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TESTIMONY

REASSESSING SARBANES-OXLEY:
THE COST OF COMPLIANCE IN TODAY'S CAPITAL MARKETS

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Before the U.S. House Committee on Financial Services
Subcommittee on Capital Markets

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EXECUTIVE SUMMARY

Key Findings

Compliance ≠ Accuracy. Effective internal controls do not guarantee accurate financial reporting. A company can have weak controls and clean financials—or strong controls and misstatements. Yet the Sarbanes-Oxley Act of 2002 (SOX) elevates internal control audits to a status equivalent to financial audits, often blurring that distinction.

Form over Substance. SOX created a regime where internal controls may be optimized for auditability rather than effectiveness. This has institutionalized a culture of documentation and testing that can distract from the ultimate goal: the fair presentation of financial results.

Persistent Restatements. While restatements surged after SOX's enactment, declined, and then surged again, they remain common. This pattern suggests that SOX has not materially reduced reporting errors—and may, in some cases, contribute to them by diverting attention to form over substance.

Distorted Capital Formation. Since SOX, the number of public companies is down almost half while large private companies have grown sixfold. Regulatory costs, particularly Section 404(b), are among the contributors to this shift—deterring initial public offerings (IPOs), prompting exits, and burdening small firms disproportionately.

Unequal Investor Value. Sophisticated and active investors often view SOX disclosures as duplicative or irrelevant, while passive investors rely on them as system-level guardrails. Yet companies—and ultimately their employees and active investors—bear each firm's cost of maintaining these guardrails.

Recommendations

Support Bills. Advance proposals to revise the Section 404(b) thresholds for low-revenue issuers and to clarify auditor independence rules for pre-IPO companies. Both bills reflect a more proportionate, risk-based approach to oversight and would relieve unnecessary compliance costs without weakening investor protection.

Tailor Compliance to Risk. Replace blunt, size-based thresholds with a risk-based framework that better aligns audit intensity with risk exposure.

Rebalance Audit Priorities. Reinforce the primacy of financial statement accuracy over formal control attestations. Officer certifications and board oversight should carry more regulatory weight than audit boilerplate.

Refocus the Compliance Framework. Encourage regulators and standard setters to shift from procedural checklists toward professional judgment and substantive accountability.

Conclusion

SOX was a prompt and effective response to corporate scandals, but it has ossified into a costly compliance architecture that too often prioritizes process over performance. A targeted, evidence-based reassessment—especially of Section 404(b)—is overdue. Congress has modernized every major securities law; SOX deserves the same attention. The goal is not to weaken investor protections, but to strengthen them by restoring the primacy of accurate financial reporting as the North Star of our capital markets.

I. Introduction

Chair Wagner, Ranking Member Sherman, and members of the subcommittee, thank you for the opportunity to testify at this important hearing on the Sarbanes-Oxley Act of 2002 (SOX). I understand that this hearing is being held to examine how SOX has affected public companies and capital formation, particularly with respect to compliance burdens, audit requirements, and internal control attestations under Section 404(b). I have been informed that the Committee is especially interested in understanding whether certain provisions of SOX have outlived their original purpose or unintentionally discourage companies from going or staying public.

I am Lawrence A. Cunningham, the Director of the University of Delaware's John L. Weinberg Center for Corporate Governance, and have decades of experience in corporate governance and financial reporting.[1] I have been a tenured professor at top universities; served on public company boards and advised others; authored a widely adopted textbook on accounting, finance, and auditing for lawyers; and written extensively on these subjects, including influential articles on SOX and internal controls over financial reporting (ICFR) (excerpts from which appear in the Appendix hereto).[2] Earlier in my career, I served on the staff of the short-lived Independence Standards Board and submitted a comment letter on the first auditing standard under SOX proposed by the Public Company Accounting Oversight Board (PCAOB).[3]

My testimony focuses on the compliance and audit requirements of Section 404, including the 404(b) mandate for independent attestation of ICFR and their effects on public companies, capital formation, and investor outcomes. While SOX was a voluminous bill, these were by far the most consequential provisions;[4] many others were incidental, ineffective, or superfluous.[5]

One core insight I offered in my early analysis of SOX, and one that has proven more salient over time, is that the statute shifted the focus of financial reporting from a primary emphasis on the substance of disclosures to an equal emphasis on the form of control compliance.[6] Over two decades, SOX has fostered a sprawling compliance infrastructure in which internal controls come to be inadvertently designed for auditability rather than effectiveness.[7] This culture risks prizing documentation over discernment, checklists over judgment, and dilution of professional skepticism.[8]

That structural shift, reinforced by auditor incentives and regulatory expectations, helps explain why financial report restatements remain common and why financial reporting quality has not improved in proportion to the compliance effort. In this testimony, I explore the causes, consequences, and potential remedies for this shift.

II. Context

SOX replaced a decade of incremental reforms with a sweeping federal overhaul in response to the collapses of Enron and other corporate giants that shattered investor confidence. It imposed new obligations on executives, auditors, and directors and created the PCAOB to police audit firms.

Yet SOX did not arise in a vacuum. During the 1990s, the Securities and Exchange Commission (SEC) had already begun tightening the system—Chairman Arthur Levitt's "Numbers Game" campaign targeted earnings manipulation; a 1999 Blue Ribbon Committee spurred the NYSE and NASDAQ to require independent, financially literate audit committees; and the Auditing Standards Board issued guidance to strengthen auditor–committee dialogue. These were incremental, tailored reforms.

In the public panic after Enron, Congress replaced that measured trajectory with a one-size-fits-all regime. Passed at speed, SOX layered uniform mandates onto companies of every size and sector—an extraordinary breadth that has endured for twenty-three years. The question now is whether those laws are effective today.

When he was an SEC Commissioner, current SEC Chairman Paul Atkins observed that Section 404 is SOX's "most controversial provision."[9] Section 404(a) requires management to establish and maintain internal control over financial reporting (ICFR) and to include in the company's annual report a written assessment of ICFR effectiveness. Section 404(b) requires a registered public accounting firm to attest to and report on that assessment.

While ICFR tools and practices long pre-dated SOX, these attestation requirements significantly increased the required investment and cost of maintaining them with a one-size-fits-all set of mandates that were invariant to the diversity in size and complexity of the thousands of companies affected.

SOX imposed enhanced independence requirements for external auditors, including restrictions on the types of non-audit services they may provide to their audit clients. These restrictions curtailed longstanding practice of accounting firms offering consulting services—such as financial information systems design or internal audit outsourcing—to audit clients. While these limitations reduced certain lines of business for audit firms, SOX created entirely new and very lucrative lines to replace that lost revenue.[10]

SOX introduced a dual-reporting regime that combines the traditional audit of financial statements with an audit of ICFR. While ICFR is intended to support the reliability of financial reporting, it is not determinative. A company can receive an unqualified opinion on its financial statements even if its internal controls are found to be ineffective, and conversely, it can have effective internal controls while its financial statements contain material misstatements.

These realities reflect the fact that effective internal control, while important, is neither a necessary nor sufficient condition for financial statement accuracy. The integration of these two audit components can obfuscate their respective purposes, but for financial analysis, it is the fair presentation of the financial statements that ultimately matters.[11]

Moreover, compliance has been vastly more expensive than anticipated, especially the auditor fees. Given the high fixed costs involved, smaller companies face disproportionately large costs.[12] Repeated efforts have been made to make this fairer and more rational, including exempting companies that fall below certain size metrics designated as "smaller reporting companies" and "emerging growth companies."[13] As a result, while all companies must comply with 404(a)'s officer certifications, a majority of public companies are exempt from 404(b).[14]

Despite these changes and exemptions, the auditing of ICFR remains a central element of the post-SOX framework and is treated as a functionally co-equal component alongside the audit of financial statements.[15] This structural elevation of ICFR continues to shape compliance and oversight practices and warrants reexamination.

III. Benefits

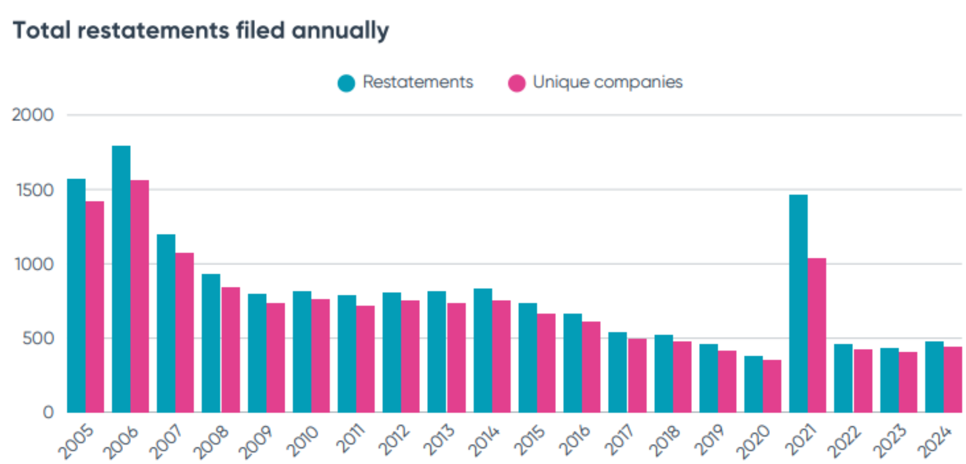
SOX was enacted with the promise of strengthening financial reporting through a host of reforms. Some of its achievements are clear and commendable. Yet the overall record is, at best, mixed—and the path to those benefits has often come at a steep price. This section examines the intended gains and the difficulties in realizing them, while a fuller accounting of costs follows in the next section.

A. Restatements

An accounting restatement occurs when a company corrects previously issued financial statements. Corrections can arise from mistakes, fraud, or changes in accounting rules or interpretations. Restatements are typically made when the original financial statements are found to be materially inaccurate and could mislead investors.

Restatements reflect the quality of financial reporting. A high number or frequency of restatements may indicate weaknesses in accounting practices, internal controls, or oversight processes. As such, restatement patterns are often used to evaluate the reliability and quality of financial reporting.

Restatements surged after SOX, peaking at 1,788 in 2006, and while they declined thereafter, they never vanished—and are rising again.[16] In 2024, public companies disclosed 479 restatements, up 10% from the prior year and more than 25% from 2020.[17] (Figure 1 below.) The average restatement cited two issues—the most since 2007—and over half affected net income or retained earnings, 65% negatively. High-profile companies like Archer Daniels Midland, Macy's, and CSX were among those restating.[18] The leading issues included debt and equity accounting, revenue recognition, and liability estimates, underscoring the persistence and complexity of financial reporting errors even two decades after SOX.[19]



Source: Audit Analytics, Financial Restatements (June 2025)

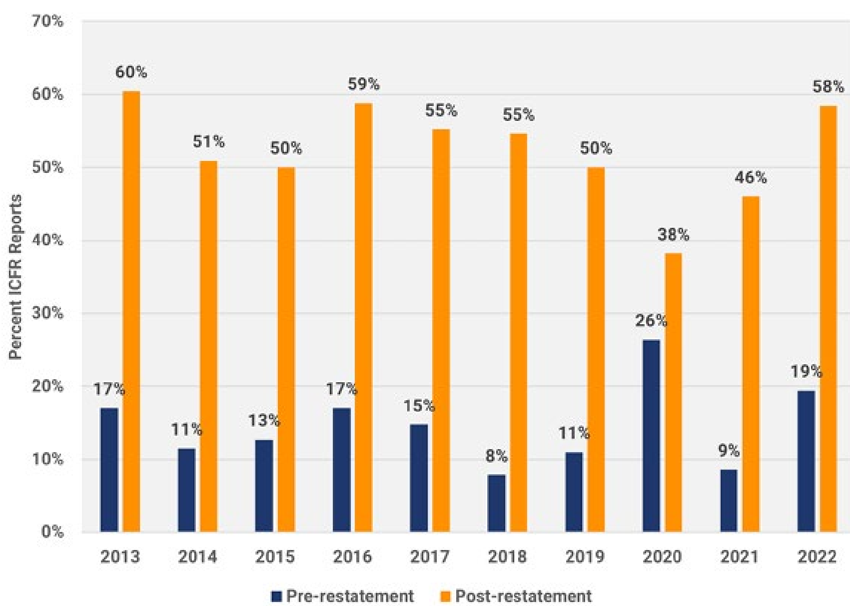
A plausible reason for persistent restatements is that SOX focuses at least as much attention on internal controls as on the financials themselves—controls that companies rightly design to prevent material errors but that auditors must also document for attest purposes. Over time, such an emphasis can shape a compliance culture preoccupied with testing and documenting controls—often at the expense of analyzing or improving the quality of the financial disclosures.

B. Early Warning System

The elevation of control testing was intended to create an early warning system in which weaknesses in controls would signal risk of financial misstatements. But there is evidence of a disconnect between ICFR and financial reporting. For example, an early study found that while 733 companies had reported material ICFR weaknesses through 2006, only 59% of those corrected the problems during the first year after reporting them and 30% kept reporting the same weakness three years later.[20] The disconnect is clearer from a study showing that a majority of companies don't disclose material ICFR weaknesses until after they issue a restatement of its financial report.[21]

Practitioners report a practical side-effect: because audit firms were required to document and test controls exhaustively, engagement teams sometimes spent less time probing complex accounting judgments—the very issues that often trigger restatements. The emphasis on control documentation diverts scarce auditor hours away from higher-value technical analysis. PCAOB inspection cycles compound the problem: partners frequently address prior-year control questions in the middle of current-year quarter-end and year-end work, pulling attention from live reporting issues. These examples illustrate how a well-intended focus on controls can unintentionally crowd out the substantive accounting scrutiny that investors ultimately rely on.

The Center for Audit Quality recently found that management's internal control reports rarely identify the accounting issues that later lead to restatements.[22] In fact, during the period from 2013-2022, only 8–26% of ICFR reports preceding a material restatement cited the relevant issue, while 50–60% did so only after the fact.[23] (Figure 2 below.) This suggests that internal control attestations, while well-intentioned, often fail to serve as early warnings. Instead, they function more as post-mortems—confirming what went wrong, rather than helping to prevent it from occurring. This reinforces the need to refocus SOX more on the accuracy of reported numbers, not the auditability of controls.



Source: Center for Audit Quality (June 2024)

Leading audit firms such as EY and Deloitte emphasize that ICFR audits provide distinct and valuable assurance—particularly in identifying control weaknesses that may not surface in a financial statement audit.[24] They caution that investors should not infer control effectiveness from a clean financial audit alone. Yet in doing so, they underscore the very concern at the heart of this testimony: that internal control audits have been elevated to a status that rivals, and sometimes overshadows, the audit of the financial statements themselves. Even as these firms defend the value of ICFR audits, they acknowledge the complexity, cost, and potential for investor confusion—

reinforcing the need to rebalance our regulatory framework to prioritize the accuracy of reported results over the auditability of internal processes.

C. Reporting Quality

Material weaknesses in ICFR are associated with low quality financial reporting,[25] larger abnormal accruals,[26] greater likelihood of restatements, less accurate forecasts, and lower earnings quality.[27] Some even see weak ICFR as a warning sign of fraud.[28] In theory, therefore, prompt disclosure of ICFR weaknesses could improve the quality of financial reporting and help investors.

Whether the theory works in practice is hard to determine. For one, any observed improvements post-SOX may be due to other SOX reforms, including strengthened audit committees or the officer certifications, which were intended to produce the same benefits and appear to do so more effectively given that such officers rather than auditors are typically the bad actors.[29]

Observed data suggests reporting quality rising and falling over time. For example, the number of adverse 404(b) reports rose to a peak of 480 by 2005, gradually declined to 139 in 2020, then rose again to peak at 246 in 2019.[30] The aggregate number of adverse 404(a) assessments rose from 16.5% in 2007, peaked at 23.9% in 2014 and fluctuated in the low 20s since. For the subset of companies exempt from 404(b) the figures were higher, rising from 27.4% 2007, peaking at 42.4% in 2014 and fluctuating in the high 30s and low 40s thereafter. Such figures do not support the theory that control audits improve financial reporting quality.

D. Earnings Management

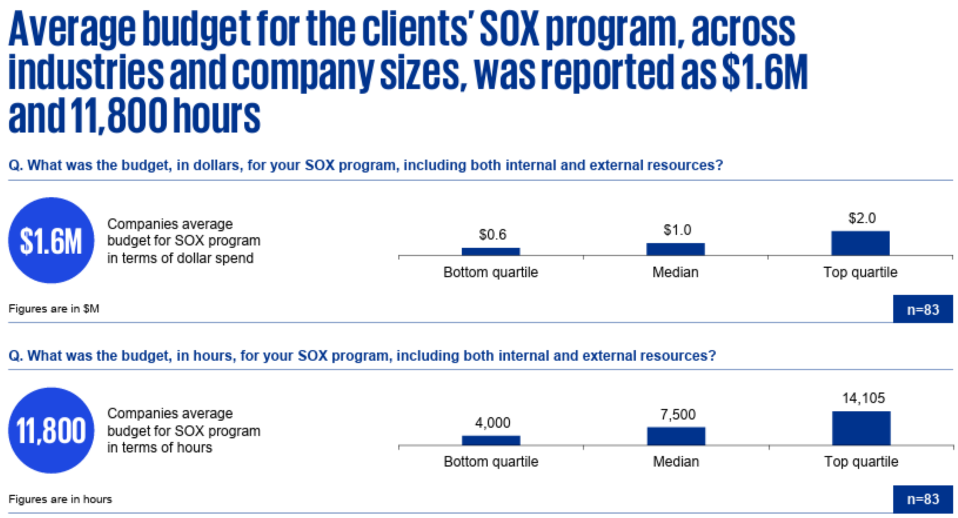
Perhaps the area where SOX's greatest success was achieved is earnings management—the manipulation of accounting policies to present desired reporting results.[31] For example, one study segmented firms just above and just below the 404(b) compliance breakpoint finding those subject to 404 to have lower discretionary and total accruals than those exempt.[32] Another found that earnings quality increases after a company corrects a material weakness that 404 prompted disclosing.[33] This success was greatest in SOX's earliest years, when earnings management appeared to decline.[34] In its later years, the evidence is mixed.[35] Earnings management, even under SOX, varies with factors ranging from the CEO's tenure and risk outlook to a company's share buyback practices.[36]

IV. COSTS

The burden of SOX compliance—especially under Section 404(b)—is both heavy and growing. Direct costs are high and rising: building control systems, documenting them, testing them, and paying external auditors to attest to them. Indirect costs are harder to quantify—and likely higher still.

A. Direct Costs

In the early years after its passage, implementing SOX cost larger companies an average of $7.3 million and smaller ones an average of $1.5 million.[37] Ongoing compliance costs trended lower by between 16% and 31%, since some initial costs were one-time events and the learning curve flattened.[38] However, in subsequent years and recent ones, costs have tended to increase and continue to do so, with recent average annual budgets of $1.6 million and 11,800 hours spent.[39] (Figure 3 below.)



Source: KPMG (2023)

Protiviti reports annually on SOX compliance costs. Average costs rose from $1.338 million in 2016 to $1.339 million in 2018;[40] hours and effort had not decreased significantly between 2009 and 2019;[41] and cost, hours and effort rose through 2022.[42] Average costs remain high at around $1.5 million with a quarter of companies paying more than $2 million and only a quarter or less incurring costs below $500,000.

Small companies remain disproportionately burdened: the larger companies (float > $10 billion) face average costs of $2 million while smaller ones (float < $1 billion) still face average costs of $1 million.[43] For smaller companies, SOX costs are meaningful percentages of revenue and cash flows.[44]

B. Indirect Costs

With the enactment of SOX, director workloads increased, along with director compensation.[45] Audit committees on average meet twice as frequently than pre-SOX.[46] Again, related costs fall disproportionately on smaller companies.

The regulations skew incentives. For example, companies may increase dividends or buybacks to avoid becoming accelerated filers subject to 404(b) or may issue more debt than equity to avoid crossing the threshold making them subject to 404(b).[47]

There is even evidence that 404(b) compliance impairs innovation, as proxied by the number of patents and patent citations between regulated and unregulated firms[48] and reduced R&D spending by companies before and becoming subject to 404(b)—without any compensating improvement in financial reporting quality.[49]

A recent review in *Accounting Insights* underscores how SOX has reshaped the operating environment for smaller public companies and private firms considering an IPO:[50]

- *Resource diversion*. Smaller issuers lack the scale to absorb compliance overhead; sizeable portions of operating budgets fund internal-control software, continuous employee training, and outside advisers rather than R&D or market expansion.

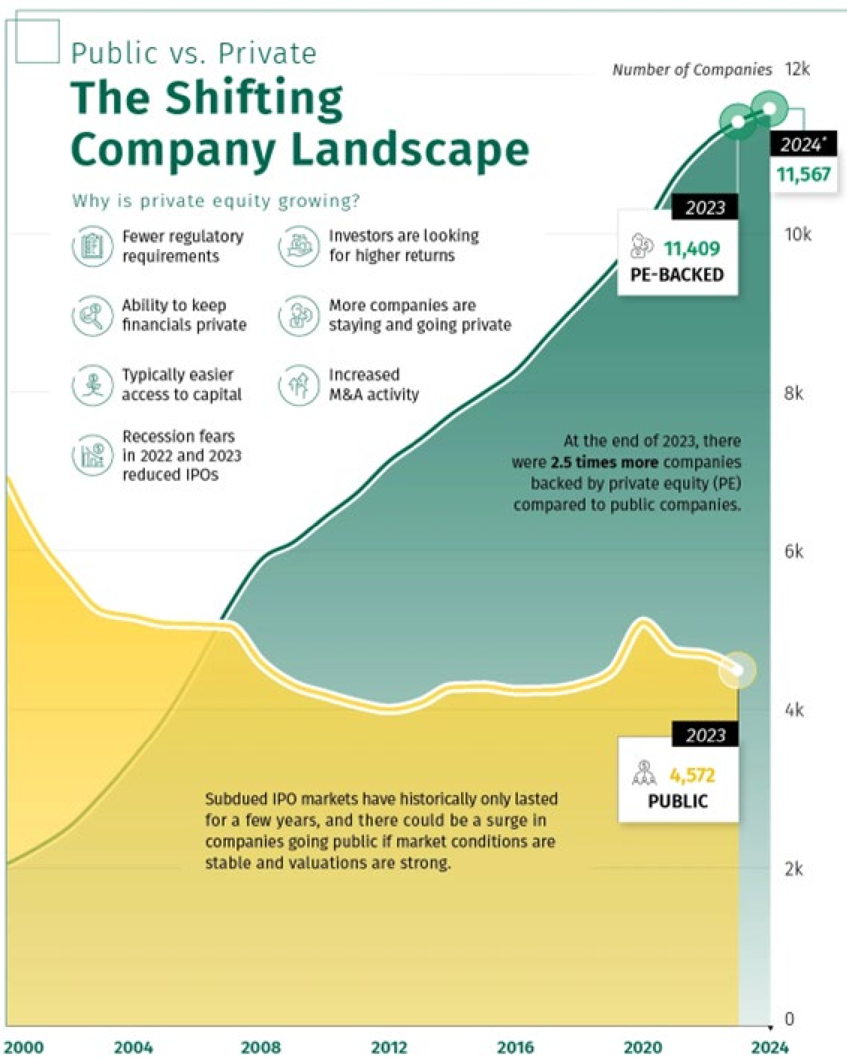
- *Rigid risk-management systems*. To satisfy audit expectations, many firms have adopted large-enterprise internal-control frameworks ill-suited to their size, sacrificing agility for formality.
- *Accelerated reporting cycles*. Shorter filing deadlines and real-time disclosure expectations force small companies to reorganize workflows and invest in advanced reporting tools, again tilting resources toward compliance infrastructure.

V. CAPITAL FORMATION

A core objective of the federal securities laws is to promote capital formation.[51] Yet the Sarbanes-Oxley Act—particularly in its more burdensome provisions—has increasingly worked at cross purposes with that aim, as its rising costs have contributed to the shrinking and shallowing of U.S. public capital markets.

A. Public/Private Markets

Since SOX, the number of public companies has dropped from ~6,500 to ~4,000 while the number of large private companies soared from ~2,000 then to ~12,000 today. (Figure 4 below.)



Source: Citizens Bank (Dec. 2024)[52]

Many factors contribute to these developments, including:

- the rise of private credit markets;
- mergers and acquisitions (M&A); and
- regulatory costs.

While it is difficult for Congress to drive trends in such areas as private credit or M&A, it has substantial control over the regulatory burden. The calculus for going or staying public varies by industry. The IPO-to-exit ratio illustrates this:[53]

- high in pharmaceuticals and biotech;
- balanced in retail, materials, and consumer durables; and
- inverted in banking, software, tech hardware, media, and telecom.

It's also useful to appreciate that companies that deregister their equity securities from public company status may nevertheless issue debt that leaves them subject to certain SOX regulations.[54]

That said, research on SOX's impact reveals factors that likely shape how companies assess the pros and cons of being public versus private:

- negative stock returns of -13% to -15% during SOX's passage[55]
- a rise in going-private transactions post-SOX;[56] and
- the combined cost to smaller firms of audit fees and reduced market value was as high as 167%.[57]

A new study finds that the median public company spends 4.3% of its market cap on compliance.[58] While regulation is not the sole reason for fewer public firms, it is a significant—and controllable—factor.

B. Exits

Over the past two decades, a steady stream of U.S. public companies chose to go private in part to escape the rising burdens of regulatory compliance—especially those imposed by SOX. While the exodus of small-cap companies in the mid-2000s was well documented—more than 200 firms voluntarily delisted or "went dark" between 2003 and 2008, citing the disproportionate costs of Section 404(b)—similar pressures are surfacing again today.[59]

The SEC's own 2011 study on 404(b) recorded how smaller issuers reacted, with one commentator quoted as saying: "When asked if the costs of Section 404 motivated their company to consider going private, 31.5 percent of smaller firms said they were seriously considering it and 38.2 percent said they were somewhat considering it."[60]

In 2017, Staples was taken private by Sycamore Partners in a $6.9 billion deal, after years of regulatory costs and shareholder pressures had worn on its operating flexibility. In 2022, Twitter (now X Corp.) was acquired by Elon Musk in a $44 billion take-private, a move he explicitly linked to concerns about disclosure mandates.

In 2025, both Walgreens Boots Alliance and Nordstrom agreed to go private—deals valued at nearly $10 billion and $6.25 billion, respectively—amid board-level conversations about the rising complexity of operating as a public company.

These are not failing companies fleeing accountability but longstanding businesses opting out of public markets to regain strategic control and shed what they view as excessive procedural burdens. When well-capitalized, brand-name firms exit the public sphere to escape red tape, it signals not just a market shift but a necessary policy inflection point.

C. Entrants

The number of small IPOs has also declined.[61] While private investors increasingly hold firms longer pre-IPO,[62] SOX-related costs—both before and after listing—are material deterrents.

The 2012 JOBS Act offered relief to emerging growth companies (EGCs). Key provisions included reduced disclosure requirements, delayed implementation of new accounting standards, and exemptions from 404(b)'s control audits. Studies show it worked, as scores of companies went public in its wake.

Yet the exemption is temporary, lasting only five years from the IPO. Companies often begin preparing for post-EGC compliance years in advance, incurring costs early.[63] As a result, the exemption is more nominal than substantive for many firms.

The SOX compliance architecture continues to deter some high-growth, innovative companies from going public. The result is a public market that is older, smaller, and less dynamic than it could be.

Big Four accounting firms routinely warn of these costs. Deloitte calls SOX compliance "one of the more significant undertakings" for IPO candidates.[64] EY emphasizes multi-year planning and resource-intensive preparation.[65] These burdens discourage many from pursuing public listing altogether.

VI. INVESTOR PROTECTION

SOX was enacted with a clear intended beneficiary: investors. The law's fundamental purpose was to restore trust in financial reporting and corporate governance after a period of catastrophic failures. Yet even among investors, perspectives on SOX—particularly 404(b)—are not uniform and the empirical evidence mixed.

Evidence about SOX's effectiveness from stock market pricing and reactions is inconclusive.[66] There is some evidence that disclosing material weaknesses may increase a company's cost of capital, particularly for companies who do so continuously for several years. But in general, there is little or scant evidence that adverse 404 disclosures reduce stock price or increase the cost of capital.

The divergence in investor attitudes was evident in comment letters submitted to the SEC on its proposal to exempt certain low-revenue or smaller companies from 404(b). The SEC release depicted this divide (footnotes omitted):[67]

> Many commenters asserted that, even if the ICFR auditor attestation requirement did not apply, other existing requirements would provide investors in these issuers with sufficient protection, . . . including SOX Section 404(a); Nasdaq's listing standards, surveillance, and enforcement; the required management certifications; and the obligation of an independent auditor to consider ICFR when conducting a financial statement audit. . . . Some commenters expressed a view that the ICFR auditor attestation requirement is not important or material to investors generally. . . . One [said] investors do not significantly change

> their long-term value assessment of an issuer based on these disclosures. . . .
>
> Conversely, other commenters asserted that the ICFR auditor attestation requirement is an important investor protection and that eliminating it would undermine such protection. One commenter disputed the contention . . . that eliminating the ICFR auditor attestation requirement for low-revenue issuers would not significantly affect the ability of investors to make informed investment decisions. Some commenters stated that the ICFR auditor attestation requirement increases investor confidence generally and that investors view the requirement as beneficial.

The divergence in investor attitudes may reflect differences in investment strategy, analytical capability, and risk tolerance. Long-term, concentrated shareholders—such as value investors in the tradition of Warren Buffett—tend to analyze financial statements directly, assess accounting quality independently, and scrutinize management's disclosures closely.[68] For these investors, the marginal utility of mandated attestations or internal control audits may be low. They often view such requirements as duplicative of their own due diligence or, worse, as distractions that burden management and distort priorities.

In contrast, passive index investors—who now comprise a significant and growing share of the market—lack the resources, focus or incentives to evaluate the financial reporting quality of given companies. For them, regulatory guardrails such as internal control attestations, CEO/CFO certifications, and PCAOB oversight serve as system-wide protection that enable them to avoid the costs of firm-specific investment research. These investors are less likely to challenge the value of SOX requirements because they rely more heavily on the integrity of the system itself.

What emerges is not a consensus, but a tension: between investors who want greater discretion and those who need stronger assurances; between those willing to pay for customized analysis and those who rely on standardized compliance. That tension reinforces the importance of regulatory flexibility—and cautions against treating all companies or investors as if they face the same risks or possess the same tools.

VII. Pending Legislation

The sub-committee's hearing notice includes two draft bills that reflect a welcome shift toward a more risk-based and proportionate approach to oversight under SOX. Both proposals align with the core themes of this testimony: focusing on material risks, reducing unnecessary compliance burdens, and restoring regulatory flexibility, all without compromising investor protection.

A. Thresholds

One draft bill would require the SEC to revise the thresholds used to determine smaller reporting companies, accelerated filers, and large accelerated filers. The practical effect would be to exempt a broader set of low-revenue public companies from the costly auditor attestation requirement under Section 404(b).

This reform is especially relevant for early-stage life sciences companies, which often must access public markets earlier than other sectors due to their long research and development timelines and limited access to private capital. Unlike technology firms, which may delay public offerings while raising significant private funds, many biotech firms face no viable alternative to going public. Yet, once public, they are subject to 404(b) audits that can consume $1 million or more annually—resources diverted from scientific work, not from risk-prone financial operations.

This proposal would tailor compliance more appropriately to risk. These firms are typically pre-revenue, have straightforward capital structures, and already face strong market and regulatory scrutiny. They remain subject to management certifications under Section 404(a), financial statement audits, and audit committee oversight. The additional layer of auditor attestation under 404(b) offers limited incremental benefit in this context. Recalibrating the thresholds, especially based on revenue, would relieve a costly burden that does not materially enhance investor protection.

B. Pre-IPO Engagements

A second draft bill would address a growing problem in the application of PCAOB and SEC independence rules. It would require regulators to treat an auditor as independent for work performed before a company became public, so long as the auditor complied with applicable professional standards at the time.

This is a sensible correction to what has become an overly rigid rule. Many private companies engage audit firms years in advance of a public offering. Under current law, if those auditors are later found to have violated technical independence rules—even unintentionally and minimally—the issuer may be forced to switch auditors or re-audit past financials, at significant expense and with no evidence of compromised integrity. This bill would clarify that historical independence should be assessed under the standards in place at the time of the audit, not retroactively reinterpreted after an IPO.

This proposal reflects a broader concern addressed in my testimony: the elevation of form over substance. Rigid compliance rules that add cost without improving audit quality or investor protection undermine the purpose of SOX. Allowing companies and auditors to rely on well-established professional standards—rather than retroactive technicalities—would reduce waste while preserving trust.

VIII. Conclusion

SOX has provided companies with an intricate compliance playbook—but not necessarily with more reliable financial reports. By elevating internal control attestations to parity with the audit of the financial statements, SOX has unintentionally shifted attention from *what* companies report to *how* they document the reporting process. The result is a costly culture of control compliance that can obscure, rather than illuminate, real economic performance.

Regulation that evolves with evidence—not ideology—best serves investors, companies, and the economy. This hearing gives Congress the chance to restore balance: to ensure that *accurate financial reporting*, not voluminous documentation, remains the North Star of U.S. capital market regulation.

Some have characterized any effort to reform SOX as tantamount to dismantling investor protections or inviting another wave of corporate scandals.[69] That is inaccurate. The goal of this hearing, and of my testimony, is not to weaken accountability but to strengthen it by ensuring that our laws are properly tailored to serve their purpose.

Twenty-three years after SOX's enactment, we must distinguish between the law's enduring principles and its outdated mechanics. Preserving investor trust requires more than ritual compliance; it demands a system that prioritizes substance over form, clarity over complexity, and effectiveness over redundancy. Reforming SOX is not about forgetting Enron—it's about learning from such frauds, and from the decades of experience since, to build a smarter, more resilient framework for the future.

END NOTES

[1] My full curriculum vitae is available from https://weinberg.udel.edu/.

[2] See Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And it Might Just Work), 35 Connecticut Law Review 915 (2003); Lawrence A. Cunningham, The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills, 29 Journal of Corporation Law 267 (2004). Excerpts from two of those early articles—written in 2003 and 2004—are included in Appendices A and B because they offer contemporaneous perspective on SOX's enactment, its original policy aims, and the emergence of internal controls as a centerpiece of federal corporate governance.

[3] Comment Letter No. 15, Lawrence A. Cunningham, Docket 008, SEC Release No. 34-49884 (June 17, 2004) [link: rb.gy/yznif5]. The ISB's four-year duration (1997-2001) was cut short by disagreement between the SEC and the profession over the provision of non-audit services to public audit clients, a practice that SOX effectively abolished in 2002. See SEC Historical Society, https://rb.gy/7m8h3t.

[4] SOX had far-reaching effects, including in legal education. In its wake, law school courses on accounting for lawyers began incorporating coverage of auditing. One reflection of this shift was the expansion and retitling of a leading textbook on the subject, which I wrote: originally published as *Introductory Accounting and Finance for Lawyers* (3rd ed. 2002; prior editions dating to 1995), it was renamed I*ntroductory Accounting, Finance, and Auditing for Lawyers* beginning with the 4th edition in 2004 through its current 8th edition in 2023. The length grew accordingly between those editions, from approximately 300 to 500 pages.

[5] John C. Coates IV, The Goals and Promise of the Sarbanes–Oxley Act, 21 Journal of Economic Perspectives 91, 109-110 (2007) (citing Cunningham, The Sarbanes-Oxley Yawn, above).

[6] Cunningham, Appeal and Limits of Internal Controls, above.

[7] See Michael Powers, The Audit Society: Rituals of Verification (1997); Afterword: Audit Society 2.0?, 21 Qualitative Research in Accounting & Management 2 (2024).

[8] See David J. O'Regan, The Closing of the Auditor's Mind? How to Reverse the Erosion of Trust, Virtue and Wisdom in Modern Auditing (2025). O'Regan focuses on internal auditing but his observations apply equally to external auditing—and especially of internal controls.

[9] Paul S. Atkins, Commissioner, U.S. Securities & Exchange Commission, Remarks at the 4th Annual Financial Services Conference (Jan. 31, 2006), [https://perma.cc/3SBT-BMHP].

[10] See Cris Shore and Susan Wright, How the Big 4 Got Big: Audit Culture and the Metamorphosis of International Accountancy Firms, 38 Critique of Anthropology 303 (2018).

[11] The PCAOB implemented the audit requirements for internal control over financial reporting in 2004 through Auditing Standard No. 2 (AS2). AS2 was widely criticized for being overly prescriptive, complex, and costly, particularly for smaller public companies. In response to these concerns, the PCAOB replaced AS2 with Auditing Standard No. 5 (AS5) in 2007. AS5 sought to make internal control audits more risk-based, scalable, and efficient. Public Company Accounting Oversight Board, Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, Release No. 2007-005 (June 12, 2007).

[12] See Advisory Comm. on Smaller Public Companies, Exchange Act Release No. 53,385, at 20 (Feb. 28, 2006) [https://perma.cc/UL7R-3V4J].

[13] For example:

• In 2007, the SEC approved a revised PCAOB auditing standard to simplify compliance, eliminate unnecessary processes, and focus on the most critical aspects of the issuer's internal controls. See Order Approving Proposed Auditing Standard No. 5, Exchange Act Release No. 56,152 (July 27, 2007), [https://perma.cc/3BFT-FN9X]; see also Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, 72 Fed. Reg. 35324 (June 27, 2007) (codified at 17 C.F.R. pt. 241); Internal Control over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers, 73 Fed. Reg. 38094, 38094–95 (July 2, 2008) (codified at 17 C.F.R. pts. 210, 228, 229 & 249).

• The 2010 Dodd-Frank Act exempted *non-accelerated filers* from 404(b). See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 989G, 124 Stat. 1376, 1948 (2010) (codified as amended at 15 U.S.C. § 7262 (2018)).

• The 2012 JOBS Act exempted *emerging growth companies* (those with revenues less than $1 billion) from 404(b). See Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 101, 103, 126 Stat. 306, 307–10 (2012) (codified as amended at 15 U.S.C. §§ 77b(a)(19), 78c(a)(80), 7262(b) (2018) and indexed to inflation). For newly public EGCs, the status ends upon the fifth anniversary of its IPO.

• In 2020, the SEC exempted from the class of accelerated filers "*smaller reporting companies*"—those with revenues less than $100 million. (Estimated savings per company: $210,000, about half in audit fees and half in non-audit costs). See Accelerated Filer and Large Accelerated Filer Definitions, 85 Fed. Reg. 17178, 17178 (Mar. 26, 2020) (codified at 17 C.F.R. pts. 229, 230, 240 & 249). See also 17 C.F.R. § 230.405 (2022) for definitions of "smaller reporting companies."

[14] Stephen M. Bainbridge, Symposium: Sarbanes-Oxley at 20, 78 Business Lawyer 647 (2023) (in 2020 there were 3,142 §404(b) filings compared with 6,205 §404(a) and in 2014 the figures were 3,795 and 7,449).

[15] U.S. Government Accountability Office, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, GAO-06-361 (April 13, 2006), https://www.gao.gov/products/gao-06-361.

[16] Center for Audit Quality, Financial Restatement Trends in the United States: 2013 – 2022 (June 2024) https://thecaq.wpenginepowered.com/wp-content/uploads/2024/06/caq-financial-restatement-trends-us-2013-2022_2024-06.pdf

[17] Audit Analytics, Financial Restatements (June 2025), https://rb.gy/fmg04j.

[18] Stephen Foley, Accounting Errors Force US companies to Pull Statements in Record Numbers, Financial Times (Dec. 9, 2024).

[19] Mark Maurer, Macy's Accounting Scandal Raises Questions About Which Errors Matter, Wall St. J. (Dec. 18, 2024) https://www.wsj.com/articles/macys-accounting-scandal-raises-questions-about-which-errors-matter-fdebaa17?utm_source=chatgpt.com

[20] Karla Johnstone, Chan Li and Kathleen Hertz Rupley, Changes in Corporate Governance Associated with the Revelation of Internal Control Material Weaknesses and Their Subsequent Remediation, 28 Contemporary Accounting Research 331 (2011).

[21] Sarah C. Rice and David P. Weber, How Effective Is Internal Control Reporting Under SOX 404? Determinants of the (Non-)Disclosure of Existing Material Weaknesses, 50 Journal of Accounting Research 811 (2012).

[22] Center for Audit Quality, Financial Restatement Trends, above (page 4, key findings: "Ineffective ICFR reports are generally issued after a restatement is announced, i.e., ICFR reports are not predictive of restatements.").

[23] Id. page 34, figure 16, panel B ("Anywhere between 8% and 26% of the time, the ICFR reports issued in advance of a 4.02 restatement cite at least one accounting issue underlying a subsequent restatement." and "In eight of the ten years under study, a material weakness is reported in reports subsequent to a restatement anywhere between 50% and 60% of the time.").

[24] *E.g.*, Comment Letters on Amendments to the Accelerated and Large Accelerated Filer Definitions (Release No. 34-85814; File No. S7-06-19) of EY (July 29, 2019) https://www.sec.gov/comments/s7-06-19/s70619-5879406-188753.pdf and Deloitte (July 26, 2019) www.sec.gov/comments/s7-06-19/s70619-5877285-188691.pdf.

[25] See Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney, Jr. and Ryan Lafond, The Effect of SOX Internal Control Deficiencies and Their Remediation on Accrual Quality, 83 Accounting Review 217, 247 (2008).

[26] Jean Bédard et al., Literature Review: Current Knowledge on Internal Control 9 (2017) *[https://perma.cc/5YWX-AH4N]*.

[27] Id. (citing Gene Kim, Vernon J. Richardson & Marcia Weidenmier Watson, IT Does Matter: The Folly of Ignoring IT Material Weaknesses, 32 Accounting Horizons 37 (2018).

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[29] Ujkan Q. Bajra, Florin Aliu, Armand Krasniqi, Ejup Fejza, The Impact of the Sarbanes–Oxley Act on the Integrity of Financial Reporting: Was it Meritorious?, 34 Journal of Corporate Accounting & Finance 184 (2023) ("financial statement assertions improve with compliance with SOX302 but not with SOX404"); Parveen P. Gupta, Heibatollah Sami and Haiyan Zhou, Do Companies with Effective Internal Controls over Financial Reporting Benefit from Sarbanes-Oxley Sections 302 and 404?, 33 Journal of Accounting Auditing & Finance 200, 200 (2018).

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[32] Peter Iliev, The Effect of SOX Section 404: Costs, Earnings Quality, and Stock Prices, 65 Journal of Finance 1163 (2010).

[33] See Hollis Ashbaugh-Skaife, Daniel W. Collins, William R. Kinney, Jr. and Ryan Lafond, The Effect of SOX Internal Control Deficiencies and Their Remediation on Accrual Quality, 83 Accounting Review 217 (2008).

[34] See, e.g., Zvi Singer and Haifeng You, The Effect of Section 404 of the Sarbanes-Oxley Act on Earnings Quality, 26 Journal of Accounting, Auditing & Finance 556 (2011).

[35] See Cori O. Crews and George R. Wilson, Sarbanes-Oxley and Earnings Quality, 29 Journal of Finance & Accounting 1 (2021) (reviewing studies).

[36] Id.

[37] CRA International*,* Sarbanes-Oxley Section 404 Costs and Implementation Issues: Survey Update *5-6* (2005).

[38] Cyrus Afshar & Paul Rose, Capital Markets Competitiveness: A Survey of Recent Reports, 2 Entrepreneurial Business Law Journal 439 (2007).

[39] Proviti (June 2024 polling data) https://www.protiviti.com/us-en/whitepaper/empowering-sox-innovation ("The scope, hours and costs for SOX compliance continue to increase"); see also full report: https://www.protiviti.com/sites/default/files/2024-08/empowering-sox-innovation-protiviti.pdf; KPMG (2023 survey data: 40% of participants reported an increase in the year-over- year cost of SOX, with an average spend of $1.6M, and 11,800 hours). https://kpmg.com/us/en/articles/2023/kpmg-sox-report.html

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[41] Protiviti, Benchmarking SOX Costs, Hours and Controls 4 (2019) [https://perma.cc/A4UP-W237].

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[51] See Securities Act of 1933 § 2(b), 15 U.S.C. § 77b(b); Securities Exchange Act of 1934 § 3(f), 15 U.S.C. § 78c(f); H.R. Rep. No. 104-622, at 16 (1996).

[52] https://www.citizensbank.com/corporate-finance/insights/private-equity-trends.aspx

[53] Shivaram Rajgopal, Have Reporting Burdens Led To More Firms Staying Private?, Forbes (June 8, 2025). The variation can be explained by industry features that create different cost-benefit breakpoints. For example, pharmaceutical and biotech firms need substantial, long-term capital and already operate under heavy disclosure norms (e.g., clinical trial transparency), so the incremental cost of public reporting may be relatively low. Firms in banking, software, tech hardware, media, and telecom have easy access to private capital and need to protect sensitive intangible assets, implying a steeper trade-off, where the burdens of being public more nearly outweigh the benefits. It may not be possible to dial regulations to suit these tradeoffs but it is valuable to appreciate them when interpreting data about the effects of regulation.

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[59] See, e.g., GAO, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies, GAO-06-361 (2006); Leuz, Triantis and Wang, Why Do Firms Go Dark? 45 Journal of Accounting and Economics 181 (2008).

[60] U.S. Securities and Exchange Commission, Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 for Issuers with Public Float Between $75 and $250 Million (April 2011), 74–75.

[61] Vartika Gupta, Tim Koller and Peter Stumpner, Reports of corporates' demise have been greatly exaggerated (2021), https://www.mckinsey.com/capabilities/strategy-and-corporate-finance/our-insights/reports-of-corporates-demise-have-been-greatly-exaggerated; Vanguard, What's behind the falling number of public companies?
https://static1.squarespace.com/static/56cc7bc60442621c56ef83be/t/5d45a132c2f0c50001083645/1564844339212/Vanguard+Shrinking+US+companies.pdf

[62] Shivaram Rajgopal, Have Reporting Burdens Led To More Firms Staying Private?, Forbes (June 8, 2025).

[63] https://www.ey.com/en_us/insights/consulting/why-sox-preparation-can-be-the-key-to-ipo-success

[64] https://www2.deloitte.com/us/en/pages/advisory/articles/ipo-challenges-and-sox-compliance-for-newly-public-companies.html

[65] https://www.ey.com/en_us/insights/consulting/why-sox-preparation-can-be-the-key-to-ipo-success To paraphrase EY's guidance to pre-IPO companies:

- SOX compliance requires the creation of a comprehensive internal control framework from scratch, including a governance structure that separates oversight from execution.
- Companies must identify control owners within business and IT functions and establish steering committees to guide the implementation process.
- Materiality thresholds must be defined, significant accounts mapped, and risks documented. External auditors must be consulted early to align scope and methodology.
- While Section 302 formally requires CEO and CFO certification annually, in practice companies implement quarterly bottom-up certifications from control owners to ensure real-time responsiveness.
- Entity-level and IT-related controls must be documented, with control gaps remediated and a Risk and Control Matrix finalized.
- Internal training is essential to maintain compliance, and companies often spend significantly to ensure that those executing controls are properly trained.
- All of this must be paired with a robust change-management system to assess how organizational or technological changes affect internal controls.

[66] Jean Bédard et al., Literature Review: Current Knowledge on Internal Control 9 (2017) [https://perma.cc/5YWX-AH4N].

[67] Securities and Exchange Commission, Final Rule: Amendments to the Accelerated Filer and Large Accelerated Filer Definitions, Release No. 34-88365 (March 12, 2020), pages 15-20, available at https://www.sec.gov/rules/final/2020/34-88365.pdf.

[68] See Warren E. Buffett & Lawrence A. Cunningham, The Essays of Warren Buffett (8th ed. 2023) (Part VII: Accounting).

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APPENDIX A

Lawrence A. Cunningham, The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work), 35 Connecticut Law Review 915 (2003) (excerpts from the Introduction and Part II.A; footnotes omitted; pagination bolded in text)

The Sarbanes-Oxley Act must be understood in its economic, political and historical context. The Act followed the telecom/dot.com-infused stock market bubble of the late 1990s, which featured new and poorly understood companies. The history of that era will be written many times from numerous perspectives with a scope beyond that necessary to establish sufficient background to understand the climate in which the Act was adopted. A few insights about the environment are offered in a capsule overview, beginning with broader financial trends, highlighting the four galvanizing corporate debacles, and concluding with a sense of the regulatory landscape leading up to the Act.

A. Events

The late 1990s were a period of economic expansion and technological innovation of a magnitude that comes once a generation in American business history. Extraordinary change was led by the exploitation of technologies, enabling the widespread use of the Internet and proliferation of telecom infrastructure. To give one practical illustration of this change, in 1996 hardly anyone used email and a minority used cell phones; by 2000, a vast majority used both regularly.

Heady financial times such as these invariably attract to investing millions of people who lack business knowledge, and to business thousands of people who lack moral scruples. This combination produces and sustains an exaggeration of the real achievements and an obfuscation of the setbacks. With flushness fueling financial fantasies, accounting and corporate governance become, at worst, obstacles to overcome. At best, they become technical burdens to meet as painlessly as possible rather than tools to promote quality financial reporting or disciplined management oversight. The spirit of the times overcomes the spirit of the rules.

The hallucinations of the late 1990s came to an end in March 2000, when investors recognized that a financial bubble had arisen. This drove stock market indexes down—they plunged immediately and remained stagnant for months. Eighteen months later, the terrorist attacks of September 11, 2001 jolted markets and caused complex economic and political **924** uncertainties. Threats to invade Iraq and topple its leadership kept nerves unsteady, an unease that would continue for more than a year.

The unraveling of Enron, a direct product of the era's financial fantasia, began in late 2001 and escalated in early 2002, heightening already high marketplace anxieties. Even then, however, investors held on and markets held sideways, and politicians commenced hearings but kept them on the sidelines. In the early days of the forthcoming domino effect, President George W. Bush was able, with some credibility, to attribute the Enron debacle to a few rotten apples. Other Republicans likewise showed no inclination toward a regulatory response.

As the Enron shenanigans unfolded, the number of obvious rotten apples at the company increased. Also, the number of professional service firms that participated with or aided those rotten apples soared. The brightest spotlight shone on Enron's outside auditing firm, Arthur Andersen, LLP. As the heat bore down on Arthur Anderson, its employees engaged in felonious acts of obstructing justice, such as destroying evidence of wrongdoing and altering records. Such activity resulted in client flight, a criminal jury verdict, and ultimate dissolution. The debacles of Enron and Arthur Andersen provoked public disgust, Congressional hearings and more than forty reform bills directed at auditor oversight. These bills, however, were put on the back burner.

An accounting meltdown at Global Crossing, Ltd. began to tip the dominos. Dubious financial reporting concerning a wide range of practices and policies surfaced at the telecom industry's darling, just as the Enron disclosures were widening. This was the beginning of the end for Global Crossing and its industry cohorts, and the company sailed toward bankruptcy. Even so, while Democrats in Congress eagerly stepped up hearings, hauled executives and professionals before them, and drafted reform proposals, it remained possible that the upheavals would fade into the recesses of public memory without call for formal political action.

But there was more. A wave of reported corporate debacles mounted the pressure for Congress to respond in Spring 2002. These newer scandals were characterized by distinctly different kinds of misbehavior. For example, the widely-publicized cases of Adelphia Communications Corp. and Tyco International Ltd. involved corporate loans to executives on sweetheart terms. These were stories of individual greed, rather than direct **925** accounting corruption of the type practiced at Enron or Global Crossing.

Other stories involving accounting corruption that had been buried in the business section of top newspapers for years now became front-page news everywhere and feature stories on broadcast and cable television shows. These companies included household names such as AOL Time Warner Inc., Rite Aid Corp. and Xerox Corp. The parade of disparate tales of illicit activity was extended and saturated by events concerning ImClone Systems Inc. This biotech company's CEO allegedly told his father and daughter, and perhaps home furnishings maven Martha Stewart, about company prospects that led to claims of insider trading in violation of federal securities law.

Investors may have been able to properly classify these unrelated events for a while. Enron and the other ongoing accounting scandals were about companies dressing up accounts to obscure the truth; the self-dealing loans made to executives at Adelphia and Tyco were relatively ordinary (if despicable) incidents of corporate misconduct that are the price paid for a market-based system of finance and governance; and events at ImClone concerned arcane regulations governing the wrongful disclosure of nonpublic information. But non-experts in accounting, corporate governance and securities law are not good at maintaining these distinctions (especially when they have just lost enormous investment capital) and the press showed little interest in doing so.

The gales of Enron were strong and these other episodes amplified them. The ultimate tipping point arrived in June 2002, with a true and pure accounting deception so large that there was no turning away from Congressional action, even for President Bush and his fellow free-market Republicans. That month WorldCom Inc.'s internal auditors revealed that top dogs had cooked its books to the tune of several billion dollars, a scandal with partners at other marquee names from the telecom boom, particularly Qwest Communications International Inc., whose starring role in the mischief was uncovered the next month.

926 Not coincidentally, several characteristics adorned each of the four massively scandal-ridden companies—Enron, Global Crossing, WorldCom, and Qwest. First, they were all new. WorldCom effected an initial public offering in 1995, Global Crossing and Qwest both went public in 1997, and Enron transformed during the mid-to-late 1990s from a stodgy natural gas company into a broadband and risk management mirage. Second, these four companies (the "Big Four Frauds") stand out as using the most appalling accounting and exhibiting the most supine corporate governance. These companies were far different in daring, scope, and type from other accounting or corporate governance aggressions of any period. Third, all used the same outside auditor, the once-venerable and now dead Arthur Andersen. While Enron's aggression was the manifest causal link to Arthur Andersen's demise, the interaction of all four companies with that erstwhile member of the Big Five auditing firms undoubtedly infected its culture.

By mid-summer 2002, the wave of reports from each of the Big Four Frauds seemed endless. Worse, these reports were paralleled by investigations **927** into the practices, during the pre-March 2000 boom years, of additional culpable professionals. Besides auditors and executives, questions were raised concerning the role of securities analysts, lawyers, and credit rating agencies. In many of these cases, particularly with securities analysts, damning evidence surfaced of their complicity.

The multi-billion dollar scale of the Big Four Frauds wrought proportional personal losses for millions of ordinary Americans. All this happened in the wake of the imploding financial bubble that stripped several trillion dollars from equity owners, a large percentage from the same ordinary Americans already directly impacted by the collapse of the Big Four Frauds. This combination of forces produced a natural tendency to overreact. The upshot was the wholesale questioning of the quality of financial reporting throughout corporate America. These calls were made worldwide.

Perspective was in order, but rarely broke through. One conception would have classified the disparate scandals more clearly, emphasizing that Enron was essentially a Ponzi scheme, diabolically engineered and disguised by a coterie of pathological fiends (President Bush was right about that). Another would have observed that the other three members, as well as Adelphia, suffered from telecom mania on their way into the balloon, and telecom fever when it deflated. More broadly, everyone could have been reminded that when the balloon held helium, few complained about manifestly aggressive accounting when business performance was measured by revenue, not earnings or cash; by eyeballs hitting Internet sites, not dollars customers paid. But victims do not like to be blamed.

Despite such plausible but unpopular perspectives, cries to do something were loud and could not be ignored. The noise created political capacity in Congress for reform-minded legislators to craft improvements and pressured those more reluctant to regulate. The result was the Sarbanes-Oxley Act, the product of Congressional hearings conducted throughout the period following Enron's first sordid revelations, and **928** gaining momentum rapidly in the weeks before enactment in late July.

APPENDIX B

Lawrence A. Cunningham, The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills , 29 Journal of Corporation Law 267 (2004) (excerpts from the Introduction and Parts I.C. and III; footnotes omitted; pagination bolded in text; shading to emphasize greatest relevance)

Introduction

Corporate internal controls have become a first-order policy option to respond to a wide variety of national problems. In response to early 2001's financial scandals, Congress adopted the Sarbanes-Oxley Act (SOX), to bolster controls over financial reporting and mandated audits of them. . . .

Accompanying the proliferation of corporate internal controls to address various policy objectives has been a rise of audits to test those controls. But audits are also limited in what they can do. Auditors cannot guarantee that the controls they test are in fact effective, though they can offer some assurance about that. More important, as audit proliferates as a way to test control effectiveness, pressure builds to create controls that can be audited. This means that controls are increasingly designed according to whether they can be audited, not according to whether they are likely to be effective. The proliferation of controls and auditing of them creates so many controls that, by sheer volume, it becomes more difficult to determine which controls are likely to be effective.

Numerous systemic forces make controls appealing as a policy option. . . . Resistance to overt federal preemption of state corporate law makes controls attractive as an alternative way to inject federal policy into internal corporate affairs. The rise of the monitoring model of the board of directors in corporate governance makes controls essential tools to enable this indirect supervision of corporate affairs. . . .

Backing these powerful systemic forces making controls appealing [is] the auditing . . . profession[]. In the case of auditors, controls are an appealing way to diversify the profession's services. Auditors can both design and test controls. The profession encourages control proliferation and auditing of controls as part of its business strategy. In their marketing, however, auditors oversell both what controls can accomplish and how auditing of controls can help make controls more effective. . .

[**270**] These systemic and professional forces put pressure on having controls and having them audited, rather than having controls that are likely to be effective. Controls to prevent become ends in themselves. Legislators and regulators can adopt or encourage controls in the name of doing something in response to crises. Corporations adopt them as a way to defend against liability claims when undesired events occur despite conscientious controls. Auditors test controls to provide comfort. These choices produce controls for controls' sake. The paradoxical upshot of control and audit proliferation is the more controls there are, the less actual control exists. . . .

[**272**] Auditors monitoring controls can only test certain kinds of controls. There is a difference between control effectiveness and control auditability. A corporation can have controls that are more effective but less auditable and controls that are less effective but more auditable. The less we trust those whose behavior we use controls to influence by increasing audit, the more controls will be produced that can be audited. But the infallibility complex concerning auditing systematically biases us to controls that can be audited rather than controls that are effective. In this cycle, the end point undercuts the goal: we seek control because we do not trust the agent and then add a monitor who can only monitor certain controls, and those controls may be less effective in controlling the agent's behavior than controls that

cannot be audited. . . .

I. C. Pressure

1. *Systemic*. . . . **[282]** The rising significance of internal controls paralleled the rise of the monitoring model of the corporate board of directors. Internal controls moved from an incident of audit practice to a tool to implement indirect board supervision of corporate performance. The tools address problems of asymmetric information in hierarchical organizations (individual employees have incentives to skew information to their benefit at the expense of the organization') and risks of managerial opportunism (managers with short tenures or compensation tied to short-term performance have interests in conflict with those of the corporation as a whole). The monitoring model's impact on internal controls is akin to deregulation's impact: they trade direct for indirect power.

The monitoring model led to the universal use of audit committees for large public corporations. Audit committees were not common until the late 1970s, after the New York Stock Exchange adopted rules in 1978 requiring them (though the SEC encouraged audit committee use as early as 1940). Audit committees are supervisors of controls. Auditors work with audit committees to conduct financial audits. Both are functionally reliant upon internal controls to aid in the processes intended to enable preparation of fair financial statements. While control and audit are thus distinct exercises, both have grown in parallel fashion since the 1970s and they tend to reinforce each other. Many regulatory directives promoting controls simultaneously promote audits of them.

Self-observation capabilities developed along with this monitoring model and audit committee reliance upon controls. As pressure mounted on boards to assume **[283]** responsibility for designing and administering financial and compliance controls, the corporate internal auditing function blossomed. The evolutionary history of the internal audit function parallels the proliferation of controls generally. Internal audit began as an analogue to external auditing. As controls evolved to include non-financial systems elements, the internal audit function grew to encompass their design, administration and testing. . . .

2. *Professional*. A second force behind the rise and appeal of internal controls--and reinforcing each of these systemic forces--are the professionals involved in selling them. Chief among these are auditors. The auditing profession's business interest is to promote such controls, though somewhat indirectly. Its principal interest is to promote the need for testing and offering assurances with respect to controls. For example, the auditing profession for at least four decades made the case that it is necessary for internal financial controls to be formally and publicly audited, an aspiration finally granted for financial audits of SEC registrants in SOX.

The auditing profession diversified its activities substantially beginning in the mid-1980s, conducting far more attestation services apart from traditional financial audits. The apotheosis of this expansion that emerged since the late 1980s is the ethics audit. This audit reports on management's performance in monitoring the risk of unethical behavior throughout a company.

KPMG's trademark version of this exercise was advertised as "ethics process management," a service related to six risks that bear on corporate ethics: sexual harassment, environmental contamination, antitrust infractions, improper foreign **[284]** payments, fraudulent financial reporting, and race discrimination. In other words: the service is addressed to preventing all the hot-button ills of our time. … .

The AICPA's Special Committee on Assurance Services (known as the Elliott Committee) in the mid-1990s argued for expanding the profession's scope of assurance services, leading many public accounting firms to redesignate their auditing departments as assurance departments. The Elliott Committee emphasized that risk assessment services, a strong growth segment, could rise to 10-20% of annual financial audit fees. . . .

Auditors boast of their product's value. The attestation profession encourages expectations concerning what controls can do and how the profession can help. This is [**285**] true even though these professionals know that inflated expectations may come back to haunt them. In fact, auditors stoke this business. When internal controls are recommended or required, for example, they conduct surveys and report results on who has what level of controls and who does not. This stimulates market growth in the public assurance business, boosting revenue. . .

[295] **III. Control Limits: Audit Views**

. . . SOX requires auditors to attest to assertions management now must make concerning the effectiveness of a company's controls over financial reporting. Auditors have greatest experience with such financial controls. These were created in part to enable them to provide assurance concerning financial statement assertions without need for verifying every transaction. Though even in this exercise controls have limited efficacy, auditor experience with them provides ability to assess these limits with some degree of reliability. When auditors extend their traditional audit tools to investigate and attest to assertions relating to policy controls, limits multiply.

[296] A. Audit Risk

All attestation engagements are designed to provide reasonable assurance as to the covered assertions. None provides absolute assurance. In other words, risk cannot be eliminated. The best a practitioner can do is to hold risk to a relatively-low but statistically-acceptable level. Auditors divide risk into various classifications.

1. *Attestations*. At the broadest level, attestation risk is "the probability that an attestor may unknowingly fail to modify a written conclusion about an assertion that is materially misstated."[122] More focused is the definition of audit risk when applied to a financial audit: "the probability that an auditor may unknowingly fail to modify an opinion on financial statements that are materially misstated."[123]. . . .

In the preliminary stage of an engagement, auditors design tests of controls. These are audit procedures to assess the efficacy of internal controls to prevent or detect material misstatements. The tests address control risk (discussed further in the next section). Evidence from these tests defining control risk is in turn used to set an acceptable level of detection risk; this is done by executing substantive tests.

Substantive tests are audit procedures designed to detect material misstatements or to identify assertions likely to contain material misstatements. They address detection risk. Substantive tests are of two types: (1) tests of detail are designed to detect material misstatements in accounts and (2) analytical procedures are evaluations of data drawing on comparisons such as in relevant trends, baselines or forecasts. . . .

B. Control Risk

Auditors see internal controls as a factor in assessing attestation risk. They posit an inverse relationship between control quality and audit scope: superior controls demand an audit of lesser scope and intensity; weaker controls demand a more intense and expansive audit. For example, a high-quality internal financial control system can reduce the required scope of an audit while low-quality systems indicate a broader audit plan (all other things being equal). But while audit planning requires an understanding of controls as a source of measuring and minimizing attestation risk, control quality cannot be measured by volume. More controls are not necessarily better or more effective.

Consider the audit risk formula . . . . The model separates the risks but they are in fact related to one another. Suppose two companies embracing identical internal control systems but bearing different inherent risks (one sells only ice cream in the U.S. and the other sells a range of consumer products in 100 countries). Control risk in isolation appears to be the same. But given the different inherent risk, the identical control systems indicate greater control risk in the complex company than in the simple company.

Until SOX, reports on internal controls for SEC registrants were required only when tests of controls revealed significant deficiencies (called reportable conditions). This reporting remains the case for non-SEC registrant reviews of internal controls. Thus there remain two different types of reports on internal control: audit (reportable conditions) and attestation (full test of all controls and opinion on management's assertions concerning control effectiveness, discussed in the next section). Either way, the standard auditor's **[299]** opinion letter on these matters emphasizes the "inherent limitations" of the exercise. . . .

[301] C. Auditing Control

Auditing of assertions by navigating an internal control environment is complicated but entails only a partial encounter with all controls. This is an additional limit on auditors' ability to confidently attest to assertions with 100% conviction. As if to overcome this limit of internal controls, accompanying their expansion in the past few decades there has been an expansion of auditing to test them fully.

Auditing is increasingly used to generate comfort in a wide variety of activities, such as environmental operations, employee relations, and compliance with regulatory requirements. Under pressure due to periodic series of heavily-covered corporate **[302]** scandals, from the 1970s to today, corporations have been forced to enhance their internal governance systems. These changes in governance have not only led to the creation of a wide variety of internal controls, but also increased the need for independent parties to audit their effectiveness and integrity. The increasing appeal of internal controls as a policy option is thus accompanied by the increasing appeal of auditing as a policy option. A paradox appears: that the appeal of auditing as a policy option is stoked by the decline of internal controls as a failsafe.

1. *Financial Control Audits*. This is the story of SOX. In the 1970s, the SEC persuaded Congress in response to crises to pass the FCPA requiring companies to have internal financial controls. In the early 2000s, in response to crises perceived to originate in internal control failure, the SEC persuaded Congress to pass SOX requiring auditors to audit those internal controls.

In this cycle of control mandates followed by audit mandates, pressure builds on audits to create controls that can be audited. But we just saw that controls do not automatically reduce audit risk and may increase it. For many contexts, direct-testing rather than control-testing is necessary. Accordingly, attestations concerning overall control systems tell only a partial story. They cannot speak to the effectiveness of underlying substance over which controls offer no reliable assurance.

SOX nevertheless places enormous confidence in controls, requiring officers to certify them and auditors to attest to that certification. This means auditors must fully assess financial controls, not merely test them as part of a general financial audit. SOX requires officer certifications of the design and effectiveness of internal controls. This move is only a partial sealant. These officer certifications require attestation by those officers that they both designed the control systems and tested them, finding them effective. The risk of self-review bias is self-evident.

To seal this crack, SOX requires auditors to issue a report on an entity's internal control over financial reporting in conjunction with the entity's financial statement audit. Standards for this work were promulgated by the Public Company Accounting **[303]** Oversight Board (PCAOB). . . .

The possibility that effective controls may nevertheless yield materially inaccurate financial statements is critical to emphasize. To the extent it is deemphasized--as it is in the PCOAB's Standard--two key points arise. These apply to the SOX-style audit of financial controls as well as audits of all other types of controls.

First, de-emphasis risks inducing users of control-audit opinions into a false sense of complacency that controls assure outcomes, whether preventing fraud, producing fairly-presented financial statements, or other goals. That raises false expectations, an error that will create costs, not benefits, from any control-enhancement regime.

Second, de-emphasis on the possibility that effective controls do not guarantee substantive results indicates an elevation of the concept of control as an end in itself--control for control's sake, without regard to what controls can do. Controls as ends in themselves are logically less effective than controls consciously designed for instrumental purposes.

A non-corporate parallel illustrates. A university internal-control proposal called for academics given research grants to prepare time-sheets. Part of the motivation was to create a control that was auditable. While the scheme would achieve that objective, it would have skewed incentives toward reading and away from writing or teaching. Also it would not accurately measure the effectiveness of the researcher's performance, as it would simply abstract one aspect from the vast complexities of the underlying activity.

No audit is capable of measuring effective performance, however, for audits seek only to verify data or systems. The point renders audits of controls fractionally valuable compared to audits of assertions. An opinion that time-sheets are being completed (control system checks out) or even that they accurately reflect reading hours (output certified) says nothing about the value of the research (which is ultimately what all the controls and audits are supposed to be worried about). Controls attempt to prevent the need to exercise judgment. But judgments cannot be avoided.

2. *Auditor Advertising and the Expectations Gap*. . . . In addition to direct costs are the costs associated with creating false complacency. The comfort-sense of systems, controls, and audits obscures the real underlying risks. Doing these things may help but risks remain. Audit certifications, both financial and otherwise, direct or of controls, always have offered more than they give. The auditing literature refers to this as the expectations gap.

Some auditors wonder about its source. One factor may be the expectations the profession creates, compared to the known limits of its craft. The gap widens when auditors advertise products incapable of delivering the promise. Auditors could help close it by aligning their advertisements, and especially lobbying, with the reality they face. After all, this is what they will argue when internal control failures go undetected and victims of fraud or terrorism sue them.

The expectations gap typically refers to the difference between what a financial auditor can do and what investors using financial statements expect. Amid control and audit proliferation this expectations gap assumes larger dimensions. There is an expectations gap between what auditors and controls can do concerning a wide range of policy matters and what the public, lawmakers, and legal culture expects them to accomplish.

One reason for this expansion of the expectations gap is that controls have been transformed from bearing a traditional positive-aspirational function of meeting corporate **[306]** objectives in administrative controls toward a more negative-preventive function of policy/compliance controls. . . .