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Business Wins Easing of a Sarbanes-Oxley Rule

By KARA SCANNELL

Nov. 13, 2006 (Associated Press) — WASHINGTON - Business has won the battle to ease one of the most controversial requirements mandated by the Sarbanes-Oxley corporate-reform law: that companies first review their own systems for ensuring accurate financial reports and then have them tested by outside auditors.

The nation's business lobby, which says Sarbanes-Oxley is too burdensome, would like to see even broader changes in the law, which was passed in the wake of the Enron scandal to promote good corporate governance and prevent fraud. Democrats' success in Tuesday's congressional elections makes wholesale changes in the statute less likely.

But securities and accounting regulators are yielding to pressure for a more flexible reading of a provision of the law known as Section 404. Regulators have said they will propose guidance next month to help companies and auditors interpret Section 404 in a way likely to save them time and money.

That's a big victory for business, which has mounted a concerted push to alter the regulation. It could also be good news for U.S. stock exchanges, which in recent years have blamed Sarbanes-Oxley, and particularly Section 404, for discouraging companies from going public in the U.S. or listing stock here.

At issue is a four-paragraph section of the law that requires publicly traded companies to review and assess the controls they have in place to ensure reliable and accurate financial reporting. Companies must document such things as who can get access to their financial records and what procedures they have in place for recognizing revenue. The rule is intended to prevent any kind of fraud, manipulation or even error in a company's financial statements.

But companies, both large and small, have complained that the way Section 404 is interpreted is overly broad and requires them to spend many hours and millions of dollars documenting things that have nothing to do with the

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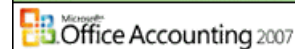
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integrity of their financial statements. According to a study by one industry group, companies on average spent \$3.8 million each in fiscal 2005 to comply with the rule. Some companies say auditors are interpreting the rules so literally that they are asking management to account for such things as who has access to an office key.

"The problem with 404 is the way it was implemented," John Thain, chief executive of the New York Stock Exchange, said at a recent conference. Mr. Thain says Section 404 lacks a "materiality standard."

Indeed, many business leaders say the rule encourages excessive caution and applies to too many corporate functions that don't have a material impact on a company's bottom line.

Some companies, meanwhile, have discovered a booming business in helping others comply with Section 404 and could see their growth slow if the rule is relaxed.

Besides the Big Four accounting firms, which provide the required audits, a variety of software products and consulting services have sprung up since the rule took effect in 2004. International Business Machines Corp., Oracle Corp., SAP AG and Microsoft Corp. have added software to their lineups to help businesses adhere to the rule. Sarbanes-Oxley work has also increased the revenue of Movaris Inc. and Paisley Consulting.

The Securities and Exchange Commission conceded earlier this year that the provision wasn't working as intended. In May, it said it would rework the rule so that companies - and their auditors - aren't engaging in "overly conservative" audits and are instead focused on areas that present a risk to the company and its investors. The agency also said it hoped to tailor the rule to companies of all sizes, so that small businesses, in particular, weren't overburdened.

The SEC says it will unveil its changes next month. The agency, along with the Public Company Accounting Oversight Board, the auditing industry's overseer, said it will propose a revision to the auditing standard known as AS2 that auditors follow when testing management's assessment of company controls.

SEC Chairman Christopher Cox wrote to the oversight board this week, urging it to include in its changes some of the recommendations made by the SEC's small-business advisory group, including one that the auditing rule be adapted to companies based on their size. In his Nov. 6 letter, Mr. Cox said the SEC agreed that the standard needed to be focused on matters that are material, or relevant, to a company's financial results.

It isn't clear how far the SEC might be willing to go in making it easier and less costly for businesses to comply with Section 404. And some observers are skeptical that the problems can be fixed.

"This may be a bell that can't be un-rung," says Joe Grundfest, a former SEC commissioner and co-director of the Rock Center for Corporate Governance at Stanford University. "The audit firms have already incorporated a lot of the inefficient 404 process into their integrated audits, and once audit firms have processes in place, it's very hard to persuade them to back off and ease up on those processes."

Much of the business community continues to support Sarbanes-Oxley's overall goal of improving corporate governance. But many complain that portions of the law, such as Section 404, and the broader regulatory climate are beginning to put U.S. companies at a competitive disadvantage. Two private-sector commissions have been set up to recommend regulatory changes.

President Bush, Vice President Dick Cheney and Treasury Secretary Henry Paulson have all backed an effort to rework the rules, suggesting the pendulum has swung too far. Even Rep. Barney Frank of Massachusetts, the Democrat who will be chairman of the House Financial Services Committee

in the new Congress, has said some regulations are too burdensome.

David Chavern, chief of staff at the U.S. Chamber of Commerce, said that "right after the Enron scandals, there was a view among business that they just have to keep their mouth shut even if they saw problems. I think we were able to move out of that and talk about the problems without being apologists for the bad guys."

The SEC's Mr. Cox has opposed pressure from some business groups to rewrite other parts of Sarbanes-Oxley. He said recently that while it's always important to look at legislation, "because Sarbanes-Oxley is of such recent vintage, there is less reason to think that is necessary."

The drumbeat of complaints about Section 404 has intensified as companies have begun to implement the rule - and foot the bill. Businesses say they are spending hundreds of man-hours and millions of dollars to hire employees and set up new computer systems to document and manage reams of data, as well as paying their auditors to recheck everything they have done.

Companies say auditors have become too conservative because they fear being sued by the SEC or investors if a fraud is uncovered at a company they advised. SEC Commissioner Paul Atkins, a Republican, often recites the tale of a European executive who identified 500 key internal controls while his firm's auditor found 60,000.

A study in the CPA Journal by Jack Ciesielski, editor of the Analyst's Accounting Observer newsletter, and Thomas Weirich, an accounting professor at Central Michigan University, found that audit fees for S&P 500 companies surged 63 percent to \$4 billion in 2004 from \$2.5 billion in 2002, the year Sarbanes-Oxley passed. While those fees include regular audit-related fees, Mr. Ciesielski said much of the increase is a result of Section 404, which went into effect in 2004.

"The whole auditing world changed," Mr. Ciesielski said. He said he thinks the increase in fees is a positive development, and that it suggests that auditors probably weren't doing a thorough-enough job before. "You never hear investors complain about the size of audit fees," he said. "But you will hear them complain about shoddy (financial) reporting."

A 2005 study by Financial Executives International, a membership and advocacy group for financial executives, found that compliance costs related to Section 404 have begun to drop, although not as much as many companies and the SEC had anticipated. On average, companies paid \$3.8 million apiece in fiscal 2005 to comply with Section 404, down 16 percent from 2004, the study showed. Companies had expected their auditor fees to drop 26 percent in the second year the rule was in effect, after having paid out for necessary software and other start-up costs the first year, according to FEI.

Critics of Section 404, including Treasury Secretary Paulson, often cite the number of large IPOs done on foreign exchanges in London, Hong Kong and other places as evidence that the U.S. may be losing ground to its competitors, in part because of the regulatory environment. Of the top 20 IPOs so far in 2006, just three have occurred in the U.S., according to Dealogic. In 2002, before Sarbanes-Oxley went into effect, nine of the top 20 IPOs took place in the U.S., including one company that chose a dual listing.

Other factors influence companies' decision to list outside the U.S., including lower fees elsewhere, but many small and foreign businesses have complained loudly about Section 404. In an effort to reduce the loss of IPOs and foreign-company listings, the SEC recently proposed giving newly public U.S. companies and those based outside the U.S. that are listing for the first time on U.S. exchanges more time to comply with the measure.

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