

The Winding Road of SOX Compliance |

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Imagine you've been told you must go on a business trip every year or there will be severe personal consequences. You give the destination and dates to your travel planner, and he provides you with an agenda, cost estimates, and maps. Your planner tells you the first year's trip should cost no more than \$910 and assures you it won't be too onerous. Just before you leave, he

explains that although you're not going to the destination you picked yourself, you'll enjoy it once you understand the many "good things" his destination offers.

Skeptical but nonplussed, you embark on the trip. It quickly becomes an unimaginable nightmare. The maps your planner has provided are seriously flawed. You're lost, confused, and never actually reach the intended destination. Highways your maps instructed you to follow charge obscenely high tolls. You're not allowed to turn back. The final bill for the first year's mandatory trip: a whopping \$300,000! Having no choice, you return to the office and pay the bills. Outraged, you confront the travel planner, who casually shrugs and offers: "I'm the only trav-



el planner in town, and you have to get your trip plans and maps from me. While I have some sympathy, don't expect next year's trip to be any better. Forget what I said before

about the \$910 trip cost and get used to the new, higher cost of travel."

This story exemplifies the reality of Sarbanes-Oxley (SOX) regulation since its inception in 2002. The final destination Congress defined was "more reliable auditor certified financial disclosures." The travel planner is the Securities & Exchange Commission (SEC) and its new subsidiary, the Public Company Accounting Oversight Board (PCAOB). In reality, the SEC estimated a cost of \$91,000 per company to comply with Section 404(a) when they issued Section 404 Final Rule on June 5, 2003. For some companies, the final cost of SOX Section 404(a) compliance reached as high as \$40 million in the first year. While many agreed changes were needed, the current destination may not have been the desired choice. As a result, the U.S. has been slowly losing ground to other countries whose markets aren't as cumbersome and restrictive.

The key question asked by corporate America and its shareholders who have footed the bill for SOX so far is: "What caused the largest cost estimation error and business disruption in the history of securities regulation, and, more importantly, will the

SEC take bold and decisive action to get it right on SOX compliance?"

To answer this question, we must reflect on some of the critical moments of SOX implementation that have led us to our current state of affairs:

Ineffective Guidance

- ◆ The SEC (in the SOX legislation) determined that the 1992 internal controls framework of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) was "suitable" in providing management with guidance to assess whether it had an effective or an ineffective system of internal controls over financial reporting. IMA's research study released in October 2006, *Management's Assessment of Internal Control over Financial Reporting*, concludes that the SEC expected the COSO 1992 framework to perform a set of tasks it was never designed or intended to do. The SEC and its chairman came to the same conclusion.
- ◆ The SEC in effect abdicated responsibility for providing adequate guidance for management to assess and report on internal control by assigning the PCAOB the responsibility to develop external auditor guidance in the form of Auditing Standard No. 2 (AS2). The problem is that the PCAOB's mission and guidance are intended to support the external auditors—using decades-old thinking and very traditional audit standards. Since COSO 1992 wasn't up to the job of providing adequate assessment guidance for management on how to actually comply with SOX Section 404 (the pass/fail effectiveness attestation), management

had no choice but to use AS2 as their only trip map.

Making the Grade

- ◆ AS2, the de facto primary guidance for management, turned out to be a trip map no one was able to follow. Many accelerated filers are still lost in a maze of control tests and flowcharts and still have large armies of consultants on staff trying to get a "passing grade" each year from their external auditors. The cost of complying with SOX Section 404 was, therefore, grossly underestimated.
- ◆ IMA and FEI (Financial Executives International) research indicates there is massive variability between various audit pass/fail graders. Even graders from the same CPA firm vary in their views on how much and what kind of controls are enough to pass. The grading criteria that auditors are using are far from clear and haven't been empirically validated as appropriate.

Effects on Small Business

- ◆ The SEC appointed a small business advisory committee to examine whether it was possible for smaller public companies to use the same assessment guidance that accelerated filers use. The committee concluded that if smaller companies were forced to take the same trip accelerated filers take, it would be detrimental to most and urged significant regulatory relief from the major SOX provisions (in effect, small businesses could avoid the trip altogether). The SEC has rejected this recommendation, intending to develop its own management assessment guidance for companies of all sizes.

- ◆ Relief for accelerated filers for year-end 2006 appears modest at best. In the absence of major changes to the SOX guidance, smaller public companies that have so far been allowed to delay their own trip face exorbitant costs over the next two years.

Through its solicitation of input on the current SOX rules in the form of the questions posed by its July 2006 Concept Release, the SEC has an opportunity to fix an unprecedented series of wrong turns and put SOX regulation back on track. On December 13, 2006, the SEC announced its plans to develop SOX implementation guidance to management, which hasn't existed to date. So far, IMA is in broad agreement with some of the principles the SEC has put forth and (at time of publishing) looks forward to reviewing an exposure draft. Most importantly, PCAOB's new AS5 guidance to auditors (to be released) needs to align with the SEC's management assessment guidance, with the same grading and rating criteria and methodology. If not, auditing standards (the new AS5) will continue to be the de facto standard for management, keeping American businesses traveling on the same weary path.

If America's global competitiveness and position as the world's preeminent capital market is to be maintained, the time to make sweeping changes to the current SOX regulatory regime is now. If U.S.-listed companies want change, the time to lobby for real change is now. Let's all tell the travel planner we want a new trip plan that costs less and gets us there quicker. SOX—the law—isn't the problem. Getting it wrong again would be. What do you think? Please share your thoughts with me at psharman@imanet.org. ■