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First-Year Verdict of SOX 404: Burdensome, Costly, and Confusing

Now that most public companies have completed their compliance with Section 404 of the Sarbanes-Oxley Act, the feds concede that it's too onerous and say they'll make the rules easier.

During a packed roundtable meeting of financial managers, audit committee members, external auditors,

investors, analysts, and regulators at the Securities & Exchange Commission (SEC) headquarters on April 13, William Donaldson, chairman of the SEC, and William McDonough, chairman of the Public Company Accounting Oversight Board (PCAOB), acknowledged that Section 404 has some unintended burdens. According to a report from PricewaterhouseCoopers, the burdens are significant costs, confusion about applying judgment, and duplicative efforts by management and auditors.

McDonough promised that the PCAOB would provide some guidance on applying Auditing Standard No. 2 (AS No. 2), "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." This is the standard that, under Section 404, external auditors use to at-

test to and report on management's assessment of the adequacy of a company's internal controls. McDonough also said the PCAOB would consider reopening the rule if the guidance didn't provide enough help.

For his part, Donaldson said, "I would be very disappointed if we didn't find some things we could do."

Panelists told regulators that many auditors aren't flexible about what types of problems to disclose, according to a report from *The Wall Street Journal*. They also said auditors are forcing companies to disclose issues that aren't germane to financial reporting, and they complained that auditors are second-guessing management's judgment about how to document internal controls. Yet accounting firms, fearful of

regulatory scrutiny, are applying rigid interpretations of the rules.

Others voiced concern that SOX is a distraction for senior managers and gives investors a false sense of security. Executives commented that they're less comfortable soliciting technical advice from external auditors for fear of receiving critical internal control assessments. Some executives said they're not entirely sure what constitutes a "material weakness" of internal controls, while others questioned how well investors can identify the



severity of material weaknesses when so many are being disclosed.

By early May, 160 companies out of 1,864 in the Russell 3000 index had received an adverse opinion from their public accountants because of material weaknesses in their internal controls. The data, culled by Raisch Financial Information Services and published in *Compliance*

Week, came from 10-Ks filed since November 2004 in which a company's accounting firm said its internal control over financial reporting was "not effective," "ineffective," "not fairly stated," or "not fairly presented."

But not all companies with material weaknesses received an adverse opinion. Out of nearly 750 internal control problems disclosed, approximately 50% were related to financial systems and procedures, *Compliance Week* reported. Those problems typically involved the financial close process, account reconciliation, or inventory processes. Twenty-two percent of filers in March had internal control problems with their tax accounting, while accounting for leases and loans accounted for 14% of the material weaknesses. Both types of weaknesses were typically due to "financial systems and procedures."

In testimony on Capitol Hill in late April, SEC Chairman Donaldson addressed Section 404 extensively. At a hearing before members of the Committee on Financial Services of the U.S. House of Representatives, chaired by Rep. Michael G. Oxley (R.-Ohio), Donaldson said that of all the regulations of the Sarbanes-Oxley Act, Section 404 has "drawn the most attention." He said that complying with Section 404 has been time-consuming and expensive and that even companies that already had good internal controls systems had the daunting task of documenting and comparing them against a benchmark. "This is a complex undertaking for a small company and exponentially more so for a firm with multiple lines of business, thousands of employees, and global operations."

But he had only plaudits for the material weaknesses disclosed, saying disclosure of them would benefit investors by giving them a purview of

a company's controls over and impact on financial reporting and management's plan for remediating the problems.

At the same time, the SEC chief cautioned that not all material weaknesses are the same. Many are caused by a multitude of different factors, and the financial markets shouldn't overreact to disclosure of them. Instead, the weaknesses should be seen as an opportunity for "continual improvement in controls over financial reporting" and an improvement in "the quality of information management relies on to make decisions."

Donaldson also addressed compliance costs, saying they were "higher than we and public companies anticipated," but that may reflect initial outlays, and 404 compliance costs in the second and subsequent years would decrease substantially.

A March study by Financial Executives International of 217 companies with average revenues of \$5 billion put total compliance costs for year one at an average of \$4.36 million, up from the \$1.9 million that these companies had expected. The \$4.36 million came from \$1.34 million in internal costs, up from \$613,250 expected; \$1.72 million for external costs—primarily for consulting, software, and other vendors—up from \$732,100; and \$1.3 million for Section 404 auditor attestation, up from \$590,100.

Apex Silver Mines in Denver said in a letter to the SEC that it spent more than \$2 million and found only two weaknesses. Grant Prideco, an oil-drilling parts manufacturer, said its audit fees jumped from \$350,000 to \$4 million, plus another \$2 million in outside consultants. Autodesk, a software company, spent \$6 million, 28,000 hours, and had 130 of its 135 internal auditors

working on Section 404 compliance to find 16 "inconsequential deficiencies," CEO Carol Bartz said. The company found one financial deficiency involving \$7,000.

No wonder there's a movement afoot to roll back portions of Sarbanes-Oxley.

Section 404 is a "demonstrable disaster," Joseph Grundfest, a former SEC commissioner and a Stanford law professor, reportedly said at a conference in early February. "This should be treated as a regulatory equivalent of an airplane crash" that needs to be investigated to determine the cause of failure. A board member of Oracle Corp., Grundfest said the real impact of Section 404 is stifled innovation and delay in new products.

In an April 19 editorial, *The Wall Street Journal* opined that the "complaints the regulators heard [at the SEC's roundtable] will surprise no one who remembers how that bill, punishing business as a class, was whooped through in days... Whether SOX will prevent the next WorldCom is impossible to know, though we have our doubts. What we already know is that SOX is more burdensome than its critics imagined."

But regulators are stalwart. At his hearing, Rep. Oxley said he had "heard a complaint or two about the costs, but the benefits have not been disputed." On *The Journal's* op-ed page on March 29, Donaldson wrote: "[T]he voices calling for a rollback of portions of Sarbanes-Oxley, citing Section 404 as the poster child for over-regulation, are short-sighted. The principles behind the Act are unassailable, and action was long overdue. The time, energy, and expense that companies are now investing in their internal controls will, I predict, earn a handsome return for years to come." ■