

June 26, 2007

The Honorable Steve Chabot  
The Honorable James DeMint  
The Honorable Christopher Dodd  
The Honorable Tom Feeney  
The Honorable Barney Frank  
The Honorable E. Scott Garrett  
The Honorable Steve Israel

The Honorable Paul E. Kanjorski  
The Honorable John F. Kerry  
The Honorable Mark S. Kirk  
The Honorable Gregory W. Meeks  
The Honorable Charles E. Schumer  
The Honorable Olympia J. Snowe  
The Honorable Nydia Velázquez

**RE: IMA Call for Congressional Intervention on SOX 404**

**EXECUTIVE SUMMARY**

**After careful study and evaluation the Institute of Management Accountants believes that the revised PCAOB Audit Standard No. 5 and final SEC management guidance released last week are still sub-optimal.** We recommend that a further delay of at least one year be granted for smaller public companies so that more radical changes, together with a rigorous SEC led cost-benefit analysis and plan to measure success, can be implemented to “get it right” for investors, businesses of all sizes, and U.S. global competitiveness.

Requiring thousands of non-accelerated filers to comply with a sub-optimal SOX regulatory regime will perpetuate high costs, maintain and further exacerbate costly levels of external auditor legal liability, and further disrupt small businesses from being the entrepreneurial growth engine that has created 60% to 80% of net new jobs over the past decade. Smaller businesses, while needing to focus on rigorous internal controls and transparency to raise capital and compete in the capital markets, will find it difficult to cope with the significant inefficiencies and technical flaws that remain in the revised section 404 regulatory guidance.

**IMA also believes there are two fundamental flaws in the timing of the requirement for smaller publicly traded companies to comply with SOX (management attestation section 404 part “a” – first report in 2008 for companies with fiscal years ending after December 15, 2007; auditor attestation section 404 part “b” – first report in 2009 for companies with fiscal years ending after December 15, 2008):**

1. Increased legal liability for CEOs and CFOs of smaller public companies if the company’s auditor uncovers a material weakness during their auditor report one year AFTER the first management control effectiveness representation that was present at the time of the first representation (and management can not demonstrate full due diligence in their first section 404(a) control assessment).
2. Increased legal liability for audit committees that will be associated with the first CEO and CFO certification that is not auditor quality assured. It is important that the SEC communicate clearly that management is strongly advised to complete a full and rigorous control assessment in the first round even though their external auditor will not be providing an opinion. A section 404 “practice year” may sound appealing now, and have political value, but CEO/CFO control representations not done carefully and rigorously may not fare well later if major errors are found in the company’s accounts. It is important to note that non-accelerated filers currently have a very high rate of restatement error.

The IMA estimates that a large percentage of non-accelerated filers, if examined today, have “ineffective” internal control. Additionally, neither the SEC nor PCAOB have made any efforts to date that we are aware of to determine just how massive the task will be for non-accelerated filers to comply with the new rules. Therefore, we are “flying blind” in terms of the impact of releasing thousands of non-accelerated filers into a costly and error-prone regulatory regime.

### **SUMMARY OF RECOMMENDATIONS**

Over the past two years IMA has conducted rigorous market research and consulted with thought leaders around the globe with an aim to apply objective and critical analysis, provoke honest and vigorous debate, and propose cost-effective and practical solutions. We have also developed educational products to help advance the profession and address arguably the biggest pain point for U.S. investors, businesses and global competitiveness in decades. A summary of our recommendations consistent with our comprehensive market research and thought leader pieces follow.

1. **Congress should intervene and make changes to the Sarbanes-Oxley Act as soon as possible to refocus the SEC management guidance and Audit Standard 5.** We recommend that Sections 103 (a) and 404 (b) be re-written to satisfy what we believe was the original intent of Congress when it passed Sarbanes-Oxley legislation in 2002. In short, the PCAOB and SEC have elected to retain an audit opinion which requires auditors to complete a full-scale audit of management’s internal control systems and assign a subjective pass-fail grade. This is duplicative of management’s responsibility (section 404 (a)) and is very costly since the auditor’s quality bar must be set at an exceedingly high level to minimize the massive litigation risk attached to “wrong” external audit opinions. Our view is that the new SEC guidance for management guidance will continue to be trumped by the more granular and prescriptive AS No. 5 as the new de facto standard for management, perpetuating high cost and inefficiency. The focus should be on reducing the frequency of auditor certified financial statements that contain material errors.

Scores of small and large accelerated filers, IMA, the Institute of Internal Auditors, the National Venture Capital Association, NASDAQ, the Institute of Chartered Accountants in England and Wales as well as Canada, U.K. and Japan have opposed the SEC and PCAOB’s interpretation of section 404 (b). On the other hand, the SEC and PCAOB have eliminated the audit opinion which would require the auditor to assess and report directly on whether management has met the “standard” for its assessment set by the SEC in its management guidance. The IMA has already provided the regulatory bodies and legislators with suggested language changes for sections 103(a) and 404(b) of the Act.

2. **Congress should intervene and require that the new SEC management guidance be re-worked with input from experts in the risk, quality and performance management disciplines.** In short, the new SEC guidance released on June 21 and AS No. 5, while relatively more risk-based compared to AS No. 2, are still not risk-based by any global standard and rely heavily on decades-old audit thinking which is likely to perpetuate high cost and lack of scalability.

The implication of this is that auditors and management will be disconnected on the critical cost/benefit questions of “how much control is enough” and “how much testing and documentation is necessary” to meet the auditor’s high quality bar driven by the very real fear of litigation. Excessive controls, testing and documentation drive high cost which disproportionately impacts smaller businesses.

The IMA, a not-for-profit organization, has provided the SEC, PCAOB and legislators with a market-tested and scalable assessment methodology that is truly risk-based as just one example of guidance which is not prescriptive, but also not vague and ambiguous as the newly released SEC management guidance. Additionally, as part of our 100 page comment letter/global discussion paper submitted to the regulators on 9/15/06, we provided sample attestation letters for both the auditor and management to illustrate how we believe SOX was intended to be interpreted.

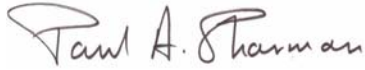
3. **In addition to providing a tangible estimate of the average cost for non-accelerated filers to comply with section 404, Congress should require that the SEC and PCAOB develop a plan to measure on-going performance of the new guidance in reducing the frequency of materially wrong auditor certified financial statements.** We do not believe that it is enough for the SEC to indicate that they will be carefully watching surveys of the real costs of implementing their new guidance as the new rules come in to force. By the time the full extent of the costs are known it will be too late to prevent damage to a sector of our economy that can least afford expensive “trial runs”. In our view , there are at least two areas requiring immediate attention:

- a) The error rate on predicting internal controls effectiveness using the methodologies prescribed in the accelerated filer community is still alarmingly high and root causes should be better understood before requiring the much larger non-accelerated filer community to comply with the rules. In short, although senior management and auditors are concluding under the current in-force rules that controls are “effective” beyond a remote likelihood, subsequent events are proving these predictions wrong in an alarmingly high number of cases. A February, 2007 report from Audit Analytics reported that the frequency of restatements among Accelerated Filers was over 13% in 2006 (about 1 in 8). These are firms that have spent massive amounts of money complying with the current section 302 and 404 regulations.

The IMA’s new Finance GRC (Governance, Risk and Compliance) Research Practice will make this analysis a priority (using data from Audit Analytics, Glass and Lewis and other sources). Further, we call on the major external audit firms and the AICPA to engage in this type of rigorous analysis to better understand the real root causes of the current management and auditor control effectiveness opinion error rate. A failure rate of 1 in 10 is unacceptable to U.S. and global investors.

- b) Since so many countries and major global accounting associations have rejected key provisions in the new SEC/PCAOB guidance, as part of the cost-benefit analysis, the SEC and PCAOB should assess whether investors in the U.S. are in fact better protected than investors in the U.K., Canada, Japan and a growing number of countries that have rejected the current SEC/PCAOB regulations for section 404(b).
- 4. Especially for small businesses, the auditor-registrant relationship and the “quality bar” should be seriously re-examined and relaxed enabling small businesses to optimally serve their investors with the appropriate level of governance, internal controls, transparency and protections.**
- a) Smaller public companies often lack the quantity and depth of resources necessary to interpret accounting rules that are increasingly complex and are a primary cause of restatements to the financial statements. In practice, external auditors play key roles providing accounting assistance (and more) to their clients. Under the current SOX rules requiring the auditor to fully audit, opine on and grade management’s effectiveness of internal controls over financial reporting (under section 404 part b), the external auditor can not be a part of management’s control system because in effect they would be grading their own work. Smaller public companies will have to engage other outside accounting experts for costly assistance handling complex accounting transactions adding more costs to being a U.S. listed company.
- b) On the second point, the new guidance still requires that management produce *draft* financial statements that have ZERO material errors. While a laudable goal, there is no evidence or research to suggest that investors in the U.S. are protected any better than in other countries with this quality bar of absolute perfection.
- 5. To ensure long-term and sustainable success that protects investors at reasonable cost, the regulatory and legislative branches should seriously consider the more macro recommendations that impact U.S. global competitiveness.** Two key studies can be invaluable in this regard: The “Interim Report of the Committee on Capital Market Regulation” (January, 2007) prepared for the City of New York; and, the “U.S. Chamber of Commerce sponsored Commission on the Regulation of U.S. Capital Markets in the 21<sup>st</sup> Century” (March, 2007). Generally, these studies address systemic issues that are at the root of the current audit opinion failure rate, such as U.S. regulatory complexities in structure (e.g., relative to the FSA in the U.K.) and implementation, the external auditor’s legal liability, and, the need for additional training, education and certification.

In closing, IMA continues to stand ready to assist legislators and regulators to “get it right” on SOX 404. Thank you.



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Mark Boyland  
Vice President and General Counsel

cc:

Mr. Christopher Cox – Securities and Exchange Commission  
Mr. Mark Olson – Public Company Accounting Oversight Board  
Mr. Charles Maresca - U.S. Small Business Administration Advocacy  
Ms. Amanda Engstrom - U.S. Chamber of Commerce