Manufacturers Alliance/MAPI
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March 31, 2005

Mr. Jonathan G. Katz
Secretary
Securities and Exchange Commission
450 Fifth Street, NW
Washington, DC 20549-0609

RE: File No. 4-497

Dear Mr. Katz:

Background

The Manufacturers Alliance/MAPI (Alliance or MAPI) is submitting these comments in response to the Securities and Exchange Commission's (SEC or Commission) request for written feedback from registrants, auditors, investors, and others on their experiences with implementing the internal control requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). As background, the Alliance is the leading executive development and business research organization serving the needs of the senior management of our more than 400 member companies. Our diverse membership includes the full range of manufacturing and related business service industries. One of our primary activities is the operation of our Council program where executives in nearly every management discipline are brought together with their peers to share business knowledge, expertise, and best practices. Within this program structure are several Councils made up, respectively, of Chief Financial Officers and other senior financial executives and top-level internal auditors from many of our member companies. Almost 180 financial executives participate in our various dedicated Council programs and a similar number of senior internal auditors participate in those programs designed for their discipline. Representative of the companies whose executives are on these Councils are Agilent Technologies, Alcoa, Black & Decker, Boeing, Caterpillar, Cooper Industries, Dana, Deere & Company, Diebold, Eaton, Emerson, General Motors, Harley-Davidson, Harris, Hewlett-Packard, Johnson Controls, Microsoft, Motorola, Parker Hannifin, United Technologies, and Verizon. Almost all of these member companies are "accelerated filers" under SOX. Moreover, a substantial majority of these entities are large corporations with annual revenues in excess of $5 billion.

These written comments reference several earlier Alliance studies devoted to the impact and cost of SOX compliance being experienced by companies within our membership. Those earlier studies, as well as the preliminary results of an ongoing survey of financial executives as to the cost of Section 404 compliance, are attached for the Commission's reference. Moreover, and perhaps of most importance to the matter presently before the Commission, these comments—which were developed with the assistance of key executives in our member companies—suggest practical solutions to SOX compliance problems faced by registrants that can be adopted within the framework of the existing statute and which would greatly assist companies in their efforts to meet the dictates of Section 404.

Alliance Studies Into the Burdens and Costs of Sarbanes-Oxley Act Compliance

Since the passage of SOX in 2002, MAPI has closely followed the implementation of the new law and gauged its compliance impact upon the publicly traded companies within our membership. Two years after the statute went into effect, in August 2004, the Alliance reviewed its implications for the investing public and our members. In a report entitled "Sarbanes-Oxley Act of 2002—Alliance Presentation to Certain Congressional Committees and the Securities and Exchange Commission Regarding Oversight of the Sarbanes-Oxley Act of 2002" (Attachment I), we offered detailed suggestions as to how the Act's focus could be improved and how it might be amended so as to eliminate some of the unnecessary regulatory burdens it places on public companies that have no concomitant beneficial effect of restoring investor confidence in the U.S. financial capital markets.

More relevant to the subject being addressed in the upcoming April 13 public roundtable discussion, an Alliance survey of certain internal auditors in our companies conducted in October 2004 (Attachment II), found that a substantial majority of the respondents (59 percent) expected to pay their external auditor for Section 404 attestation work during the first year of compliance an additional fee of at least 50 percent above their total audit fees incurred in connection with their companies' consolidated annual financial statements. Most respondents to a brief follow-up survey of the same group of internal auditors reported earlier this month that their companies have received supplementary external auditor fee increases beyond those they contemplated last fall. Consequently, for a majority of the internal auditor respondents, the additional Section 404 fee component will amount to at least 75 percent of what they are paying for their annual financial statement audit. Moreover, a significant minority of the respondents saw this Section 404 audit fee equaling 100 percent or more of what they are paying for traditional financial statement audits. Based on information we have periodically gathered on the total annual audit fees (excluding a Section 404 component) our member companies incur and on the specific findings of our Section 404 cost surveys of internal auditors, it is safe to say that a large majority of Alliance members will incur several million dollars in additional external auditor fees attributable to Section 404 attestation work during the first year of compliance.

These results are being echoed in a separate survey being conducted at present of financial executives in our member companies (preliminary results appear as Attachment III). To date, the key findings of the ongoing survey are as follows:

- External auditor fees for 404 compliance totaled an estimated \$110.2 million, almost as much as the \$124.2 million spent by 54 companies on the external financial statement audit excluding 404 attestations.

- The cost of compliance, including external audit fees, external (non-audit) assistance for compliance, and internal audit costs for 404 compliance totaled an estimated \$352.7 million for the 56 firms who participated in this survey.

- The cost of compliance, expressed as a percent of net income before taxes, averaged 5.9 percent. The median percentage was 4.1 percent. These percentages are high and indicate that the cost of 404 compliance has significantly impacted the bottom lines of many companies.

- Most firms (42 out of 47 who responded) report that their audit costs for 404 attestations exceeded initial quotes. Of the 42 firms reporting that audit costs exceeded initial quotes, 63 percent reported that the excess was 50 percent or higher.

- Sixty-nine percent of the respondents say that the relationship between their company and its external auditor has deteriorated to varying degrees. The remaining respondents indicated "no change" (21 percent) or "improved" relations with their external auditors (10 percent).

Clearly, these costs of Section 404 compliance are significant. Combining the external and internal costs companies are incurring in meeting these obligations, amounts being expended are having a very real adverse impact on the competitiveness of many affected U.S. companies. The some 41 quotes from senior financial officers, which are set forth in their entirety in Attachment III, offer candid insights as to their views of the utility of this expensive exercise. A recurring theme in these comments is that any benefits attributable to Section 404 of Sarbanes-Oxley (e.g., increased investor confidence, improved financial controls, etc.) have been eclipsed by the cost of the compliance process as it now stands.

Specific Problem Areas and Practical Solutions

As intimated previously, with the help of senior executives with relevant experience in Alliance member companies, we attempt to identify some of the most significant problem areas publicly traded companies have encountered in their first year of Section 404 compliance—problems that gave rise to unnecessary or inefficient external auditor activities. Some problem areas suggest corrective action the Public Company Accounting Oversight Board (PCAOB) could take, which would substantially reduce the cost of compliance for companies, while still ensuring that they have in place an adequate internal control structure and procedures for financial reporting. Other problem areas we have identified call for audit firms to revise their audit operating procedures. We emphasize that the requested changes are limited in scope, but will enable larger registrant companies to comply with Section 404 in a more time- and cost-efficient manner.

PCAOB Auditing Standards

In practice, Auditing Standard No. 2 has required companies and their external auditors to direct 80 percent of the internal controls effort at compliance in areas where neither the recent corporate fraud scandals originated, nor any fraud of such magnitude could conceivably originate. The terms "more than a remote likelihood" and "more than inconsequential" contained in the 255-word definition of when a control deficiency should be classified as a "significant deficiency" in Paragraph 9 are especially troublesome. Likewise, the usage in Paragraph 10 of the term "more than a remote likelihood" in defining when a "significant deficiency" should be designated a "material weakness," is also of considerable concern. The term "remote likelihood" has the same meaning as the term "remote" as used in Financial Accounting Standards Board (FASB) Statement No. 5, meaning that the likelihood of occurrence is more than remote when the chance of occurrence is ***more than slight***. Auditing Standard No. 2 goes on to define a misstatement as inconsequential " . . . if a reasonable person would conclude, after considering the ***possibility*** of further ***undetected*** misstatements, that the misstatement, either individually or when aggregated with other misstatements, would ***clearly be immaterial*** to the financial statements. . . ."[Emphasis added.] A "slight" likelihood of occurrence of a misstatement that is "more than inconsequential" conceivably could be interpreted to include virtually everything.

The above-mentioned terms create unrealistically low thresholds for denoting a deficiency as significant and, in turn, for identifying a significant deficiency as a material weakness. As a result, companies are compelled to focus on matters and exposures that are largely not material to their company's financial statements. Indeed, a good argument could be made that all year-end audit adjustments—no matter the amount—result from some type of significant deficiency or material weakness in internal controls. Further, the definition's focus on the potential for a misstatement—"what could happen"—versus whether a misstatement actually has occurred or it is probable that it will occur. Consideration should also be given to whether the misstatement has quantitative and qualitative significance—"does it really matter" from a financial statement perspective. The Auditing Standards governing the effectiveness of internal controls over financial reporting should be designed to concentrate on "tone at the top," "fraudulent accounting at the top," and entity-level controls type issues. Instead, the Auditing Standards terminology is all-encompassing. Consequently, the Auditing Standards extend to internal control procedures far beyond activities of top-level (or even middle-level) management to include those of low-level employees. While Section 404 imposes a responsibility on management to establish and maintain an adequate internal control structure, the Auditing Standards have compelled companies to create a substantially more complex structure where considerable audit resources are devoted to amounts of little or no consequence.

As implemented at many companies, a significant amount of time and effort was devoted to testing internal controls and evaluating the process controls at a low level within their organization, such as accounts payable, purchasing, and invoicing. By comparison, relatively little time and effort was consumed in reviewing and testing at the entity level or control environment level where significant financial reporting fraud occurs.

In place of such a sweeping definition of significant deficiency, we urge adoption of a more focused quantitative/qualitative definition that would allow for the classification of deficiencies to be conducted with far greater clarity. Under this definition, a significant deficiency would be a deficiency—or combination of deficiencies—that has resulted in or it is probable to result in a misstatement of a corporation's financial statements (income statement, balance sheet, etc.) such that the impact to the financial statements would be cause for investor concern. Quantitatively, this should be a ***demonstrated or probable*** 5 percent impact on income from operations, provision for income taxes, or on one-line items; such as discontinued operations or accounting changes, current assets, non-current assets, current liabilities, non-current liabilities, cash flow from operating activities, investing activities, or financing activities. In addition to this quantitative aspect, qualitative factors should also be considered. For example, a misstatement that alters compliance with debt covenants, credit rating agency ratings, or factors having substantially similar implications, would also be deemed significant deficiencies. Ultimately, with this or a similar definition in place, efforts would be redirected to where fraudulent financial reporting occurs most frequently.

The term "remote likelihood" is used again relating to significant accounts. In an audit of internal control over financial reporting, Paragraph 27 of Auditing Standard No. 2 requires the auditor to obtain sufficient competent evidence of the effectiveness of controls over all relevant financial statement assertions related to all significant accounts. Paragraph 61 indicates that an account is significant ". . . if there is more than a ***remote likelihood*** that the account ***could*** contain misstatements that ***individually, or when aggregated*** with others, could have a material effect on the financial statements. . ." [Emphasis added.] Here, too, the slight likelihood that an account could contain a misstatement is sufficient to treat an account as significant, even more so because the significance determination must include consideration of materiality that is done both individually and on an aggregated basis with other accounts. The result is an interpretation that every account is significant unless it is so immaterial as to be utterly meaningless to the financial statements. Such language leads to a sweeping definition that tends to grab everything in its path and results in documentation and testing that adds no value. This was not the intent of Congress when it enacted Section 404.

A different problem that has arisen from the requirements of Auditing Standard No. 2 involves the time period for testing of controls. Auditing Standard No. 2 provides that, for controls over significant nonroutine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the external auditor should perform tests of controls closer to or at the "as of" date (i.e., Section 404 requires companies and their external auditors to report on the effectiveness of the internal control structure as of the last day of the fiscal year, rather than at an interim date). PCAOB should consider permitting more reliance on interim tests. This would reduce the need for duplicate testing (interim and prior to year-end) and lessen the logistical burden the Auditing Standard places on companies and their auditors to conduct testing within a relatively concentrated timeframe.

PCAOB Staff Guidance

The PCAOB staff has issued a series of opinions in a question-and-answer (Q&A) format on issues related to implementation of the PCAOB standards. We believe the PCAOB's Q&As could be improved if they employed a more business-oriented guidance approach. Such an approach would include specific examples of items the staff would like to see in, say, a revenue-cycle review—from the definition page with identified Committee of Sponsoring Organizations of the Treadway Commission (COSO) controls to the development of audit program steps. Similarly, the Q&As could explain how the staff would expect inventory to be reviewed—actual testing of counts during the physical inventory or verification that the physical inventory counts took place and the counts had a review to determine they were correct. The Q&As could also give some specific examples of what is important in reviewing the processes in a financial statement close process (e.g., reauditing every footnote or simply verifying the review process works by testing that key items are being performed).

External Audit Firms

As we have discussed above, the definitions of "significant deficiency" and "material weakness" in Auditing Standard No. 2 virtually require all deficiencies to be treated as either a significant deficiency or a material weakness. The external audit firms have compounded the problem these overly broad definitions have created through the document they collectively prepared, "A Framework for Evaluating Control Exceptions and Deficiencies." That document presumes a worst-case scenario whereby management must prove why a deficiency does not warrant categorization at a more serious level.

The independence rules in Auditing Standard No. 2 (Paragraphs 32-35), as currently interpreted by the external audit firms, have caused perhaps as much frustration and additional cost to clients as anything related to implementing Section 404. Audit firms have told audit committees and management that they can no longer assist in determining how to implement accounting pronouncements until the implementation occurs incorrectly. Instead, management is encouraged to hire a second firm as experts on complex and complicated accounting issues. It is certainly prudent to obtain outside accounting expertise given the complexity of several recent pronouncements. Indeed, the financial statements of numerous companies will be significantly impacted by such pronouncements as FASB Statement No. 123(r) (which focuses primarily on accounting for share-based payment transactions for employee services) and FASB Interpretation No. 46, "Consolidation of Variable Interest Entities." Yet the advice to hire a second firm, while prudent, adds cost and aggravation to the financial reporting process. It is important for the PCAOB to consider the implications inherent in the independence standards and the additional cost burden companies incur by retaining a second accounting firm for the purpose of obtaining expertise.

The complexity of recent accounting statements raises another serious issue relative to Section 404 compliance. Both the Commission and the PCAOB should recognize that longer, more complex, and detailed accounting pronouncements increase the risk that audited companies will have errors in adopting the pronouncements, with a greater likelihood that such errors become significant deficiencies or material weaknesses in the system of internal control over financial reporting.

The collective experience of Alliance members is that none of the Big 4 audit firms are communicating consistent information from all of their offices. Thus, for example, some offices at each of the firms have informed their clients they expect that almost every company will have at least one significant deficiency, while other offices at each firm have not conveyed this message. Furthermore, many companies are finding that the interpretations of the audit firm engagement partner assigned to their audit take precedence over any PCAOB guidance. Often, those interpretations cause the audit firm to expend more effort and thereby add to its fees. The firms' national offices should be strongly encouraged to take a more proactive role to ensure interpretations are consistent firm-wide. Consistency across a firm does not undermine the ability of specific audit engagement teams within the firm to design an audit program that is aligned with the nature of each client's business operations, size, and complexity.

Although SOX 404 requires an internal management review of business processes, apparently the Big 4 are uniformly leaning toward insisting on full internally prepared and documented audits. Neither Item 308(a) of the SEC's Regulation S-K nor Paragraph 20 of Auditing Standard No. 2 that delineate management's responsibilities in an audit of internal control over financial reporting require management's efforts to be so extensive. It is suggested that both the SEC and the PCAOB clarify that they do not interpret Section 404 to place audit responsibilities on a company's management (in fulfilling its internal control assessment requirement) equal to those of the external auditor (in fulfilling its attestation requirement).

We would also like to illustrate how an external auditor's seemingly straightforward and technical determinations can result in significant inefficiencies in the audit process. One of the Big 4 firms has determined that, in order for controls testing to be relied upon for the "as of date," testing must be performed within 60 days prior to the date the firm attests to management's assessment of the effectiveness of internal controls. It has also determined that when there is a failure in a control, a minimum amount of time must pass—two months—in which the remediated control is performing and can be tested multiple times for management to be able to rely upon the control and say the control is effective for the "as of date." This means if testing is performed and a monthly control is found to have failed as of Month 11, then even if management can prove the control was working as of Month 12, it can not rely on that control as being effective as of Month 12 even though it was proven to be working as of Month 12.

Due to the interpretations mentioned above, two rounds of testing are essentially required. Because there has to be testing within 60 days of the assertion date, a calendar year-end company would have to test all key controls in November and December. However, the two-month rule about remediation makes November-December testing too risky. If any exceptions are found (as there almost always will be), there will not be enough time to prove before year-end the remediation has occurred. Accordingly, testing must be done earlier than November-December to allow for the two-month working control remediation requirement, and testing must be done again in November-December to be late enough for the 60-day "as of date" rule. We take exception to the external auditor's position of saying a control is not working as of December 31 when, through testing, management has proved it was working as of that date. Adoption by the auditor of a 90-day "as of date" rule and a change in the requirement of having multiple good tests for purposes of being able to rely on a remediated control are corrective actions that could largely alleviate the necessity for double testing. As discussed above, another means of lessening the need for double testing would be for the PCAOB to permit greater reliance on interim testing.

We have also learned of some instances where the external auditor discounted most management testing not performed during the fourth quarter, except for repetitive, high volume, automated transactions. This implies that, in the view of the external auditor, management testing before the fourth quarter has little value. We are not aware of any empirical evidence to support this view. Moreover, limiting management testing to the fourth quarter places an undue burden on the finite resources of management.

Auditing Standard No. 2 specifically directs in Paragraph 145 that the audit of internal control over financial reporting should be integrated with the audit of the financial statements and the auditor must plan and perform the work to achieve the objectives of both audits (although the objectives of the procedures for the audits are not identical). Also, Paragraph 146 recognizes an interrelationship between the two types of audit. It provides in part that "[t]he understanding of internal control over financial reporting the auditor obtains and the procedures the auditor performs for purposes of expressing an opinion on management's assessment are interrelated with the internal control over financial reporting understanding the auditor obtains and procedures the auditor performs to assess control risk for purposes of expressing an opinion on the financial statements." Paragraph 146 further suggests it is efficient for the auditor to coordinate obtaining the understanding and performing the procedures. In reality, many companies did not see any efficiencies that translated into a reduction in the number of hours charged for the financial statement audit. Yet, an integrated audit should have led to the financial statement audit benefiting from the internal control work performed. We request that the PCAOB clarify its expectations concerning how the integrated audit should work in practice.

We acknowledge that Auditing Standard No. 2 allows the auditor significant flexibility to determine when it can use the work of others to alter the nature, timing, or extent of the work the auditor would have otherwise performed. Nevertheless, it has been the experience of some of our member companies that the auditor's reliance upon the work of others—specifically the work of the internal audit department—varied by the actual person who performed the work. Often, less reliance was placed upon employees in the internal audit department and more reliance was placed upon work performed by contract auditors retained by internal audit. Apparently, at least one Big 4 firm is telling audit committees that to reduce the audit firm fee, the audit committee should engage a third-party consulting firm to perform management's testing. The PCAOB should clarify the reliance, or lack of reliance, the external auditor may place on work performed by a qualified internal audit department.

A final point should be made about the relative roles of the external audit firms and the PCAOB. Unfortunately, it appears that, thus far, through their audits, the Big 4 firms, and not the PCAOB, have been the principal interpreters of Auditing Standard No. 2. As questions emerged during 2004 about definitions, the constant response was not that the PCAOB was addressing this issue for better clarification, but rather that the firms were meeting to agree on interpretation and application. The PCAOB should assume the lead role in interpreting its own Auditing Standards. By doing so, many of the interpretive consistencies between the firms and within the firms could be obviated.

Conclusion

As we have stated in our earlier studies of the impact of the Sarbanes-Oxley Act, the new law has helped to restore confidence in U.S. financial capital markets. It also has had costly and indiscriminate adverse side effects for public companies. The most important of these include increased burdens on management teams, inconsistencies in application of the new regulations, and significantly greater costs for outside audit. The challenge going forward for lawmakers and regulators alike is to see that the law evolves in a way that helps maintain a high level of investor confidence in the markets while, at the same time, reducing costly regulatory burdens on companies that do not serve that end. Section 404 compliance costs are real and they adversely affect the competitiveness of many U.S. companies. We believe that effective oversight can significantly reduce these costs without an erosion of confidence in the markets.

We have attempted to identify some of the more serious problems companies are experiencing with Section 404 and offer some practical solutions. A more comprehensive disposition of our concerns about Sarbanes-Oxley and the need for further-reaching solutions emerges from a reading of our earlier work in this area and, as such, we encourage the Commission to review the attached studies.

We commend the Commission for providing this opportunity for involved parties to voice their concerns about Section 404. The Manufacturers Alliance appreciates having this chance to present the views of many of the almost 400 executives who participate in our financial and internal auditor Council programs on these important issues and stands willing to further develop those views as the need arises.

Thank you for your consideration of our comments.

Sincerely,

Thomas J. Duesterberg
President and Chief Executive Officer

Attachments

MANUFACTURERS ALLIANCE/MAPI www.mapi.net

Executive Letter

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EL-203 August 19, 2004

Sarbanes-Oxley Act of 2002

Alliance Presentation to Certain Congressional Committees and the Securities and Exchange Commission Regarding Oversight of the Sarbanes-Oxley Act of 2002

Reflecting on milestone events in Congress since the turn of the millennium, most observers would agree that the enactment of the Sarbanes-Oxley Act of 2002 (SOA or Act) most certainly qualifies as such.

In particular, the unprecedented U.S. economic recovery of the late 1990s was followed—for much of the manufacturing sector—by a correspondingly prolonged and painful period of recession. The latter, in turn, was complicated by terrorist attacks on the domestic homeland and resulting warfare that still is under way against known and clandestine belligerents.

In these chaotic circumstances, unethical operators of poorly governed enterprises took liberties with their shareholders, wreaked havoc in U.S. financial markets, and thereby gave impetus to SOA. As a consequence, many prominent, blameless public companies have come to be subject to onerous new government controls broadly applied to them in a systemic attempt by Congress to curtail the depredations of a small minority.

With two years elapsed since SOA's enactment, interested parties have had ample time to reflect on the benefits and costs. Although the Act contributed to the restoration of investor confidence in U.S. financial capital markets, the costs of compliance are significant and represent additional overhead to be borne by affected public companies in global competition. SOA's overseers now should reevaluate the statute, improve its focus, and afford relief where due.

Having so concluded, the Manufacturers Alliance/MAPI (Alliance or MAPI) undertook by the attached letter to congressional committees and the Securities and Exchange Commission (SEC or Commission) to catalyze the oversight process. Oversight is an ongoing legislative and executive responsibility, notably in the case of complex legislation such as SOA, and we believe that overseers should accelerate the review notwithstanding that the task may bridge successive congresses and administrations.

The remainder of this cover note summarizes Alliance views, omitting most SOA section references for brevity. For detail, interested parties should read the accompanying statement in full.

Summary of Alliance Position

The Alliance provided the following summary of recommendations, followed in the statement by a detailed explanation that sets forth the nature of the grievance in each instance and cites specific provisions of SOA that invite scrutiny in the manner suggested:

1) ***Costs and benefits***. Reexamine SOA provisions that drive excessive costs or are questionable as to benefits. Such provisions impair competitiveness and, at the least, require modification.
2) ***Regulatory styles***. Assign priority to reappraisal of SOA "mandates." If self-regulation is infeasible, consider disclosures or performance targets and incentives, avoiding prescriptive rules in all cases.
3) ***Auditor independence***. Reconsider the need to curtail such remaining activities of public company accounting firms and their related/affiliated parties as cast doubt on auditor independence.
4) ***Conflicts generally***. Pursuant to studies commissioned by SOA, reevaluate remaining

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compromised relationships affecting U.S. financial capital markets and involving persons in positions of public trust.

5) ***Internal audit***. To help advance the stated goals of SOA while affording improved cost-efficiencies to affected public companies, recognize internal audit's role in corporate governance
6) ***Materiality***. Turn SEC's "materiality" guidance project over to FASB, or, if retained at the Commission, leave adequate leeway for professional judgment and avoid "cookbook" solutions.
7) ***Average prudent investor***. Ensure that any new public company disclosure provisions are satisfying the needs of the "average prudent investor," and minimize differential treatment of information users.
8) ***Abusive lawsuits***. Understand the vulnerability of entities and their managers to abusive class-action lawsuits and provide safe harbors where conducive to compliance while curbing misuse of the judiciary.
9) ***Criminalization***. Avoid further criminalization of the federal securities laws in keeping with their original purpose as standards of disclosure for which the market itself would judge compliance.
10) ***Administrative procedures***. Comply fully in all proceedings with the letter and intent of the Administrative Procedure Act (APA) to ensure due process to persons affected by proposals.
11) ***Scope of applicability***. Maintain the limited applicability of SOA and be sensitive to the burden of the Act on smaller public companies, consistent with past SEC practice.
12) ***Proliferation, preemption, uniformity***. Take into consideration that some states are adopting SOA-type laws of their own and that conflict and overlaps will arise in the absence of steps to prevent them.
13) ***Going private***. Examine and report on assertions that SOA's burdens are causing public companies to go private or present an unacceptable impediment to private companies wishing to go public.
14) ***Director shortage***. Examine and report on charges that duties imposed by SOA are thinning the ranks of persons willing to serve as directors and, specifically, as members of audit committees.
15) ***Section 404***. Review SOA Section 404 and PCAOB/SEC implementation via Auditing Standard (AS) No. 2 for propriety, cost-efficiency, and clarity, including provisions affecting work sharing, sampling, retesting, control-inadequacy characterizations/definitions, attest qualifications, and transitions.
16) ***Minority shareholder project***. Keep the minority-shareholder-empowerment project on a separate track and stay focused on SOA oversight rather than diversionary suffrage issues.
17) ***Forecasting***. Reject new or revised initiatives that would require that public company managers forecast their enterprises' expected results of operations on the public record.
18) ***Disaggregated reporting***. Refuse appeals for more disaggregated financial accounting and reporting rules and, instead, leave any such matter to the Financial Accounting Standards Board.

Concluding Note

The attached Alliance statement closes by acknowledging that SOA has helped to restore confidence in U.S. financial capital markets, in spite of costly and indiscriminate side effects. The acid test of the Act will be whether the securities laws as thereby amended and subsequently refined prove better able than in the past to contain abuses in an equitable and self-executing way. This will require that oversight parties target and refine SOA along lines recommended in the MAPI statement, and the process should begin forthwith.

As noted earlier, we suggest that interested parties read the statement in full text, which contains reference to specific SOA sections in need of screening as well as related reasoning and citations. As always, the Alliance welcomes comments on this presentation.

Thomas J. Duesterberg
President and Chief Executive Officer

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Thomas J. Duesterberg
President and Chief Executive Officer

August 18, 2004

The Honorable Michael G. Oxley
Chairman
House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515-6050

The Honorable Richard C. Shelby
Chairman
Senate Committee on Banking, Housing, and Urban Affairs
534 Senate Dirksen Office Building
Washington, DC 20510-6075

Re: Oversight of the Sarbanes-Oxley Act of 2002

Dear Messrs. Chairmen, and Members
and Staff of the Committees:

The Sarbanes-Oxley Act of 2002: Oversight Recommendations

Introduction

On this second anniversary of the Sarbanes-Oxley Act (SOA or Act) of 2002,[1] Manufacturers Alliance/MAPI (Alliance or MAPI) wishes to recommend several provisions of SOA that call for oversight review or amendment either by Congress or, within its scope of administrative discretion, the Securities and Exchange Commission (SEC or Commission).

Overall, in our opinion, SOA is performing reasonably well for legislation enacted in an emergency. However, many prominent public companies now are subject to government controls broadly applied to them because managers of a few poorly governed firms violated the law. The costs of compliance with these controls are significant and represent additional overhead to be borne in global competition. If the crisis in our markets is past, then overseers should consider improving SOA's focus and affording relief where due.

As you know, oversight is an ongoing legislative and executive responsibility, notably in the case of complex legislation such as SOA. Most SOA sections already are effective, some being standalone in nature and others sufficiently separable to allow evaluation without substantial risk of misinterpretation. Notwithstanding little time remaining in the 108th Congress, we believe that accelerated review is in order.

[1] See Public Law 107-204, July 30, 2002, 116 Stat. 745, online at http://www.pcaobus.org/rules/Sarbanes_Oxley_Act_of_2002.pdf.

Overseers will see that some recommendations contained in this statement call for congressional attention, whereas others are amenable to refinement by SEC. In either instance, we assume that the Commission (in addition to the committees of Congress[2] with primary jurisdiction) will be involved, regardless of which participant has the lead role. Accordingly, we also are providing SEC with copies of this statement.

For each recipient, we request that these views be placed in the public record maintained with respect to SOA oversight.[3] When public hearings are called, we would appreciate being invited to testify.

Interest, Orientation, and Intent

The Alliance, established in 1933, is a national organization of manufacturing enterprises and related business service providers,[4] most of which are publicly owned and global in the scope of their activities. Our organization's primary purposes are economic and policy research and continuing professional education. When our deliberations reveal information that might be useful to policymakers, we generally offer such information for the public record to persons who are directly accountable or need to know.

Our involvement as a commentator on federal securities law and tax policy developments is of long standing. In addition, we have reported on and submitted views with respect to activities involving the formulation of generally accepted accounting principles (GAAP) since the first involvement of standard setters in the private sector.

Like the securities laws that SOA amends, the Act affects nearly all Alliance member companies because most are publicly owned. These member companies, further, are "accelerated filers"[5] under SOA. Naturally, they have thoughts regarding the Act's performance versus specifications as well as cost-efficiency as a general matter. As we will demonstrate, some recalibration is in order.

Each recommendation in this statement takes into consideration investor protection and the furtherance of orderly financial capital markets, both being primary objectives of the federal securities laws. The Alliance and its members understand the role that these laws have had in nurturing the U.S. financial capital markets. Nothing herein is intended in derogation of the principles underlying such laws.

We recognize further that markets must be liquid, efficient, and relatively free of abuse if they are to be attractive to investors and issuers alike. Individuals and institutions should be able to invest at prices that continuously reflect all material information publicly available for issuers, and the information should be as accurate and complete as sound management judgment and GAAP will allow.

In reconsidering SOA, we trust that overseers will be mindful that, as securities markets increasingly become global, regulatory principles applicable to them ought to follow suit.[6] However, harmonization should not be achieved at the expense of diminished market integrity in the United States.[7]

We tender these recommendations with constructive intent, and hope that they will be useful.

Recommendations, In Brief

For the convenience of reviewers, we present this brief summary of recommendations. However, we urge attention to the full text set forth later in this letter.

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[2] Although this statement is addressed to the House Committee on Financial Services, http://financialservices.house.gov/, and the Senate Committee on Banking, Housing, and Urban Affairs, http://banking.senate.gov/, we also intend it for their related oversight subcommittees.

[3] We request that this statement be included in the record of the House Committee on Financial Services' SOA hearing of July 22, 2004, and any further such record to be compiled following Labor Day recess. The Committee heard five invited witnesses on July 22, and their written submissions are online at http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=326.

[4] See Manufacturers Alliance/MAPI Inc. online at http://www.mapi.net.

[5] This reference is to accelerated filers of periodic reports and disclosures concerning website access to reports, as described in SEC Release No. 33-8128 of September 5, 2002. See http://www.sec.gov/rules/final/33-8128.htm.

[6] The private sector rule makers for financial accounting and reporting are moving on this with reasonable dispatch considering the enormity of the task. An example of this for conceptual frameworks can be seen at http://www.fasb.org/project/research_projects.shtml.

[7] See http://www.iasb.org/uploaded_files/documents/8_128_040420-pav.pdf for a provocative presentation on GAAP globalization to the Senate Governmental Affairs Subcommittee on Financial Management by International Accounting Standards Committee Foundation Chairman Paul A. Volcker on April 20, 2004.

Oversight parties will note that we have broached in this statement several controversial topics ***not*** currently covered by SOA. The reason is that the issues in question arise repeatedly under the rubrics of "governance" and/or "accountability." Rather than fail to comment now, we present brief views on such items (i.e., recommendations 16–18, below).

We recommend the following actions generally in reviewing SOA, and wherever possible will be specific in detailed remarks to follow this list:

1. ***Costs and benefits***. Review the Act and purge it of provisions that drive excessive costs or are questionable as to benefits. Such provisions impair competitiveness and, at the least, require modification.
2. ***Regulatory styles***. Wherever SOA resorted to mandates, they deserve priority review. If self-regulation is infeasible, consider performance targets and incentives, and avoid prescriptive rules in all cases.
3. ***Auditor independence***. Reconsider the need to curtail such remaining activities of public company accounting firms and their related parties as cast doubt on auditor independence.
4. ***Conflicts generally***. Pursuant to studies commissioned by SOA, reevaluate remaining compromised relationships affecting U.S. financial capital markets and involving persons in positions of public trust.
5. ***Internal audit***. To help advance the stated goals of SOA while affording improved cost efficiencies to affected public companies, recognize internal audit's role in corporate governance.
6. ***Materiality***. Turn SEC's "materiality" guidance project over to the Financial Accounting Standards Board (FASB), or, if it instead is retained at the Commission, leave adequate leeway for professional judgment and eschew "cookbook" solutions.
7. ***Average prudent investor***. Ensure that any new public company disclosure provisions are satisfying the needs of the "average prudent investor," and minimize differential treatment of information users.
8. ***Abusive lawsuits***. Understand the vulnerability of entities and their managers to abusive class-action lawsuits and provide safe harbors where conducive to compliance while curbing misuse of the judiciary.
9. ***Criminalization***. Avoid further criminalization of the federal securities laws in keeping with their original purpose as standards of disclosure for which the market itself would judge compliance.
10. ***Administrative procedures***. Comply fully in all proceedings with the letter and intent of the Administrative Procedure Act (APA)[8] to ensure due process to persons affected by proposals.
11. ***Scope of applicability***. Maintain the limited applicability of SOA, and be sensitive to the burden of the Act on smaller public companies, consistent with past SEC practice.
12. ***Proliferation, preemption, uniformity***. Take into consideration that some states are adopting SOA-type laws of their own and that conflicts and overlaps will arise in the absence of steps to avoid them.
13. ***Going private***. Examine and report on assertions that SOA's burdens either are causing public companies to go private or present an unacceptable impediment to private companies wishing to go public.
14. ***Director shortage***. Examine and report on charges that duties imposed by SOA are thinning the ranks of persons willing to serve as directors and, specifically, members of audit committees.
15. ***Section 404***. Review SOA Section 404 and Public Accounting Oversight Board (PCAOB)/SEC implementation via Auditing Standard (AS) No. 2,[9] for propriety, cost-efficiency, and clarity, including provisions for work sharing, sampling, retesting, control-inadequacy characterizations/definitions, attest qualifications, and transitions.
16. ***Minority shareholder project***. Keep the minority-shareholder-empowerment project on a separate track, and stay focused on SOA oversight rather than diversionary suffrage issues.
17. ***Forecasting***. Reject new or revised initiatives that require that public company managers forecast their enterprises' expected results of operations on the public record.
18. ***Disaggregated reporting***. Refuse appeals for more disaggregated financial accounting and reporting rules and, instead, leave any such matter to the FASB.[10]

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[8] See APA, 5 U.S.C. Subchapter II, online at http://www.archives.gov/federal_register/public_laws/acts.html.
[9] SOA Section 301 established the Public Company Accounting Oversight Board (PCAOB), and Auditing Standard (AS) No. 2 is an auditing standard applicable to SOA Section 404 attestation to control over financial reporting, as promulgated by PCAOB and confirmed by SEC earlier in 2004. See AS No. 2 online at http://www.pcaobus.org/documents/rules_of_the_board/Standards%20-%20AS2.pdf.
[10] See, e.g., Statement of Financial Accounting Standards No. 131 dealing with disclosures about segments of an enterprise (and related information), summarized at http://www.fasb.org/st/summary/stsum131.shtml.

Background

Congress enacted the federal securities laws in the 1930s under circumstances that, in wavelike fashion,[11] recurred 70 years later and drove enactment of SOA. Then and now, the object of public policy was to arrest a "crisis of confidence" occasioned by abusive practices affecting public companies. In both cases, an economic downturn followed unprecedented prosperity and accentuated the flight from securities markets.

To recap, by late 2000, the dot-com bubble had burst, and recessionary conditions were spreading. The tragic September 11 terrorist event in 2001 introduced a new element of uncertainty and was followed by hostilities in Afghanistan. When conditions seemed most bleak, certain "prestigious" public companies and their certified public accountants imploded under allegations of criminal behavior.

By the time SOA approached final consideration in Congress in July 2002, equity markets had lost trillions of dollars of value. More losses were certain if the hemorrhage could not be staunched. Congress and the Administration acted boldly and with dispatch by enacting SOA. Of necessity in such a chaotic setting, the Act was a hasty compromise with some intrusive thrusts and some potential gaps.

As the most sweeping overhaul of the federal securities laws since the 1930s, SOA was intended to deal with governance failings and financial reporting improprieties, to cure accounting and audit rulemaking inadequacies, to explore areas of suspected abuse, and to sensitize all financial capital market participants to their responsibilities.

Although SOA-driven costs have been a magnet for criticism of parts of the Act, the alternatives in July 2002 were unacceptable. Now with two years of experience post-enactment, some companies report process improvements and better control environments traceable to SOA-imposed disciplines. Although opinions remain mixed, the business community generally acknowledges the Act's redeeming qualities and looks ahead to improvements.

The various titles of the Act endeavor to achieve the following:

Title	Topic
I.	Improve public company accounting oversight by establishing the Public Company Accounting Oversight Board (PCAOB),[12] a private sector regulator more closely overseen by SEC than its predecessors;
II.	Strengthen the rules of independence applicable to auditors;
III.	Establish new rules of corporate responsibility for officers, directors, and attorneys;
IV.	Enhance and accelerate financial disclosures;
V.	Call for new rules to deal with conflicts of interest of security analysts;
VI.	Reinforce SEC's resources and authority;
VII.	Order new studies and reports about structural issues and abuses by market participants;
VIII.	Provide new and more rigorous rules of corporate and criminal fraud accountability;
IX.	Stiffen white-collar criminal penalty provisions;
X.	Establish or increase corporate fraud penalties; and
XI.	Record the Senate view that chief executives should sign corporate tax returns.

The common denominators of SOA are as follows: increased and expedited disclosure; the clarification and codification of various governance duties; new prohibitions to lessen conflicts of interest; more clearly defined accountability for information about affected public companies; new or increased penalties for misbehavior or failure to act when action is due; and fact-finding studies.

Where fact-finding seemed in order, SOA mainly commissioned studies of known or suspected areas of abuse of trust and failures of accountability involving participants in financial capital markets. The studies deserve mention inasmuch as they could generate further legislation and regulation. Among the institutions put under the looking glass were those of credit rating agencies, investment banks, and security analysts.

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[11] For online information about Kondratieff waves, see http://faculty.washington.edu/modelski/IPEKWAVE.html.

[12] Interested parties can access extensive PCAOB documentation, including the underlying statute, standards (and comments), and web casts of activities at http://www.pcaobus.org/. SEC reviews and affords separate due process to all PCAOB rulemaking, and the related SEC proceedings, including comments thereon, appear at http://www.sec.gov/rules/pcaob.shtml.

Since enactment, SOA and its implementing rules have led to ***increases*** in the following: director and management attention to internal accounting and financial reporting controls; director and management time spent with auditors; audit committee meetings and/or hours of proceedings per meeting; sensitivity of all market participants to governance, control environments, accounting quality, and auditor independence; and costs related to all of the foregoing.

In conducting oversight, the cognizant committees and SEC should—consistent with past practice reflected in the federal securities laws—be mindful of the economic advantages of privatization and the balance to be struck in securities market regulation between the maintenance of orderly financial capital markets and minimal interference with the forces of supply and demand.

Recommendations, In Detail

Most observers would agree in the aftermath of SOA that the Act has been a positive factor in restoring order, but also has been less than discriminate in its impacts. Now that the crisis is in abeyance, policymakers should return to the Act and refine it based on findings to date.

In speaking to the matter of SOA oversight by Congress and SEC, the Alliance is mindful that a revisit in either forum could expose the Act to non-germane proposals. Also, we are aware that oversight of the Act is not a short-term endeavor, and, with few legislative days remaining in the 108th Congress, necessarily may bridge successive Congresses and Administrations.

Our recommendations to follow address selected SOA provisions as well as several federal securities law "perennials" offered in the name of governance or accountability reform.

Costs, Benefits, and Competitiveness

In reviewing the most comprehensive overhaul of the federal securities laws to date, Congress and SEC necessarily should look to purge provisions that drive excessive costs or confer few benefits.

The reason, of course, is that the incremental costs to a regulated party may impair competitiveness. Customarily, too, the "lines" drawn by regulations with respect to coverage can have the same effect. The discriminating effects of costly rules, whether, for example, between smaller and larger businesses, public or private entities, or domestic and foreign companies, can dictate who wins and who loses in global markets.

This matter of incremental added cost hardly is an abstraction. The U.S. economy's manufacturing sector suffered recession and lost employment for three years between fall 2000 and fall 2003. Fixed costs of doing business, including those of regulation, had a role in this retrenchment even though global recession following an unprecedented recovery was the primary driver. Employers who moved or outsourced to other jurisdictions were responding rationally to alternative operating environments.

As to the purported benefits of regulation, the Alliance concurs in the view that SOA benefited financial capital markets by helping to restore investor confidence. However, we scarcely could quantify much less allocate the Act's benefits. Benefits often amount to conjecture, whereas one usually can quantify costs at the margin and trace them to their origin.

SOA's reviewers should keep this cost-benefit discrepancy in mind because the Act is one of the costliest pieces of legislation ever enacted in the name of corporate governance, and it was assembled on the run. Reviewers should assign priority to clearing out the doubtful provisions and moderating those that have proven excessive. We will provide examples later in this statement.

By way of preview, Section 404 leads the way[13] among those SOA provisions in need of moderation. The related, sizable hike in external audit fees is, in a sense, the "tip of the iceberg" in that it is accompanied by more involvement of directors, senior management, internal auditors, company accountants and attorneys, and other outside consultants—work that is costly and is superimposed on the preexisting agenda.[14]

Still other costs that are derivative of Section 404 include those of new software tools, additional personnel training at all levels, director fees, and indemnification associated with new potential liabilities (e.g., for directors' and officers' liability insurance).

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[13] See, e.g., "Benchmarking the Costs of Complying With Sarbanes-Oxley Section 404," ER-570e, Manufacturers Alliance/MAPI Inc., June 14, 2004, abstract at http://www.mapi.net/html/abstract.cfm?PubID=248.

[14] For further detail, see "Testing, Staffing, and External Audit Fees Related to Sarbanes-Oxley Act of 2002 Section 404 Compliance—A Manufacturers Alliance/MAPI Survey, S-101, of July 2004.

We return later in this statement with specific suggestions pertaining to SOA Section 404 and related PCAOB Auditing Standard No. 2. Suffice it to say here that we do not oppose the provision in concept. However, some of the implementation clearly is oppressive.

Regulatory Styles

To the extent that SOA resorted to command-and-control regulatory devices, they deserve priority review in our opinion. If self-regulation is not feasible, oversight parties should reconsider using performance targets and incentives in place of mandates, and avoid prescriptive rules in all cases.

In the words of Justice Louis D. Brandeis, "Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."[15] SOA already relies on "sunshine" to disinfect and "transparency" to inform. For example, material information concerning affected public companies must be reported in more nearly "real time."[16]

Disclosure-type regulation is used throughout the federal securities laws, and investors are serviced at less cost by such regulation than otherwise would be incurred if prescriptive mandates were in effect. Investors also, usually, are better informed as a result. Rather than speculate about this, we commend the real-time disclosure rules[17] to reviewers' attention for reevaluation with a view to optimal information flow at least cost.

In addition to being relatively inexpensive, disclosure interferes less than any other form of regulation with markets and market participants. Market efficiency partly is a function of equal and simultaneous access to material information, and disclosure is the *sine qua non* of the efficiency equation.[18] To the extent that SOA relied on disclosure, the outcome likely is as intended. To the extent that the Act resorted to invasive regulatory devices, they deserve priority review.

The opposite of the command-and-control paradigm in rulemaking entails incentives, including those ranging from recognition of achievement to relief from regulatory obligations for parties who achieve objectives. Regulation by incentive may seem counter-intuitive to some parties, but it exists and works.[19] For example, oversight parties should consider relieving issuers from certain SOA Section 404 duties provided they meet performance standards. With imagination, onerous parts of SOA could be made more tolerable.

We also believe that self-regulation can work in the public interest and that policymakers should defer to such mode of regulation wherever possible. The FASB bears out this assertion. FASB is private and authoritative, and promulgates generally accepted accounting principles (GAAP). Although under close SEC watch, FASB has come a long way from predecessors that contended naively that accounting rulemaking solely was the business of accountants.

Further on self-regulation, the PCAOB—organized pursuant to SOA and subject to SEC review—now issues generally accepted auditing standards (GAAS)[20] and also licenses and peer reviews public company auditors. Notwithstanding close Commission oversight of all its activity, this new audit institution remains in the private sector, as do the SEC's self-regulatory organizations, such as the New York Stock Exchange[21] and National Association of Securities Dealers.

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[15] "What Publicity Can Do," *Other People's Money*, Chapter 5, p. 92 (1932); first published in *Harper's Weekly*, December 20, 1913.

[16] See, e.g., SOA Section 409, "Real Time Issuer Disclosures."

[17] See http://www.sec.gov/rules/final/33-8400.htm#seci implementing SOA Section 409 in part. For implementation of SOA Sections 406 and 407 on disclosures for senior financial officer codes of ethics and disclosures with respect to audit committee financial experts, also see http://www.sec.gov/rules/final/33-8177.htm and correcting release http://www.sec.gov/rules/final/33-8177a.htm.

[18] See, e.g., SEC's Regulation FD (i.e., "fair disclosure") at http://www.sec.gov/rules/final/33-7881.htm.

[19] Consider emissions trading in the context of air pollution abatement rules. An example appears in "2004 Report to the Legislature: State Regulation on Emissions Trading Methodology, (Health and Safety Code Section 39607.5)," California Environmental Protection Agency, Air Resources Board, March 2004, at http://www.calepa.ca.gov/Publications/Reports/Mandated/2004/EmTrading.pdf.

[20] Inasmuch as PCAOB now is the arbiter of "GAAS," the Board's Auditing Standard (AS) No. 1, to prevent confusion, requires that the auditor during an engagement refer to "the standards of the Public Company Accounting Oversight Board (United States)." See AS No. 1 at http://www.pcaobus.org/documents/rules_of_the_board/Standards%20-%20AS1.pdf. On an interim basis, PCAOB uses auditing standards of the American Institute of Certified Public Accountants that were in existence on April 16, 2003.

[21] See, e.g., http://www.nyse.com/regulation/p1020656068597.html?displayPage=%2Fregulation%2F1022221392702.html.

On a final regulatory note, we counsel against narrow and highly detailed regulations. Rather, we urge that oversight parties examine SOA-related output to be certain that it is principles-based.[22] Prescriptive rules attempt in futility to cover every possible contingency, and the outcome is predictable. They fall short of purported goals, are readily subject to evasion, and expose regulated parties to countless and unmanageable amendments and interpretations.[23]

Auditor Independence

Conflicts of interest characterized many of the irregularities addressed by SOA. As former SEC Chairman Arthur Levitt found to his consternation, conflicted relationships can be deep-seated and persons benefiting from them will defend their "territory" at considerable cost to everyone.[24] Fortunately, Chairman Levitt did not shrink from the task of proscribing or dismantling defective institutional and personal dealings.[25] However, the job is ongoing, and SOA provides new authority.

Therefore, oversight parties should reconsider aspects of SOA Title II, "Auditor Independence," with a view to curbing the remaining activities of public company accounting firms and related parties that cast ***actual or perceived*** doubt on auditor independence. External auditors have the public trust to uphold, and cannot bear that responsibility while pursuing activities that appear to compromise their independence. If the lines drawn in SOA are less than bright, they should be recast in a manner to erase doubt.

In particular, Congress and SEC should reconsider SOA Section 201(a), "Prohibited Activities," and also examine experience to date with the provision requiring pre-approval for non-audit services. In auditor-independence regulatory proceedings to date, the accounting profession has contested the proposed limitations. Consequently, the separation of public accounting (i.e., attestation duties) and so-called "consulting" activities of other kinds remains incomplete.

The Alliance would prefer not to see a repeat of the accountability and audit debacles of 2001-2002. Also, we would prefer to see self-regulation succeed for financial accounting, reporting, and audit. Although fulfilling these preferences could mean the elimination of surviving "gray" areas of auditor-client relationships, all interested parties stand to benefit from more nearly unimpeachable auditor independence.

For example, overseers will want to reconsider tax services still offered by some public company accountants to attest clients. Some of this activity is benign for auditor independence, but certain practices (e.g., planning and shelters) are troubling. PCAOB has begun this process, and the conundrums are apparent.[26] However, PCAOB can resolve the conflicts, so we recommend leaving the job to the Board.

Allow us to emphasize that we broach this issue only in the context of the attest firm's provision of certain of these services to attest clients, ***not*** as those services might be rendered to other parties. Finally, parties to the debate on this matter might usefully keep in mind that SEC retains full authority to perform all accounting and audit activities currently delegated to the private sector.[27]

Other Conflicts of Interest

Just as conflicts of interest have been under close scrutiny lately in the auditor-client relationship,[28] so too are they an irregularity addressed elsewhere by SOA.

The provisions in question include those pertaining to conflicts of public companies' inside and outside directors, investment bankers,[29] security analysts,[30] credit-rating agencies,[31] investment advisors,[32] and more.

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[22] Pursuant to SOA Section 108(d)(1), SEC staff conducted a study of and endorsed the use of principles-based (a/k/a "objectives-oriented") standards for accounting. The study can be downloaded at http://www.sec.gov/news/studies/principles basedstand.htm, and was summarized in Manufacturers Alliance/MAPI e-Alert-249 of August 26, 2003.

[23] Consider FASB's first attempt at a Statement of Financial Accounting Standards (SFAS) on Accounting for Leases, i.e., SFAS No. 13, which became the "poster child" for this contention. FASB encountered the same fate with "special purpose entities" used for off-balance-sheet financing, one of the schemes involved in scandals that gave rise to SOA.

[24] For an appeal of SEC to win the cooperation of the then-reluctant external audit profession, see "The Public's Profession," SEC Chair Levitt, October 24, 2000, at http://www.sec.gov/news/speech/spch410.htm.

[25] See SEC Release No. 33-7919 of November 21, 2000, bringing closure to the most bitterly contested auditor independence regulatory project to date, at http://www.sec.gov/rules/final/33-7919.htm. SOA amended the rule, as noted in footnote 13.

[26] The web cast of PCAOB's July 14, 2004 session can be accessed at http://www.connectlive.com/events/pcaob/. Download comments of SEC Chief Accountant Nicolaisen at http://www.sec.gov/news/speech/spch071404dtn.htm.

[27] See, e.g., SOA Section 3(c) negating any construction of SOA that would impair or limit its authority in such a way.

[28] SEC's rule is online at http://www.sec.gov/rules/final/33-8183.htm, corrected by http://www.sec.gov/rules/final/33-8183a.htm.

Any relationship that could skew the independent judgment of a person in a position of public trust or simply able to influence the movement of the financial capital markets deserves periodic review.

As mentioned, the beneficiaries of conflicted relationships never yield readily, and conflicts proliferate in any tolerant environment. The forces and effects that militate against objective—much less independent—judgment are so manifest and complex that total elimination is an unrealistic objective. Nonetheless, they can be minimized, and persons occupying positions of trust should strive for independence in reality and appearance.

We therefore recommend that SOA's overseers reevaluate the independence of parties on whom investors primarily rely, and consider adding reinforcement where needed. Conflicts must be minimized, whether real or perceived, and the integrity of U.S. financial capital markets to a greater or lesser extent is at stake in this exercise. Studies that were commissioned by the Act should provide valuable leads for such a review.

For example, the General Accountability Office (GAO) found that certain investment banks facilitated and participated in complex financial transactions with a failed company despite allegedly knowing that the intent of the transactions was to manipulate and obscure its true financial condition.[33] Although investment banks are not responsible for the financial reporting of their clients, GAO stated that, if it is proven that the investment banks knowingly assisted in securities law violations, SEC has the authority to take legal action against them.

GAO further cited research analysts at investment banks who made favorable recommendations for firms that soon thereafter failed. For example, certain investment banks allegedly pressured analysts covering several of the failed firms to give investors favorable or misleading investment recommendations in order to keep or win lucrative work from the companies, creating serious conflicts of interest.

Elsewhere, both SEC and the Senate Committee on Governmental Affairs have studied credit rating agencies. Among the Commission's findings are that users would like to have more information about the rating analysts' key assumptions or expectations regarding the issuers' financial performance and industry trends, as well as specific events or financial triggers that might prompt a reconsideration of their ratings.

The purpose here is not to impugn the integrity of entire sectors in the financial industries. However, the public trust is a substantial responsibility, and the stakes are high. Also, the rewards are very significant to persons and institutions so entrusted. Although perfection is not expected, the investing public is entitled to a level of performance and diligence commensurate with the level of trust these financial intermediaries enjoy or hope to instill. SOA's studies point the way.

Internal Audit's Role

The internal audit profession increasingly is achieving greater stature and independence in companies, and this is a positive governance development that, in our opinion, should have been acknowledged more conspicuously in SOA.[34]

Perhaps Congress and regulators elected otherwise because internal auditors are paid by the enterprises that employ them. Also, such auditors frequently report in one or another manner to chief financial officers who supervise enterprise accounting controls, audit, and financial and similar relationships, and are assigned financial statement certification responsibilities by the Act.

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[29] Studied by the Government Accountability Office (i.e., GAO, formerly known, until July 2, 2004, as the Government Accounting Office) pursuant to SOA Section 705. See the GAO study of March 2003 online at http://www.gao.gov/new.items/d03511.pdf.

[30] See SOA Title V calling for restrictions, including disclosure rules, from SEC or its self-regulatory organizations.

[31] Studied by SEC pursuant to SOA Section 702. The Commission study was issued January 24, 2003, and can be downloaded from http://www.sec.gov/news/studies/credratingreport0103.pdf.

[32] Responding to questionable conduct by investment advisors, SEC recently issued code of ethics standards under the Investment Advisors Act of 1940. See http://a257.g.akamaitech.net/7/257/2422/06jun20041800/edocket.access.gpo.gov/2004/pdf/04-15585.pdf. Also see SEC's recent rules, at http://a257.g.akamaitech.net/7/257/2422/06jun20041800/edocket.access.gpo.gov/2004/pdf/04-17460.pdf, containing governance rules for investment companies.

[33] *Op. cit.*, footnote 29.

[34] Under a recent New York Stock Exchange (NYSE) rulemaking, NYSE Section 303A(7)(d) requires each listed company to have an internal audit function, http://www.sec.gov/rules/sro/34-48745.htm. See the release just cited for SEC's order approving a number of NYSE and National Association of Securities Dealers (NASD) governance proposals for listed companies.

As an operator of continuing professional education activities for corporate general auditors, the Alliance is familiar with their profession and work. During a decade to date of our close exposure to internal audit, the profession has grown rapidly in stature, influence, and independence, along with the globalization and consolidation of companies. Enterprises of all types and sizes, public or private, are well served by internal auditors' surveillance work.

Internal audit work is extensively financial in nature and will remain so for as long as these professionals are charged with financial statement compliance work, which includes internal accounting and reporting controls. As you may know, internal auditors were instrumental in bringing some of the pre-SOA abuses to light.[35] Increasingly, these auditors are accorded a status and independence not otherwise seen on management teams.

In recent years, we have observed and documented changes in the reporting relationships of general auditors, with the trend now being toward functional reporting to the Audit Committee Chairman and administrative reporting to the Chief Financial Officer (CFO). Of course, internal auditors are compensated by the enterprises for which they work, as are external auditors. Compensation for services rendered does not preclude objectivity, and independence increasingly is a function of individual stature, duties assigned, and top management's intensity about good enterprise governance and risk management.

Oversight parties should consider how their formal recognition of internal auditors could advance the purposes of the Act while affording options for more cost efficiency. We will revisit this topic in the context of SOA Section 404.

Materiality

Materiality is a pervasive concept in accounting. Items that are immaterial do not reach the threshold where separate accounting or disclosure is required. However, materiality begs for definition. Without definition, no two parties would consistently agree about this characteristic of information.

Accountants—from those at FASB who pondered this issue officially in 1974 to those on the SEC staff who defined materiality in 1999[36]—usually agree that "cookbook"-type definitions are inappropriate. Although accountants often have used "rules of thumb," they tend now to concur that such sweeping generalizations are just as inappropriate as detailed instructions.

Having alluded to SEC's Staff Accounting Bulletin (SAB) No. 99, we note that the pronouncement proved useful even though it did not provide a roadmap. Rather than endorse a rule of thumb or attempt a universal definition, the staff emphasized the qualitative considerations (i.e., principles)[37] that apply, and then gave examples consistent with past approaches of the Commission.

We understand from SEC Chief Accountant Nicolaisen that the Commission staff is now working on "more detailed" materiality guidance, reportedly one or two additional pronouncements that will supplement or replace SAB No. 99. Even though SEC does not endorse staff statements, we believe that SEC will use the new SABs, as it already does, internally when reviewing and opining on the adequacy of disclosures. [38] Also, the Division of Enforcement could be expected to use them in compliance proceedings.

When FASB withdrew its 1974 Discussion Memorandum on materiality, the purpose was one of "order" in that the Board decided after commencing the dialogue that a GAAP pronouncement was premature. In particular, FASB thought it best at the time to first complete the conceptual framework of financial accounting and reporting. We see occasional reference to FASB's insertion of quantitative materiality thresholds in its projects, but are not aware of a revisit to the topic generally.

SEC does not appear to have indicated why the Commission removed this project from the Board. Also, to our knowledge, the Commission has not served notice of timing or the output to expect beyond the "more detailed guidance" alluded to by Chief Accountant Nicolaison.

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[35] E.g., Sherron Watkins (Enron) and Cynthia Cooper (WorldCom) were internal audit "whistleblowers" in two of the more serious cases. See http://news.bbc.co.uk/1/hi/world/asia-pacific/3300445.stm.

[36] Staff Accounting Bulletin No. 99, issued August 13, 1999, at http://www.sec.gov/interps/account/sab99.htm.

[37] *Op. cit.*, footnote 19.

[38] Under SOA Section 408(c), major issuers, as defined, will have a review of their disclosures, including financial statements, by SEC not less than once every three years.

Our preference would be to keep materiality with FASB, which is entrusted with formulating GAAP and interpretations thereof. The SEC staff's work certainly is authoritative literature, but the end objective would seem to us to be principles of general application—indeed global application.[39]

If SEC allows its staff to keep this project, public participation would be in order. Also, we would urge that the staff not opt in favor of either rules of thumb[40] or exceptional granularity. Rules of thumb are too imprecise. At the other extreme, we have found from cookbook-style rules of the past that they cannot possibly anticipate all of the situations that will arise. In addition, such rules convey a false illusion of precision and uniformity where it does not exist.

Finally, we would like to see some refreshed and more specific statement of the intended applicability of SABs, inasmuch as they are issued without formal Commission endorsement but presumably are binding.

Average Prudent Investor

When regulatory discussions of disclosure concern volume of output, "information overload" usually surfaces in the argument, even though it sometimes strikes proponents of disclosure proposals as a pretense for avoidance. Certainly, the point should be raised in SOA oversight even though the "overload" characterization is unfortunate.

With respect to the organization and prioritization of information, purpose affects the former and the assumed capabilities of the user affects the latter. Periodic disclosure documents naturally do not have the detail of registration statements, and registration statements themselves must be selective if they are to convey to potential investors the material enterprise information needed in deciding whether or not to invest.

Over the years, the direction of change with respect to volume of information has been toward increased data and explanation thereof, whether in financial statements, footnotes, or specialized disclosures like the Management's Discussion and Analysis (MD&A) of Financial Condition and Results of Operations.[41] SEC's position usually has been that the investor should be able to see and understand an enterprise, in material aspects, through the eyes of management.

The trend toward increased data and explanations has been accompanied by calls for summarized output. One outcome has been the use by some companies of summary annual reports,[42] with more detailed versions available on request. The use of such reports has been conditional because of concern about "differential disclosure," that is, some users receiving more information than others.[43]

The user still is the "average prudent investor,"[44] presumably—although not so defined—an informed generalist with enough financial acumen to read clearly stated, well organized, material financial information and grasp the import of material enterprise attributes, transactions, and events. To meet the presumed capabilities of this investor, SEC generally has requested that management digest information, whether in the MD&A, footnotes, or elsewhere.

SOA overseers, in our opinion, should reconsider the totality of new disclosure called for by the Act, and cut back on incremental reporting that has not clearly benefited the users of affected companies' financial

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[39] Regarding materiality in the international standard-setting arena, see paragraphs 29 and 30 of the International Accounting Standards Board's Framework (i.e., conceptual framework), at http://www.iasb.org.uk/. [Login needed for online access to this item.] Also see the much more recent and more comprehensive pending Accounting Standard 1031. "Materiality," of the Australian Accounting Standards Board, at http://www.aasb.com.au/.

[40] For background on materiality, including such approaches, see "Materiality Decisions in the Computer Age: The Old Ways Don't Hold Water," by Lee J. Seidler, *The CPA Journal*, May 1999, at http://www.nysscpa.org/cpajournal/1999/0599/features/599p22.html.

[41] I.e., SEC's Regulation S-K, Item 303, at http://www.sec.gov/divisions/corpfin/forms/regsk.htm#mana, as amended by SOA Section 401(a) to create a separate captioned section dealing with off-balance-sheet arrangements and aggregate contractual obligations, with January 29, 2003, implementation by the Commission online at http://www.sec.gov/rules/final/33-8182.htm. For interpretive guidance on the MD&A, see http://www.sec.gov/rules/interp/33-8350.htm of December 19, 2003.

[42] E.g., http://www.delta.com/pdfs/annual_reports/DeltaAR2003.pdf and http://www.mcdonalds.com/corp/invest/pub/annual_report.html.

[43] Differential disclosure still surfaces in accounting standards debates. See, e.g., the recent request for comments by the Accounting Standards Board of Canada (AcSB) or IASC, at http://www.cica.ca/multimedia/Download_Library/Standards/Accounting/English/e_ITC.pdf, or http://www.iasb.org/current/dp_pv.asp, respectively.

[44] The "average prudent investor" concept also is tied to notions of "materiality." See, e.g., SEC's Regulation S-X on the form and content of financial statements under the federal securities acts, http://www.sec.gov/divisions/corpfin/forms/regsx.htm#terms, at 17 CFR 210.1-02 ("Definitions"). In particular, "The term material, when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters about which an average prudent investor ought reasonably to be informed."

reports. In that connection, some provisions of the Act are amenable to boilerplate responses that add little and may obscure more valuable information.

In particular, attention should be given to Title IV with respect to enhanced financial disclosures. What is achieved by having issuers disclose whether or not they have a code of ethics for senior financial officers and then requiring them to explain the reason that they do not if that is the case?[45] If the issuer's answer is "no," and the issuer explains that it has a code covering everyone, what intelligence has the statement user gained?

Similarly, what is achieved by having issuers disclose whether or not they have a financial expert on the audit committee, and then further disclosing any absence of such an expert. Consider an explanation to the effect that the committee is populated with seasoned operating executives who have expertise more encompassing that the four items listed in the statute.[46] Although we favor disclosures over mandates, the disclosure should be meaningful.

Abusive Lawsuits

We have mentioned litigation in the context of forecasting. In our opinion, concern about nuisance litigation as a general matter is a factor to be considered in disclosure regulation, and the lawsuit factor cuts several ways.

Accounting restatements too often are accompanied by class action lawsuits brought allegedly to redress investor grievances. The costs of defending can be significant, and we remind overseers that accounting is not yet a science. Aversion to such suits may be conducive to more prudent management in a small number of cases. However, class actions are, at best, a perverse form of prophylaxis that exacts a questionable toll for all public companies and returns little to class participants.[47]

SOA properly took steps to prohibit management from profiting from its errors. In the same spirit, the class action lawyers should not profit unfairly from nuisance lawsuits. Accounting by enterprises for transactions and events still has a significant subjective element, and we recommend that anything in the Act suggesting otherwise or purporting to have management underwrite financial statements be reconsidered.

For example, SEC contends that financial statement certifications by chief executive officers (CEOs) and CFOs have been effective. Overseers should determine and report on whether and how the certification provisions are working.[48] However, in revisiting the mechanism, we counsel against further restriction. In particular, companies should remain at liberty to determine how internal lines of accountability will be drawn.

As to the "sense of the Senate" resolution to the effect that CEOs should sign enterprise tax returns,[49] we believe that CEOs are accountable for total enterprise performance, but not for the detail of tax law and compliance. The tax properly is a joint responsibility of personnel who generate the data and specialists who prepare the filings. These individuals report directly or indirectly to parties certifying to the financial statements, but such reporting does not make tax experts of the latter parties. Nothing more is needed.

Further, to the extent that tax reporting is derivative of financial reporting, which is substantially so, the existing certifications could be construed to underlie the tax return in some measure.

Criminalization

Since the 1970s, the securities laws—primarily disclosure documents at the outset in 1933—have become encrusted with provisions that exact penalties for one or another type of behavior considered antithetical to purposes of such laws. This perhaps was to be expected in that some kinds of conduct need more than exposure to light to inhibit misbehavior.

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[45] See SOA Section 406.

[46] We refer to SOA Section 407 overall and to (b)(1) through (4) of the section.

[47] Obtaining class-action reform has been a frustrating endeavor. The latest effort at the federal level, best characterized by S. 2062 in the 108th Congress, failed after painstaking efforts to craft a bill that would satisfy a majority. See Rand's Institute for Civil Justice for extensive research into the costs and benefits of class-action lawsuits as well as reform possibilities, http://www.rand.org/icj/.

[48] For a compilation of due diligence ideas for CEOs and CFOs, see *Client Memoranda*, "CEO/CFO Certification: Time for Reflection," Fried Frank Harris Shriver & Jacobson, August 16, 2002, at http://www.ffhsj.com/cmemos/020816_sarb_ceo_cfo_cert.htm.

[49] See SOA Section 1001.

Given the depraved actions of a few persons who drove SOA to enactment, no one was surprised to see strong medicine prescribed. Also, fixed-dollar fines enacted in the distant past arguably needed updating. However, we perceive a profound difference between regulation by disclosure and regulation by prohibition and criminal penalty. The former relies on mutual cooperation and supply and demand in the marketplace, whereas the latter rely on enforcement, investigations, trials, and punitive measures.

We mention this because SEC historically has been unlike other government regulators in terms of cost and efficiency—truly an outstanding performer in achieving its mission without legions of personnel and extravagant budgets. Furthermore, the Commission has overseen development of safe and productive financial capital markets. Enterprises place considerable value on their listings on exchanges overseen by SEC, and investors around the globe find their best executions on those exchanges.

In our opinion, the conscious effort of legislators and SEC to choose less intrusive forms of regulation and to exercise reserve with regard to punitive measures has contributed to the Commission's success. Obviously, too, disclosure rules are less costly to administer than criminal penalties. We trust that oversight parties will heed this message and continue to build on the Commission's strong conceptual foundation rather than add to the punitive measures increasingly appended in the last three decades.

On one item specific to SOA and something of a mystery from time of enactment, the CEO/CFO certification provisions of SOA Sections 302 and 906 have struck many observers as inconsistent and in need of technical correction. Whereas Section 302 has many of the characteristics of the SEC certification rules proposed prior to SOA enactment,[50] Section 906 includes a criminal element and other variations that may have been inadvertent.[51]

Overseers should review inconsistencies in Sections 302 and 906, and, to the extent of error, omission, or inconsistency, conform the provisions of each to the more moderate pattern. SEC has contended that, because Section 906 is a criminal item, it must defer to the Department of Justice. Oversight parties could deal with the matter without further ado.

Administrative Procedures

The Administrative Procedure Act (APA)[52] became law years ago to ensure that persons potentially subject to federal rules could participate in their formulation. APA may not have been the first law aimed at improving "transparency" in government rulemaking. However, the statute's principal purpose was "sunshine" and due process. In all but emergencies, agencies proposing rules were to respect the rights of interested parties to comment or be heard (or both) and to be advised of the disposition of and reasoning with respect to matters in issue.

We cite this because of SEC's seemingly preemptory handling of PCAOB's Auditing Standard No. 2 as to the primary external auditor's attestation to management's assessment of the condition of a SOA-affected enterprise's control over financial reporting. The Board extended appropriate due process, adopted its standard, and then turned the matter over to SEC for review. SEC allowed the proper period for comment, but then adopted the PCAOB document without change, ***subject to*** Commission and Board "guidelines" yet to issue.

The Alliance understands the time constraints under which SEC was operating. However, we also sense that the Commission should have acted by rulemaking in the context of APA and due process to resolve several controversial matters that instead were left to so-called guidelines. We refer to such items as the applicability of the standard to recent acquisitions, consolidated but non-controlled subsidiaries, equity investors, Section 404 attestation qualifications, transition periods, significant control deficiencies, and the nexus between attest qualifications and types of control deficiencies.

Each matter raised and perhaps others now will be subject to guidelines, all to be issued at some undefined time in the future. Although SEC managed by this circumlocution to keep on the course indicated by an effective date already moved due to delays in implementation,[53] due process regrettably took a back seat.

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[50] See http://www.sec.gov/rules/proposed/34-46079.htm for Securities Exchange Act Release No. 34-46079 of June 17, 2002.

[51] This is among the implementation considerations discussed in "CEO and CFO Certifications and New Filing Deadlines for Annual and Quarterly Reports," Covington & Burling, August 30, 2002, at http://www.cov.com/publications/download/oid6454/304.pdf.

[52] *Op. cit.*, footnote 3.

[53] By letter of March 4, 2003, Manufacturers Alliance/MAPI requested the first stay of the deadline for the SOA Section 404 attest. See http://www.sec.gov/rules/proposed/s74002/manufact030403.htm.

We assume that SEC acted in good faith. At the least, however, the Commission could have presented its case for this digression. If guidelines will continue to be the prescribed remedy, when might they be expected? Is their status to be merely advisory or somehow the same as that of regulations having the force and effect of law? Can the output be equivalent to rulemaking if not done in the prescribed manner? Will SEC/PCAOB allow an opportunity for the public to comment on a proposal?

Some disclosure from SEC would have been reassuring to persons, notably those in the early waves of affected parties with fiscal years ending on or soon after November 2004. To some extent, they and their primary external auditors are left to their own devices with respect to compliance with AS No. 2 on the points in issue. Some discretion generally is welcome, but decisions from an authoritative source also help where opinions may be polarized.

Even if overseers find that guidelines are an allowable outcome in these circumstances, we suggest that SEC consider affording due process, and, in any event, be mindful in its pronouncements to indicate the extent to which the guidelines are discretionary.

Scope Issues

As in conducting an audit, "scope" is an issue with any official pronouncement or action—whether legislation, regulation, ruling, enforcement, or, as just noted, "guidelines." Although much of a mandate's scope is defined in the authorizing provision, a field of discretion usually remains for interpretation by rule makers and enforcers.

Naturally, oversight parties should review this characteristic of SOA for competitive disparities. Subject matter itself is an issue, and so are the matters of exclusions, exceptions, thresholds, effective dates, and transitions, including special provisions to allow for classes of regulated parties who for one or another reason are deemed less able to bear the burden.[54]

We do not intend to revisit all of these matters, and we recognize that oversight parties also are unlikely to stray far from an agenda of priority items. Notwithstanding, we urge that overseers approach their task in a skeptical and inquiring way rather than focus only on known sticking points. Some requests for relief may be without merit, and others may be at risk of being overlooked.

One concern in the context of SEC regulation is the differential between registered and non-registered companies. However, in SOA, we also note differences: (1) in the consequences for public and private companies; (2) between affected public companies here and exempt public companies here or abroad; and (3) between accelerated and non-accelerated filers.

We urge overseers to keep foremost in mind that regulation is a cost of doing business, can be substantial, in some measure is "fixed," and, in the latter case, is not necessarily subject to management control. Whereas managers pursuing cost control prefer to contend that all costs are "variable," they surely do not have in mind the outlays associated with most regulations.

As demonstrated in a 2003 Alliance study, external overhead costs add at least 22.4 percent to the unit labor costs of U.S. manufacturers (nearly $5 per hour worked) as compared to their major foreign competitors.[55] Although much of this burden comes from high corporate tax rates and employee benefits, smaller but substantial outlays are caused by litigation costs and regulatory compliance outlays.

We therefore commend to the oversight parties' attention every scope discrepancy in SOA and request that attention be given to them ***de novo***, as would be done with proposed spending in a zero-based budget review. For every scope discrepancy that Congress allowed, the costs of compliance were increased for parties not eligible.

Proliferation/Preemption/Uniformity

We recommend that the oversight committees and SEC take into consideration that some states are adopting SOA-type laws of their own and that conflicts may arise in the absence of close coordination. State securities (i.e., "blue sky") laws are nothing new, of course, but the effects thereof usually have been

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[54] For interesting thoughts on this topic, see "Preliminary Views on Accounting Standards for Small and Medium-Sized Entities," International Accounting Standards Board Discussion Paper, June 2004, http://www.iasb.org/uploaded_files/documents/8_891_pv-sme.pdf.

[55] Information about "How Structural Costs Imposed on U.S. Manufacturers Harm Workers and Threaten Competitiveness," a study jointly produced by Manufacturers Alliance/MAPI Inc. and National Association of Manufacturers, December 2003, including an abstract, can be found online at http://www.mapi.net/html/abstract.cfm?PubID=232.

uniquely local whereas securities markets and the focus of federal securities laws have been interstate and international.

To the extent that SOA's coverage is incomplete, intentionally or not, states may wish to craft their own legislation to fill the gap. The states, as we illustrate below in this statement, also may issue more rigorous rules of a sort already contained in the Act, because the states are not expressly or impliedly preempted from doing so. The potential for mischief is obvious and abundant without uniformity.

For example, SOA intended to cover certain public companies. For their part, states could decide to apply their own versions of SOA to the excluded enterprises incorporated in or doing business in their jurisdictions. Affected entities doing business in several states thereby might become subject to multiple and varying versions of the Act.

Arguably, some companies not reached by SOA would benefit from the same governance and accountability mandates as their public company counterparts. Advocates for inclusiveness also contend that not-for-profit organizations operate in the public interest and, hence, deserve similar treatment. However, the omissions were deliberate, and we counsel caution notwithstanding our previous contentions in this statement about scope.

We further find that some flow-down or spillover of SOA-type duties already is occurring in entities not covered by the Act, although certainly not equivalent to the coverage applicable to major public companies. Inasmuch as the federal securities laws were enacted to protect investors and regulate public markets for financial capital, we frankly do not see the parallels to justify extension to private companies, although, they, of course, also have governance and accountability responsibilities.

The bottom line is that proliferation could present an intolerable burden. Although SOA, as a federal statute, could be thought to preempt state law where the same matters are addressed, this depends entirely on congressional intent—which perhaps should be clarified in favor of preemption. We are not persuaded that "conflict" or "field" preemption would apply in this context.[56]

As noted, some states already have raised the SOA "ante." A case in point is the California Corporate Disclosure Act,[57] which was signed into law on September 28, 2002, two months after SOA enactment. The new California law applies to every publicly traded company incorporated or doing business in California, and calls for more disclosures—beyond those required by SOA—to be filed annually with the Secretary of State.

Multiple and overlapping laws clearly are a burden and an exposure for companies, whether currently covered by SOA or not. Fortunately, most state proposals that would "improve" on SOA in some way, typically with local adaptations and additions, have fallen short of enactment.[58] However, the outlook currently is not favorable to preeminence of the Act to the exclusion of the states pursuing their own agendas.

Going Private

We recommend that oversight parties examine and report on charges that SOA-related burdens are either causing public companies to go private or presenting an unacceptable impediment to private companies wishing to go public. Much of the information in circulation about such inhibitions is anecdotal,[59] and oversight proceedings are an opportunity to review the matter. The Act's provisions should drive behavior in intended ways, but should be neutral on such matters as ownership and capitalization.

[56] For a review of applicable federal preemption principles, see *United States v. Locke*, 529 US 89, 120 S.Ct.1135 (2000), online at http://a257.g.akamaitech.net/7/257/2422/30jan20021440/www.supremecourtus.gov/opinions/boundvolumes/529bv.pdf.

[57] Chapter 1015 of the Statutes of 2002 (AB 55 of the 2001-2002 Session), effective January 1, 2003, amending Sections 1502 and 2117 of the California General Corporation Law, online at http://www.leginfo.ca.gov/cgi-bin/displaycode?section=corp&group=01001-02000&file=1500-1512, and http://www.leginfo.ca.gov/cgi-bin/displaycode?section=corp&group=0200-03000&file=2100-2117.

[58] See http://www.ohioscpa.com/publications/ohiocpa/default.asp?article=603-9 summarizing Maryland, New Jersey, and New Mexico attempts to enact SOA supplements.

[59] To be more precise, credible survey information on costs exists, but the reports of SOA's effects in inhibiting behavior are anecdotal. See, e.g., http://quote.bloomberg.com/apps/news?pid=10000039&refer=columnist_berton&sid=adD5HRu_FIGg "U.S. Companies Consider Going Private To Skirt Law," and http://www.nareit.com/portfoliomag/04julaug/feat2side.shtml, "Despite Rising Costs, Recent IPOs Still Positive on Going Public," respectively.

As already noted, SOA Section 404 is the single costliest provision of the Act for affected companies. Even before all such costs can be counted—in that Section 404 is effective for fiscal years ending on and after November 15, 2004, in most cases—the best estimates of new attest fees are significant.

More specifically, the added fees for Section 404 are expected to be an incremental addition in the first year of applicability ranging from about 25 percent to 75 percent of the cost of the financial statement attestation itself, depending largely on enterprise characteristics. This fee is in addition to other costs that affected enterprises have incurred and will incur pursuant to SOA.

Enterprise organization, control-environment variables, and labor tradeoffs in performing the audit account for the widespread of Section 404 estimates. In any event, having a six- or seven-digit fee added on to the otherwise applicable attest amounts is sizable if not severe. Companies will take all reasonable steps to minimize these incremental fees. However, Section 404 is demanding and AS No. 2 nothing short of implacable—both discussed below under "Control Over Financial Reporting."

We do not contend that marginal cost increases should be fatal to a regulation. On the other hand, if the impacts are unintended, then policymakers ought to be asking why, and should be measuring the consequences. Rather than assume that the "going private" contention is contrived, we urge overseers to investigate. We return to Section 404 shortly.

Director Shortage?

Oversight parties also should examine and report on charges that SOA-imposed duties are thinning the ranks of persons willing to serve as directors and, more specifically, as members of audit committees. Certainly, corporate directors carry more potential liability than before as a result of SOA, even if the Act merely underscores responsibilities for which, as some parties contend, directors always should have been held to account.

Rather uniquely, public company directors have tended to be accomplished senior persons who accept leadership roles more nearly to stay engaged and contributing rather than to reap pecuniary rewards. A corollary of this is that they are aware of and sensitive to potential liability related to their activity. If such liability increases noticeably, they may prefer to avoid the exposure.

Also, the added requirements imposed on directors may be changing the profile of qualified candidates more so than the availability of able persons for such duty. For example, the new governance demands on public companies are thought to be lessening the supply of CEOs for directorships at companies, other than the enterprises for which they have full-time responsibility. However, CFOs and other executives are becoming more prominent in this role.[60]

As noted earlier, directors of SOA-affected public companies now meet more frequently, put in longer hours, and interface more than before with management and auditors. Also, such persons are, more so than before, being held to account for their diligent supervision of the companies they serve. This is as intended by Congress, but also may have unintended side effects.

Audit committees in particular have been cast in the role of sentinels looking out for the interests of public company investors.[61] In this role realignment, some side effects may not have been foreseen—notably if SOA is resulting in a dearth of qualified persons. Rather than accept anecdotal reports of shortage at face value, oversight parties should determine whether and to what extent any such aversion is happening.

Perhaps the allegation is a canard. For example, director fees are rising more rapidly now than before, and one might expect higher fees to affect the number of qualified persons available. Are the increasing fees

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[60] See http://www.spencerstuart.com/ArticleViewer.aspx?PageID=10096&ArtID=4074797 for an interesting perspective on "governance" committees and board trends generally. Also see, "The Impact of Public Scrutiny on CEOs and Boards," David Nosal, Korn-Ferry International, at http://www.kornferry.com/Library/ViewGallery.asp?CID=663&LanguageID=1&RegionID=23.

[61] Former SEC Chair Levitt's speech of September 28, 1998, entitled "The Numbers Game," catalyzed creation of the private sector Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, the first of several recent reforms pre-dating SOA's audit committee revisions. Chair Levitt's speech can be seen online at http://www.sec.gov/news/speech/speecharchive/1998/spch220.txt, and the February 1999 report and recommendations of the Blue Ribbon Committee are at http://www.nyse.com/pdfs/blueribb.pdf.

suitably offsetting the aversion to increased potential liability? Are the legislative and executive branches of government doing enough to stem the tide of abusive lawsuits?[62]

Little reliable information is in circulation to help decisionmakers understand how supply and demand factors are sorting out. Hence, oversight parties should reach out for the information and report on their findings. A good place to begin would be the executive search firms[63] familiar with changes in the market for qualified directors.

Control Over Financial Reporting

Section 404 pertaining to control over financial reporting has given rise to SEC rules requiring each annual report to contain an internal control report: (1) stating management's duty for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) containing an fiscal yearend assessment of the effectiveness of said structure and procedures.

The provision further states that each registered public accounting firm that prepares or issues the audit report on financial statements for an issuer shall attest to, and report on, the assessment made by the issuer's management using standards for attestation engagements adopted by PCAOB. The latter attestation is to be done in the context of the annual financial statement audit, and not be the subject of a separate engagement.

Both PCAOB and SEC conducted due process routines in proposing and then going final with the implementing regulations, although—as indicated earlier—the Commission's performance has raised some questions. Many comments were received by the respective agencies, and PCAOB adopted few whereas SEC adopted none, at least to date. The outcome, effective for fiscal years ending on or after November 15, 2004, for accelerated filers,[64] is a new attestation by the primary external auditor performed, as noted, in conjunction with the annual financial statement audit.

We are in the wrong forum to repeat arguments already presented to the authorized agencies. However, we must recap to some extent to reach the larger principle relevant for oversight. In brief, we commented to PCAOB that its attestation proposal was unnecessarily prescriptive and potentially very costly for audited entities. We urged flexibility, including a rebalancing of the orientation to, manner of, and obligations for auditor testing of controls subject to management's assessment.[65]

For example, we requested that the Board not confine various categories of work to the external auditor because auditor and client should have some leeway in agreeing on a division of labor for the attest activity. We disfavored requiring external auditor walkthroughs of all significant processes, because we think it sensible to allow auditor sampling where cost-efficient and to permit reliance on credible work of others.

We pointed out the extravagance of requiring the external auditor annually to obtain evidence of the effectiveness of control for all relevant assertions for all significant accounts and disclosures rather than affording discretion to "cycle" the work in a cost-efficient manner. Also, we suggested leaving room for auditor-client collaboration and agreement on otherwise redundant control testing at yearend, which is logistically impractical and a pointless inconvenience.

Elsewhere, AS No. 2 is unacceptably vague in its references to types of "significant deficiencies," and equally ambiguous in articulating the connection between types of control inadequacies and attest qualifications. Not least, neither PCAOB nor SEC clarified reasonable questions raised about deferring 404 attest procedures in the case of acquisitions made in the later months of fiscal years of entities otherwise subject to such attest.

PCAOB conceded only minimally to these and other calls for reason, and SEC promised only SEC/PCAOB guidelines without committing to a schedule.[66] The Board could have reached more reasonable accommodations, as could the Commission reviewing the PCAOB output. AS No. 2 is "final" in a sense, but the standard already is a prime candidate for revision.

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[62] See *I Pay, You Pay, We All Pay: How the Growing Tort Crisis Undermines the U.S. Economy and the American System of Justice*, Manufacturers Alliance/MAPI Inc., Arlington, VA, May 2003, abstract at http://www.mapi.net/html/abstract.cfm?PubID=208.

[63] *Op. cit.*, footnote 39. Also see, e.g., http://www.heidrick.com/default.aspx, and http://www.russreyn.com/.

[64] SEC extended the compliance dates on February 24, 2004, http://www.sec.gov/rules/final/33-8392.htm.

[65] See Alliance comment letter #99 to PCAOB at http://www.pcaobus.org/rulemaking_docket.asp.

[66] SEC stated that it would issue a few "guidelines" on selected items. See http://www.sec.gov/rules/pcaob/34-49884.htm.

Overseers definitely should add Section 404 and AS No. 2 to their list. Concessions must be made to reason, and oversight parties can do so within the spirit and intent of SOA. If concern about potential liability is driving the outcome, then some accommodation by means of exceptions or safe harbors is in order—at least until Congress can evaluate progress with treatments thus far administered and come to grips with excesses of the plaintiffs' bar.

Each of the items raised in our statement to PCAOB, summarized above, is worthy of reconsideration, and we regard this as priority business for the oversight committees.

Minority Shareholder Project

SEC commenced its latest chapter of the minority shareholder project with a proposal in October 2003 to govern security-holder nominations for boards of directors of public companies.[67]

In brief, the Commission's proposal would require under certain circumstances that public companies include in their proxy materials nominees not endorsed by board nominating committees. As on prior occasions, this topic has proved controversial, attracting thousands of comments in this iteration.

One might reasonably wonder why any regulatory body would propose to sanction the presentation for shareholder vote of board nominees who have not been vetted by the company's independent nominating committee. However, this shopworn idea has proved unusually durable. In particular, disgruntled minority owners of public companies have sought to install their own advocates in positions of authority.

For persons favoring the idea, the objective of giving minority shareholders a resonant voice and potentially contrary vote at the highest level in enterprises seems consistent with pluralism and diversity. In fact, however, this is rather like giving the minority party in Congress a voice and a vote at the policymaking sessions of the majority party.

In the proponents' view, SEC's empowerment of minority interests along the lines under consideration would improve governance and ensure accountability. For that same reason, such parties can be expected in SOA oversight proceedings to attempt to put the minority representation undertaking on the same track with review of the Act—a special-interest diversion, in our opinion.

The Alliance will not dwell here on the grounds on which SEC's minority shareholder proposal was poorly timed as well as ill advised on the merits. This organization's views already are in the public record of the Commission's proceeding,[68] and we cannot improve on them here without detracting from the purposes of this statement.

We should add with respect to director nominations that SEC has expended sufficient energy lately on the matter of disclosures about nominating committee independence, functions, and communications between security holders and boards of directors.[69] Rather than superimpose an intrusive mandate on top of a sensible disclosure regulation, the topic should be put to rest.

Forecasting

Another area of securities regulation with distinct limitations involves mandated forecasting. We recommend against new or revised initiatives that entail asking public company managers to predict their results of operations on the public record. Although forecasting rules were not raised in SOA, we mention them because any sweeping review of the Act will attract non-germane "accountability" riders.

Since the early 1970s, before which forecasting was prohibited in SEC filings, the Commission periodically has proposed that registrants publish everything from budgets to strategic plans. Although some companies make use of limited forecasting on the public record, many managers elect not to do so. In the nature of forecasts, they are uncertain and a result deviating from prediction is just another excuse for plaintiffs' attorneys to file class-action lawsuits.

As an indication of the sensitivity of public companies to forecasting, most refuse to project results and the prevalent practice with virtually all press releases has been to append to them a forecasting disclaimer designed to invoke the safe harbor that Congress provided in the Private Securities Litigation Reform Act of

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[67] SEC's Exchange Act Release No. 34-48626 of October 14, 2003, at http://www.sec.gov/rules/proposed/34-48626.htm; *Federal Register* of October 23, 2003, Vol. 68, No. 205, pp. 60784 – 60826.

[68] The full text of the statement is at http://www.sec.gov/rules/proposed/s71903/mapi121903.htm.

[69] See SEC's Securities Act Release No. 33-8340 of November 24, 2003, at http://www.sec.gov/rules/final/33-8340.htm.

1995.[70] To some extent, such a notice serves to ward off abusive lawsuits for disclosures that have a forward-looking element.

Meanwhile, the quarter-by-quarter performance expectations of securities intermediaries—particularly sell-side security analysts—have come to be widely published and generally available in summary format on third-party websites. As public company executives and Street intermediaries are well aware, forecasts can drive markets and selective disclosure is illegal.

We think it desirable that such information as circulates about expected results of operations be in the form of "Street expectations" when managers of enterprises choose not to forecast. These widely available estimates are based on intermediaries' research using their own models and such publicly available guidance as issuers choose to provide.

As matters stand, nothing about forecasting is mandated and prudent managers are meticulous about avoiding selective disclosure. Issuers project or not as they please, and have a safe harbor to invoke if they choose to present forward-looking information. For the time being, at least, forecasting is a potentially controversial topic that is at rest. We recommend leaving it "as is," and certainly would not want it reconsidered in the context of SOA oversight.

Segment Reporting

Periodically since the late 1960s, SEC has taken an interest in disaggregated financial reporting, as have private sector rule makers. This was not an issue in SOA, but could arise as a rider to any legislation intended to refine the Act in the name of "accountability." Proponents would argue that full disclosure by management calls for more disaggregation of enterprise information.

From the start,[71] public company managers have expressed concern about disaggregated reporting, primarily because the information can be competitively sensitive. Another concern has been the inclination of rule makers to prescribe how revenues and costs are to be attributed or allocated—not infrequently using "one size fits all" techniques.

Companies naturally do not wish to publish trade secrets or information otherwise detrimental to competitive position. Likewise, enterprises cannot justify the costs of maintaining additional books and records that call for cost accounting or segment reporting in a way at variance with methods best adapted to their individual circumstances.

To the extent that any revisit is paid to segment reporting, we urge that the task be left to FASB. Certainly, the topic is not germane to SOA other than as another disclosure presumably in the name of accountability. In the meantime—as with forecasting—investors already have considerable information, including conference calls and exposure to the reports of securities analysts.

Note our reference again to Street information. Without further effort of Congress or the SEC, transparency is increasing on a voluntary basis and technology is making it widely available. Market participants have easy, inexpensive, and equal access to significant amounts of issuer information without any resort to cumbersome mandates.

Concluding Comments

Although we are skeptical about parts of SOA, the Act was necessary in the circumstances and has helped to restore order in the U.S. financial capital markets. We commend those in Congress and the Administration who made tough decisions in a market emergency. Further, we applaud those in SEC and affected companies who have worked tirelessly to meet implementation deadlines.

We anticipate that investor confidence will continue to revive as market participants come to realize that persons bent on fraud and abuse will not have their way and that effective remedies exist for the redress of grievances. The U.S. financial capital markets should continue to benefit as investors regain confidence in public company governance, external audit independence, and market integrity.

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[70] Public Law 104-67, 109 Stat. 737 (1995). Sections of PSLRA are scattered through the Securities Exchange Act of 1934, as amended, which is 15 U.S.C. 78a, the latter being online at http://www.law.uc.edu/CCL/34Act/index.html.

[71] The dialogue began in earnest in 1965 when then-SEC Chief Accountant Andrew Barr asked AICPA for its views in respect to disclosing in corporate reports enterprise income by product line. On April 25, 1967, Manufacturers Alliance/MAPI submitted to then-SEC Chairman Manuel F. Cohen a statement subsequently published as *Top Management Looks at Product-Line Reporting*.

However, to recap, a small number of sensational breaches of ethics and good sense brought SOA into existence to the chagrin and considerable inconvenience of persons in the business community who were blameless. Because a few wrongdoers can and did wreak market havoc, sweeping remedies were chosen in place of the selective enforcement proceedings that normally would be the remedy of choice.

All businesses now must adapt to a new regime of government-imposed controls that few expected and the vast majority did not deserve. This new overlay of regulation comes at a cost to the subject companies' competitiveness in global markets. Although the restoration of confidence in U.S. financial capital markets will be the ultimate prize, SOA's overseers now should "target" and otherwise refine the Act.

As the attention of policymakers returns to this topic, we caution against overly optimistic expectations. Excesses and misbehavior that panic the unwary will again, on some future occasion, distort the U.S. financial capital markets. The litmus test of SOA will be whether the securities laws as thereby amended and subsequently refined, prove better able than in the past to contain abuses in an equitable and self-executing way.

Finally, we are pleased to see, once again, that the "system" worked as intended when faced with a challenge. Now that the heavy lifting has been accomplished, continuous improvement along lines we suggest is next in order.

The Alliance appreciates having this opportunity to comment and stands ready to assist with supplemental information and opinion.

Respectfully submitted,

FW Holman Jr.

Francis W. Holman, Jr.
Vice President

cc: The Honorable William H. Donaldson
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ATTACHMENT II

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S-103 **October 2004**

Sarbanes-Oxley Act of 2002
Section 404 External Audit Fees

A Manufacturers Alliance/MAPI Survey

Third MAPI Survey Shows Most Up-to-Date Data on Costs of Section 404 Compliance; Results From October Survey Show Rising Costs From Compliance; Some Economies of Scale Achieved With Additional Auditor Functions

by
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The Alliance promotes the technological and economic progress of the United States through studies and seminars on changing economic, legal, and regulatory conditions affecting industry.

Sarbanes-Oxley Act of 2002
Section 404 External Audit Fees

A Manufacturers Alliance/MAPI Survey

Compilation and analysis by

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With the assistance of
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Further information on this subject may be obtained
by contacting Mr. Miller at 703-647-5104 or
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Price: $40.00 for Members; $60.00 for All Other Purchasers

Sarbanes-Oxley Act of 2002 Section 404 External Audit Fees

A Manufacturers Alliance/MAPI Survey

Key Survey Results

- For a substantial majority of the respondents (59 percent), the additional fee they expect to pay their external auditor for Section 404 attestation work is at least 50 percent of the total annual audit fees. Another 36 percent of the respondents expect the additional fee they will pay to fall in the range of 25 percent to 49 percent. A substantially higher percentage of the group of respondents whose external auditor is KPMG (88 percent) and a significantly lower percentage of respondents whose external auditor is Deloitte (45 percent) expect to pay more than 50 percent of the total annual audit fees for Section 404 attestation work. Two-thirds of the largest companies in the survey—those with total annual revenues of $5 billion or greater—also project their additional audit fees for Section 404 attestation work will exceed 50 percent.
- At a majority (55 percent) of the respondent companies, audit committee reaction to the 404 external audit fees has not been positive. The audit committees of those companies are displeased with these fees, although they have agreed to them with ongoing monitoring assessment. Nevertheless, the audit committee at a substantial majority (68 percent) of the respondent companies has been either highly pleased or moderately pleased with the external auditor as regards its Section 404 work.
- Only a small minority of respondents (8 percent) are obtaining a Section 404 fee reduction from their external auditor for its "first-time-through" investment.
- A majority of the respondent firms (62 percent) will realize economies of scale reflected in either the Section 404 audit fee or the traditional audit fee, because the external auditor is providing both of these services.

Introduction

In July 2004, the Manufacturers Alliance/MAPI released the results of a benchmarking survey[1] of its two General Auditors Councils. That survey provided information about member companies' initial year compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX).[2] In particular, the survey produced data on the progress companies were making in their Section 404 documentation and testing, as well as various metrics on what was being tested and the use of internal audit staff. Additionally, information was obtained regarding the impact of Section 404 work on external auditor fees. However, considering that the survey

[1] *Testing, Staffing, and External Audit Fees Related to Sarbanes-Oxley Act of 2002 Section 404 Compliance—A Manufacturers Alliance/MAPI Survey*, S-101, July 2004.

[2] Section 404 requires companies subject to the annual reporting requirements of the Securities Exchange Act of 1934 to include in the annual report an internal control report. That report includes an assessment made by management of the effectiveness of the company's internal control structure and procedures for financial reporting. In turn, the public accounting firm that prepares and issues the audit report for the company must attest to and report on that assessment.

responses were submitted by mid-July, only 35 percent of the respondents had by that time finalized fee negotiations with their external auditor. Some members desired an updated survey that would focus on external audit fees at a later time when more companies had completed external auditor fee negotiations. Assuming that most calendar year-end companies would have finalized fee negotiations by October, a brief survey questionnaire on external audit fees was circulated to the Council members at the beginning of October.

With regard to those fees, this latest survey posed many of the same questions from the previous survey. Those questions solicited information on what additional fees (as a percentage of total annual audit fees) companies expect to pay for Section 404 attestation work, whether a savings in either the traditional audit fee or the Section 404 fee is being realized from economies of scale, and when fee negotiations were concluded. The latest survey questionnaire also asked new questions about whether the external auditor accepted a Section 404 fee reduction for its "first-time-through" investment and the extent of any such reduction, how the audit committee has reacted to the 404 external auditor fees, and what the audit committee perception of the external auditor is with regard to Section 404. In addition, the questionnaire also inquired about each respondent's company size (as measured in worldwide revenues) and its primary external auditor.

Survey Responses

Survey questionnaires were sent to members of the two Alliance General Auditors Councils. A substantial majority of the companies represented on the General Auditors Councils are relatively large firms primarily in the manufacturing sector. Sixty-four members returned completed questionnaires.

At the same time, the survey results below are not intended to be (nor are they) necessarily a representative sample of the SOX Section 404 compliance practices of U.S.-based manufacturing companies. Rather, they represent the current practices of the 64 respondent firms.

Highlights of the Survey Results

External Auditor Fees

— Relative to their total annual audit fees,[3] a majority of the respondent firms (59 percent) expect to pay their external auditor an additional fee for Section 404 attestation work of at least 50 percent.[4] Included in that group of respondents are eight firms (12.5 percent of all respondents) that expect to pay an additional fee of at least 100 percent. Another 36 percent of all respondents expect the additional fee they will pay to fall in the range of 25 percent to 49 percent (Chart 1, page 3). Eighty-eight percent of those firms with KPMG as their external auditor expect to pay an additional fee of at least 50 percent. However, only 45 percent of firms using Deloitte expect an additional fee exceeding 50 percent. Two-thirds of the largest companies in the survey—those with total annual revenues of between $5 billion and $9.9 billion, plus those with total annual revenues of $10 billion or greater—also project their additional audit fees for Section 404 attestation work will exceed 50 percent.

— A substantial majority (78 percent) of respondents indicate that the external auditor's Section 404 attestation fee reflects a degree of reliance on the work performed by internal audit in connection with its SOX attestation. Yet, for about two-thirds of that group of respondents (68 percent), the incremental amount of the attestation fee that is being saved amounts to less than 20 percent (Chart 2, page 3).

— A majority of the respondent firms (62 percent) will realize economies of scale reflected in

[3] Respondents were instructed to interpret "total annual audit fees" as referring only to fees incurred in connection with a company's consolidated annual financial statements.

[4] As a comparison, the same proportion of respondents (59 percent) in the July survey expected to pay an additional fee of ***less*** than 50 percent for Section 404 attestation work.

Chart 1
Additional External Auditor Fees for 404 Attestation Work

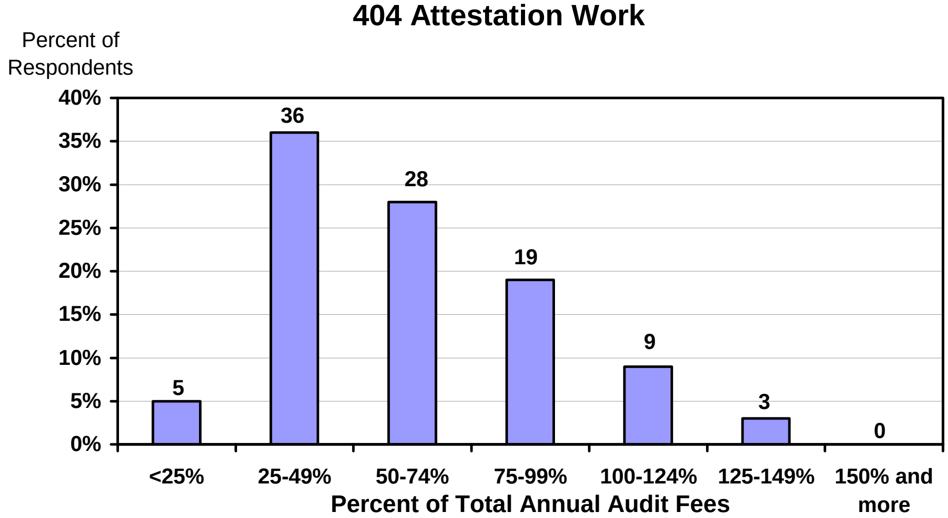
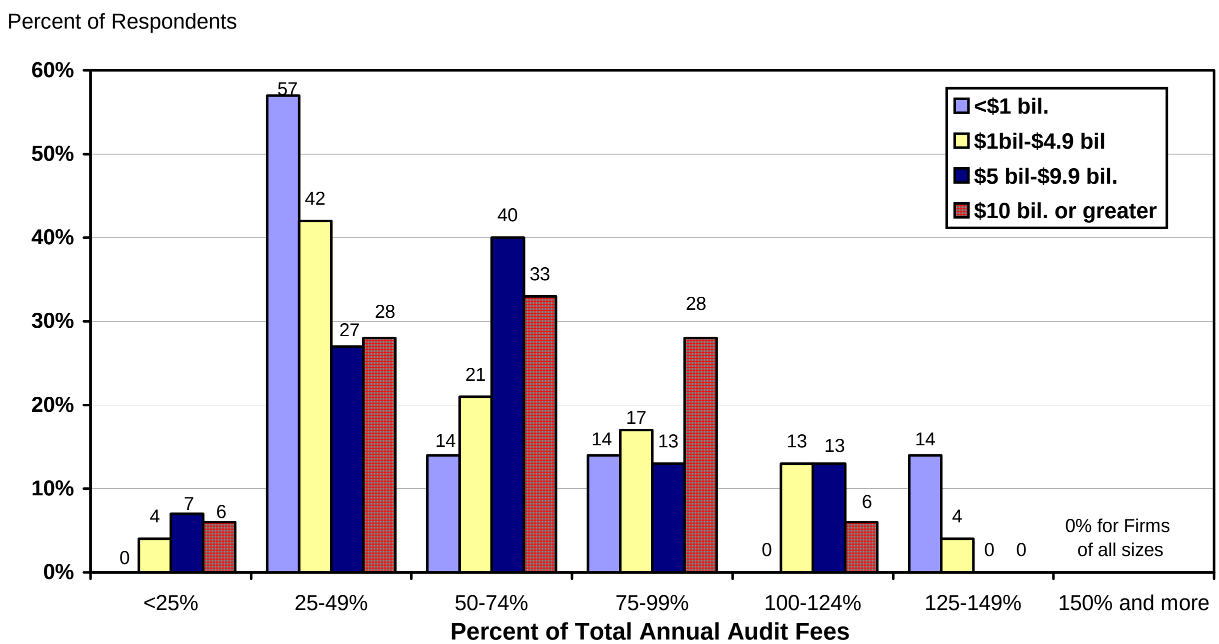


Chart 2
Additional External Auditor Fees for 404 Attestation Work by Size of Company in Revenues



either the Section 404 audit fee or the traditional audit fee, because the external auditor is providing both of these services. Perhaps surprisingly, only one-half of the very largest firms participating in the survey—those with total annual revenues of $10 billion or greater—are obtaining economies of scale. Of the firms that further responded about the extent of the reduction in fees due to the economies of scale, the same number of firms (10 of 38, 26 percent) indicate that financial statement audit fees will be reduced by between 6 percent and 9 percent and between 10 percent and 19 percent, respectively. An additional 11 firms (29 percent) will obtain a fee reduction of less than 5 percent. Twenty-three firms indicate they will realize a reduction in Section 404 audit fees arising from the economies of scale, with 10 of those firms receiving a 10 percent to 29 percent reduction and another 6 firms receiving a 6 percent to 9 percent reduction (Chart 3).

— A small minority of respondents (8 percent) are obtaining a Section 404 fee reduction from their external auditor for its "first-time-through" investment.

— Forty-four companies (69 percent of respondents) have finalized fee negotiations with their external auditors. Among those 44 firms, September was the month during which the largest number of firms—12—concluded negotiations. Eight more firms concluded their fee negotiations during October and seven more firms did so during August.

— At a majority (55 percent) of the respondent companies, audit committee reaction to the Section 404 external audit fees has been negative. The audit committees of those companies are displeased with these fees, although they have agreed to them with ongoing monitoring assessment. Yet, for a substantial majority (69 percent) of the respondent companies, the audit committee has been either highly pleased or moderately pleased with the external auditor as regards the quality of its Section 404 work.

Company Information

The questionnaire posed several background questions to gain information about the companies participating in the survey:

— A plurality of the respondent firms (38 percent) has annual worldwide revenues for the latest fiscal year of between $1 billion and $4.9 billion. An additional 28 percent of respondents have at least $10 billion of total revenues, and

Chart 3

Fee Reductions Due to Auditor Performing Both Traditional and 404 Audit Work

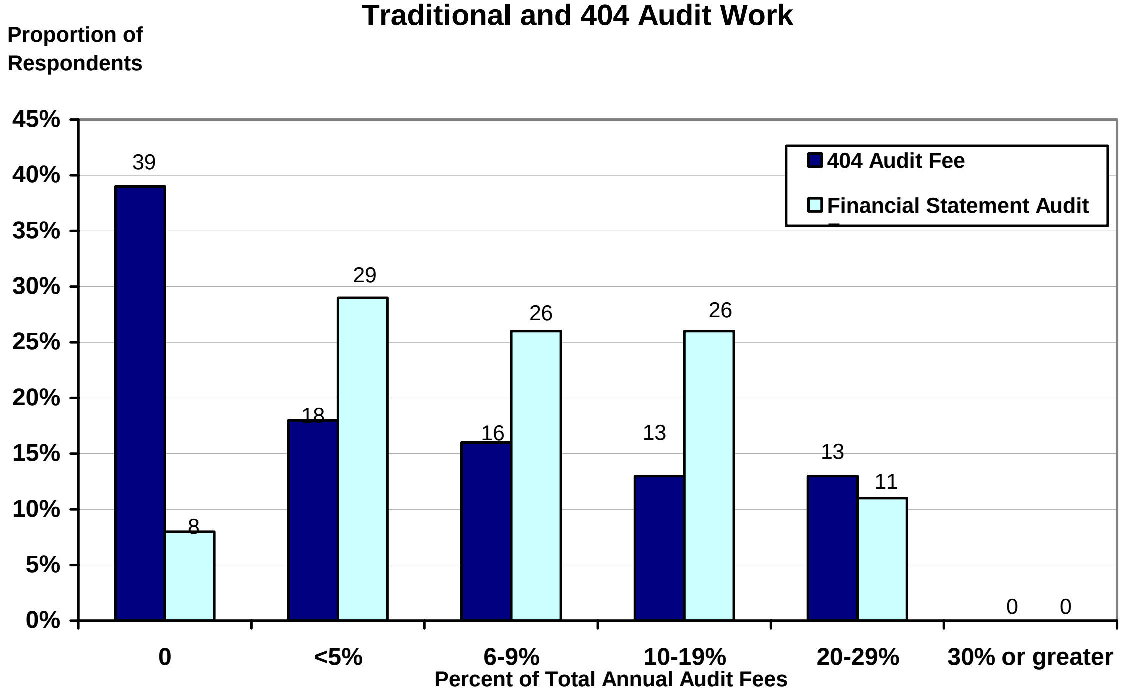


Chart 4
Sales Revenues of Survey Participants

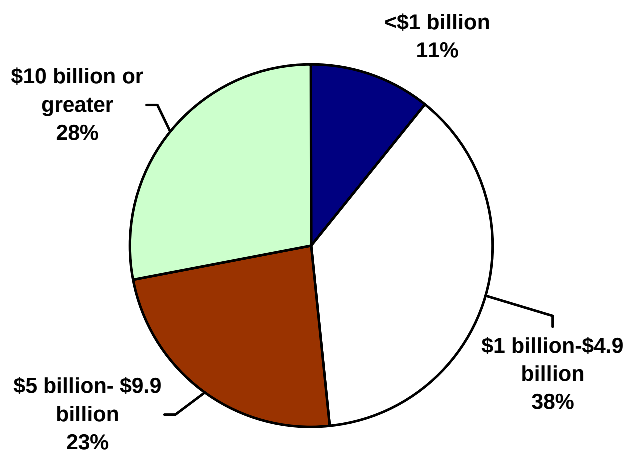
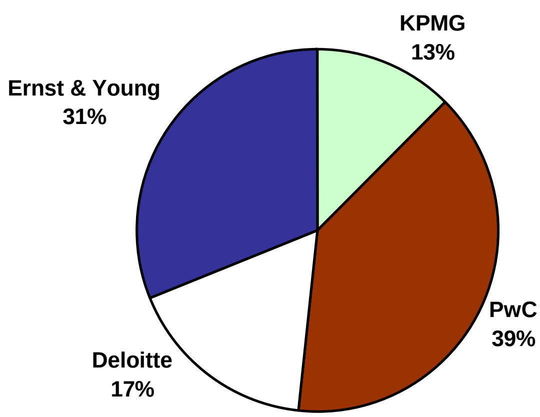


Chart 5
Primary External Auditors of Survey Participants



another 23 percent of respondents have revenues between $5 billion and $9.9 billion. The remaining firms (11 percent) have revenues of less than $1 billion. (Chart 4 above).

— Nearly three-quarters (73 percent) of the respondent firms have December fiscal yearends. Another 8 percent of respondents have an October fiscal yearend, while June and September are the fiscal yearends for, respectively, 6 percent and 5 percent, of the respondents. The fiscal year ends for the other respondent firms occur during the following months: March (3 firms), May, and August.

— The primary external auditor (PEA) for a plurality (39 percent) of the respondent firms is PricewaterhouseCoopers, although Ernst & Young is the PEA for the next largest proportion (31 percent) of the respondents. Of the other Big Four audit firms, Deloitte is PEA for 17 percent of the respondents and KPMG is PEA for the remaining 13 percent of the respondents (Chart 5 above).

Concluding Comment

This latest survey provides more extensive data than that of the previous survey reflecting a much larger proportion of respondents which have finalized external audit fee negotiations. This new data clearly supports the conclusion that an overwhelming majority of respondent firms expect to incur a considerable amount of additional external audit fees attributable to external auditor Section 404 attestation work. Although some firms project their external audit fees more than doubling, even additional fee amounts in the 50 percent to 99 percent range that nearly one-half of the respondents expect to experience will certainly result in quite sizeable extra audit costs reaching into the millions of dollars for the larger companies. Most respondents do report that by the audit firm providing both Section 404 and traditional audit work, the fees for either or both reflect some economies of scale. Yet, only a small number of firms are realizing a reduction in either type of fee at or above 20 percent. Alternatively, only a few firms are obtaining some Section 404 fee reduction from their external auditor for its "first-time-through" investment.

As might be expected, new information obtained from this survey also reveals that audit committees of companies responding to the survey are displeased with the Section 404 external auditor fees. Although no fees have been rejected, only a minority of respondents' audit committees consider the fees fair and reasonable. The external audit firms should take note that the audit committees of their client companies involved in this survey have placed their Section 404 fees under ongoing monitoring assessment. So far, however, audit committee displeasure with the Section 404 fee has not translated into most audit committees holding a negative perception of their external auditors relative to their Section 404 work.

The Survey Results

The detailed responses to the survey questionnaire follow.

SOX 404 External Audit Fees

SURVEY RESULTS

[Number of respondents (companies—64[1])]

A. COMPANY INFORMATION

1. Total Annual Revenues Latest Fiscal Year (Worldwide)

	Percent of Respondents[2]
Less than $1 billion	11
$1 billion-$4.9 billion	38
$5 billion-$9.9 billion	23
$10 billion and greater	28

2. Company's fiscal year ends

	Percent of Respondents
December	73
May	2
June	6
September	5
October	8
Other (Specify month)	6

Other months specified: March (3 companies); August (1 company)

3. Company's primary external auditor

	Percent of Respondents
PricewaterhouseCoopers	39
Deloitte	17
Ernst & Young	31
KPMG	13
Other (Identify firm)	0

[1] Because some respondents did not answer every question, the total number of responses for some survey questions is less than 64.
[2] Percentage totals for some survey questions may not add to 100 because of rounding.

B. EXTERNAL AUDITOR FEES

1. Expressed as a percentage of your total annual audit fees, what additional fee do you expect to pay your external auditor for Section 404 attestation work? **Note: "total annual audit fees" should be interpreted as referring only to fees incurred in connection with a company's consolidated annual financial statements.**

	Percent of Respondents
Less than 25	5
25-49	36
50-74	28
75-99	19
100-124	9
125-149	3
150 or greater	0

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	**Percent of *E&Y* Respondents**	**Percent of *KPMG* Respondents**	**Percent of *Deloitte* Respondents**
Less than 25	4	0	0	18
25-49	36	45	13	36
50-74	16	30	63	27
75-99	24	20	0	18
100-124	16	0	25	0
125-149	4	5	0	0
150 or greater	0	0	0	0

Responses are segregated below by respondents' annual revenue categories

	Percent With Revenues of *Less Than $1 Billion*	**Percent With Revenues of *$1 Billion–$4.9 Billion***	**Percent With Revenues of *$5 Billion–$9.9 Billion***	**Percent With Revenues of *$10 Billion or Greater***
Less than 25	0	4	7	6
25-49	57	42	27	28
50-74	14	21	40	33
75-99	14	17	13	28
100-124	0	13	13	6
125-149	0	4	0	0
150 or greater	0	0	0	0

2. Does the SOX 404 attestation fee reflect a degree of reliance on the work performed by internal audit in connection with its SOX attestation?

	Percent of Respondents
Yes	78
No	22

2. Does the SOX 404 attestation fee reflect a degree of reliance on the work performed by internal audit in connection with its SOX attestation?—*continued*

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	**Percent of *E&Y* Respondents**	**Percent of *KPMG* Respondents**	**Percent of *Deloitte* Respondents**
Yes	72	85	75	82
No	28	15	25	18

3. **If you answered "Yes" to question 2,** what is the incremental amount of the attestation fee (percentage) that is being saved due to this reliance?

	Percent of Respondents (48)
5 or less	13
6-9	15
10-19	40
20-29	27
30-39	6
40 or greater	0

4. Are there economies of scale reflected in either the 404 audit fee or the traditional audit fee because the audit firm is providing both of these services?

	Percent of All Respondents
Yes	62
No	38

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	**Percent of *E&Y* Respondents**	**Percent of *KPMG* Respondents**	**Percent of *Deloitte* Respondents**
Yes	75	55	38	64
No	25	45	63	36

Responses are segregated below by respondents' annual revenue categories

	Percent With Revenues of *Less Than $1 Billion*	**Percent With Revenues of *$1 Billion–$4.9 Billion***	**Percent With Revenues of *$5 Billion–$9.9 Billion***	**Percent With Revenues of *$10 Billion or Greater***
Yes	67	62	73	50
No	33	38	27	50

5. **If you answered "Yes" to question 4,** what is the reduction in fees (percentage) related to the financial statement audit that is being saved due to this economies of scale?

	Percent of All Respondents
0	8
5 or less	29
6-9	26
10-19	26
20-29	11
30 or greater	0

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	Percent of *E&Y* Respondents	Percent of *KPMG* Respondents	Percent of *Deloitte* Respondents
0	18	0	0	0
5 or less	29	50	0	17
6-9	29	0	80	17
10-19	12	40	0	67
20-29	12	10	20	0
30 or greater	0	0	0	0

6. **If you answered "Yes" to question 4,** what is the reduction in fees (percentage) related to the 404 audit that is being saved due to economies of scale?

	Percent of All Respondents
0	39
5 or less	18
6-9	16
10-19	13
20-29	13
30 or greater	0

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	Percent of *E&Y* Respondents	Percent of *KPMG* Respondents	Percent of *Deloitte* Respondents
0	35	40	20	67
5 or less	24	20	0	17
6-9	12	10	60	0
10-19	12	20	0	17
20-29	18	10	20	0
30 or greater	0	0	0	0

7. Did your external auditor accept a 404 fee reduction for its "first-time-through" investment?

	Percent of All Respondents
Yes	8
No	92

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	**Percent of *E&Y* Respondents**	**Percent of *KPMG* Respondents**	**Percent of *Deloitte* Respondents**
Yes	0	10	13	20
No	100	90	88	80

8. **If you indicated "Yes" in question 8,** what reduction in 404 fees (percentage) was accepted?

	***Number* of Respondents**
5 or less	0
6-9	0
10-15	2
16-19	0
20-24	2
25 or greater	1

9. How are your external auditor fees quoted?

	Percent of Respondents
Fixed fee	37
Range of fees	35
Hourly	19
Other (Specify)	10

Six respondents indicated that fees were quoted other than by the means specified above. However, of those six, four have a fixed annual audit fee plus their SOX fee is based on hourly work performed. Another with a fixed annual audit fee has its SOX fee within a range. The sixth respondent merely indicated that costs are estimated.

10. Have you finalized fee negotiations with your external auditor?

	Percent of All Respondents
Yes	69
No	31

10. Have you finalized fee negotiations with your external auditor?—*continued*

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	Percent of *E&Y* Respondents	Percent of *KPMG* Respondents	Percent of *Deloitte* Respondents
Yes	60	65	88	82
No	40	35	12	18

11. **If you answered "Yes" in question 10,** indicate below the month when negotiations were concluded

	***Number* of Respondents (44 Total)**
January	0
February	1
March	3
April	1
May	7
June	1
July	4
August	7
September	12
October	8
Other (Specify)	0

12. Audit committee reaction to 404 external auditor fees

	Percent of All Respondents
Fee amount considered fair, reasonable, and agreed to	38
Audit committee is displeased, fees agreed to, but with ongoing monitoring assessment	55
Fee amount rejected	0
No audit committee action at this time	8

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	Percent of *E&Y* Respondents	Percent of *KPMG* Respondents	Percent of *Deloitte* Respondents
Fee amount considered fair, reasonable, and agreed to	32	30	63	45
Audit committee is displeased, fees agreed to, but with ongoing monitoring assessment	64	50	38	55
Fee amount rejected	0	0	0	0
No audit committee action	4	20	0	0

13. Audit committee perception of external auditor as relates to 404

	Percent of Respondents
Highly pleased	9
Moderately pleased	60
Moderately displeased	30
Highly displeased (considering or may consider switch of auditors)	2

Responses are segregated below by respondents using each external auditor

	Percent of *PwC* Respondents	Percent of *E&Y* Respondents	Percent of *KPMG* Respondents	Percent of *Deloitte* Respondents
Highly pleased	5	5	14	22
Moderately pleased	59	58	57	67
Moderately displeased	32	37	29	11
Highly displeased	5	0	0	0

C. ADDITIONAL COMMENTS

Respondents were asked to provide additional comments about any noteworthy aspects of their company's external audit fee negotiation experience specifically attributable to SOX 404. These comments appear below:

- Agreement of range 40 percent to 60 percent has worked well, and PEA recently acknowledged that precise final actual is TBD, but will definitely be close within the range.
- 404 fees estimated at 35 percent of regular fees, but estimate will be adjusted in fourth quarter based on actual time experienced by the external auditor.
- Though fee negotiations have been finalized, in this year of SOX implementation, PwC has maintained the position that audit fees will be based on the actual hours incurred versus the traditional fixed fee arrangement. PwC is unwilling to accept the risk of exceeding a fixed fee arrangement due to unknowns. In addition, PwC has been unwilling to absorb one-time-only planning, training, and start-up costs associated with the initial year of SOX implementation.
- External auditor continues to ask for more fees at every turn. The company's perception is that we are paying for their training in this area since we are one of their biggest clients in this region.
- Overall, we believe the outside audit profession is taking advantage of the situation.
- Even though we have not concluded our fee negotiation, the audit committee was not happy with the range of fees being quoted.
- Since [company name deleted] has a 9/30 yearend, our external auditor is performing a "404 lite" review—concentrating on major locations this yearend. Their financial audit activities were not affected by this review.
- EA seems to be very disorganized specifically in terms of conducting this review on a global basis. The process has definitely strained the relationship. Specifically, as it relates to question 7 [fee reduction for "first-time-through" investment] my sense is the EA views their investment time as management cost as opposed to their investment in the new line of business cost. Essentially, they want this work to be cost plus.
- I did not answer question 13 [audit committee reaction to Section 404 external audit fees] since it's too early to tell. While I see no evidence of displeasure at this time, the work is not yet complete and no attestation has been made.

- E&Y has refused to put a cap on the estimated fee amount. We have to negotiate/monitor an effective hourly rate for actual hours incurred; paying an hourly rate minimizes the amount of skin E&Y has in the game. They have limited incentive to be efficient and have been difficult in negotiating the effective hourly rate. They have not been timely in their communications of actual hours incurred, which has made it difficult for management to monitor and change.
- We [have a] 10/31 yearend, so we won't know the final outcome until next year.
- Our company is a calendar yearend and at the time of the response, we have not held the second quarter audit committee meeting. I'm expecting much clearer information after the next audit committee meeting. Also, we change PEA this year, so answering some of the question 4 items [involving economies of scale from providing Section 404 and traditional audit work] and those related to it were not possible.
- Auditor's inability to define their exact required process has been frustrating. We clearly are experiencing, and paying for, their inefficiencies. Also, training and providing sufficient instruction to foreign offices has been very costly.
- We expect, unfortunately, to see increases in the internal control over financial reporting audit fees as 12/31s finish the initial 404 compliance and Deloitte learns of the work requirements at those clients. We expect it, but management and the audit review committee will not easily accept it
- In theory, there should be a reduction due to economies of scale reflected in the fee. We can't see a real dollar savings (question 4). Fixed fees are negotiated annually for attestation work. However, E&Y provided a range of fees for the 404 test work (question 9). We have finalized negotiations for the fees for attestation test work, but not for the 404 test work (question 10). February for attestation work only—404 fees have not yet been finalized.
- The external auditors are running scared of the Public Company Accounting Oversight Board so their default is to do more, which costs their clients more. Their clients have little choice but to accept the high rates and high hours. Our external auditors were stubborn and compromised little in the negotiations.
- Audit committee perceptions are hard to read, no reactions or visible issues with EA.
- We appreciate that this is a first year for all of us. As it relates to the audit fees, the audit committee wants to understand how much 404 will cost, as opposed to feeling like we have provided an open checkbook.

ATTACHMENT III

Manufacturers Alliance/MAPI
Knowledge · Solutions · Results · 1933

March 29, 2005

CFO Council
Financial Council

The Cost of SOX Compliance and the Compliance Process: Selected Survey Results

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A questionnaire on compliance with the Sarbanes-Oxley Act (SOX) was sent to senior financial executives who are members of the Manufacturers Alliance/MAPI CFO and Financial Councils. Based on publicly available data, the revenues for the companies responding to this survey ranged from approximately $200 million to $25 billion in 2004 and total revenues were just over $170 billion. Most, but not all, of the 56 respondents were 12/31 companies.

The questionnaire was divided into six parts and covered a wide range of issues associated with the compliance, including the cost of complying with Section 404 of SOX. Some selected aggregate results pertaining to the cost of complying with section 404 are presented below. Responses to questions related to the compliance process also are presented along with comments submitted by survey participants on the lessons learned during the compliance process. The results presented here are preliminary and will be updated as additional responses are submitted.

The Survey's key findings include:

- External auditor fees for 404 compliance totaled an estimated $110.2 million, almost as much as the $124.2 million spent by 54 companies on the external financial statement audit excluding 404 attestations.

- The cost of compliance, including external audit fees, external (non-audit) assistance for compliance, and internal audit costs for 404 compliance totaled an estimated $352.7 million for the 56 firms who participated in this survey.

- The cost of compliance, expressed as a percent of net income before taxes, averaged 5.9 percent. The median percentage was 4.1 percent. These percentages are high and indicate that the cost of 404 compliance has significantly impacted the bottom lines of many companies.

- Most firms (42 out of 47 who responded) report that their audit costs for 404 attestation exceeded initial quotes. Of the 42 firms reporting that audit costs exceeded initial quotes, 62.5 percent reported that the excess was 50 percent or higher.

- Sixty-nine percent of the respondents say that the relationship between their company and its external auditor have deteriorated to varying degrees. The remaining respondents indicated "no change" (21 percent) or "improved" relations with their external auditors (10 percent).

Company Information

1. What are your company's total worldwide annual revenues for the latest fiscal year?

	Number of Companies
Less than $1 billion	20
$1 billion – $4.9 billion	27
$5 billion – $9.9 billion	4
$10 billion and greater	5
Total	**56**

2. How many employees are in your company (worldwide)?

	Number of Companies
Less than 2,500	9
2,501 – 5000	12
5,001 – 10,000	14
10,001 – 20,000	8
20,001 – 50,000	10
Greater than 50,000	3
Total	**56**

3. What best characterizes the geographic spread of your company's operations?

	Number of Companies
Primarily North American (Total revenue from North America > 60%)	26
Mixed (Revenue from North America is between 40%–60% of total revenue)	23
Global (Revenue from North America is < 40% to total revenue)	6
Total	**55**

4. How would you characterize your company's organizational structure?

	Number of Companies
Primarily centralized	5
A mixture of centralization and decentralization	28
Primarily decentralized	23
Total	**56**

5. Who is your company's primary external auditor?

	Number of Companies
PricewaterhouseCoopers	17
Deloitte	7
Ernst & Young	20
KPMG	11
Other (Grant Thornton)	1
Total	**56**

Cost of Section 404 Compliance

1. How much will your external, financial statement audit *(excluding 404 attestation)* cost in the first year of compliance with Sarbanes-Oxley?

Total	$124,212,000
Range	$180,000 – $21,000,000
Average	$2,300,000
Median	$1,109,000

Based on 54 responses

2. How are you being billed by your auditor for 404 attestation work?

	Number of Companies	**Percent**
On an hourly basis	33	60.0
Fixed bill, based on the auditor's estimate of the time required	4	7.3
Fixed fee with a provision for adjustment if time required exceeds what was estimated.	16	29.1
Other	2	3.6

Based on 55 responses

3. If billed on an hourly basis, how many hours were billed (or will be billed) by your external auditor *for 404 attestation* in the first year of compliance with Sarbanes-Oxley?

Range:	650 – 25,600 hours
Average:	7,461 hours
Median:	5,208 hours

Based on 37 responses

4. What will the external auditor fees for 404 attestation total in the first year of compliance with Sarbanes-Oxley?

Total	$106,300,000
Range	$190,000 – $18,000,000
Average	$1,969,000
Median	$1,200,000

Based on 54 responses

5. How much will you spend for external but non-audit assistance used in 404 attestation in the first year of compliance with Sarbanes-Oxley?

Total	$117,192,000
Range	$0 – $30,000,000
Average	$2,254,000
Median	$1,000,000

Based on 52 responses

6. How many internal hours have been devoted to 404 attestation in the first year of compliance with Sarbanes-Oxley?

Total	1,809,125 hours
Range	2,000 – 380,000 hours
Average	36,183 hours
Median	17,450 hours

Based on 50 responses

7. What is the cost of internal work for 404 attestation in the first year of compliance with Sarbanes-Oxley?

Total	$101,695,000
Range	$150,000 – $15,000,000
Average	$2,075,000
Median	$1,500,000

Based on 49 responses

Total Cost of 404 Compliance

The total cost of 404 compliance for the 56 companies in the sample can be estimated by combining the results in questions 4, 5 and 7. On average, firms spent $6.3 million for 404 compliance. The total cost shown in the table below is based on the average total cost multiplied by 56. The median cost was $3.7 million. Since there is a wide disparity in the amounts spent for attestation owing to the variation in the size of firms in the sample, the median provides a better indication as to where the center in the sample is.

	Adjusted Total*	Average	Median
External Auditor Fees for 404	$110,237,000	$1,969,000	$1,200,000
External but non-audit assistance for 404	$126,207,000	$2,254,000	$1,000,000
Internal Audit costs for 404	$116,223,000	$2,075,000	$1,500,000
Totals	**$352,667,000**	**$6,298,000**	**$3,700,000**

*Most (43) respondents provided data on all three components of their attestation costs (see questions 4, 5 and 7). As shown in the tables following questions 4, 5 and 7, most respondents provided estimates for some but not every component. The adjusted totals in this table are based on the averages for each component derived from questions 4, 5 and 7, multiplied by 56, the number of firms in the sample.

404 Compliance Costs as a Percent of Net Income before Taxes

The averages of the calculated ratios of different compliance costs to net income before taxes provide an indication of the impact of 404 compliance costs on companies. [1] The results, shown in the table that follows, are based on 37 firms that provided data on all three compliance cost components *and* that reported a positive net income before taxes in 2004.[2]

	Total 404 Audit Costs
Average Cost of Compliance as a Percent of Net Income before Taxes	5.9%
Median Cost of Compliance as a percent of Net Income before Taxes	4.1%
Range	
Minimum	0.2%
Maximum	22.8%
Standard Deviation	5.9%

8. Have your audit costs for 404 attestation work exceeded the initial quotes?

	Number	Percent
Yes	42	93
No	5	11

Based on 47 responses

[1] Data on net income before taxes were collected from public sources after the questionnaires were returned.
[2] Forty-three firms provided data on all three compliance cost components, but six reported net losses before taxes in fiscal year 2004.

9. If your audit costs have exceeded initial quotes, by how much?

	Number	Percent
Less than 10%	1	2.5
11- 20%	7	17.5
21-30%	5	12.5
31-40%	3	7.5
41-50%	1	2.5
50% or more	25	62.5

Based on 42 responses

10. Have you tried negotiating a lower cost for 404 attestation work?

	Number	Percent
Yes	35	73
No	15	31

Based on 50 responses

11. If you tried negotiating a lower cost, by what percent was the cost of 404 attestation work reduced?

	Percent
Average	11.7
Range	0 – 32.4

Based on 20 responses. Two other respondents indicated that negotiations were still in progress or that it was too early to tell.

12. Did you use internal resources to directly assist outside auditors with 404 work?

	Number	Percent
Yes	26	51
No	27	53

Based on 53 responses

13. If you used internal resources, what was the approximate percentage reduction in your external 404 audit costs?

	Percent
Average	18.1
Range	2 – 50

Based on 14 responses.

14. What was the average hourly audit rate for the financial statement audit?

Average	$198
Median	$185
Range	$115 – $400

Based on 39 responses

15. What was the average hourly audit rate for 404 attestation?

Average	$217
Median	$205
Range	$150 – $500

Based on 42 responses

16. What do you expect will happen to your financial statement audit costs (on a same entity basis) in 2005?

	Number	Percent Change (Average)	Range (percent)
Companies expecting increase	31	+8.4	+3 to +50
Companies expecting decrease	13	-9.8	-2 to -20
Companies expecting no change	5	0	

Based on 49 responses

17. What do you expect will happen to 404 attestation costs (on a same entity basis) in 2005?

	Number	Percent Change (Average)	Range (percent)
Companies expecting increase	2	+12.5	+5 to +20
Companies expecting decrease	46	-25.0	-5 to -60
Companies expecting no change	1	0	

Based on 49 responses

18. What is your expectation regarding the relationship of 404 attestation costs to financial statement audit costs in 2005 (in terms of their proportions of total audit costs)?

	Number	Percent
404 costs will constitute a slightly smaller proportion of total audit costs	29	55
404 costs will constitute a significantly smaller proportion of total audit costs	14	26
The proportion between the two will not change	10	19

Based on 53 responses

The Compliance Process

1. Which of the following best describes the impact various changes that the audit approach and SOX 404 have had on your company's relationship with your auditor?

	Number	Percent
No change	11	21
We have a closer relationship	5	10
The relationship has cooled	22	42
The relationship has become somewhat adversarial	12	23
The relationship as become so bad that we likely will change our external auditor	2	4

Based on 52 responses

2. Which of the following statements best describes the interaction between finance personnel and your auditors?

	Frequency	Percent of Respondents
We had to complete work without consultation with auditors; otherwise we would have been deemed to have a material weakness.	7	13
We only provided completed information so no difference was noted	4	8
Our auditors would discuss issues with us to reach a conclusion as long as it was our work in the end.	39	74
We had to consult another firm on certain issues since our auditors would not assist us	9	17

Based on 53 responses, 5 of which contained multiple selections. All 5 multiple responses included the need to consult another firm. Four included the need to work without consultation with auditors and two said auditors would discuss issues to reach a conclusion.

3. As a result of the audits for 2004, what changes do you expect in finance personnel resources at your company?

	Frequency	Percent
No changes	16	31
Add staff with more accounting and reporting expertise	28	54
Hire outside resources with accounting and reporting expertise to assist in the audit	4	8
Add staff ***and*** hire outside resources	4	8

Based on 52 responses

4. What is your audit committee's reaction to the overall costs of audit in the wake of SOX?

	Frequency	Percent
The costs are considered fair and reasonable	2	4
The costs are considered high, but the audit committee recognizes the impact of SOX.	24	47
The costs are considered too high, even allowing for compliance with SOX	24	47
The audit committee has not formally reacted yet	3	6

Based on 51 responses

Lessons Learned

1. What are the main lessons learned from your SOX effort?

Many of the candid responses submitted to this question indicate that SOX has generated real benefits. However, a recurring theme running through these comments is that these benefits are not commensurate with the high cost of compliance borne by companies.

Responses:

1. 1). Very costly and time-consuming effort. 2). External auditors requiring more documentation. 3). Difficult to justify cost incurred (both internal and external) relative to benefits. 4). Confirmed the existence of weak controllers in certain locations.
2. It was a massive effort by people throughout the company. We need to work on a sustainable process to reduce the required annual effort. We need to automate controls and take advantage of IT systems wherever possible. We need to consolidate the number of critical IT systems. We need to use the knowledge gained to standardize systems and processes and strive for consistency across the company.
3. Extensive Government regulation (interference) is not the answer. The approach adopted only adds to the costs without obtaining a commensurate benefit. In short it is a non-value added exercise!
4. 1). Effort required to achieve compliance is significant and beyond initial expectations. 2). The efforts expended will improve the operations on the company in some ways, but the estimated benefit would be in the range of 15% to 20% of the total cost incurred. 3). Year #1 focus is to achieve ' effective SOX' or compliance. Year #2 focus will shift towards SOX to lower costs, eliminate non-essential activities and streamlining of the methodology employing IT alternatives. 4). Decentralized operations are penalized when they have a large number of operations with different IT platforms. 5). Decentralized companies must reconsider the cost-benefits of having independent operations and, at minimum, consider the possibility of centralizing some certain functions such as accounts payable processing, payroll processing and management information systems.
5. 1). It is important to management the process early to be cost effective and efficient. 2). Get external auditor engaged early and maintain frequent communication on all of the issues. 3). Keep business unit leaders and senior management engaged and informed.
6. Very significant effort. Greater awareness of and attention to controls throughout the company, and more intensive board oversight. That said, the detailed transactional focus of the effort will likely produce very little real benefit in addressing original concerns of the act. Need to pay more attention to monitoring and entity wide controls. Should pare documentation back to smaller set of critical controls. Need continuous assessment process, not just an annual exercise.
7. 1). Can't afford to retain decentralized financial organization structure. 2). Cost of compliance is extremely high, with nominal benefit to more accurate financial information.

8. 1). It is significantly more onerous than anticipated even with expectations of it being very difficult. The External Auditor’s expectations are to over control risk and they are having a hard time distinguishing between financial controls verses operational controls. Make sure you get Operation's support of this soon in the project because many of the controls are owned by operations, not finance. Have a core team of people experienced in assessing risk and preparing process flow documentation, prepare all the documentation. Consistency, accuracy and completeness are critical in the design and documentation phase. 2). Please note the internal costs and outsourcing cost referenced in this survey are on an inception-to-date basis. Audit related costs are based on the 2004 audit. Hourly rates are an average based on an initial proposal last year. Final audit fees are currently being discussed with the firm.
9. Reinforced the need for standardization and reminding associates of the importance of strong internal controls.
10. Need for strong project management skills, strong coordination with external auditors and constant monitoring of risk and controls.
11. Our auditors have said that we've done the best job with 404 of any of clients. Nonetheless, it has become painfully obvious that the accounting profession has used the act and the 404 compliance to fleece Corporate America and line their own pockets. It is clear that the effort has not improved the quality of internal control and the effectiveness of the controls over financial reporting. In fact, the opposite may be the case with so much attention taken away from what's relevant and redirected to the irrelevant. I see this as a crisis for the profession. Add to that the view that much of what is being directed by the profession is oriented to limiting their liability and you compound the problem.
12. The main lesson is to identify what our external auditors consider key controls. We had a difficult time aligning ourselves with the external auditors. We should have mandated more cooperation or find another audit firm.
13. It must be a continuous process. Tangible problems can emerge in unexpected areas.
14. Focus on identifying and testing key controls; the importance of formal documentation to external auditors; importance of identifying application controls.
15. Decentralized operations create a significant compliance cost penalty; encourages standardization and centralization and therefore has changed the way the organization sees itself; driven improvement in processes and control particularly in IT; the need for an "internal" / co-sourced internal audit capability; open communication with the external audit and the need to closely define the support the business can provide them in completing their work.
16. Effective/efficient SOX compliance is not a quarterly/annual concern. Internal control must be considered each day for all business transactions processed.
17. The PCAOB did an exceptionally poor job at anticipating and planning for the implementation issues of SOX 404. The process should have been implemented over a two-year period with the first year focused on documentation and identification of controls at the company level, with preliminary testing of company-level and fraud controls only, but with no remediation required in the first year. The PCAOB during the first year should have focused on clarifying scope and testing requirements and determination of the significance of test exceptions and the extent of remediation necessary. During the second year, companies should then have tested and remediate any internal control deficiencies. The PCAOB gave audit firms two years to get their audit practices correct, the same requirement should have been provided to reporting companies for the same reasons.
18. Need integration between IT & Finance, More attention needed on international and/or smaller locations, Inconsistent processes and controls applied across the company (inefficient processes), Difficult to rely on business application controls due to complexity of computing environment, Need for clear ownership of controls and hand-offs in process to sustain documentation, IT General Computer Controls lagging maturity of process controls.
19. Our assessment process has identified a number of areas where we could improve our internal control structure. However, most of our remediation time & effort was simply focused on "documenting" controls that were already in place. Also, It is extremely difficult to complete a task on a professional level when the rules keep changing, the guidance is vague and open to interpretation, and a "one size fits all" standard applies. Finally, when you consult with your primary external auditor, you should ask if they are in a "consulting" or "auditing" mode.
20. Validation of an existing strong control environment.

21. (1) Implementation of internal controls must be done in a way that can be sustained, (2) general computer controls must be a focus of a company's internal controls effort, (3) documentation of processes/controls is a cultural change that needs top management's support.
22. We have learned that we have historically relied upon experienced individuals with integrity to prepare and review financial statements. Under SOX, we have learned that "if it isn't documented, it isn't done." Our documentation has improved significantly; however, we suspect that the increased cost is not worth the benefit to be received.
23. The annual cost of SOX compliance is in excess of any conceivable fraud that could occur at our company. Financial reporting improvements are minor in comparison to the overall cost. I anticipate many small- to mid-sized companies (Market Cap below $1 billion) will seek mergers or opportunities to become private, as the cost to benefit ratio of SOX 404 compliance is excessively out of line.
24. As the Company is not required to comply with the provisions of section 404 until 2005, we will continue to learn lessons throughout the process. We have learned that the compliance effort is extremely costly and time consuming—on the PMO, the internal and external resources dedicated solely to the initiative, and the process owners. We have learned that even where the Company has strong controls in place, improvement will be needed throughout the organization to strengthen documentation/evidence of those controls. Our international locations have required greater PMO oversight, and that trend is expected to continue through our initial year of compliance.
25. Start early and standardize the program to the greatest extent possible.
26. Scoping of the effort for 404 purposes has to be separated from the company's on-going internal control efforts. If not, they tend to blend together and you either end up going too deep with the testing to get the IC work done that needs to be done - or risk not going deep enough to meet the more important control objectives.
27. The Audit firms have taken advantage of a situation to maximize fees while applying under-qualified resources without adequate supervision. The controls focused on are not those critical to improving operational effectiveness.
28. Don't document control at too detailed a level. Identify critical controls. Communication is key. It cannot be overlooked. Use strict criteria to define what a deficiency is. Test early. Remediation takes a long time.
29. Need to focus on most significant controls to reduce internal and external effort. Need to simplify number of processes used across the entity. PCAOB documentation requirements are far too restrictive with regard to time spent on documenting what clearly are not even potential significant deficiencies.
30. Our legacy financial systems do not have the built-in controls necessary for today's environment. Though not material, there are a number of pervasive systems access and segregation of incompatible duties risks that we are having to come to grips with.
31. We documented and tested to many controls, we will reduce this in 2005.
32. The cost of compliance is exacerbated in a decentralized financial and IT environment.
33. Too detailed. 404 Scope needs to be scaled back--based on cost/benefit.
34. We thought we had good controls going into the process and we believe the effort proved us correct. The effort pointed out certain deficiencies but clearly the findings were not worth the costs.
35. The cost of SOX was significant due to multiple systems and decentralized processing. The IT effort was larger than anyone anticipated. The value of the work provided by external consultants was not in line with their fees. Local management has to be more aggressive in resolving issues with their Local external auditors. Additional training will be required in order for Local management to assume responsibility for Local SOX efforts.
36. We needed to improve our IT General controls and the interfaces between systems that feed some of our financial systems. We did benefit from standardization and improved controls around key account reconciliations, assumptions and documentation of non-routine and estimation processes, and that controls need to reside at the appropriate level in the organization. Although Internal Audit has completed much of year one testing, to be successful in sustaining and leaning out future efforts, we will need to keep the process owners engaged and develop processes to monitor the control environment. If this does not happen, each and every year will continue to be costly and inefficient.
37. We needed to improve our IT General controls and the interfaces between systems that feed some of our financial systems. We did benefit from standardization and improved controls around key account reconciliations, assumptions and documentation of non-routine and estimation processes, and that controls need to reside at the appropriate level in the organization. Although Internal Audit has

completed much of year one testing, to be successful in sustaining and leaning out future efforts, we will need to keep the process owners engaged and develop processes to monitor the control environment. If this does not happen, each and every year will continue to be costly and inefficient.

38. That politicians need to better understand the ramifications of their actions before codifying them into law.
39. Always audit through the computer!
40. Approximately 20% of the work yields valuable results and the remaining 80% is just an administrative burden.
41. Keep policies, procedures, and documentation up-to-date! Need standardized procedures and common systems. Focus on lean & continuous improvement.