

## America is on Trial - A Costly Tax called Sarbanes Oxley - Section 404

### How my life has changed recently (Preface):

I am the Controller at a publicly held mid-cap retail company. I have been in this industry for over 12 years and was in the Public Accounting industry for four years. Our Company is an exciting and growing retailer that has been very successful, providing value to its shareholders since going public. We employ over 6000 people. While we are very proud to have produced one of the highest operating margins among our peers this fiscal year, we also have an unblemished regulatory record, recently having undergone both an SEC review and an IRS review without major exception. We don't consider this commendable – just natural. In fact – the overwhelming majority of US publicly traded companies accomplished this same task last year, despite the perception of the press created by Enron and a few others and before the institution of Sarbanes Oxley Section 404

Previously, my (and my Staff's) typical day was spent controlling the financial transactions of our Company; working with our Operational Departments to carry out crucial initiatives; safeguarding our assets; analyzing results and focusing to improve financial performance; or otherwise adding value. Personally, I was passionate about my work and my actions had purpose.

Recently, based on new regulations imposed (404) around internal controls and other actions by the SEC, including restatement requests that have no major impact or significance to the reader of financial statements, I can no longer provide this value. The majority of my recent days have been spent documenting countless procedures and processes, which to most employees of this Company are second nature. The requirements demand an unnecessary level of scrutiny that requires my Department to spend thousands of hours justifying the Company's forthright actions (as opposed to managing our business). It is a struggle to explain common sense.

It has become increasingly difficult filling new staff positions within my budget constraint since the lucrative draw to this new (regulatory) field is leaving a void in staff resources. The intense demand by the Accounting and Consulting Firms has significantly inflated the starting wages for new graduates. This cost will ultimately be passed on to us through increased audit fees.

The window to test the documentation is too narrow which makes it highly unlikely that the auditors will perform quality diligence. In our case, it is difficult for our Auditors to understand over 30 years of chronology behind our specific business model and its related controls in a matter of just several months. I find it even more difficult to understand how our Auditors will provide an opinion as to the effectiveness of these controls based on their experience (or lack thereof). Most likely they will be forced to ultimately continue to rely on the word of the Company's Management.

Because of the lack of resources available to the firms performing this work, the inefficiency and tardiness of official standards and the lack of adequate training of the audit teams, our Company will be expected to pay in excess of one million dollars toward additional accounting and legal bills for 404 compliance work alone this year. This amount doesn't recognize our Company's internal time and focus. So the real cost is much higher. It appears these costs will be institutionalized going forward.

Our normal financial audit fees have doubled in recent years based on purported additional audit procedures required because of 404 and SEC regulatory impositions; one would think that the controls testing and reliance on controls would have reduced the scope of our financial (substantive) audit?

One million dollars is approximately one penny of earnings per share to our Company. Sadly, we will expend these resources with accountants and lawyers without a return; as opposed to hiring critical merchants and store personnel; or opening a new store; or mailing a new catalog; the types of investments that generate earnings.

More than three quarters complete on our specific 404 project, this monumental effort has resulted in insignificant recommendations to “add and retain hardcopies of crucial initials on all documents relating to all controls.” I ask - will this assure adequate control? Those initials are only as good as the personnel writing them – so it seems fairly subjective after all of this work – rather it won’t assure better controls, but will only allow the Firms and the SEC to point fingers. Maybe the finger should be pointed at the audit firms to have done a better job auditing; a better job protecting public shareholders. I seem to recall this was the critical ingredient missing from the Enron recipe.

### **Innocent until Proven Guilty?**

The Internal Control Audit procedures have not examined the process, but focused on creating piles of “documentary evidence” instead of listening to the key personnel who control the Company, day-in and day-out, regarding where the Company believes it encounters risk and exposure. Our specific project required recognizing and testing 500-700 “primary controls” under the 404 rules; when in practicality, in my tenured opinion as Controller, this could have been accomplished in a review and testing of 15 to 20 major controls.

I realize my true passion is gone; and while some folks may now be financially enticed to enter this field; I, along with other seasoned and skilled personnel in other companies, who have successfully managed the finance and compliance areas, will anxiously await the opportunity to exit this field after the bitter and invasive taste of this new regulation.

### **How has this happened?**

The corporate scandals and abuses that have occurred over the last several years have been born from overregulation - a mass of complex tax laws, accounting standards and other regulation, including the SEC’s, that have acted to shelter these viruses from detection. The penalty to these perpetrators has been criminal prosecution in many cases.

Even the brightest scholars, regulators or accountants have difficulty interpreting and managing this regulatory quagmire – How do we expect a non-financial layperson or shareholder to understand?

The off-balance sheet scams, revenue acceleration and fraudulent accounting practices of some of these unscrupulous companies in the past has been so complex, that, regardless of the controls documentation, most outsiders would not understand or detect these schemes—certainly their auditors didn’t.

Lets state the obvious, adequate audit procedures existed; if only the Audit firms executed them. This ultimately led to the demise of Arthur Andersen.

### **What has been the reaction to these scandals? Our lawmakers introduced legislation that created additional rules and regulations.**

Would it not have been prudent to focus on improving the effectiveness of the application of the existing audit procedures by the Audit Firms?

We all agree that standards are extremely important. They are an integral part of fair and consistent reporting. They are necessary to create a level playing field and maintain a benchmark of analysis for the shareholder. However, what would truly benefit the users of this information is more meaningful reporting in smaller volume. A simplification of the process will be more understandable and timely; allowing shareholders to react quicker. The response in this case should not have been adding more reporting and more sophisticated disclosure. It should have been to simplify and reduce disclosure while demanding stiffer penalties to firms and Company's that are negligent or commit fraud.

There were some good recommendations.

The move to require certifications by the Chief Executives and the rules to ensure an independent Board of Directors goes a long way without nearly as much effort and cost. These executives are motivated by the greater prospect of criminal prosecution if they mess up. In my experience, this example has resonated to all parties involved throughout the ranks.

### **The impact of 404:**

A business inherently relies on risk and reward decisions to drive their operating margins. A business naturally does not want to incur serious risk of loss because it will ultimately reduce profit margin– so a business maintains its operations to balance this risk. It is clearly in its best interest. It is an integral part of its mission. A business goes to great length not to over estimate risk or prevent all risk. Measures that would attempt this would be much too costly and would ultimately reduce efficiency and profit. Businesses are aware of the concept of diminishing return. It is the motivation of a business, among other benefits, to maintain this delicate balance to try and enhance their performance while maximizing the value for their shareholders. This successful balancing helps businesses focus – to create capital investment; it helps small business flourish; it is critical to start-up ventures and critical to the success of a healthy economy, markets and ensuing job creation.

**Section 404 is opposed to this concept.** It attempts to cover too many control variables and places emphasis on reviewing areas that do not indicate a history of risk. The scope of these recommendations is too large. The shift from management of a process to documenting the process is a distraction that will hurt the process.

This was bound to occur because the SEC and other regulatory bodies are asking the Accounting Firms to be responsible for attesting to these controls. They can't. The Firms' only possible reaction, in turn, is to try to attempt to amass enough documentation to protect them. Worse, the inflated scope won't be effective in its focus and will recommend false remedies to rely on controls that are not meaningful in substance and ignoring those that are important.

This is a means by which to identify future blame, or point future fingers – away from the Accounting Firms when a problem is discovered.....as opposed to understanding the analytical expertise of a business' process, its managers and their qualifications. The Firms will recommend installing unnecessary technology to monitor controls rather than using that investment to monitor business performance. They will focus on creating audit trail for the potential of frivolous litigation by the class action lawyers (they also see the opportunity) as opposed to truly understanding risks and their controls. Don't be fooled – that paper trail is only as good as the employee producing it.

### **So – now what?**

Prior to 404 – the financial audit ruled. It still rules! Why? The financial audit is much more reliable since it tangibly tests the results and confirms the financial statements and disclosures. While a financial audit is also expensive (because of litigation risk) it is much more efficient and accurate. For example, it is more dependable to physically count an inventory and confirm the count under audit, versus shifting the focus to the mechanics, procedures and

documentation of preventing the loss of inventory. While both may be important – the reader of the financial statement ultimately gets to the point of accuracy of information by way of the financial audit opinion. That determination could be made under the existing standards prior to 404.

I implore our lawmakers to repeal the internal control requirements of 404. Change the focus of this effort to ensure the correct execution of the existing financial substantive audit programs by the Accounting Firms. It will always be more reliable and will let business focus on what it knows is important – adding value for its shareholders. Maybe - then - I can go back to what I do best – adding value to our business.