reduces conflicts of interest and promotes greater independence.

8. Auditor Registration and Separation of Consulting Services from Auditing: The Act lists nine types of services that no longer may be performed by accounting firms.

This also reduces conflicts of interest and promotes greater independence.

APPENDIX 2

Financial Control Framework:

The PCAOB requires that the registrant use a reasonable control framework to assess the effectiveness of its internal controls. The internal control framework used by the Big 4 accounting firms is provided by COSO.

COSO originally was formed in 1985 to sponsor the National Commission on Fraudulent Financial Reporting, an initiative that studied the factors that can lead to fraudulent financial reporting. The National Commission was jointly sponsored by five major professional associations in the United States – the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives International, the Institute of Internal Auditors, and the Institute of Management Accountants. This was not an exercise in which registrants' voices were effectively heard. Business never imagined that anyone ever would consider that COSO should become a mandate.

COSO is a framework and a methodology for evaluating internal controls that runs for hundreds of pages in length. This is a very, very comprehensive framework that is geared towards a large multi-billion dollar company with a very high standard of mature and comprehensive internal controls. Although this framework has been around for over 10 years, the vast majority of CFOs had never heard of it before Section 404.

COSO defines internal controls as a "process, effected by an entity's board of directors, managements and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations."[24]

The COSO framework does discuss some special considerations for internal controls over financial reporting for small and medium companies. However, the lack of clarity on this point means that in practice, the implementation of the standard by the PCAOB and the Big 4 does not differentiate between the stages of a company's development.

IT Controls Framework:

COBIT was developed as an ideal standard that multi-billion dollar companies would aspire to achieve over many years. Because of the major problems with implementation and the massive cost, it is not a practical guide for small and medium-sized companies.

The framework being applied by the PCAOB and the Big 4 for IT controls is similar in nature to the COSO framework. It was developed in the 1980s before modern systems had emerged, and also runs hundreds of pages in length. The following are some key points related to COBIT:

- It is comprised of 34 high-level control areas, and 318 detailed control objectives.
- Implementation of the COBIT framework is intended literally to take years of gradual adoption
- through detailed process improvement work.
- IT Governance Institute (ITGI), in drafting the COBIT-based control recommendations for IT, relied heavily on PwC, Deloitte, and KPMG for the analysis of COBIT relative to Section 404, and for authorship of the recommendations.

- Initial guidance from ITGI and its contributors recommended evaluating the IT control environment relative to a subset of COBIT consisting of 21 high-level control areas and 137 detailed control objectives.
- The expert reviewers, whose comments helped shape the document, did not include U.S. business in this process.[25]

COBIT suffers from the same major flaws as COSO. It was not developed with the intention of being applied to all companies regardless of size. It was developed as an ideal standard that multi-billion dollar companies would aspire to achieve over many years. Although it has been around for more than 10 years, again, CFOs had never heard of it before Section 404. From the major problems with implementation and the massive cost, it clearly is not a practical guide for small and medium-sized companies.

One of the biggest problems with COBIT is that it goes beyond the financial reporting process and mandates standards for all areas of IT. In addition to the controls around the financial applications, it mandates standards for areas such as physical security of data centers, network security, web security, backup policy, etc. These areas relate to the business risks management decides to take, and they do not relate to the financial reporting process, except in a very tangential way.

AeA is not aware of any significant financial loss suffered by investors as a result of failures in these areas at U.S. public companies. From our research, it appears that half of the $35 billion in cost incurred for this Section 404 process is related to the IT area as a result of the extension of Section 404 way beyond the financial reporting process.

APPENDIX 3

In order to attain a clean report under Section 404 from its external auditors, a registrant will need to complete the following process:

- Complete an initial scope determination
    - Determine which specific locations/business units are material
    - Determine which accounts within those locations/units are material
- Document all identified processes and controls in an internal control format
- Identify the key processes, risks, and controls
- Document control environment
- Verify key processes and controls by reviewing documents and walking through the process to confirm the accuracy of the documentation
- Develop test plan for all key controls
- Get auditor acceptance of documented processes and controls
- Company test all key controls during fiscal year
- Auditor test key processes and controls during fiscal year
- Company retest key controls as of fiscal year end
- Auditor retest key controls as of fiscal year end

This approach has a number of challenges in addition to the lack of appropriateness for small and medium-sized businesses.

- It requires the attestation as of year end that forces both companies and their external auditors to test key controls twice. This means controls get tested four times.
- It requires all controls to be documented and confirmed, even if they are not key controls and are not required to be operating in order for the financial statements to be accurate. The number of total controls for a small or medium-sized company can range from 300 to 600. For multi-billion dollar companies, it can be greater than 1,000. From discussions with many CFOs, it appears that only about one third of identified controls are key controls.
- It requires a defined format for the documentation, eliminating the possibility of practical reuse.

APPENDIX 4

GAO
Accountability·Integrity·Reliability

Highlights

Highlights of GAO-03-864, a report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services

July 2003

PUBLIC ACCOUNTING FIRMS

Mandated Study on Consolidation and Competition

Why GAO Did This Study

The audit market for large public companies is an oligopoly, with the largest firms auditing the vast majority of public companies and smaller firms facing significant barriers to entry into the market. Mergers among the largest firms in the 1980s and 1990s and the dissolution of Arthur Andersen in 2002 significantly increased concentration among the largest firms, known as the "Big 4." These four firms currently audit over 78 percent of all U.S. public companies and 99 percent of all public company sales. This consolidation and the resulting concentration have raised a number of concerns. To address them, the Sarbanes-Oxley Act of 2002 mandated that GAO study

- the factors contributing to the mergers;
- the implications of consolidation on competition and client choice, audit fees, audit quality, and auditor independence;
- the impact of consolidation on capital formation and securities markets; and
- barriers to entry faced by smaller accounting firms in competing with the largest firms for large public company audits.

www.gao.gov/cgi-bin/getrpt?GAO-03-864.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Davi M. D'Agostino (202) 512-8678 or d'agostinod@gao.gov.

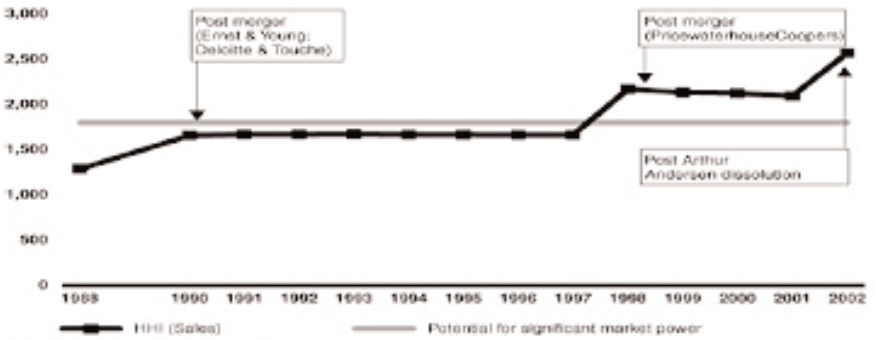
What GAO Found

Domestically and globally, there are only a few large firms capable of auditing large public companies, which raises potential choice, price, quality, and concentration risk concerns. A common concentration measure used in antitrust analysis, the Hirschman-Herfindahl Index (HHI) indicates that the largest firms have the potential for significant market power following mergers among the largest firms and the dissolution of Arthur Andersen (see fig. below). Although GAO found no evidence of impaired competition to date, the significant changes that have occurred in the profession may have implications for competition and public company choice, especially in certain industries, in the future.

Existing research on audit fees did not conclusively identify a direct correlation with consolidation. GAO found that fees have started to increase, and most experts expect the trend to continue as the audit environment responds to recent and ongoing changes in the audit market. Research on quality and independence did not link audit quality and auditor independence to consolidation and generally was inconclusive. Likewise, GAO was unable to draw clear linkages between consolidation and capital formation but did observe potential impacts for some smaller companies seeking to raise capital. However, given the unprecedented changes occurring in the audit market, GAO observes that past behavior may not be indicative of future behavior, and these potential implications may warrant additional study in the future, including preventing further consolidation and maintaining competition.

Finally, GAO found that smaller accounting firms faced significant barriers to entry—including lack of staff, industry and technical expertise, capital formation, global reach, and reputation—into the large public company audit market. As a result, market forces are not likely to result in the expansion of the current Big 4. Furthermore, certain factors and conditions could cause a further reduction in the number of major accounting firms.

Hirschman-Herfindahl Indexes, 1988-2002



Source: Who Audits America, 1988-2002.

United States General Accounting Office

REFERENCES

The following is an extensive, but by no means exhaustive list of sources for the research conducted to produce this paper. We have provided citations for instances in which we used specific data, quotations, or material that could be primarily attributed to one or two sources.

1. Pub. L. No. 107-204 116 Stat. 745 (2002).

2. *See* Appendix 1 for more information.

3. At the time of enactment, the SEC estimated "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)." AeA expects the aggregate cost to be closer to $35 billion. *See* SEC Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 17 CFR PARTS 210, 228, 229, 240, 249, 270, and 274. The rule can be found at http://www.sec.gov/rules/final/33-8238.htm#P632_164786. The estimate does not include the costs associated with the auditor's attestation report, and the SEC acknowledged that it received comments suggesting this amount could be substantial.

4. *Id*.

5. *See* http://www.sec.gov/news/press/2004-174.htm.

6. Pub. L. No. 107-204 116 Stat. 745 (2002).

7. *Id*. The Board references the PCAOB.

8. After its creation, the PCAOB began its review of Section 404, and in 2004, it issued "Auditing Standard No. 2: An Audit of Internal Control Over Financial Reporting Conducted in Conjunction with an Audit of Financial Statements" to provide guidance on Section 404 implementation, which was approved by the SEC. "Auditing Standard No. 2" can be found at http://www.pcaobus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/Auditing_Standard_2.pdf.

9. The major audit firms — Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers — often are referred to collectively as the "Big 4."

10. *See* Appendix 2 for more detail. Information about COSO can be found at http://www.coso.org/index.htm. Information about COBIT can be found at http://www.itgi.org.

11. The study can be found at http://www.cfenet.com/pdfs/2004RttN.pdf.

12. *Id*.

13. We are basing this amount on the SEC's estimate that the cost associated with outside professionals would be

approximately $34,300 per company in addition to the $91,000 Section 404 cost per company, which comes out to approximately 27 percent.

14. *See* SEC Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, 17 CFR PARTS 210, 228, 229, 240, 249, 270, and 274. This can be found at http://www.sec.gov/rules/final/33-8238.htm#P632_164786.

15. FEI Press Release: "Size Matters: Larger Companies Will Spend More for Sarbanes-Oxley Compliance Requirements," 2/10/2004, http://www.prnewswire.com/cgi-bin/stories.pl?ACCT=105&STORY=/www/story/02-10-2004/0002106643.

16. The estimates of the aggregate cost are based on the FEI studies and other calculations based on the number of companies listed on the AMEX, NASDAQ, and NYSE exchanges and internal surveys. AeA believes that this estimate is likely to understate the actual cost.

17. FEI Press Release: "Sarbanes-Oxley Compliance Cost Estimates Soar 62% Since January '04," 8/11/2004. http://www.fei.org/files/spacer.cfm?file_id=1151.

18. AeA estimates that Section 404 is going to cost approximately $35 billion. This number is based on estimates from FEI's July survey as well as extensive discussions we have had with many CFOs.

19. The study, "The Cost of Being Public in the Era of Sarbanes-Oxley," can be found at http://www.foley.com/files/tbl_s31Publications/FileUpload137/2017/Public%20Study%20Results%20FINAL.doc.pdf.

20. *Id.*

21. According to the Associated Press article, "Company Delistings Nearly Triple in 2003," 12/13/2004, the number of public companies delisting from the U.S. exchanges tripled in 2003. It is likely that this process has accelerated significantly in 2004.

22. Chairman Donaldson's speech "U.S. Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers" can be found at http://www.sec.gov/news/speech/spch012505whd.htm.

23. *See* Appendix 4 for an Executive Summary of the Government Accountability Office's study that estimates that public companies audit 99 percent of public companies in terms of revenue. A copy of this study can be found at http://www.gao.gov/new.items/d03864.pdf.

24. More information about COSO can be found at http://www.coso.org/publications/executive_summary_integrated_framework.htm.

25. The list of acknowledged authors can be found at http://www.galegale.com.br/Cobit%20Sarbanes-Oxley.pdf.

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