



Moody, Famiglietti & Andronico, LLP
Certified Public Accountants and Consultants

Sarbanes-Oxley

SOX Section 404 Compliance for Smaller Public
Companies - SEC Latest Developments

Perspectives

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Recent SEC Action:

On May 17th, 2006 the Securities and Exchange Commission (SEC) issued a decision with respect to the compliance requirements under Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404" or "the Act"). In that issuance, the SEC noted that all companies would still be expected to comply, regardless of size.

On July 11th, 2006, the SEC issued Concept Release No. 34-54122 for public comment. In this concept release the SEC phrased questions around many of the core challenges that smaller publicly traded companies are facing and solicited feedback on what form of guidance would be helpful. Feedback is due back to the SEC 60 days from the issuance date. The release is located at [SEC Concept Release 34-54122](#).

On August 9th, 2006 the SEC issued two more releases in regards to compliance with the SOX Section 404. They are as follows:

The first release is a final rule extending for an additional year the deadline for foreign private issuers that are accelerated filers, but not large accelerated files. The foreign private issuers considered are those that file their annual reports on SEC Form 20-F or SEC Form 40-F. For initial compliance with the Section 404(b) requirement, these foreign private issuers are to provide an auditor's attestation report on internal control over financial reporting in their annual reports. This group of issuers will be required to comply only with the Section 404 requirement to include management's report on the effectiveness of the company's internal control over financial reporting in the Form 20-F or Form 40-F annual report filed for their fiscal year ending on or after July 15, 2006. They will not need to comply with the requirement to provide the registered public accounting firm's attestation report until they file a Form 20-F or Form 40-F annual report for a fiscal year ending on or after July 15, 2007. This extension is effective 30 days after publication in the Federal Register. [SEC Release No. 33-8730]

The second release consists of **proposals** for smaller public companies and for newly public companies.

The first **proposal** of the second release is for smaller public companies that are non-accelerated filers. The SEC has proposed to further extend the deadline for initial compliance with the Section 404 requirement. The first deadline is for the inclusion of management's report on internal control over financial reporting to be filed for fiscal years ending on or after December 15, 2007. This is an additional five month extension from the original extension of fiscal years ending on or after July 15, 2007. In addition, the SEC is also proposing to extend the deadline for the complete initial compliance with Section 404(b) to December 15, 2008, which includes management's report, as well as the external auditors' assessment and report on the public traded company's internal control over financial reporting.

The second SEC **proposal** is to provide a transition period for newly public companies (first time registrants) before they become subject to compliance with the internal control over financial reporting requirements. Under this proposal, such a company would not become subject to these requirements until it previously has been required to file one annual report with the SEC. Thus the management's assessment and external auditor's attestation would be due with the second annual filing.

MFA Perspective

MFA has seen a wide variety of responses to the recent rulings from our clients, ranging from a proactive approach to compliance to the more conservative approach of deferring substantial action until the SEC finalizes the deadlines. Regardless of where a company may be in its outlook, there are two main points that a decision maker should be aware of. The first is that Section 404 compliance is here to stay, and the second is that all public issuers will need to comply. What remains to be answered is what the final compliance due date will be and what the compliance process will look like.

Clearly, Section 404 compliance is not an easy undertaking. The costs are significant, the effort is complex and time consuming, and what truly needs to be accomplished can be difficult to discern. Finding, dedicating and judiciously employing company resources to accomplish compliance goals have been a daunting challenge, even for the largest American corporations and their teams of seasoned professionals. Further complicating any decision to move forward or not is the ambiguity of the guidelines and the heated debate within the political and business communities.

Placing all ambiguities aside, the fundamental question is: why should an organization be compliant? The argument for and against are vociferous. Any cost conscious executive is going to be loathe expending precious resources on a compliance effort. In order to answer our clients concerns, MFA segregates those of our clients that are not yet required to comply into three categories. Based on which of these categories a client falls in, we advise our client on what the best course of action may be to achieve better internal controls.

For Non-Accelerated Filers

As it stands today (subject to the 12/15/07 potential extension), public issuers that are considered to be non-accelerated with a 7/15 deadline and a 12/15 deadline will have to be compliant or state otherwise with the first fiscal year end filing after 7/15/07. To achieve compliance, MFA strongly advises our clients to start the planning process early on and to plan the effort thoroughly. The better the organization plans and marshals its resources, the greater the potential for cost savings. A realistic assessment of an organization's internal capacity for project execution will enable the organization to acquire the long term resources necessary to achieve its goals. The judicious scoping of the effort and the alignment of dedicated resources should equate to an efficient and streamlined Section 404 effort which should lead to substantial cost savings.

MFA's approach to compliance typically encompasses the following:

- Phase One is the thorough planning and scoping of a client's Section 404 effort.
- Phase Two is to assess the corporate governance environment.
- Phase Three is to document and assess the companies processes and embedded internal controls.
- Phase Four is to test the company's internal controls and to assist management in coming to a conclusion.

Private Enterprises

An increasing number of private enterprises throughout the marketplace have chosen to become Section 404 compliant. Though these organizations are not undergoing an external affirmation of their internal controls they are preparing their organizations for the future. As reported in the *Wall Street Journal*, the benefits often quoted by private enterprises for being compliant often include:

- Management strategically wants to position the Company for sale or take it public.
- Management desires access to capital at the terms and conditions most favorable to the Company.



- Boards of Directors with public-company experience see the benefits.
- Management understands strong internal controls stimulate improved efficiency.
- Customers require strong internal controls, especially, for example, where the company's software product offerings are an integral part of the customer's product offerings - SAS No. 70.
- Lenders are more likely to approve loans.

MFA recommends that those private enterprises seeking to build better internal controls into their organizations should do so in a phased approach. Undertaking a review and assessment of each key business function individually is the best way to identify, prioritize and correct the potential areas of weakness. By undertaking the review one department at a time, the private enterprise will maximize its return on its investment by adopting change intelligently and allowing the organization to assimilate and disseminate the lessons learned.

Non-Profits

As the marketplace at large struggles with the thorny issues of Section 404 compliance, Non-Profits have also been seeking some of the same benefits of compliance. Historically, Non-Profits have been quite susceptible to fraud and misuse of contributed funds. This leads to a loss of confidence in the donor base and future contributions. Instituting internal controls greatly enhances the image of the Non-Profit and its ability to differentiate itself in its contribution gathering efforts. Many influential and affluent companies and individuals understand and have experienced the benefits of being compliant with Section 404. They will look upon other compliant organizations with a positive perspective.

For Non-Profits, accomplishing robust internal controls over their processes is often a challenge. When working with these clients MFA recommends doing the following:

- Identify the key risk areas.
- Identify the key personnel and their access to mission critical resources.
- Identify areas where a lack of segregation of duties exists.
- Establish monitoring controls over key risk areas.

Final Thoughts

In articulating these perspectives, MFA acknowledges that there is no one way to achieve compliance or to institute effective internal controls. In fact, MFA would strongly discourage a cookie cutter approach to achieving compliance or effective internal controls. Typically, the circumstances facing each organization will require a thoughtful assessment of what is logical to the organization and what truly needs to be accomplished in order to achieve compliance.

Regardless of what your end goal and rationales are, MFA recommends that compliance options be identified now so that your organization can stand ready to react to its mission critical goals. Whether that is reacting to the next round of SEC Section 404 decisions or is the strategic strengthening of your organization, MFA has found that through the judicious application of such an undertaking, management will have a good understanding of its options. They will then be prepared to deal with the evolving marketplace.

Material Discussed in this Perspective Issue is meant to provide general information and should not be acted on without obtaining professional advice tailored to your firm's individual and specific needs. This information is for general guidance only and is not a substitute for professional advice.

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ABOUT the Author

Mr. Pacheco is passionate about providing winning business solutions to the diverse business problems experienced by the MFA client base. Richard's expertise is applied to various aspects of business operations. He specializes in business processes, regulatory compliance, financial analysis and business valuations. With his eleven years of business experience, proficiency in business valuations and familiarity with publicly traded entities of various sizes, he plays an instrumental role in the firm's consulting practice. This makes him sought after by clients seeking greater management of their internal control endeavors and business process analysis from start to finish. He has had tremendous success leading clients through the maze of Sarbanes-Oxley compliance.

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ABOUT MFA - Moody, Famiglietti & Andronico, LLP & MFA Risk Services, LLC.

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