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Sarbanes-Oxley Section 404 Implementation Needs Modification

It was bound to happen. A law as far-reaching and complicated as the Sarbanes-Oxley Act of 2002 (SOX) was bound to contain unintended glitches when put into practice. SOX contains 11 titles and 69 sections, and each of them is crammed with detailed requirements directly affecting public accounting firms and the boards of directors and senior management of public corporations. The SEC's numerous pronouncements implementing some of the SOX provisions run to hundreds of pages of detailed explanation and regulations.

SOX's ambitious objectives were to increase the basic trust of shareowners, creditors, and the public in the reliability of material corporate disclosures of financial and operating performance by public corporations. There were two strategies to bring this about: (1) provide a new system of oversight of public accountants (a truly landmark change in the global professional status of those with U.S. presence) and (2) require modifications to portions of governance procedures of publicly held U.S. corporations.

In general, the overall approval rating of SOX has remained positive. Public accounting firms have directed attention to firm governance issues that hadn't received sufficient consideration. The Public Company Accounting Oversight Board (PCAOB) began its ambitious program of inspecting audit firms and setting new auditing and ethics standards. Audit committees seem to have grasped the scope of their responsibilities more fully and have begun to perform in earnest the processes many hoped they were already carrying out.

The major negative feedback has been focused on SOX Section 404, which requires management to assess and report on the effectiveness of internal controls over financial reporting and includes a requirement for the external financial statement auditor to attest to management's assertion. According to *BusinessWeek*, "CEOs and CFOs complain they're burdened with huge implementation costs as armies of nitpicky auditors check every corner of their operations" ("Death, Taxes, and Sarbanes-Oxley?" January 17, 2005, p. 28). The average estimated cost of first-year implementation for large companies has reached upward of $35 million, with continuing high costs expected in future years.

A significant part of the excessive costs appears to result from the PCAOB's Auditing Standard No. 2, which emphasizes application transaction control processes rather than overall company-wide controls. Standard No. 2 deals with the external auditor attestation required by SOX 404. Among its many requirements, the standard directs the external auditor to perform at least one "walk-through" analysis of the processes involved with each major class of transaction. According to paragraph 80, the walk-through should "encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified."

Paragraph 116 of Auditing Standard No. 2 further describes the need for the external auditor to personally perform certain tests, such as the walk-through, because of their importance. These requirements seem especially onerous and time-consuming as the large amounts of detailed documenting and testing of controls for routine transactions could result in unwarranted costs for both the external auditor and the company.

Focusing on transaction and application details takes away emphasis from the more relevant and important company-wide controls provided by the control environment, including integrity and ethical values. As stated in the COSO (Committee of Sponsoring Organizations of the Treadway Commission) definition and AICPA Audit Guide on internal control: *"The effectiveness of internal control cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of other internal control components."*

Analysis of Standard No. 2 seems to show its emphasis is on documenting, testing, and evaluating specific control procedures for processing routine transactions. Risk analysis would undoubtedly show that control weaknesses in routine transaction processing would likely have limited risk of material impact on financial statements. A better approach would emphasize evaluating the critical overall controls of the control environment, whose weaknesses resulted in the enactment of SOX in the first place.

The Standard does briefly refer to company-level controls in paragraphs 52-54, saying they "often have a pervasive impact on controls at the process, transaction, or application level." In spite of this, almost all of the remainder of Standard No. 2 sets forth specific requirements for documentation and testing of process, transaction, and application controls. For example, paragraph 41, concerning management's documentation, emphasizes transaction processing and how material misstatements could occur. Paragraph 47 requires the auditor to obtain an understanding of specific controls by inspecting documents, tracing transactions, observation, and inquiry. And examples of the nature of the controls tests, cited in paragraphs 93-97, all relate to processing routine transactions.

A general statement that external auditors should evaluate controls designed to address the risk of fraud, including risk assessment processes and code of ethics/conduct provisions, is contained in paragraph 14. There's also mention of what the control environment contemplates in paragraph 114, but this is made in the context of the use of others' work in testing. It notes that an external auditor shouldn't rely on the work of others to "reduce the amount of work he or she performs on controls in the control environment." Yet there's no guidance as to what types of evaluation and testing work concerning the control environment should be performed by the external auditor.

Emphasizing overall company controls rather than processing controls for specific types of transactions would enable the advancement of Congress's post-Enron objectives in passing SOX. These were intended to prevent fraud by the Cs (i.e., the CEOs, COOs, and CFOs), as well as to increase the credibility of corporate financial disclosures. According to Professor Ira Solomon in a November 9, 2004, *Wall Street Journal* article, it's ironic that current SOX 404 efforts "miss both targets" and create a false sense of security. Solomon urges a broader focus on corporate controls in general and an "enrichment of auditors' thinking skills so that they can assess changing risks in public companies' complex, dynamic systems of business-process and financial reporting controls." The concept that controls should be needed only when risks are present seems to be missing from the PCAOB's thinking.

We all can understand the need for the PCAOB to respond to the concerns of public accountants. The responsibilities of external auditors for detection and/or prevention of fraud in financial statements have been discussed for decades. Among the issues requiring closure is enabling investors and the public to have a better understanding of the purpose and limitations of an "audit" of internal controls over financial reporting.

To address these concerns, the SEC has appointed an advisory committee to assist in examining the impact of SOX and other aspects of the federal securities laws on smaller public companies. We hope that this committee will note the many concerns of high cost and limited value that have been expressed and not limit its study to only issues affecting smaller public companies. Instead, the committee should recommend changes in scope that will decrease the cost and enhance the return on the investments being made in SOX 404 compliance.

The many ethics-related components of SOX require more attention in the implementation of Section 404. ■

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