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The (a)(b)(c)'s of Sarbanes-Oxley 404

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Section 404 of the Sarbanes-Oxley Act (SOX) continues to be in the news and a challenge for some companies. We now have Section 404(c), as well as a recently issued SEC Staff study thanks to Dodd-Frank. What does this mean for public companies? Did you know that the management's report on internal control over financial reporting (ICFR) per Section 404(a) is now considered "filed" rather than "furnished" for all non-accelerated filers? This is a higher level of liability than in previous years. Did you know that new public issuers are the only filers who are not required to provide management reports on the effectiveness of ICFR since they have an option to not include one in their first 10-K report? This article answers these and other questions to provide the latest landscape on SOX 404.

SEC Staff Study on 404(b)

The workload triggered by the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Dodd-Frank Act) is enormous - over 450 rules, 40 reports to Congress and 70 studies. One of these studies is the [Study and Recommendations on Section 404\(b\) of the Sarbanes-Oxley Act of 2002 For Issuers with Public Float Between \\$75 and \\$250 Million](#) (SEC Staff Study on 404(b), or Study) released on April 22, 2011 by SEC Staff. The Study was triggered by Section 989G(b) of the Dodd-Frank Act and calls for the SEC Staff to report on methods for reducing the compliance burden, as well as thoughts if a complete exemption for such companies from Section 404(b) compliance would encourage companies to list on exchanges in the United States in their initial public offerings (IPOs).

For clarity purposes:

- 🕒 Section 404(a) requires management to report on the effectiveness of ICFR.
- 🕒 Section 404(b) requires an auditor attestation with respect to an issuer's ICFR.
- 🕒 Section 404(c) provides that Section 404(b) does not apply for an issuer that is neither an accelerated filer nor a large accelerated filer. This group of issuers is commonly referred to as 'non-accelerated' filers.

Yes, that's right, there is now a Section 404(c), which is a newly enacted statute of SOX, as amended by the Dodd-Frank Act. Of the 9,092 unique issuers¹ that filed annual reports with the SEC on Forms 10-K

¹According to the SEC Staff Study on 404(b): *The number of unique issuers excludes investment companies, asset backed securities issuers that file annual reports on Form 10-K but are not required to file audited financial statements or management's assessment of internal control over financial reporting, issuers that file annual reports on Form 10-K but are not required to file audited financial statements or management's assessment of internal control over financial reporting because they are considered inactive under Rule 3-11 of Regulation S-X [17 CFR 210.3-11], certain Canadian issuers that file annual reports on Form 40-F, guarantors that are issuers for purposes of the federal securities laws but for which there is not separate reporting under Rule 3-10 of Regulation S-X [17 CFR 210.3-10], and certain financial institutions that report to other regulators pursuant to Section 12(i) of the Exchange Act. The number of unique filers also excludes filers that were delinquent with their 2009 annual report as of January 4, 2011.*



or 20-F for fiscal years ending anytime in 2009, over 60% (5,518) were non-accelerated filers per SEC Staff Study on 404(b).

Among the findings of the SEC Staff Study on 404(b) are:

- ④ The 2007 reforms of the SEC's June 2007 interpretive release and the PCAOB's ([Public Company Accounting Oversight Board](#)) adoption of AS 5 had the intended effect of reducing the compliance burden and improving implementation of Section 404.
- ④ The costs of Section 404(b) have declined since the SEC first implemented the requirements of Section 404, particularly in response to the 2007 reforms.
- ④ Investors generally view the auditor's attestation on ICFR as beneficial.
- ④ Financial reporting is more reliable when the auditor is involved with ICFR assessments.
- ④ There is not conclusive evidence linking the requirements of Section 404(b) to listing decisions of the studied range of issuers.

The SEC Staff Study on 404(b) made the following two recommendations:

1. **Maintain existing investor protections of Section 404(b) for accelerated filers, which have been in place since 2004 for domestic issuers and 2007 for foreign private issuers.** The Study states, "*there is strong evidence that the auditor's role in auditing the effectiveness of ICFR improves the reliability of internal control disclosures and financial reporting overall and is useful to investors.*"
2. **Encourage activities that have potential to further improve both effectiveness and efficiency of Section 404(b) implementation.** Specifically, SEC Staff cites PCAOB monitoring activities to better assist auditors in performing top-down, risk based audits of ICFR. In addition, they cite COSO's (The Committee of Sponsoring Organizations of the Treadway Commission) current project to review and update its internal control framework to help contribute to effective and efficient audits by providing management and auditors with improved internal control guidance that reflects today's operating and regulatory environment to enhance the ability to design, implement, and assess internal controls.

To sum up the SEC Staff Study on 404(b), not much was learned from what previous surveys and reports had already concluded. Clearly, the SEC Staff sides with preserving Section 404(b). However, it is not their decision or even the decision of the SEC Commissioners. Like the passage of 404(c), it would take an act of the U.S. Congress and President's signature to exempt further groups from the ICFR external audit requirement.

The Study does highlight evidence that issuers with the auditor attestation on ICFR requirement generally had a lower rate of restatement than issuers that did not have such a requirement. In addition, the Study states: *For all accelerated filers in the EDGAR² population with a management report on ICFR, approximately 4.5% reported ineffective ICFR. For all non-accelerated filers in the EDGAR population with a management report on ICFR, approximately 28% reported ineffective ICFR.* Indeed, SEC Staff suggests that an auditor attestation on ICFR contributes positively to the maintenance of effective controls and therefore provides a valuable investor protection.

² EDGAR (Electronic Data-Gathering, Analysis, and Retrieval) is the SEC's automated system for the collection, validation, indexing, acceptance, and forwarding of submissions of required forms to the SEC.



While there are benefits of Section 404(b), as evidenced by a lower rate of restatements and ICFR material weaknesses, what is the cost? The Study does not shed significant new light on this topic as SEC Staff heavily referenced their [2009 SEC Staff Study on Section 404](#). Audit fees are obviously one major component of total 404(b) compliance costs, but there are also internal costs associated with preparing for and responding to external audit requests. Total SOX 404 compliance costs typically increase as issuer size increases and decrease as issuers gain compliance experience. However, SOX 404 expenses as a percentage of total revenue is usually significantly higher for smaller companies. This was one of the main arguments for the passage of Section 404(c).

The strong recommendation for controlling SOX 404 costs is for management to periodically challenge costs to confirm if they are getting the most “bang-for-the-buck.” This includes leveraging entity-level controls and automated controls, especially continuous monitoring. If the external auditor is comfortable with the company’s culture and control owners’ competency, this should go a long-way in supporting their opinion. Likewise, if they can more efficiently test automated controls as opposed to larger sample sizes that manual controls typically warrant, it should serve as a downward dynamic on their fees.

Other Key SOX-404 Considerations

Here are some important developments and reminders as you walk, or think about walking, down the SOX 404 path:

- ④ All issuers, including non-accelerated filers, continue to be subject to Section 404(a) requiring management’s report on ICFR. This is not likely to change so accept it and strive for efficiencies.
- ④ All issuers must maintain documentation as “evidential matter” to support management’s assessment of the effectiveness of ICFR (per Item 308 of SEC Regulation S-K). This means that complying with Section 404(a) is far greater than simply inserting a report into the annual report.
- ④ New public issuers continue to be the only filers that are not required to provide a management report on the effectiveness of ICFR. They have the option to not provide this report for their first 10-K filed per Item 308 of Regulation S-K. However, they must comply with SOX 404(a) by submitting such a report beginning with their second 10-K filing. If they take advantage of this relief in their first 10-K report they must state that management’s and the auditor’s report on ICFR were not provided due to the first-year exemption allowed by the SEC.
- ④ Management’s Report on ICFR for all non-accelerated filers will be considered “filed” rather than “furnished” under the Securities Exchange Act of 1934 for fiscal years ending on or after June 15, 2010. This is a higher level of liability.
- ④ Non-accelerated filers are no longer required to provide a statement within their management’s report that an auditor’s report on ICFR has not been provided, if indeed this is the case. However, non-accelerated filers may continue to voluntarily submit audit reports on their ICFR. The SEC Staff Study on 404(b) reported that 60 non-accelerated filers voluntarily included such an attestation in their 2009 10-K filing.

Concluding Thought

Compliance complacency can be dangerous, especially with regards to SOX 404 considering the liability and reputational exposures. Know the applicable SEC rules and strive for an effective and efficient compliance process to stay within the good graces of your investors and regulators.



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