

WHITE PAPER

THE SEC SHOULD TAKE A STAND ON SECTION 404 (B)

By Thomas A. Basilo, CPA

9.27.2008



WithumSmith+Brown Global Assurance

A Limited Liability Company

Experience. Methodology. Service

wsbga.com

THE SEC SHOULD TAKE A STAND ON SECTION 404 (B)

By Thomas A. Basilo, CPA

WHITE PAPER

I find the February 2008 decision to delay Section 404 (b) implementation for smaller public companies with market caps under \$75 million puzzling. While SEC Chairman Christopher Cox defends that the Commission has not completed its Web-based survey of companies that are already subject to Section 404 and its in-depth interviews with smaller public companies to gauge the cost/benefit relationship of SOX, the fact is that the only companies that have implemented Section 404 of SOX are accelerated filers under the old standard of AS2. It is well-documented that significant dollars (\$39 billion in total) were spent by companies complying with AS2 and those costs have reduced dramatically. Since none of the non-accelerated filers have actually undergone a Section 404 (b) audit, any data compiled is certainly not indicative of the actual cost that non-accelerated filers will experience. I can understand that the SEC wants to gauge the impact AS5 is having on accelerated filers, but I fail to see the relevance of the probable cost reduction on implementation for non-accelerated filers.

The reason for my puzzlement is that the non-accelerated filers and accelerated filers are not at the same compliance stage. The major costs associated with compliance of Section 404 are for design, documentation and implementation of a system of internal control over financial reporting ("ICFR"). What the SEC

failed to factor into their cost estimate of \$91,000 to comply with SOX was the fact that most companies had not kept up with system and procedures documentation of their ICFR and had to create the documentation from scratch. This took a major effort and the SEC reacted by allowing the non-accelerated filers to delay implementation several times so that they could prepare for compliance in an orderly fashion.

However, most smaller public companies have not taken advantage of this time and continue to procrastinate. Since Section 404 (a) is a self assessment, most non-accelerated filers I have talked to do not have a sense of urgency to document ICFR, believing that their ICFR are adequate. They continue to hope that the SEC will eliminate the Section 404 (b) requirement and they will never need to undergo a more detailed documentation process. With the SEC continually giving a mixed message to the smaller public companies, I cannot understand how they will assess the cost side of the cost/benefit equation.

So what about the benefit side of the equation? No one can deny that the implementation of SOX has been a benefit to the U.S. public market. While many studies have proved this point, the most compelling statistic

(Continued on page 2)



A Limited Liability Company

Experience. Methodology. Service

wsbga.com

THE SEC SHOULD TAKE A STAND ON SECTION 404 (B)

WHITE PAPER

is in U.S. IPO activity (the very area those opposed to SOX stated would be destroyed). According to Ernst & Young, capital raised by U.S. based companies in 2005 (the first year following SOX 404 compliance) reached almost \$30 billion and increased 14% to \$34 billion in 2006. SOX has accomplished precisely what was intended, namely to restore credibility to the U.S. public markets. By forcing companies to be more transparent in their financial reporting, thousands of material weaknesses in internal controls have been identified and are being remediated. The benefits of SOX appear to be clear.

I think it is time for the SEC and Chairman Cox to take a stance and decide once and for all whether all companies, regardless of size, need to have an effective, documented system of internal control to obtain public financing. The SEC has studied the issue for four years, resulting in the implementation of a new standard (AS5) under which auditors will be guided to assess the effectiveness of a company's ICFR. In addition, the financial and investment communities are embracing the control structure and recent audit pronouncements are now requiring auditors to make an assessment (but not opine) of the effectiveness of ICFR. It appears that the various overseers are potentially going in opposite directions.

Although the SEC believes it is doing the smaller public companies a favor by delaying compliance with SOX, I believe the apparent indecision of the SEC on its direction with regard to non-accelerated filers is detrimental for a number of reasons:

Investors do not want a repeat of the 2001 debacle. This would be even more devastating to U.S. company investment than the collapse of Enron and other major companies because the foreign markets are so much stronger now. Another major fraud would send more investments overseas.

Smaller public companies are more vulnerable to control deficiencies due to the size of their financial staff, lack of segregation of duties and the ability of management to override controls. The risk of material error in the financial statements is greater than that of larger public companies, requiring more oversight.

Recent studies have confirmed that companies who have not complied with Section 404 or who have material weaknesses in their internal controls are paying more for their audits, thus negating any cost savings perceived by non-compliance.

Having effective ICFR is simply good busi-

(Continued on page 3)

THE SEC SHOULD TAKE A STAND ON SECTION 404 (B)

WHITE PAPER

ness. Many companies that are compliant have become more efficient and better managed, and have increased their use of technology to improve controls. Further, companies that are Section 404 compliant have traditionally received a higher multiple when sold.

The indecision on SOX compliance has increased anxiety among the CFO community. The inability to budget and plan its resource allocations is becoming a problem.

It appears that no one wants to make a decision to rescind Section 404 for non-accelerated filers, because the impact politically will be devastating if another massive fraud takes place. If rescission of Section 404 is not recommended, I would like to suggest two alternatives for the SEC to consider.

The first:

- Require Section 404 (a) compliance annually.
- Require all non-accelerated filers to comply with Section 404 (b) for years ending on or after December 15, 2009.
- Non-accelerated filers that receive a clean opinion on the effectiveness of

internal controls over financial reporting would only need to comply with Section 404 (b) every three years.

- Companies that have material weaknesses will be required to comply with Section 404 (b) until all material weaknesses are remediated, then can comply every three years.

The second:

- Require Section 404 (a) compliance annually.
- Make compliance with Section 404 (b) optional for non-accelerated filers and permit filers to prominently display that they are 404 compliant.

Both of these recommendations would have a positive impact on costs for non-accelerated filers. In addition, I believe most of the strong and well-managed companies will comply with Section 404 voluntarily and other companies will feel the competitive pressure to also comply.

There are no perfect solutions but I believe these are fair and reasonable compromises. ■