Sarbanes-Oxley

Will the SEC admit it got it wrong?

The guardians of US securities markets grossly miscalculated the cost of section 404 of the Sarbanes-Oxley Act. *Tim Leech* looks at ways to make the regulations more practical

The evidence is overwhelming that US stock market regulators as well as the body charged with policing the accounting profession – the Public Company Accounting Oversight Board (PCAOB) – have lost sight of what Congress asked for in section 404 of the Sarbanes-Oxley corporate governance laws.

In mid-April, the US Securities and Exchange Commission (SEC), the agency that regulates securities markets in the US, hosted a roundtable on Sarbanes-Oxley, specifically section 404, under which auditors have to attest to the effectiveness of accounting disclosure controls over a firm. Based on feedback so far, the vast majority of companies and executives consider section 404 to be one of the most onerous, expensive, and arguably naïve pieces of SEC legislative interpretation in the agency's history. The magnitude of the error in the SEC's cost estimates for section 404 is indicative of just how far off the mark it was in its forecasts.

Cost of $4.36m per firm

The SEC originally estimated the average incremental burden for an annual filer under Sarbanes-Oxley would be 383 hours per company "and the portion of that burden that is reflected as the cost associated with outside professionals is approximately $34,300 per company". A March 2005 survey by Financial Executives International, the US professional organisation for corporate finance executives, reported the actual costs companies have incurred at $4.36 million per company.

The SEC asked for input on what people think is really wrong with section 404 and received thousands of pages of thoughtful, and not so thoughtful, analysis and commentary. Hundreds of people have proposed ideas on what should be done to fix the problem without undue negative impact on shareholders. The SEC and PCAOB responded with a less than robust paper on May 16. The only group that appears to be generally happy with the current regulations are the external auditors. Canadian security regulators are poised to adopt a regulation that is almost a mirror image of the flawed US guidance.

What is it about Section 404 and the related regulations that it has resulted in one of the biggest backlashes and corporate compliance expense drains in the history of public companies? The law, as written by Congress, is not the problem. It calls for what many people would have assumed should have been the case all along. The problem to be solved was fairly simple. Management in thousands of public companies were not taking their responsibility for designing and maintaining strong accounting control systems very seriously. In fact, in some companies, chief executive officers and chief financial officers overrode the accounting control systems that did exist in order to report profits where they wanted them to be, not where they were in reality. Enron, WorldCom, HealthSouth, Adelphi, Nortel in Canada, and Ahold in Europe are extreme examples.

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Most experienced CFOs and controllers know the game well. External audit partners, at least those that have been around awhile, also know the game. The hundreds of accounting restatements made since Sarbanes-Oxley was enacted are evidence that all was not right in the land of corporate accounting disclosures.

A survey by *CFO Magazine* in March of 2004 disclosed that 47% of the CFOs surveyed still "felt pressure from superiors to use aggressive accounting techniques". The global situation pre-Sarbanes-Oxley was a lot worse than could be attributed to just "a few bad apples".

A large majority of corporate executives acknowledge, at least privately, that the accounting situation had deteriorated to the point where many investors distrusted, for good reasons, the accounting disclosures made by public companies.

For the capital markets to function efficiently investors need to believe they are getting at least approximately true financial results on which to base their investment decisions. Restoring trust was necessary. Sarbanes-Oxley, as written, seemed to be a reasonable and prudent way for Congress to proceed.

What went wrong?

So, what went wrong? A full analysis of the flaws in sections 404 and its sister section 302, under which CEOs and CFOs must certify the reliability of their financial statements, is not possible here. But the short answer to the question of what went wrong is that the SEC and the PCAOB, the agency created by Congress as part of the solution and appointed by the SEC to establish the standards on how these two sections were to be accomplished, quite wrongly must have assumed that most companies already had established control assessment systems, documentation and personnel in place to meet this requirement. The only other conclusion to be drawn is that they actually knew how much work would be involved, but didn't want to scare people senseless early in the game.

So assuming the SEC did not consciously mislead Congress and the public at large when it forecast the probable costs of implementing section 404, how could it have made an error of this size?

Prior to Sarbanes-Oxley, most publicly listed companies in the world had very little formal assessment documentation and evidence to support explicit or implied representations from senior executives that there was an "effective" system of internal controls in place.

Internal auditors, the people used in some companies to review and report on internal control, had often left out detailed assessment of the processes that pro-

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duced the company's financial statements on the basis that the external auditors were covering that area and it would be inefficient for them to cover the same ground. Many chief internal auditors did then, and still do today, report for practical purposes of performance evaluation to the company's CFO.

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Reporting major deficiencies on how your boss does his or her work has always tended to be a career limiting move fraught with risk. The SEC relegated the task of developing detailed guidance in this area to the brand new, just established, and not even fully staffed, PCAOB. The SEC chose this path instead of devoting the time and resources to carefully assessing how a company could comply with the rules as written by the SEC and PCAOB within the time and costs estimates noted above. For instance, how could an average company actually accomplish what was required by section 404 for about $35,000?

The SEC and PCAOB enacted rules to accomplish the task using fundamentally the same audit approach for internal control taught in external audit firms in the late 1970s. These approaches are labour intensive and involve creating voluminous documentation including carefully crafted flowcharts. Revisions proposed by the SEC and PCAOB are unlikely to change fundamentally how external auditors want to approach their work.

Companies had limited experience identifying and grading control deficiencies prior to Sarbanes-Oxley. The Institute of Internal Auditors, the dominant organisation in the world responsible for setting standards in this area had published no guidance for its 100,000-plus members on how to consistently grade and report weaknesses in internal control. Senior management and boards were not receiving "apples to apples" reports on control problems. The Institute has not so far rectified the problem.

The regulations for section 404 enacted by the SEC and PCAOB call for CEOs and CFOs to certify that they have an effective control system in accordance with COSO (Committee of Sponsoring Organizations of the Treadway Commission), a control model developed in 1991/92. COSO, as helpful as it was at that time, was never intended for pass/fail control effectiveness reporting. The SEC, by delegating enormous subjective power to external auditors (the same external auditors who are almost certainly going to be sued in the future for incorrectly certifying financial statements) has placed the external auditor in a position where they can lower their audit risk, the risk of issuing an incorrect clean opinion. It has done this by enacting regulations that directly or indirectly provide external auditors with the power to force clients to do an extensive amount of work to document accounting processes and controls, test the controls and then extensively check that management has completed the work. External auditors in the US, and soon in Canada, can correctly state that they have been forced to do this by the oversight agencies that will audit, and if necessary, sanction them. If I were an external audit partner today I would certainly prefer less rather than more audit risk/litigation settlements, even if the house were in my spouse's name. The May 16 guidance does little to change the litigation exposure dynamics for external auditors.

What should be done?

Even a quick review of the submissions to the SEC on SOX section 404 reveals that there is no shortage of ideas on what should be done to fix the problems created by these new regulations. Key areas that need to be addressed to make the regulations more practical include:

One Requiring external auditors to audit the process used by management to assess and report on internal control. If the process is strong and producing reliable assessments the amount of work should be modest. If the assessments are incomplete or, worse, consciously deceptive this should be immediately reported as a serious problem to the audit committee and the SEC. External auditors should not be asked to form a subjective opinion on how much control they think is enough. This was partly addressed by the May 16 guidance.

Two Requiring the assessment approach used by management to focus on identifying and disclosing to the audit committee and the external auditor the current holes in the accounting control system. The external auditor will then have to decide if they can still form an opinion on the accounting disclosures. The May 16 guidance suggests, but does not directly require, that this type of approach be taken.

Three In cases where there are serious problems in the accounting controls systems and the external auditors are still giving a clean opinion on the accounts, the auditors should have to explain to the audit committee the strategy they have used to audit the numbers, the amount of extra work required because of weak controls, and the related costs to provide a clean opinion on the accounting disclosures.

Four Establishing a new standard setting organisation that will produce globally accepted standards on how to cost effectively assess and report on accounting control. The SEC did not address this issue in the May 16 paper.

Five Eliminating the requirement that CEOs and CFOs report that the company has an effective system of control in accordance with COSO. It can be easily proved that COSO does not meet the criteria of a framework that will produce repeatable conclusions.

Six One of the existing professional accounting associations, or a new entity, should develop standards, professional development material and a certification programme for those that want to claim particular expertise in the area of risk and control assessment. The May 16 guidance did not address the severe skills shortage that hampers effective implementation of the rules. GRR

Tim Leech is Principal Consultant and Chief Methodology Officer at Paisley Consulting, the Minnesota-based business accountability solutions software company. He can be reached at Tim.Leech@paisleyconsulting.com