

Recent Developments in SARBANES-OXLEY

Your Questions Answered.

By David Cox, Partner Moore Colson

- 1. I read somewhere that this whole Sarbanes-Oxley law is unconstitutional anyway and will be repealed. Any truth to that?***

Well, sort of. A small accounting firm in Nevada and a group called the Free Enterprise Fund is challenging the SOX established Public Accounting Oversight Board (“PCAOB”, pronounced “Peek A Boo”) on constitutional grounds. The PCAOB is the outfit that the SOX law set-up to oversee and set standards for all accounting firms doing work for public companies, while the Securities Exchange Commission (SEC) kept its traditional role as the interpreter and enforcer of the U.S. securities laws.

The legal argument is that, because the PCAOB operates outside of Congressional oversight and has its board members appointed directly by the SEC, without the President and without approval by the Senate, it violates the Constitution’s separation of powers principles in general and the so called “Appointments Clause” specifically. (U.S. Constitution, Article 2, Section 2 if you are keeping score).

On the other side of the ball, former Senator Sarbanes and some smart law professors have their own legal opinions that the PCAOB is okay, and in any case, resolving the issue in the federal courts may take years. And then, even if struck down, Congress would likely just redo the PCAOB appointments process to be more to the Supreme Court’s liking. So I wouldn’t count on Sarbanes-Oxley going away.

Of course, the real complaint is not about the Appointments Clause, but about the cost of complying with the now infamous SOX Section 404, that requires all public companies to document and then test systems of internal accounting control over financial reporting. The impact is expected to be especially onerous for small public companies which will now need to comply with Section 404 for the first time starting this year. Recognizing these issues, both the PCAOB and the SEC have taken steps to try and ease the burden.

- 2. But if Congress wrote the law, how can the SEC and the PCAOB now make changes?***

The language of Section 404 is not at all specific, it simply states, more or less, that public companies must assess their internal controls over financial reporting and the auditors must attest to those internal controls. Exactly how you were supposed to do that, well, that was up to the registrants, the auditors and the SEC to figure out.

The SEC for its part, doing its yeoman best, issued some handy regulations as to what the law would really mean in practice, like defining the term “internal controls over financial reporting”, issuing some guidance on what public company management should do as an assessment each quarter vs. on a yearly basis, and stated that a recognized control framework should be used (e.g. “COSO”). Still, it did not get down into the nitty gritty detail of how you do an “assessment” or an “audit” of internal controls over financial reporting, decisions

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like what to test, what not to test, how much testing is required, what to put in your documentation, what to leave out.

So, the world looked to the guidance provided by the PCAOB, in the form of a 161 page production called “Audit Standard 2: An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.” Known by its affectionately diminutive nickname, “AS 2” was written for use by auditors, but in the absence of any other guidance by the SEC, it often became management’s defacto guidance.

Now, with three years of the larger public companies dealing with SOX 404, heavy compliance costs and a couple of public gripe sessions known as “roundtables”, a consensus emerged that many of the prescriptions, explanations and examples in good ol’ AS 2 caused auditors and management to go overboard in the level of effort, more than was needed to comply with the requirements of SOX law. So the PCAOB is replacing AS 2 with a new standard, which is to be called “AS 5.” At present, it’s been published in proposed “draft” form, and then there’s a public comment period and then the SEC will have to approve it in final, so look for final issuance about mid-year 2007 so it can be used on all 2007 audits.

3. *So, what exactly are the changes coming as a result of PCAOB’s new “AS 5”?*

First, the new AS 5 explicitly encourages a “top-down, risk based approach,” which means that just because an area is big dollars does not necessarily mean it needs heavy testing. This is a renewed focus on the one basic idea of 404, which is that the controls should be sufficiently designed and operating to prevent a material error in the reported financial statements within a level of reasonable assurance. So, areas less likely to generate that sort of error should be subject to less effort. Along these same lines, the new AS 5 as proposed states that the consideration of which business units or segments to include should be based on risk of material misstatement arising from them. That’s a significant departure from picking business units and segments just to get a large enough dollar coverage - an approach the old standard encouraged or at least seemed to.

Also on the risk based theme, auditors are now explicitly encouraged to consider the results (good and bad) of past year’s audit work in their internal control test scope decisions. The old standard had language (“...each annual audit must stand on its own”) that was interpreted by almost everyone to mean you could not consider results of any year other than those of the current year’s tests.

But let’s be careful here, the PCAOB did not go so far as to allow that audit work can be done on an every other year basis or a “rotation” scheme. Risk areas must get at least some attention every year. But this should reduce auditor scope in those cases where audit results have been good in the past, either in the audit work directed at the controls, or in the direct audit procedures applied to the balances themselves.

Probably the biggest change is that the new standard will change the requirements of the external auditors’ reports. In the past, auditors were responsible for “quality assuring” management’s separate process of assessing controls, and then issuing an auditors’ opinion

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on that separate process. That requirement will be gone. Auditors will still need to reach their own opinion on the internal controls themselves, but will no longer need to render that second, “quality assurance” opinion on what management did in its assessment of the same controls. Auditors will only need to consider management’s activities and results as the auditor goes about his own consideration and tests of the internal controls themselves, which is a different ballgame.

But, while removing the requirement to “quality assure” management’s process, the new standard gives auditors’ more latitude to rely directly on management’s process so as to reduce the level of the auditor’s own tests.

The new standard will also change up the definitions of control deficiencies, particularly the definition of a material weakness. The PCAOB intends to encourage auditors to look for only the important deficiencies that could lead to a material misstatement. The definition of a material weakness will be a controls deficiency with a “reasonable possibility” of leading to a material misstatement.

4. *Now we’ve covered the PCAOB. When does the SEC get to weigh in?*

For its part, the SEC has issued interpretative guidance essentially supporting all the PCAOB’s revisions and clarifications, especially the “top down risk based” theme. Both outfits have worked to sing from the same hymnal, but while they are consistent in their themes, its important to remember that the PCAOB new standard is directed at auditors, while the SEC guidance is directed at the management’s of public companies.

The SEC’s new rules illustrate how, in generating evidence of effective operation, that management can rely, at least in part, on its daily interaction with the control system, without having to use internal auditors to test controls as a separate process. It’s theoretically possible that management may not need to do any separate tests if members of management are close enough to all the controls, sufficiently close to rely on its own interaction and monitoring. However, in most cases, management will still want some formal tests of controls done by internal auditors. Another benefit of that: The external auditors might decide they can then rely on the internal auditors’ independence and objectivity for the externals’ own testing purposes, an arrangement that could save the company some audit bucks.

In any case, the absence of the auditors’ “quality assurance” process should save auditors and management alike some time and effort.

5. *Well, so after all that, we finally get to the big question. How much time and effort is going to be saved?*

There is no simple answer to that question since each company has its own unique set of circumstances. And in any event, SOX 404 is still there and its requirements to document and test internal controls are inherently labor intensive and costly, no matter how “risk based” you make your approach.

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For companies that have already implemented 404, the new guidance should lead to a revisiting of the overall risk assessment and testing schemes, rather than simply rolling forward the determinations of the past. The “same as last year” approach is always a bad idea, and an especially bad idea this year. But it’s an easy mistake to make, especially by those who remember how much effort it was to come up with their SOX 404 approach in the first place.

For the small public companies who have yet to implement, the new guidance will come just in time. The new AS 5 has a separate section discussing effective audits in the smaller company environment. In addition, the PCAOB promises yet more detailed guidance to auditors of small companies. This is in addition to the helpful guidance, tools and templates in COSO’s new “Internal Controls Over Financial Reporting – Guidance for Smaller Public Companies” which was published in June 2006. (It’s available in stores now, and in a convenient, three volume set.)

Still, the tough part is that all the new guidance for both large and small registrants is intentionally “principles-based”. (“Principles-based” is a technical accounting term for “You have to think about it really hard”). There isn’t a one size fits all, “SOX in a Box” that will buy you happily-ever-after, cost-efficient compliance, (in spite of what that software vendor told you.)

But any company, large or small, can manage the SOX 404 costs by carefully analyzing its own unique situation and then doing no more and no less than what is justified given the financial reporting risks. In my college days, we used to call that getting the “gentleman’s ‘C’.”

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