

UNITED STATES

Reflection on Section 404 for smaller companies

BY CLAIRE SPENCER



The early years of the Sarbanes-Oxley Act 2002 (SOX) saw smaller companies on the receiving end of disproportionate costs of compliance. Struck by the fixed costs in completing assessments required for Section 404, 2004 witnessed companies with revenue less than \$100m spending 2.55 percent on SOX compliance, compared to companies with \$5bn or more in revenue spending only 0.06 percent. The Securities and Exchange Commission (SEC) has made several changes to address this problem. Companies with a market cap of under \$75m can now use the SEC's simpler disclosure and reporting requirements for smaller companies compared to the \$25m cap in place under the old regime.

Section 404 is considered to be the most contentious aspect of SOX, as it requires management and the external auditors to certify (annually) to investors on the adequacy of the company's internal control over financial reporting (ICFR). This is the most costly aspect of the legislation for companies. However, if SOX compliance is viewed by companies as a key investment in improving organisational structure and operations, then improved transparency and corporate governance would follow, increasing investor confidence while improving long-term business prospects. "SOX requires management to

proactively identify and effectively mitigate risks that may result in material financial reporting errors and irregularities. Corporate governance is improved by requiring both management and the external auditors to certify on the effectiveness of a company's financial reporting internal controls. These principles are good business practice and enhance the ability of an organisation to achieve its goals. Section 404 creates transparency in financial reporting and provides investors with greater assurance on the completeness and accuracy of financial statements," says Khai Nguyen, Director of Risk Management and Internal Controls at Navigant Consulting Inc. SOX does not dictate the nature of the controls, and it is not unreasonable to expect managers to satisfy investors with regards to internal controls. Indeed, there are similar restrictions for listing on the London Stock Exchange and other international exchanges. As such, SOX's only distinguishing feature is Section 404(b) – the required certification of the internal controls by the external auditor. However, even this has been a hurdle for US-listed firms, most of which were unprepared to find their existing internal controls unsatisfactory.

Cautious implementation

The impact of the auditor role was more

psychological than physical, and practitioners have gradually been getting used to the changes. As a result, the SEC has been preparing to extend SOX's reach to include smaller companies, also known as 'non-accelerated filers', to address the financial and temporal imbalance between small and large companies. The SEC has, on several occasions, delayed the implementation date for smaller companies in order to give them more time to prepare as well as learn from the accelerated filers. The most recent of these occurred on 1 February 2008, when the SEC proposed that non-accelerated filers should have another year in which to implement Section 404(b). This would also allow the SEC to conduct a cost-benefit study to determine the impact of Auditing Standard 5 (AS5), the replacement for the more prescriptive Auditing Standard 2, on smaller companies.

Of course, there have been progressive improvements in the application of Section 404 since its initial application in 2004. Specifically, companies and their external auditors have been more focused on the risk of 'material' misstatements in the financials, says W. Scott O'Connell, a partner at Nixon Peabody. "The best change benefiting small businesses is the ability to focus attention on controls that will have the greatest material impact on the risks an individual company faces. The recognition that 'all controls are not equal for all companies' is a significant development, which allows a company to focus resources and attention on the areas most important to its business and comparatively less time on less relevant controls. The focus now is completely on those controls which, if there was a control failure, would lead to a material misstatement of the financial statements."

The process of compliance has been arduous for all companies, but the benefits for smaller companies are palpable. Indeed, if the guidelines are performed properly, there are few disadvantages. "Implementation of Section 404 has already proven to improve the quality of financial reporting. Restatements are down significantly for compliant companies as is the number of reported material weaknesses. In contrast, those numbers

are up for companies that have not yet fully implemented Section 404. The true value of these reductions will never be completely calculated on a per company basis. Improving the quality of financial reporting also improves the quality of information used internally for decision making, thus enabling management and the board to make better decisions,” asserts Trent Gazzaway, managing partner of corporate governance at Grant Thornton LLP. He continues, “on the other hand, if implementation is handled badly – perhaps by focusing on areas that have little chance of causing material errors – companies may find themselves passing over areas that deserve the most attention. Section 404 never required companies or their auditors to add an extensive unnecessary burden to evaluate controls with little or no importance to the financial statements. It does, however, expect management to be able to support reasonable conclusions about the effectiveness of ICFR and the independent auditor to perform reasonable audit procedures in order to tell investors whether they agree with management’s assessment.”

Inefficiencies in the application of Section 404 naturally have more of an impact on smaller companies, meaning they need to comply in the most efficient and cost-effective manner possible. This should be seen as an important investment in the company’s future. “It is essential that every company identify the area of its business that has the greatest exposure to material misstatement and attend to the controls for that area,” explains Mr O’Connell. These areas should be meaningful to investors, and should have a clear link to the internal control network. This will clarify which elements are able to manage or mitigate the risk. He continues, “if you have the resources, much of this work can be done internally before involving third party consultants. If not, get external advice early to identify the high exposure areas, and start developing a plan with your external auditors for the processes which will be documented and tested. Like most things, early attention will allow for efficient and cost-effective management, which often is not

possible when deadlines for compliance approach.” Management and monitoring of risk should be a continuous entity-wide business practice to ensure that the controls in place are adequate.

Risky waters

High risk or weak areas can vary from sector to sector or even company to company. For example, companies actively growing through M&A have relatively higher risk in financial consolidation processes and on a sector specific basis, software companies often experience weaknesses in revenue recognition controls and manufacturing companies in inventory management and cost accounting. A risk management strategy should be customised for a business. There are ways, however, to enhance the efficiency of the process, namely by focusing first on prioritising the risks, and then identifying the most important controls to evaluate. Mr Gazzaway identifies some risk indicators that might influence the nature and scope of the internal control evaluation process. “First is the nature of operations. As risks in operations increase due to the size or volume of transactions or the complexity of processing, the need to monitor internal control in those areas increases. Second is the exposure to external risks. Pressures and complexities imposed from the external environment can affect an organisation’s viability and increase the need to monitor certain internal controls. Examples of external risk include competition, regulation, heightened risk of litigation or loss, and changes in the market, such as technology, supply chain, customer base or economy. Lastly, the presence of valuable assets, and the possibility for inappropriate personal enrichment are risk factors that increase the need for strong internal controls and related monitoring. Once these high level risks are identified, management can further refine the risk assessment in those areas by answering the question, ‘what can go wrong here?’”

The next step is to identify the key controls that, when evaluated, will provide reasonable support for management’s conclusions regarding the internal control system’s abil-

ity to manage or mitigate the identified risks. These controls typically include those with the highest possibility of control failure. “Controls that require a high degree of judgement are highly dependent on the experience and training of those responsible for the judgements and are often associated with meaningful risks. Previous control failures are a clear indicator of control risk, increasing the need to monitor the related controls until corrective action demonstrates its effectiveness in preventing future breakdowns,” says Mr Gazzaway. Key controls might also include those whose operation would detect, in a timely manner, failures in other controls. For example, a reconciliation control might operate in such a way as to detect failures in earlier data entry controls.

More specifically, Mr Nguyen believes that the misinterpretation or misapplication of accounting policies is one of the top reasons for financial statement restatements. “Prevention of this error can be best addressed by having an independent review and assessment of the critical accounting practice by an accounting policy expert and then working closely with external auditors to obtaining final input. Other common high risk areas relate to spreadsheet errors, accounting estimates, revenue recognition policies, incomplete expense accruals and overrides of journal entry controls. For these high risk areas, proper segregation of duties and back end monitoring controls such as variance analysis and exception reporting are effective in detecting and preventing material errors.”

Future lessons

There is much that smaller companies can learn from larger companies in achieving compliance with SOX. Knowing your company and its risk profile before you even start is the first and most vital step. Going through controls one by one to find out their deficiencies is not permissible. “Within the last three years of SOX compliance, hundreds of companies have had to conclude that their financial reporting controls were materially deficient,” warns Mr Nguyen. “Management should look to these companies’ SEC filings ▶▶

to identify relevant high risk areas and causes of restatements. With AS5, external auditor related SOX procedures and fees are starting to decrease. Management needs to realise that the external auditors have no incentive to reduce scope since a reduction will decrease audit fee revenue while increasing audit risk. Management needs to have healthy discussions with the external audit team to streamline SOX assessment activities as well as eliminate the need of business owners to conduct non-critical internal controls," he says. By knowing the internal system, and how it addresses the corresponding risk, smaller companies can ensure that they remain focused on their most important issues.

Ultimately, none of this will work unless the managers of non-accelerated filers are willing

to cooperate. SOX should be viewed as adding more business value with an effective communication strategy from the top down rather than be seen simply as a compliance exercise. "Collaboration begins and ends with the commitment and support from the executive management team. If documented controls for the high risk exposure items of the company is not a central priority for the executive team, the resulting process will not be efficient, will be expensive, and may not succeed," warns Mr O'Connell.

The most successful small companies have managers and owners who have taken responsibility for their financial reporting, and have worked closely with auditors from the beginning of the auditing process. Furthermore, the process will not end with compliance, but will

continually evolve alongside the business. This both preserves and adds value, which is essentially the main objective of SOX. Keeping this in mind when using company time and resources for the purpose will assist practitioners in breaking through any remaining psychological and physical barriers surrounding SOX. It is undoubtedly tougher for smaller companies in many respects, but in many ways, small companies often lack basic internal controls and will therefore benefit greatly from going through such a rigorous self evaluation of their business processes. Fortunately, small companies can learn from the experiences of the accelerated filers and there is enough assistance available from the SEC and PCAOB to improve the effectiveness and efficiency of complying with SOX. ■



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