

Sarbanes-Oxley Section 404 Internal Controls Reporting Year One

As Larger Public Companies File Their First Section 404 Reports it is evident that lessons learned in year one will force changes to the process in the future. In addition the early reporting has indicated that the larger the company the lower the risks of having to disclose material weaknesses. In April of 2005 the majority of filers were companies with market caps over \$ 700 million and the rate of material weakness disclosures was 8 out of 100. But by early May of 2005 as the number of filers increased to over 2,700 accelerated filers, approximately 13% reported material weaknesses, this is an increase over the initial average of 8%. The numbers of material weaknesses have been increasing as smaller companies file their returns and many of the companies with adverse conclusions on the effectiveness of internal control over financial reporting either filed late, which was allowed by the SEC or they amended their initial assertions as a result of restating their financials.

The good news is that the majority - 87% of accelerated filers reported that their internal control over financial reporting was effective as of the end of their fiscal year.

Though the types of weaknesses reported varied greatly the top categories include:

- Weakness in the financial statement close process;
- Interpretation and implementation of complex accounting principles like leases
- Lack of appropriate accounting resources and expertise;
- Weaknesses in the Information technology infrastructure and environmental controls

Most companies and audit firms noted that the final costs of complying with section 404 exceeded original estimates. In some cases the cost was 2-3x the original estimates and most companies have not calculated the total number of internal resource hours, so there is no hard data to benchmark the total cost of time and resources. It is safe to say that on average companies spent one million dollars per billion of revenue, incurred additional audit fees for 404 that were equal to or above their regular audit fees and companies below a billion in revenue have spent between \$ 250,000 and \$ 1,000,000 on SOX.

The SEC and PCAOB have listened to the complaints made by companies related to the cost and time requirements related to implementing 404 and released new guidelines aimed at reducing the cost and resource requirements. The Blue Sage Group has always followed a top down integrated approach that has proven to be effective in reducing the cost and time requirements related to 404 compliance programs.

Here is the guidance PCAOB Guidance to public accounting firms:

May 16, 2005 PCAOB Release

New Policy Statement related to 404 guidelines for auditors

Implementation of Auditing Standard No. 2- Internal controls over financial reporting

http://www.pcaobus.org/News_and_Events/News/2005/05-16.asp

Summary from Board Policy Statement 2005-009

The Policy Statement discusses issues raised after the first implementations of the PCAOB's Auditing . Standard No. 2 related to sections 103 and 404 of the Sarbanes Oxley Act of 2002. The statement addresses some of the concerns raised in various events, roundtables, letters and forums related to implementing 404 compliance programs.

According to the PCAOB Statement "This Policy Statement considers several of the auditing practices observed in the first year of implementation **that may be ineffective or inefficient** means of meeting the Objectives of Auditing Standard No. 2."

"It also describes how the PCAOB intends to supervise implementation of the standard, from providing additional guidance to make audits of internal control more effective and cost-efficient to driving improvements in implementation through our inspections of registered public accounting firms."

Here is a summary of the guidance provided to auditors when complying with AS2:

1. Integrate financial statement and control audits
Combine the audit of internal controls with the audits of the client's Financial statements, "*so that evidence gathered and tests conducted in The context of either audit contribute to completion of both audits*"
2. Limit the audit scope based on high risk and eliminate low risk areas
The audit should be based on risk assessment of the client.
"Exercise judgment to tailor their audit plans to the risks facing Individual audit clients, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);"

3. Start with company and entity controls testing and limit further testing to relevant high risk areas. The audit should start at the top and “identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and ***use the risk assessment required by the standard.***”
4. Use the work of others Audit firms should “take advantage of the significant flexibility that the standard allows to ***use the work of others***”
5. Communicate with clients on internal control issues
Auditors should “***engage in direct and timely communication with audit clients*** when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports”.

If you have any questions related to the new rules contact The Blue Sage Group

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