Sarbanes-Oxley Compliance for Non-accelerated Filers:
What companies should do now to meet critical deadlines

The high-profile demise of Enron Corporation, which filed for bankruptcy protection in December 2001, provided a glimpse into the upper echelons of a massive and powerful public corporation.

Americans overwhelmingly empathized with Enron employees who lost retirement nest eggs. And perhaps most fascinating- and appalling - to observers was the deflection of responsibility by executives and board members for the wrongdoing that occurred on their watch.

Public outrage, financial magnitude of the collapse, and warnings from regulators and industry watchers about potential for other corporate crises were among the factors that spurred Congress to act.

Sarbanes-Oxley born in troubled times

Proposed legislation to address financial reporting deficiencies was passing through Congress in April 2002 when WorldCom announced massive layoffs and became the subject of independent probes by the U.S. Justice Department and the Securities and Exchange Commission (SEC). It too was collapsing.

The Sarbanes-Oxley Act of 2002, which became law on July 30, 2002, was designed to achieve several key objectives:

- Increase investor and shareholder confidence in public reporting
- Increase management accountability for financial reporting and information disclosed to the market
- Develop a stronger, more independent audit system
- Reduce accounting irregularities and aggressive financial reporting
- Ensure effectiveness of internal controls surrounding financial reporting
- Reduce fraud and increase accountability for company assets

To achieve these goals, the legislation mandates provisions such as auditor independence, protection for whistleblowers, and increased financial checks and balances for public companies.

Although public companies have already implemented many Sarbanes-Oxley requirements, compliance with Section 404 of the Act, Management Assessment of Internal Control, has and will continue to be the most time-consuming.

Elephant in the boardroom: Section 404

A company that has market capitalization of $75 million or more as of the last business day of the most recently completed second fiscal quarter is considered to be an "accelerated filer."

Accelerated filers must have complied with Section 404 by the first fiscal year ending on or after November 15, 2004.

Non-accelerated filers— generally, small and midsized companies—must be in compliance for the first fiscal year ending after July15, 2007, according to the current SEC rules. The SEC has proposed a final delay of this deadline to December 15, 2007 with Auditors' Attestation filed for fiscal years ending after December 15, 2008 (SEC release nos. 33-8731). As a result, there will be no more delays and internal control programs must be in compliance by this time.

Nonaccelerated filers that haven't begun need to begin their section 404 compliance initiative as soon as possible.

Section 404(a) of the Sarbanes-Oxley Act focuses on management responsibilities to ensure adequate internal control over financial reporting. It requires management do the following:

- Accept responsibility for the company's internal control over financial reporting
- Evaluate the effectiveness of the company's internal control over financial reporting using a defined framework
- Provide a written assessment of the effectiveness of the company's controls over financial reporting as of the end of the most recent fiscal year

Section 404(b) involves an independent audit of a company's internal control over financial reporting. The auditor of the company's financial statements is required to do the following:

- Evaluate the process management used to perform its assessment of internal control
- Evaluate the effectiveness of both the design and operation of the internal control
- Form an opinion about whether management's assessment of internal control over financial reporting is fairly stated in all material respects
- Form an opinion about whether internal control over financial reporting is effective in all material respects

The Public Company Accounting Oversight Board in its Auditing Standard No. 2, defines three classifications for problem areas identified within the control process: "control deficiency," "significant deficiency" and "material weakness." Classifications are determined by the severity of the deficiency.

Control deficiency. A control deficiency exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

The independent auditor is required to report, in writing, all control deficiencies to company management. Unless the control deficiency, or group of control deficiencies, is classified as a material weakness, the company is not required to report it further.

Significant deficiency. A significant deficiency is a control deficiency or a combination of control deficiencies that adversely affects the company's ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

The auditor must report, in writing, all significant deficiencies to both company management and the audit committee. Unless a significant deficiency is considered to be a material weakness, the company is not required to report it further.

Material weakness. A material weakness is a significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

An auditor that identifies a material weakness in a company's internal controls over financial reporting must render an adverse opinion on the effectiveness of the company's internal control over financial reporting. The company's management must disclose the existence of the material weakness in its own written assessment and is not permitted to conclude that its system of internal controls is operating effectively.

Framework for compliance: COSO standards

Sarbanes-Oxley calls for companies to ensure effective control over financial reporting. In order to evaluate existing controls, organizations need a standardized framework and criteria as a reference.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued a definitive framework on internal control in 1992. Internal Control — Integrated Framework, typically referred to as "COSO," provides the widely accepted standard for establishing internal control systems and determining their effectiveness.

Independent auditors who evaluate the effectiveness of a company's internal controls over financial reporting will likely use the COSO framework as well.

The COSO report outlines five components of an effective internal control system over financial reporting:

Control environment. The control environment sets the tone of an organization. Factors that influence the control environment include integrity, ethical values and competence of management; management's philosophy and operating style; manner in which management assigns authority and responsibility; and attention and direction provided by the board of directors and audit committee.

Risk assessment. This involves management's identification and analysis of threats and obstacles to achievement of the organization's objectives and determinations about how these risks should be managed.

Control activities. Policies, procedures, and practices that ensure management directives are carried out. These include approvals, authorizations, verifications, reconciliations, reviews of operating performance, safeguarding of assets and segregation of duties, among others.

Information and communication. The identification, capture and exchange of information must be in a form and on a timely basis to enable people to carry out their responsibilities. Organization leaders must communicate with personnel to ensure employees understand their roles in the internal control system and how control components work together. Employees must have a means of communicating significant information upstream.

Monitoring. Monitoring assesses the quality of the system's performance over time. It can be conducted in the course of regular management and supervisory activities, through separate evaluations or a combination of the two.

The following chart illustrates some of the processes, activities and policies that make up each component of internal control over financial reporting:

Monitoring
- Supervisory and managerial reviews
- Internal audit
- Management and board oversight
- Independent evaluation

Information and communication
- Internal management reports
- Business decision-making
- External information analysis
- Organization communication programs

Control Activities
- Approvals and authorizations
- Policies and procedures
- Verification and reconciliation
- Segregation of duties

Risk Assessment
- Management's objectives
- Identification of risk
- Analysis of risk
- Management of risk
- Management of change

Control Environment
- "Control is everyone's job" policy
- Integrity and ethical values
- Management philosophy
- Authority and responsibility
- Human resource policies

Nonacclerated filers win by going second

Implementing Section 404 requirements to meet the required deadline is new territory for companies, auditors, consultants and regulators alike. Based on the experiences of accelerated filers in their first-year efforts to comply with Section 404, nonaccelerated filers will find that they need all the time available between now and the deadline to fully comply with the internal control reporting requirements.

Whether or not companies work with an outside firm, the process of becoming compliant with Section 404 requires considerable time and effort. But there are a number of actions companies can take to get off to a good start.

Use a top-down, risk-based approach. External auditors and regulators are looking closely at public companies' "tone at the top" as an indicator of the overall control environment.

This is not a shift that can be achieved by mechanical means. It is a transformation that takes place when company decision makers adopt and uphold a company-wide policy of transparency in financial reporting, effective processes and effective internal control over those processes.

Allocate enough resources. Based on a carefully considered assessment of the risk of material misstatement of the company's financial statements, scope the project and make a realistic estimate of the resources, both financial and human, that will be needed to get the Section 404(a) work done in sufficient time for the independent auditor to complete Section 404(b) requirements prior to the deadline.

Companies may have employees with the skills and experience to complete some or all of the required tasks. Personnel with strong accounting, systems and computer skills can be valuable assets in this initiative. These individuals may be able to undertake some or all aspects of compliance for the company.

If adequate internal resources are not available, companies may need to seek assistance from an outside firm. Firms with experience in the company's industry will require less time to become familiar with operations and systems, which can help reduce costs.

Follow a work plan. Consultants can help companies develop a work plan for the compliance initiative. Or company personnel may be able to execute this task.

A work plan should map out the following stages of the initiative with deadlines and deliverables for each:

- Identification of major processes and controls related to significant account balances, classes of transactions and disclosures
- Documentation of processes through flow charts, written descriptions or other means
- Development of a plan for testing controls
- Testing of controls
- Identification and evaluation of control deficiencies
- Remediation, if necessary
- Retesting if necessary

The work plan should be designed to allow the external auditor to use the work performed by management to its fullest extent.

Adding value to your organization through risk management

Identifying and correcting obstacles to the company's goals are functions of risk management.

Because becoming compliant with Sarbanes-Oxley requires companies to scrutinize processes, policies and even old ways of thinking, it is an excellent opportunity to mitigate risk. Some of the risk management activities companies can undertake concurrently with compliance efforts include the following:

Promote a culture of integrity. The Sarbanes-Oxley Act directs companies to make sure adequate checks and balances are in place in critical areas. In summation, the message of the legislation is "Do the right thing."

A culture of integrity begins with company management and its policies, both formal and as understood by employees. The Sarbanes-Oxley Act says companies must have an anonymous whistleblower policy in place. Under the act, employees who report problems — both real and perceived — cannot be punished.

In addition to upholding the letter of the law, companies should strive for a control environment that promotes a culture of openness and integrity. Employees should feel they can report financial problems and fraud without fear of retaliation or ostracism. Companies' policies should reflect management's commitment to seeking out and listening to concerns about the financial statements.

Maintain a high level of accuracy and transparency in financial reporting. Contrary to some perceptions, the Sarbanes-Oxley Act did not establish new accounting or disclosure rules. It did however, direct the SEC to study the implications of principles-based, as opposed to rules-based, accounting standards.

The study is ongoing, but the message to companies is clear: "When it comes to accounting transactions, don't push it."

The following guidelines can help mitigate this potentially serious risk:

- Readers should be able to understand the company's financial statements. The statements, and notes thereto, should be clear, concise, transparent, and written in plain English.
- Organizations that rely heavily on rules-based accounting should keep in mind the "do the right thing" spirit of Sarbanes-Oxley.
- Management should strive to account for business transactions in accordance with their economic substance.
- Management should fully disclose all aspects of transactions to internal accountants and the audit committee. This helps ensure full disclosure of the transaction in the financial statements, including the type of accounting that was used and the rationale.
- Organizations should invest sufficient resources in staff or outsourcing to ensure that all significant controls are operating effectively.

Improve obsolete and inefficient processes. Most organizations operate with at least some outdated and less-than-optimal processes in place. Employees and management usually realize these inefficiencies exist, but they may not know how to correct them. They may not even believe such an undertaking is worthwhile in some cases.

Processes rarely begin through systematic design. They tend to evolve as a means of responding to problems and are subject to modification as need arises. Some processes take on a life of their own — affecting multiple departments and ingraining themselves in the organization.

Documenting and testing unwieldy processes in the interest of Sarbanes-Oxley compliance, while concurrently looking for opportunities to improve design, may exceed the scope of employees' skills and experience.

Companies that outsource this initiative should look for a firm with Sarbanes-Oxley compliance and process improvement experience. Process improvement consultants will work with the Sarbanes-Oxley team to thoroughly examine processes identified in your work plan, evaluate factors such as systems integration, identify problem areas and recommend long-term solutions.

Make compliance a team effort. Because it is simply not feasible for a controller or chief financial officer to personally ensure compliance with every aspect of Sarbanes-Oxley, almost everyone in the organization has a stake in identifying and managing risks related to accurate financial reporting.

Many processes can affect an organization's financial statements directly and indirectly. Human resources, for example, must strive to hire people who will support maintaining internal control over financial reporting.

Personnel in departments such as payroll, purchasing, inventory, cash management and sales must not only understand how the processes they own affect financial statements; they must understand the impact of processes in other departments as well.

A company that begins to address Sarbanes-Oxley requirements will likely find a number of risk areas that need remediation. Certain processes may lack adequate segregation of duties. Or there may be little control or oversight for some of the company's policies, such as its bonus structure.

One corrective approach is to establish committees in key areas, including information technology, payroll and any department with fiscal impact, to make sure their area is compliant.

Once this team approach is in place and understood, organizations can ask employees to participate in other risk—management activities, including safeguarding company assets and fraud prevention.

Counting down to Section 404 compliance

As the deadlines for completing Section 404 requirements creep closer, companies need to take inventory of their resources, consider the scope of work to be done and make a realistic estimate regarding the time it will require.

Companies that lack internal resources to execute any or all of the necessary projects may wish to seek assistance from a firm with strong Sarbanes-Oxley consulting experience.

Although company leaders, concerned about cost and impending deadlines, may be tempted to take a "checklist" approach to compliance, this has proven to not be the wisest course. Companies can, in fact, invest significant resources in basic compliance efforts that don't effectively address deficiencies in internal controls.

A strategic, comprehensive approach to compliance — one that integrates risk management — is the best way to identify and eliminate gaps in internal controls. This also provides opportunities to fine-tune outdated processes and make other changes that serve the best interests of the company and its investors.

How Freed Maxick & Battaglia can help

Whether your company is just beginning to address Section 404 requirements or hitting roadblocks with its most technical aspects, Freed Maxick & Battaglia is uniquely positioned to assist you with your compliance efforts.

We offer a customized, flexible approach that's based on your needs — combining significant experience in providing Sarbanes-Oxley services with in-depth industry knowledge and a longstanding commitment to midsized companies.

Freed Maxick & Battaglia can assist with a range of projects related to Sarbanes-Oxley implementation, including control documentation, control design assessment, control effectiveness testing, remediation efforts, internal control monitoring and ongoing testing.

And we strategically incorporate risk management tools throughout the process to help you identify and mitigate threats to your business goals. When we provide Sarbanes-Oxley compliance services, our goal is to help you get the most for the resources you invest.

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