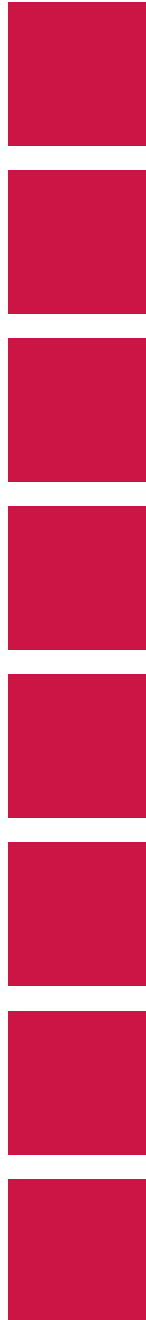


# MANAGEMENT GUIDE to Sarbanes – Oxley for Non-Accelerated Filers



We can be an alternative tool in your professional services toolbox for:

- ▶ Risk Advisory
- ▶ Tax Services
- ▶ Audit Services

Camille C. Irvin | 972-788-0330  
Director of Business Development

▶ [www.kbagroupllp.com](http://www.kbagroupllp.com)

# MANAGEMENT GUIDE TO SARBANES – OXLEY NON-ACCELERATED FILERS

## ▶ THE PURPOSE OF SARBANES - OXLEY

In late 2001, a highly publicized series of corporate reporting scandals led many public company regulators and investors to call for reforms in corporate financial reporting. Congress responded to these concerns by passing the Sarbanes-Oxley Act of 2002 (the Act). The Act mandates the most sweeping changes in reporting by publicly traded corporations since the Securities and Exchange Act of 1934. It impacts the reporting responsibilities of all U.S. publicly traded corporations and their audit firms. Every manager or director of a public company must understand what this historic Act requires and what steps may be taken to fulfill its requirements. The following is a brief discussion of the major provisions of the Act (this guide is not intended to be exhaustive):

## ▶ PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

The Act established the Public Company Accounting Oversight Board (PCAOB) to regulate auditors of public companies. PCAOB has authority to adopt standards for audits of public companies and enforce compliance with the Act in the preparation of audit reports. A violation of Rules of PCAOB is treated as a violation of the 1934 Securities and Exchange Act, giving rise to the same penalties that may be imposed for violations of that Act. All public accounting firms that audit publicly traded companies must register with PCAOB. To fund PCAOB, annual fees are assessed from all publicly traded companies and PCAOB-registered accounting firms. The Act grants “oversight and enforcement authority over PCAOB” to the SEC. All proposed rules and rule changes by PCAOB must be filed with the SEC.

The Act prohibits public accounting firms registered with PCAOB from providing certain non-audit services to companies they audit, including bookkeeping, information systems design and implementation, appraisal or valuation services, actuarial services, internal auditing, management or human resource functions, brokerage or investment services, legal and expert services unrelated to the audit or any other services determined to be impermissible by PCAOB.

## ▶ PUBLIC COMPANY AUDIT COMMITTEES

Every public company must have an audit committee comprised of members of the board of directors and the Act requires each audit committee member to be independent. The Act defines “independence” as “not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer” and as “not being an affiliated person of the issuer, or any subsidiary thereof” (AICPA Summary of Sarbanes-Oxley Act of 2002). Public companies must disclose whether at least one member of the audit committee is a “financial expert.” A company’s audit committee retains direct responsibility for the retention, compensation and oversight of any registered public accounting firm engaged by the company. The audit committee may also retain independent counsel or other advisors at its discretion.

## ► REQUIREMENTS FOR FINANCIAL REPORTS

The Act requires the CFO and CEO of each public company to prepare a signed statement to accompany the audit report. This statement must certify the “appropriateness of the financial statements and disclosures contained in the periodic report and that those financial statements and disclosures fairly present, in all material respect, the operations and financial condition of the issuer.”

All financial reports required to be prepared in accordance with GAAP must “reflect all material correcting adjustments . . . identified by a registered public accounting firm.” All annual and quarterly financial reports must disclose any off-balance sheet transactions and other relationships with consolidated entities that may materially affect a company’s present or future financial state. In addition, pro forma financial information must be presented in a form that is not misleading.

## ► MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS OVER FINANCIAL REPORTING

Section 404 of the Act requires public companies to include a report by management on its assessment of the company’s internal controls over financial reporting in each annual report. Each public company’s auditor must attest to and report on the assessment made by management on the company’s internal controls. The auditor’s attestation to the company’s internal controls must also be included in each annual report.

## ► SEC ENFORCEMENT AND PENALTIES

The final sections of the Act grant the SEC various enforcement powers and allow stricter penalties for white collar crimes.

The statements above are not an exhaustive listing of the Act’s provisions.

Section 404 presents the most costly and time-consuming work to be performed by public companies as a response to the Act. This report will examine, from a management perspective, Section 404’s requirements, as well as provide guidance in the implementation process.

## ► SARBANES - OXLEY DEADLINES FOR NON-ACCELERATED FILERS

The compliance date for Non-Accelerated Filers has changed several times since the implementation of Section 404, primarily due to the amount of effort required to comply with Section 404. Recently, the Securities and Exchange Commission extended the date for compliance for Non-Accelerated Filers from fiscal years ending on or after July 15, 2007, until fiscal years ending on or after December 15, 2007. This extension would result in Non-Accelerated Filers being required complete only management’s portion of the internal control requirements in their first year of compliance. The Commission also extended the date by which Non-Accelerated Filers must begin to comply with the Section 404(b) requirement to provide an auditor’s attestation report on internal control over financial reporting in their annual reports. The deadline was moved to the first annual report for fiscal year ending on or after December 15, 2008. The latest extensions are intended to provide cost savings and efficiency opportunities to smaller

companies and to assist them as they prepare to comply fully with Section 404 reporting requirements.

### ► CHARACTERISTICS OF NON-ACCELERATED FILERS

Sarbanes Oxley Section 404 can be a daunting task for any size company; however, many Non-Accelerated Filers are faced with challenges some “Larger” Companies can easily remedy due to size, amount of resources and capital. Some of the more definitive characteristics are as follows:

- Fewer lines of business and fewer products within lines
- Concentration of marketing focus, by channel or geography
- Leadership by management with significant ownership interest or rights
- Less complex transactions, processing systems and protocols
- Fewer levels of management, with wider spans of control
- Fewer personnel, many have wider range of duties
- Limited ability to maintain deep resources in line as well as support staff positions such as legal, human resources, accounting and internal auditing

Despite the characteristics above, Non-Accelerated Filers can efficiently and effectively implement Section 404.

### ► BENEFITS OF BEING A NON-ACCELERATED FILER

It is believed by many that Non-Accelerated Filers lack the size, resources and capital to effectively implement Section 404. However, this is not necessarily the case; their size or lack thereof can be an advantage. Smaller companies are dominated by the company’s founder or other leaders who exercise a great deal of discretion and provide personal direction to company personnel. Their in-depth knowledge of different facets of the business, its operations, processes, array of contractual commitments and business risk enables leaders to know what to expect in reports generated by the financial reporting system and to follow-up as needed when unanticipated variances surface.

Non-Accelerated Filer’s operations are straightforward with less complex business structures allowing directors to gain more in-depth knowledge of business activities. Many directors have been closely involved with the company during its evolution and have a strong historical perspective.

Due to resource constraints, managers at Non-Accelerated Filers are required to be more involved in daily operations reviewing key accounting reports of detailed transactions, selecting transactions for review of supporting documents, overseeing periodic counts of physical inventory and reviewing reconciliations of account balances all contributing to effective internal control.

The information technology control environment in a Non-Accelerated Filer’s company is generally not highly complicated. Typically there is a limited need for program change controls and many of the risks associated with in-house developed systems are avoided. The majority of information technology products used are commercially developed (off-the-shelf), bringing advantages in the form of embedded facilities for controlling which employee can access or modify specified data, performing checks on data processing completeness and

accuracy and maintaining related documentation.

All benefits above can be used to reduce business and information technology risk within a Non-Accelerated Filer resulting in an easier implementation of Section 404.

## ▶ KEYS TO A SUCCESSFUL IMPLEMENTATION

Many Accelerated Filers struggled with the implementation of Section 404 for a variety reasons: ineffective planning, lack of a risk based approach, limited guidance from the external financial auditors, focusing on the wrong control objectives and identifying too many controls. Much can be gained from their mistakes, such as:

- Focusing on financial reporting objectives directly applicable to the company's activities and circumstances,
- Taking a risk based approach to internal control (Risk based means focusing on quantitative and qualitative factors that potentially affect the reliability of financial reporting and identifying points in transaction processing or other activities related to financial statement preparation where something could go wrong),
- Right-sizing documentation (Maintaining the right amount of documentation for the size and complexity of a Non-Accelerated Filer's internal control environment) and
- Viewing internal control as an integrated process.

## ▶ A SOLUTION FOR SECTION 404

The remainder of this guide is segregated into the sections listed below. Each section includes observations, analysis and lessons learned. They are as follows:

- ▶ Project Startup
- ▶ Scoping and Planning
- ▶ Use of Service Organizations
- ▶ Documentation
- ▶ Testing
- ▶ Evaluating Control Deficiencies and Reporting
- ▶ Communication

The information provided is meant to assist management with Sarbanes-Oxley implementations. It is not a substitute for the SEC's final Section 404 rules, the Act or the PCAOB Accounting Standard 2 (the "Standard").

## ▶ SECTION I: PROJECT STARTUP

Compliance with Section 404 is complicated. The scope of the Section 404 assessment extends well beyond a company's finance and accounting departments and into major aspects of legal, tax, information technology and internal audit functions. It requires that management coordinate extensively with third parties, external auditors and providers of outsourced services.

## ► PROJECT MANAGEMENT

The first question that needs to be answered is who is responsible for Section 404. The board of directors and senior-level management are responsible. Executive commitment and sponsorship are imperative. The project will impact many of the company's major departments and functions and the common leader of these departments and functions is the chief executive officer. Section 404 is not the primary responsibility of finance, accounting and internal audit; it requires a joint effort.

We have found that Section 404 is most successful when overseen on a daily basis by the global controller / chief risk officer and supported by the audit committee and senior management (chief executive officer and chief financial officer). Use of an Executive Steering Committee will facilitate management in the implementation of Section 404. In addition to various employees/department heads, the following parties are expected to be involved in the process:

- Audit Committee
- Section 404 Project Sponsor (Chief Executive Officer / Chief Financial Officer)
- Disclosure Committee
- Section 404 Executive Steering Committee (Controller, Tax, Internal Audit, Legal, Chief Information Officer, Business Unit Representatives)
- External Auditor

A small or mid-size company will generally be able to manage its Section 404 project by relying on one or two individuals, depending on the company's complexity. These individuals should have full-time responsibility for the project. It is very difficult to manage the challenges of a Section 404 project on a part-time schedule. Without dedicated personnel with expertise in project management, Section 404 projects quickly become overwhelming.

## ► SECTION II: SCOPING AND PLANNING

Scoping is one of the most critical phases in the Section 404 project. It involves determining the documentation necessary and the nature, timing and extent of testing of controls to be performed for each significant account, disclosure and business process at each of the company's locations. Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework. The Committee of Sponsoring Organizations (COSO) framework is the most widely applied model in the United States.

The specific scoping considerations are addressed as they relate to the five components of the COSO framework. They are as follows:

- Control Environment – Establishes the overall tone for the organization and is the foundation for all other components of internal control. Sub-components include:
  - Integrity and ethical values
  - Commitments to competence and development of people
  - Management's philosophy and operating style
  - Organizational structure
  - Assignment of authority and responsibility
  - Human resources policies and procedures
  - Participation by those charged with governance (i.e., board of directors, audit committee)

- ▶ Risk Assessment – For an entity to exercise effective control, it must establish objectives and understand the risk it faces in achieving those objectives. As part of the risk assessment process, management should determine and consider the implications of relevant risks that could hinder the achievement of its objectives.
- ▶ Control Activities – These are policies and procedures that help to ensure that management’s directives are implemented. Control activities occur throughout the organization, at all levels and in all functions.
- ▶ Information and Communication – This includes the systems that support the identification, capture and exchange of information in a form and time frame that enables personnel to carry out their responsibilities and financial reports to be generated accurately.
- ▶ Monitoring – This is the continuous process that management uses to assess the quality of internal control performance over time. Examples include the following:
  - Internal controls
  - Management reviews
  - Audit committee activities
  - Disclosure committee activities
  - Self-assessment reviews

#### ▶ STEP 1: IDENTIFY SIGNIFICANT ACCOUNTS AND DISCLOSURES

The objective of the project is to determine the controls that address the relevant financial statement assertions for each significant account and disclosure in the company’s external financial reports. It requires that management review consolidated financial statements and footnotes and then move through each step, ultimately determining the internal control activities and procedures that address the relevant financial statement assertions.

The Standard indicates that an account or disclosure is significant if there is more-than-remote likelihood that the account could contain misstatements that, individually (or when aggregated with other misstatements), could have a material effect on the financial statements (as a result of either overstatement or understatement). In addition, management must consider the concept of materiality. The same definition that applies to the preparation of financial statements applies to planning and reporting the effectiveness of internal control over all financial reporting.

#### ▶ STEP 2: IDENTIFY BUSINESS PROCESSES/CYCLES AND SUB-PROCESSES/SUB-CYCLES AND MAP TO SIGNIFICANT ACCOUNTS AND DISCLOSURES

This process requires that management determine the company’s significant business processes/cycles and sub-processes/sub-cycles that generate the significant accounts. By understanding and documenting the business processes/cycles, management is able to identify the control activities that address information processing objectives/CAVR (completeness, accuracy, validity and restricted access), as well as potential “gaps” in the controls (i.e., information processing objectives for which control activities are not in place).

**▶ STEP 3: IDENTIFY THE RELEVANT FINANCIAL STATEMENT ASSERTIONS FOR EACH SIGNIFICANT ACCOUNT AND DISCLOSURE**

For each significant account and disclosure, management should identify and document relevant financial statement assertions, as well as test the controls that apply to those assertions. The assertions are as follows:

- ▶ Existence or occurrence
- ▶ Completeness
- ▶ Valuation and allocation
- ▶ Rights and obligations
- ▶ Presentation and disclosure

The Standard indicates that relevant assertions are assertions that have a meaningful bearing on whether the account or disclosure is fairly stated. The degree to which an assertion is relevant to each significant account will vary.

**▶ STEP 4: PERFORM A RISK ASSESSMENT OF THE BUSINESS SUB-PROCESSES/SUB-CYCLES**

Identify the risks within the sub-processes/sub-cycles that may result in a material misstatement in the financial statements. The risk assessment will be used to assess the nature, timing and extent of testing that must be performed in each area. The risk assessment requires significant judgment and should be performed by members of management that have sufficient knowledge of the processes and associated risks. As with the determination of significant accounts, qualitative and quantitative factors must be considered.

**▶ STEP 5: OBTAIN A COMPLETE LISTING OF LOCATIONS OR BUSINESS UNITS**

A business unit may be a legal entity (e.g., subsidiary), a division or an operational facility (e.g., a plant or sales office). Management must use significant judgment when defining a location or a business unit for scoping and testing purposes. The objective in the selection of locations is to ensure that the controls are assessed and tested at the level at which they are performed.

**▶ STEP 6: IDENTIFY LOCATIONS SUBJECT TO TESTING, ASSESS COVERAGE AND MAP LOCATIONS TO THE BUSINESS PROCESSES/CYCLES AND SUB-PROCESSES/SUB-CYCLES IDENTIFIED PREVIOUSLY**

To evaluate the significance of each location, management should prepare financial information by location; information should be reconciled with reported balances to ensure completeness. For locations that are individually important, management should document and test controls for all significant accounts and disclosures.

### ▶ SECTION III: USE OF SERVICE ORGANIZATIONS

Companies may use outside service organizations to process their financial data. However, the company is ultimately responsible for the internal control over this financial information and may need to assess the design and operating effectiveness of the service organization's system of internal control. The following steps should be performed:

- ▶ Determine if a service organization is being used
- ▶ Determine if outsourced activities, processes and functions are significant to the company's internal control over financial reporting
- ▶ Determine if a Type II SAS 70 report exists and is sufficient in scope

Obtaining a SAS 70 report from a service organization for the first time can be a lengthy process. It may take six months to a year to obtain a final report after a request is made. Therefore, companies using service organizations should make this determination as soon as possible.

### ▶ SECTION IV: DOCUMENTATION – EVIDENCE OF EFFECTIVE INTERNAL CONTROL

The documentation produced in the Section 404 project forms the basis and support for management's evaluation of internal control over financial reporting. The SEC's rules on Section 404 indicate that it is a company's responsibility to document internal control and that developing and maintaining such documentation is inherent to effective internal control. Management's documentation should support the following:

- ▶ Scoping decisions
- ▶ Evaluation of whether the company's system of internal control is designed to prevent or detect material misstatements
- ▶ Conclusions that tests of operating effectiveness were appropriately planned and performed
- ▶ Consideration of the test results when determining its assertions

The following steps should be addressed when documenting internal controls:

- ▶ Determine the scope of documentation – Identify which accounts and disclosures will be evaluated and which locations should be included in the scope
- ▶ Develop process documentation – Document the flow for significant accounts and disclosures to determine where material misstatements due to error or fraud could occur
- ▶ Develop control documentation – Document controls within each of the five components of internal control and specifically address company-level controls, anti-fraud programs and evaluation of the audit committee's effectiveness
- ▶ Assess the design of controls – Determine whether the company's controls are adequately designed to mitigate the risk of material misstatement

## ▶ SECTION V: TESTING

Management must determine whether controls over financial reporting are operating effectively. This requires testing the controls, which must include each of the five components of internal control over all relevant assertions for all significant accounts and disclosures at each individually important location and over the specific risk areas at other locations. Evidence of testing must be retained to support management's assessment of internal control over financial reporting. The testing components include the following:

- ▶ Identify the controls to be tested
- ▶ Identify who will perform the testing
- ▶ Develop and execute the test plans
- ▶ Evaluate the test results

These steps should be described in the company's overall testing strategy; key members of management (i.e., the project's steering committee) should review and approve the test plans, which detail management's philosophy and approach to the testing phase.

## ▶ SECTION VI: EVALUATION OF INTERNAL CONTROL DEFICIENCIES AND REPORTING

This is an evolving area that will require a significant degree of management judgment. Control deficiencies can range from internal control deficiencies to significant deficiencies to material weaknesses in internal control. These are defined in the Standard as follows:

- ▶ **Internal Control Deficiency** – Exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
- ▶ **Significant Deficiency** – An internal control deficiency or 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 GAAP such that there is a more-than-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.
- ▶ **Material Weakness** – A significant deficiency or combination of significant deficiencies that results in a more-than-remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

The process of identifying, assessing and classifying internal control deficiencies is as follows:

- ▶ Identify deficiencies
- ▶ Understand and assess each deficiency
- ▶ Assess likelihood of misstatement
- ▶ Assess potential magnitude of misstatement
- ▶ Identify compensating controls
- ▶ Determine classification of deficiencies
- ▶ Assess deficiencies in aggregation with others

In its annual SEC filing, a company is required to include management's report regarding internal control over financial reporting. The report must include the following:

- ▶ A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- ▶ A statement identifying the framework used by management to conduct the required assessment of the effectiveness of the company's internal control over financial reporting.
- ▶ An assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether internal control over financial reporting is effective.
- ▶ A statement that the company's registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

The Standard indicates that management may want to describe in its report any corrective actions taken after the date of assessment and plans to implement new controls and a statement that management believes the cost of correcting a material weakness would exceed the benefits to be derived from implementing new controls. Lastly, the Standard requires the external auditor to opine on management's assessment of the effectiveness of internal control over financial reporting, which includes the following:

- ▶ Has management clearly stated its responsibility for establishing and maintaining adequate internal control over all financial reporting?
- ▶ Did management use a suitable framework for its assessment?
- ▶ Is management's assessment of the effectiveness of internal control over all financial reporting free of material misstatement?
- ▶ Has management documented its assessment in an acceptable form?
- ▶ Did management properly disclose all detected material weaknesses?

**Note:** The auditor cannot issue an adverse opinion on management's assessment of its internal controls and an unqualified opinion on the effectiveness of internal control over financial reporting if management does not have a sufficient basis for its assessment of the effectiveness of internal control over financial reporting.

## ▶ SECTION VII: COMMUNICATION

Communication among management, the audit committee and the external auditor is an important part of the Section 404 project. Management must communicate all significant deficiencies and material weaknesses that it detects to the audit committee and the external auditor. The Standard requires the auditor to obtain the following representations from management:

- ▶ Acknowledgement of management's responsibility for establishing and maintaining effective internal control over financial reporting.
- ▶ Statement that management has performed an assessment of the effectiveness of the company's internal control over financial reporting and specification of the control criteria.

- ▶ Statement that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting.
- ▶ Statement of management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date.
- ▶ Statement that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's assessment, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting.
- ▶ Description of any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting.
- ▶ Statement of whether significant deficiencies and material weaknesses identified and communicated to the audit committee during previous engagements have been resolved and specific identification of any that have not.
- ▶ Statement of whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

Before issuing an opinion, the auditor must report in writing to management and the company's audit committee all significant deficiencies and material weaknesses. The communication should distinguish clearly between those matters considered to be significant deficiencies and those considered to be material weaknesses.

In addition, the Standard requires the auditor to communicate in writing to the company's board of directors if a significant deficiency or material weakness exists related to the audit committee's oversight of the company's external financial reporting and internal control over financial reporting.

The auditor must also communicate to management in writing all deficiencies in internal control over financial reporting of a lesser magnitude than significant deficiencies identified during the audit and inform the audit committee when such a communication has been made.

It is recommended that the external auditor communicate with management and the audit committee in a timely manner, as opposed to waiting until the audit engagement ends. This will ensure that (1) all necessary parties are kept informed of the audit's status and results and (2) the appropriate parties address the issues in a timely and adequate manner.