Curtis C. Verschoor, CPA, CIA, CMA, CFE
Research Professor, School of Accountancy and MIS, DePaul University
cverscho@condor.depaul.edu

Comments On Sarbanes-Oxley Section 404 Implementation -- File 4-497

Although many provisions of the Act have resulted in significant improvements in governance, it is gratifying that the SEC has recognized that the implementation of Section 404 requires review.

1. Section 404 requires each issuer's auditor to attest to, and report on, management's assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Further clarifying language in Section 404 is the statement that the attestation should be conducted in accordance with attestation standards [not auditing standards]. Further clarification of the intent of Congress is contained in the committee report which states that the Committee "does not intend that the auditor's evaluation be the . . . . basis for increased charges or fees."

In spite of this language, the PCAOB has taken the position that issuers' auditors should conduct an audit and issue an opinion on the internal control structure. This has resulted in huge increases in external audit fees. Additionally, it is hard to contemplate the confusion for readers which would likely arise if an external auditor determined that in spite of the fact that management did not do a good job of assessment, thus requiring an adverse opinion, the auditor was nevertheless convinced of the effectiveness of the internal control system itself and thus expressed an unqualified opinion. Management should be fully responsible for both maintaining internal controls and assessing and testing their quality. External auditors should only opine on management's efforts as intended by Congress.

The SEC should direct the PCAOB to recast Audit Standard No. 2 into an attestation standard only rather than an auditing standard, with commensurately different types and lower levels of testing by issuer external auditors. Two opinions do not provide twice as much assurance as one.

2. PCAOB Audit Standard No. directs issuer external auditors to spend considerable time documenting and testing control procedures involving the processing of routine transactions, rather than evaluating the strength of the control environment, which is well recognized as the most important aspect of internal control and where weaknesses provided the justification for enactment of Sarbanes-Oxley in the first place. My article containing details of the overemphasis on routine transaction processing titled "Sarbanes Oxley Section 404 Implementation Needs Modification" is attached from the March 2005 issue of *Strategic Finance* magazine.

The SEC should direct the PCAOB to revise Audit Standard No. 2 to decrease its emphasis on documentation and testing of routine and inconsequential transactions and accounts and increase reliance on tests of the effectiveness of the control environment, the oversight of the audit committee, and other entity-level controls.

The above stated views of an observer are consistent with many of those of other commentators. Comments I concur with include:

a. Overemphasis by auditors on written controls [details of routine transaction processing] rather than more informal overall controls [like monitoring and investigation of unusual or expected results]. As COSO notes "Many controls are informal and undocumented, yet are regularly performed and highly effective."

b. The objective of an assessment of the effectiveness of a system of internal control should be to ensure that published financial statements are not materially misstated. Attestations of such assessments should likewise keep in mind the level of materiality involved in financial statement preparation, and not be primarily oriented toward discovery of less material weaknesses. Detective controls are as equally effective in avoiding material misstatement as preventive controls.

c. Allow management and not auditors to determine whether the cost of additional controls is merited in view of risk. Auditors should allow management's 'business judgment rule' weighing cost and benefit to prevail except in cases of obvious lack of support. If a client insists on avoiding adequate controls for known risks [like the dangerous device manufacturer who carries no insurance], then the external auditor may need to insist on disclosure of a material risk that management has decided to assume and not mitigate.