



ISSUE PAPER

Subject: Reporting on Internal Control over Financial Reporting

Issue: MBA members that are subject to the Sarbanes-Oxley Act of 2002 (the Act) have reported exorbitantly high costs associated with their compliance with Section 404, *Management Assessment of Internal Controls*, on reporting on internal control over financial reporting. The costs, which include auditor fees, internal staffing and other costs, ran as high as 10% of members' pre-tax profits in 2004. Anecdotal reports indicate that the costs of mortgage companies' costs of reporting on internal control did not decline in 2005. MBA believes the costs of compliance with Section 404 significantly outweigh the benefits to investors and others and, in fact, threaten to undermine the primary objective of the legislation of serving investors' interests by unnecessarily decreasing investment returns.

Background: The Act was enacted in response to several high profile corporate failures and contains the most sweeping legislation on corporate governance and accounting since the Securities and Exchange Acts of 1933 and 1934. Among the most significant provisions of the bill is Section 404 which requires issuers (i.e. companies subject to the 1934 Exchange Act) to furnish investors with reports on management's assessment of the effectiveness of internal control and an auditor's report on management's assessment. Section 404 went into effect for larger companies in 2004. The SEC delayed implementation of the Section 404 requirements for smaller companies until December 15, 2007 for a report on management's assessment of the effectiveness of internal control and December 15, 2008 for an auditor's report on management assessment.

In March 2004, the Public Company Accounting Oversight Board (PCAOB), which was established as a result of the Act, released Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (AS 2), to provide guidance to management and auditors on the performance of internal control engagements. Unfortunately, the extremely detailed nature of the guidance in AS 2, combined with the increased penalties for inaccurate financial reporting imposed by the Act, created an atmosphere where auditors generally concluded that more testing and documentation was always better than less, regardless of cost/benefit

Reporting on Internal Control over Financial Reporting

Page 2

considerations. In addition to inflating audit costs, the guidance in AS 2 increased tensions among auditors and their clients.

MBA has filed three letters with the Securities and Exchange Commission (SEC) and the PCAOB on the high costs of reporting on internal control:

- On February 25, 2005, MBA sent a letter outlining MBA's specific concerns with AS 2 and making several key recommendations for reducing the costs of Section 404 compliance. MBA was the first trade association to file a letter with the SEC, and our letter was the fourteenth of about one hundred and fifty letters the Commission received in 2005 on this critical topic.
- On May 10, 2006, MBA sent a second letter stating that the current system of reporting on internal control is not sustainable without significant regulatory changes that force a shift in auditor focus away from concerns over liability to cost/benefit considerations in the performance of engagements.
- On September 18, 2006, MBA sent a third letter in response to a request for comments on a SEC "Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting." MBA's letter recommends that the Commission and PCAOB work to amend AS 2 to change the threshold for reporting under that standard before undertaking other initiatives aimed at reducing the cost of reporting under Section 404.

In addition, on May 16, 2006, MBA sent a letter to Congressman Tom Feeney (R-FL) in support of the COMPETE Act which he introduced to reduce the costs of Section 404 engagements.

MBA Position: MBA believes the SEC and the PCAOB must work to reduce the high costs of Section 404 compliance. MBA believes that if these costs are not reduced, Section 404 will undermine our country's economic growth and reduce the competitive position of U.S. public companies versus their private and foreign counterparts.

Status: On May 24, 2007, the PCAOB Board adopted Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements. If approved by the Securities and Exchange Commission, the new standard will supersede Auditing Standard No. 2. The new standard will apply to audits of all companies required by SEC rules to obtain an audit of internal control beginning for all audits of internal control for fiscal years ending on or after November 15, 2007.. The new standard reflects the Board's observations of auditors' implementation of Auditing Standard No. 2, through, among other things, inspections of internal control audits and public roundtable discussions held in April 2005 and May 2006.

Reporting on Internal Control over Financial Reporting

Page 3

Additionally, on June 27, 2007, the SEC published in the Federal Register:

- interpretive guidance regarding management's report on internal control over financial reporting under Section 13(a) and 15(d) of the Securities Exchange Act of 1934 which is effective as of June 27;
- a request for additional comment on the term "significant deficiency" which is a term that is used in the performance of internal control engagements which has a comment deadline of July 18, 2007; and
- final rules regarding amendments to existing SEC rules to (1) clarify that an evaluation which complies with the Commission's interpretive guidance (first bullet point above) is one way to satisfy the requirement for management to evaluate the effectiveness of the issuer's internal control over financial reporting; (2) define the term 'material weakness;' and to (3) revise the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting. The rules are effective beginning August 27, 2007.

The SEC Commissioners have publicly rejected any additional extensions for smaller companies to begin complying with the Section 404 requirements, in their testimony before the House Committee on Financial Services on June 26. The SEC Commissioners indicated in their testimony that smaller companies will have the benefit of the new management guidance when complying with the management report on internal control over financial reporting requirement under Section 404. However, on June 28, 2007, the U.S. House of Representatives passed the Garrett/Feeney amendment to the SEC's appropriations bill that would limit the agency's ability to require Section 404 compliance by non-accelerated filers through September 30, 2008. The Financial Services Appropriations Committee indicated its concern with the implementation costs of Section 404 on small businesses.

MBA will follow, and report if necessary, on the developments regarding any further extension of the Section 404 requirements by the SEC that may benefit its smaller member companies. MBA is considering, the possible affect of these developments on the costs of mortgage companies Section 404 engagements. If those costs do not become more reasonable over time, MBA will consider new approaches for addressing the issue, including possible legislative solutions.

Staff Contact: **Alison Utermohlen (residential)**
 (202) 557-2864

Deborah McKinnon (commercial)
(202) 557-2746

Date: **July 2007**