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February 25, 2005

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

Re: File Number 4-497

Dear Mr. Katz:

The Mortgage Bankers Association<sup>1</sup> recently solicited the views of members that are subject to the Sarbanes-Oxley Act of 2002 (the "Act") regarding the law's impact on the mortgage banking industry and, more specifically, whether MBA should support calls for the appeal or amendment of sections of the legislation. Interestingly, while our members expressed unanimous support for the Act's objectives of promoting greater integrity and responsibility in corporate financial reporting and disclosure, they also agreed that the manner in which Section 404, *Management assessment of internal controls*, has been implemented within the mortgage banking industry has served to undermine these objectives by unnecessarily reducing investors' investment returns. Our members are so concerned about the high costs of complying with Section 404 that they have requested that I convey their observations to you, along with a request that they be given the opportunity to discuss them with SEC staff and the staff of the Public Company Accounting Oversight Board (PCAOB).

#### **MBA Position**

MBA agrees with the intent and goal of the Act. We believe CEO and CFO accountability is appropriate and that a formal structure for management and their auditors to opine on the effectiveness of the internal control structure should be in place

<sup>1</sup> The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 400,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership prospects through increased affordability; and to extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters excellence and technical know-how among real estate finance professionals through a wide range of educational programs and technical publications. Its membership of approximately 2,900 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: [www.mortgagebankers.org](http://www.mortgagebankers.org).

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for all public corporations. Consequently, we are not seeking a change in the legislation but, rather, assistance in reducing our members' compliance costs. We believe there are a number of ways in which the Commission can ease our members' Section 404 compliance burden, as described below.

### **General MBA Comments**

MBA believes the high cost of compliance with Section 404 is attributable primarily to the excessive amount of testing and documentation required by Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (AS 2), released by the PCAOB in March 2004. The guidance in the standard and the increased penalties for inaccurate financial reporting imposed by the Act have created an atmosphere of "near paranoia" where auditors generally conclude that more testing and documentation is always better than less, regardless of cost/benefit considerations. Contrary to the intent of the Act, the high cost of reporting on internal control<sup>2</sup> is sapping mortgage banking companies' resources to the detriment of investors who will experience lower investment returns and, thus, declines in the values of their investments.

It is important to recognize that while the extent of testing and documentation being performed in internal control audits is not *explicitly* required by AS 2, the general perception is that the standard effectively mandates the amount of work being performed by the extensive array of factors and overlapping myriad of highly ambiguous terms (e.g. "remote likelihood," "more than inconsequential," "reasonable assurance," "material weakness," "significant deficiency," etc.) that must be considered by management and auditors in planning and performing internal control engagements. Taken as a whole, the guidance in the standard effectively puts management and their auditors on notice that they must ascertain *with near certainty* whether fraud or an error in reporting could ever, *possibly occur or go undetected* by the internal control structure. The amount of testing being performed within our industry appears to be aimed at providing almost "absolute assurance" that no fraud or errors could ever occur, which, by the PCAOB's own admission,<sup>3</sup> is an illusory concept given inherent limitations in internal control.

Some of our members' specific comments about their experiences with AS 2 and its impact on the mortgage banking industry are repeated below.

### **Specific MBA Observations**

#### *Observation #1: The concept of materiality is obsolete*

Our members contend that any concept of materiality is gone – as everything and anything in practice is deemed to be material. Generally, they have noted that independent public accounting firms have significantly increased their aversion to risk to an extreme degree. In some instances, auditors have gone overboard on their testing requirements, regardless of cost/benefit considerations or materiality, to avoid any

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<sup>2</sup> One MBA member company noted that Section 404 compliance costs were close to 10% of their 2004 pre-tax profits.

<sup>3</sup> "...internal control cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations", see paragraph 16 of AS 2.

possible future criticism of the scope of testing. This excessive testing has translated into much higher than necessary audit costs and internal costs in preparing or pulling data for the auditors.

One MBA member suggested that one possible solution would be to permit management, in consultation with their auditors, to define materiality as a threshold, formula or amount and to require disclosure of that threshold, formula or amount in management and audit reports. By using a clearly communicated materiality threshold, formula or amount, companies and accounting firms would be able to better communicate their approaches to testing internal control to investors and others. Better disclosure in this area would lead to better understanding of the nature of internal control engagements, and would help dispel misguided notions that a clean audit opinion represents a level of guarantee that errors or fraud will never occur or go undetected by a company's internal control system.

*Observation #2: Auditing firms have different interpretations of the rules*

Our members have discovered that the public accounting firms, including the Big Four firms, can differ substantially in their interpretations of the amount and type of controls that are necessary to render an opinion on management's assessment of internal control. The audit firms also differ in their opinions of the amount of reliance they can place on work performed by internal staff, which is too low in most areas, particularly in the performance of walkthroughs and in the internal technology and other non-risk or low-risk areas. Consequently, companies can be required to assess substantially greater or fewer controls than their competitors depending upon their selection of audit firms.

*Observation #3: Auditors are reluctant to advise clients about the proper interpretation and application of GAAP*

MBA members whose auditors are one of the Big Four firms contend that almost every significant audit related decision now is being referred to the firms' national offices rather than being addressed at the practice office level. Further, some of our members have been told that their auditors can no longer help them with the application of generally accepted accounting principles (GAAP) and that management has to form its conclusions independently or seek advice from another resource. This puts our members in the untenable position of seeking advice from other audit firms only to risk the possibility that their auditors may disagree with the other firm's response.

*Observation #4: Aggressive identification of deficiencies and "material weaknesses" discourages early communication with auditors and shareholders*

The implementation of the Act has led management to consult with their external auditors less frequently than is appropriate due to concerns that a consultation regarding the proper application of complex accounting standards may be viewed as an internal control deficiency or a reportable "material weakness." Also, because any change in any number in the financial statements or any note to the financial statements from preliminary to final could be deemed a reportable event, many companies will not let their auditors start their audits until the exhaustive quarterly due diligence is completed

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by management. This aversion to sharing information with auditors adversely impacts the timeliness of management reports to shareholders and compromises the accuracy of final products by discouraging early, productive communication between management and auditors regarding the proper application of accounting rules.

MBA believes discussions between management and auditors should be encouraged, rather than discouraged, as more communication can only lead to improved financial reporting. Moreover, the audit firms, especially the Big Four firms, have an extensive network of resources and individuals with significant technical expertise that can be utilized without impairing auditor independence. It only makes sense that management be allowed to avail themselves of the significant advice and assistance that their auditors can provide.

*Observation #5: Reasonableness in testing has been lost*

Our members have noted that the current system for auditing internal control has no tolerance for the type of human error that could reasonably be expected to occur in situations involving the compilation of large amounts of data in short time periods. For example, some of our members have been told by their auditors that errors found during reviews of their draft Forms 10-Q and 10-K could be considered significant deficiencies or reportable material weaknesses, despite the fact that the forms have not yet been filed and could still be in ongoing stages of final review processes.

Similarly, some of our members have been told by their auditors that any computational errors found in their routine Excel spreadsheets, which are used to add, subtract, multiply and divide numbers, could be considered reportable also. These members have been required to document their "tests" of changes to the spreadsheets. This is so onerous that some of our members are considering reverting back to doing financial analysis on less efficient columnar, paper worksheets where the audit requirements are less severe.

*Observation #6: Levels of testing in internal technology and operational areas are especially excessive*

Our members have noted that the following specific factors and requirements<sup>4</sup> have contributed to the high costs of compliance in the internal technology and operations areas:

- Excessive testing of routine process-level controls where there is little risk in most companies and, thus, little additional benefit to investors.
- Requirements that companies hire "experts" to validate the operation of application software *each and every time* a new version of the software is utilized.

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<sup>4</sup> "Requirements" as used here refers to requirements explicitly imposed by AS 2, or imposed by auditors based on their interpretations of AS 2.

- Limitations on management and auditor discretion to design and rotate tests of controls between reporting periods.
- Requirements to retest controls between interim periods and the "as of" date.
- Requirements that SAS 70 reports be obtained from all outside service bureaus that perform certain data processing functions.

We are concerned also that some may believe that SAS 70 reports provide a much higher level of assurance regarding the effectiveness of controls over certain processing functions than is actually the case. In fact, management has limited influence on: (1) the service provider's internal control structure; (2) the corrective actions that may be required to remediate a material weakness in the provider's internal control; and/or (3) the quality of the SAS 70 engagement performed to identify material weaknesses in the provider's internal control. In the event concerns are raised about a service provider's internal control, management also has limited options to quickly terminate the use of the provider, even if other reasonably priced providers – that are willing to subject themselves to SAS 70 engagements -- are available.

*Observation #7: "Point in time" opinion creates timing issues*

Management assessments and auditor opinions on internal controls must be made, pursuant to Section 404, as of a point in time, typically, at December 31st for calendar year companies. A point in time assertion requires controls to be tested as of that day or throughout the year with roll forward tests applied on the assertion date. This approach causes operational challenges with management, finance and auditors since all have conflicting priorities at year-end. Additionally, with a point in time assertion, if a control that is identified as being effective throughout most of the year, but is tested as ineffective at year-end, then the assertion that the control is ineffective is accurate, but somewhat misleading to investors. Although we realize the point in time assertion is legislatively mandated, we believe implementing regulations could address some of the challenges it presents; for example, by permitting management and auditors more flexibility to rotate tests of controls and more time to address reporting deficiencies.

*Observation #8: Audit resources are limited*

There is a limited pool of individuals with the requisite experience to perform internal audit engagements, both on the company side and external audit side. In particular, the ability of external auditors to perform quality audit procedures has been reduced due to the requirement to perform – what amounts to -- two separate engagements: an audit of the financial statements and an audit of internal control. The strain imposed on all who are involved in these engagements threatens to impair judgment necessary for good decision-making and has created unnecessary tension and discord among management and auditors.

*Observation #9: Guidance is still evolving*

The PCAOB guidance, both formal and informal, has been evolving throughout the year, with the latest formal question and answer document being issued several months ago.

It is difficult to plan and execute engagements when guidance is evolving or simply lacking, as is the case with the Committee on Sponsoring Organizations of the Treadway Commission's Internal Control-Integrated Framework which provides little guidance on matters outside control activities. Many of our members have had to rely upon informal guidance received by their auditors directly from the PCAOB.

### **MBA Conclusion and Recommendations**

MBA believes that if the cost of reporting on internal control is not reduced, compliance with Section 404 will undermine our country's economic growth and reduce the competitive position of US public companies versus their private and foreign counterparts. Many emerging companies, traditionally the source of new jobs and economic growth, may decide not to go public rather than incur the costs of reporting on internal control while existing companies may not prosper as they otherwise might because their resources are being redirected to unproductive testing and documentation activities. Ultimately, every cent spent on Section 404 compliance represents one cent less in earnings available for re-investment in research, capital equipment, and new jobs which underlie our country's future economic growth. Our members also believe that, over time, companies will not be able to secure the "best and brightest" to be a CFO of the company because their main responsibility has evolved from analyzing and improving business performance to filling out checklists and designing and testing compliance with numerous procedural internal processes.

For these reasons, MBA believes the Commission and the PCAOB must work to reduce the costs of complying with Section 404. Because the highly publicized instances of corporate accounting fraud and abuse which gave rise to the Sarbanes-Oxley legislation were due to "tone-at-the-top issues" and not process-level errors of the type being focused on under Section 404, we believe the Commission should begin by analyzing the reasons for past material errors or improprieties in financial reporting and change the current audit guidance to focus on areas of greatest risk. We recommend also that the Commission and PCAOB seek to promote more cooperation between management and auditors in the determination of reasonable levels of testing, and that auditors should be reminded that cost/benefit considerations are an important aspect of planning and performing internal control engagements.

Additionally, we recommend that:

- "Rules-based guidance" be replaced with more "principles or objectives-based guidance" as much as possible;
- Management be permitted, in consultation with their auditors, to define materiality as a threshold, formula or amount and to require disclosure of that threshold, formula or amount in audit reports;
- Information discussed or disclosed to the audit firm prior to the public release of financial data not be construed as a significant deficiency or reportable material weakness, unless it is not corrected prior to the release of the data (or longer timeframe, see following point);
- The time available to correct control weaknesses be extended in order to properly address issues (maybe prior to next year's release). Currently, if a

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weakness is identified in December (for a calendar year company), it has to be corrected immediately so it is not identified as a material weakness;

- Model testing be eliminated or reduced as much as possible;
- Limits be placed on the circumstances in which SAS 70 reports are required to be furnished by outside service bureaus or other service providers;
- Management and auditors be allowed greater flexibility in the timing of tests of controls;
- Greater communication and cooperation between management and auditors be encouraged throughout the audit process.

Thank you for the opportunity to share our views on this important matter with you. As mentioned at the outset of this letter, our members would appreciate the opportunity to meet with Commission and PCAOB staff to discuss our concerns. If the Commission and PCAOB are unable to accommodate a face-to-face meeting, we request the opportunity to participate in the Commission's roundtable discussion on April 13. I have asked Alison Utermohlen, staff representative to MBA's Financial Management Committee, to contact your office within the next week to discuss our requests. If you have any questions about our observations or recommendations, please do not hesitate to contact Alison at 202/557-2864 or at [autermohlen@mortgagebankers.org](mailto:autermohlen@mortgagebankers.org).

Most sincerely,



Jonathan L. Kempner  
President and Chief Executive Officer

Cc: The Honorable Richard C. Shelby, United States Senate  
The Honorable Michael G. Oxley, United States House of Representatives  
Mr. William J. McDonough, Chairman, Public Company Accounting Oversight Board