



**Sent via Electronic Mail**

May 1, 2006

Nancy M. Morris, Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

Re: File Number 4-511, Comments on SOX 404

The Association for Financial Professionals (AFP) appreciates the opportunity to comment on the second year experiences with the implementation of internal control reporting and auditing provisions. AFP represents 14,000 finance and treasury professionals employed by over 5,000 corporations and other organizations. AFP has a key role in representing our members and their concerns to market regulators.

Secure, transparent and efficient capital markets is a goal shared by AFP members and regulators. However, it is not easy to identify at what point regulation becomes a barrier to efficient capital markets. Increased protection of the capital markets was necessary as a response to the corporate scandals of the early 2000's. Our concern is that regulations are being interpreted and implemented in such a way that it imposes excessive cost to companies and acts as a barrier that locks out companies from the capital markets.

The Securities and Exchange Commission (SEC) has requested comments on second-year experiences with the implementation of internal control reporting and auditing provisions. AFP's members are experiencing the following challenges as they comply with SOX 404.

**Overemphasis on Processes and Excessive Engineering of SOX 404 Documentation (tick the box mentality)**

The process for performing SOX 404 work by external auditors seems to be lacking adequate understanding at the senior auditor level. Audit firms continue to send inexperienced staff accountants with computer, paper and a check list in hand ready to tick off the little boxes. This process provides little protection for the public and requires companies to allocate significant funds and staff to an inefficient exercise. The effect is an inconsistency taking place at the auditor level. While the SEC and Public Company Accounting Oversight Board (PCAOB) have encouraged a top-down risk based approach to the audit and section 404, the audit staffing and audit firm systems are still based on a bottom-up approach.

The bulk of the audit work performed by a large audit firm is done by inexperienced "staff auditors". Since these "staff auditors" have limited experience, the audit and internal control program is designed to give limited discretion. This process leads to a bottom-up audit process. Additionally, the amount of time that the senior auditor level is involved in the audit seems to be limited. Given the current environment, the senior auditor level must review, not only the audit work performed, but also the SOX 404 work performed. Sufficient time must be permitted to

allow both of these functions without the potential delay of the filing of the year-end or quarterly financial reports.

#### **Excessive SOX 404 Work and Failure of a Clear Understanding of Materiality**

AFP members continue to view the extensive documentation and testing requirements of SOX 404 as costly and ineffective in the goal of preventing corporate fraud. Auditors without clear guidance have converged on corporations with armies of accountants documenting and testing corporate controls. AFP appreciates the release of the May 16, 2005 guidance by the SEC and the PCAOB and the continued work by the SEC to search for improved efficiency in SOX 404 compliance. However, we have yet to see significant improvement “in the field” in the determination of what is material and what is not material when auditors perform their audit and SOX testing and reporting.

Costs associated with SOX 404 also appear to be affecting non-public companies. There is a push now for audits of non-public companies to begin complying with SOX 404 requirements, suggesting that this is the new “best practice.” However, this assumption of “best practice” seems to be premature until corporate management and auditors understand how to properly tailor SOX 404 to the smaller company.

#### **Internal Control Compliance Problems for Mid-Sized and Small Companies**

The combination of SOX 404 compliance requirements and the implementation of that compliance by management and auditors have made it almost impossible for mid-sized and small companies to comply without hiring excessive staff. There has been a failure of auditor and management to evaluate internal controls from a “top-down risk-based” approach. In the majority of cases, internal controls are always looked at through the concept of segregation of duties. While this approach may be workable for large companies, it is almost impossible for mid-sized and small companies. This internal control framework excludes executive management oversight of internal controls. Guidance from regulators on this issue has been absent.

AFP has concerns over a complete exemption for small and mid-sized companies from 404 as recommended by the SEC’s Small Business Advisory Group. However, there must be a shift in how internal controls are viewed for smaller companies.

#### **Limited Number of Professional Audit Firm Choices**

AFP is concerned with the limited number of CPA firms and their control of the market. Due to the increased independence requirements imposed upon auditors, many companies are already using more than one of the Big-4 firms to provide services to their company. Independence rules have required auditing to be separated from valuation services and, in some cases, tax services. Also, under the independence rules, the auditor cannot provide consulting services for internal control systems and IT software systems. The domination of the market by four CPA firms limits free market choices available to companies and risks unbalanced influence and excessive profit opportunities by these firms at the expense of AFP member companies.

#### **Continued Market Perception that the Big-4 are the Only-4 Acceptable to the Capital Markets**

There is a continued view from the market that a company financial statement has more credibility if it is audited by one of the Big-4 accounting firms. This perception does not

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encourage a level playing field and compromises a free market system for audit services. The SEC & PCAOB need to do more to foster additional competition among audit firms.

This does not mean that a local CPA firm should have the same chance of auditing an international company as a global CPA firm if the capacity and knowledge does not exist. Nor should the SEC or the PCAOB distribute audits to all registered CPA firms through some form of lottery. However, there should be an effort by both the SEC and the PCAOB to carry two important messages to the markets. The first message is that all qualified auditors have the same legal authority to provide a financial report, regardless of their firms' size. The second message is to encourage "right-sizing" of companies and audit firms. The skill sets and the size, character, price and demographics need to be considered to properly match the auditor with the company. This message will need to come from the top, with the regulators emphasizing that auditors properly registered with the SEC and PCAOB all have the same legal authority to perform an audit. A company and the auditor should practice right-sizing to find the best fit.

AFP and its membership appreciate the opportunity to comment on the matter of SOX before the SEC. If you have any questions, please contact John Rieger, AFP Director of Accounting and Reporting at [jrieger@afponline.org](mailto:jrieger@afponline.org) or 301-961-8844.

Sincerely,

A handwritten signature in black ink, appearing to read "A. A. Guyer". The signature is fluid and cursive, with a large initial "A" and a stylized "G" at the end.

Ross Guyer, AAP  
Senior Deputy State Auditor  
West Virginia State Auditor's Office  
Chairman  
AFP Government Relations Committee