

Experience with the internal controls provision has been so negative that it threatens to overwhelm the positive corporate reform trends

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meant that companies and auditors are applying too much effort in areas that produce very few accounting and reporting failures. Incredibly, reviews of internal controls at many companies have focused on information technology help desks. This effort is simply unaffordable over the long term and it is not effective in uncovering the type of issues that have damaged the credibility of corporate America.

Investors would benefit from a methodology that focused on key controls applied to critical accounting policies and the preparation of financial statements at the parent company level. These vital controls would number in the tens – as opposed to the hundreds or thousands often examined under section 404 over the past year – and should be rigorously monitored.

The roots of the fraudulent accounting entries at WorldCom to reclassify network expenses as an asset, Parmalat's fictitious cash balances, and Enron's improper removal of losses and liabilities through sham special-purpose entities were found at these high-risk points. Control breakdowns at parent level caused those failures, not micro-operational weaknesses.

By concentrating the effort, it should be possible for companies to complete their internal control reviews in one-quarter of the time and at one-quarter of the cost. A reduced, but more risk-focused approach, would produce the desired net benefit to investors. One of the most effective provisions of Sarbanes-Oxley requires companies to list their critical accounting policies. The controls on critical policies such as revenue accounting, reserve accounting and accounting for the carrying value of long-term assets can be clearly identified and tested. Reviewing the procedures and approvals of non-routine transactions is also important.

Audit committees, which are more closely involved in risk assessment today than ever before, can help target efforts to strengthen the internal control system where the highest risk of failure exists. The auditor should present an independent view of such risks and all of the internal control review and testing should be aligned with those assessments. Meanwhile, small public companies should be exempt from the requirements of section 404.

America's capital markets are rooted in trust, especially trust in the numbers. The SEC must act quickly to establish guidelines for management's review of internal controls. Clearer and more efficient auditing standards can then be issued. Continuous improvement is the hallmark of the US system; this should be simply another step in that process.

Philip Livingston is the vice-chairman of Approva Corporation, a developer of enterprise controls management software. Mark Perry is a general partner of New Enterprise Associates, a venture capital firm.

PHILIP LIVINGSTON
and MARK PERRY

American corporate law must be refined not killed

One year after implementation of section 404 of the Sarbanes-Oxley act, corporate America is finding the cost unacceptable. Fulfilling the controversial requirement for companies and their independent auditors to test and report on internal control systems is costing many times the original estimates and as much or more than preparing the traditional audit opinion. Having held hearings earlier this month, the Securities and Exchange Commission is now considering the evidence it has collected.

Given the SEC's mission to protect investors' interests, it must address a fundamental question: will potential investor losses avoided by applying section 404 exceed the cost of compliance? Or has the entire exercise simply provided a windfall for the auditors and little benefit for investors?

The experience with this provision has been so negative that it threatens to overwhelm the positive trends in corporate reform and auditor regulation embodied in Sarbanes-Oxley.

The act contained many good provisions. Obligatory certification of results by chief executives, audit industry regulation, stiffer penalties and restitution requirements for corporate wrongdoers, expanded protection for whistle-blowers, strong powers for the audit committee and the requirement for financial experts to sit on it were all positive steps that greatly strengthened America's corporate governance system and capital markets.

Our concern is that the problems caused by section 404 may lead to the baby being thrown out with the bathwater. The trend for governance reform and improved reporting should not be reversed. Rather, the internal control provision should be revised and narrowed to focus management time, auditor review and the associated spending on the areas that generate the highest risk of failure in financial statements.

The complexity of the new rules has