Sarbanes-Oxley Section 404

A Guide for Small Business

For 2007 annual reports, smaller public companies need to assess their internal control over financial reporting.

It doesn't have to be a chore

Introduction

Section 404 of the Sarbanes-Oxley Act requires public companies' annual reports to include the company's own assessment of internal control over financial reporting, and an auditor's attestation. Since the law was enacted, however, both requirements have been postponed for smaller public companies. The requirement of an auditor's attestation won't apply to most smaller public companies until their 2008 annual reports. The 2007 annual report will be the first year that the management assessment will need to be included.

This brochure is designed to help make the first time easier.

In June 2007, the SEC issued interpretive guidance to help companies assess their internal controls. This guidance was developed specifically with smaller companies in mind. The guidance is voluntary. You can find it, along with other information summarized in this brochure, on the Commission's website at http://www.sec.gov/spotlight/soxcomp.htm. We strongly encourage you to review this information.

What Constitutes Effective Internal Controls?

In a small company, just as in a large one, it is management's job to maintain a system of internal controls so that the financial statements will be reliable.

The SEC doesn't have specific rules that tell smaller public companies how to do this. There is, however, useful guidance available from other sources. One of these is the internal control framework set out by a private sector organization called the Committee of Sponsoring Organizations of the Treadway Commission. Summaries of two of their publications, *Internal Control Over Financial Reporting — Guidance for Smaller Public Companies* (2006) and *Internal Control — Integrated Framework* (1992), are available without charge at http://www.coso.org/publications.htm.

Beginning Your Evaluation

Your company's evaluation of the effectiveness of its internal controls begins by having the certifying officers consider two basic questions:

1) Do my employees understand what they need to do to properly prepare external financial reports?
2) What information do I need to make sure they have done those things?

The SEC's new management guidance suggests considering these questions in three steps.

Step 1 — Identifying Financial Reporting Risks, and Controls That Address Them

Identifying risks in your company's financial reporting starts with what you know best: how your business works. Use your knowledge of your company, as well as of how generally accepted accounting principles apply to the business, to identify which parts of the financial reporting process could lead to material misstatements. Think about "what could go wrong" by considering:

- Risk factors inherent in your business, both internal and external
- Risks in the way you authorize, process and record transactions that are reflected in the financial statements
- Your company's vulnerability to fraud

To identify which controls address those risks, consider the following:

- How do your entity-level controls relate to financial reporting elements? With what level of precision do they operate?
- Is there more than one control that addresses the same financial reporting risk? If so, which one provides the most efficient way for you to evaluate how well it works?
- Is the control automated? If so, how sturdy are the relevant IT controls? Or is the control manual — and if so, what is the risk of human error?
- Not every control within a particular process needs to be identified — only those that adequately address financial reporting risks.

Exactly how you go about identifying your company's financial reporting risks and the controls to address them will depend on your company's size, complexity, and organizational structure — as well as the particulars of the financial reporting process you use. In a smaller company with centralized financial reporting, management's daily involvement with the business may provide it with adequate knowledge to identify the financial reporting risks and related controls.

At the end of this process, you will have identified the financial reporting risks that are specific to your company, as well as the controls that will permit you to most efficiently determine whether the company's financial reporting is reliable.

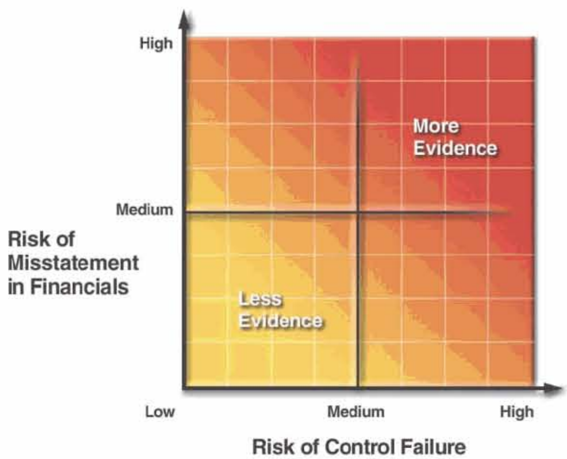
Step 2 — Do Your Controls Work in Practice?

Determining the effectiveness of the controls you've identified requires that you gather evidence about how the controls actually operate. What kind of evidence you need, and how much of it, depends on your assessment of two kinds of internal control risk:

1) The risk of a material misstatement in the financial reports
2) The risk that the control will fail to operate as designed

The greater the internal control risk, the more evidence you'll need to support a conclusion that the control is effective.

How Much Evidence Do You Need to Establish That Internal Controls Are Effective?



In a smaller company, you may not need to assign any special personnel to the task of gathering evidence on how internal controls are operating. Likewise, the procedures you follow to obtain evidence of operating effectiveness may be integrated with the daily responsibilities of the employees. As internal control risk increases, however, you may need to consider:

- Using personnel who are more objective
- More extensively validating the controls
- Testing over longer periods

The SEC's newly issued guidance provides examples of financial reporting elements that ordinarily would be considered higher risk, such as critical accounting policies. It also provides examples of controls that have higher risk, such as those that are subject to override by management, involve significant judgment, or are complex.

The SEC guidance also describes circumstances in which managers can rely on their own knowledge and supervision of controls — a common situation in smaller companies — as a way to limit the additional procedures, if any, that might be needed to gather evidence of operating effectiveness.

Once the evidence is gathered, you then determine whether the control is operating effectively. In making your assessment, you should consider:

1) Whether the control operates as designed
2) How it is applied
3) Whether it operates consistently
4) Whether the personnel responsible for the control have the authority, and the competence, to do the job

If management determines that the control is not operating effectively, then a control deficiency exists. As described below, each control deficiency must be evaluated to determine if it is a material weakness.

Step 3 — Reporting Your Conclusions on Overall Effectiveness, and Deficiencies

Your company's 2007 annual report will include your assessment of the overall effectiveness of your internal controls. In making your determination of whether the company's internal controls are effective, you should begin by assessing any control deficiencies. Is any of them — alone or in combination — serious enough to be a material weakness? If so, you can't conclude that the company's controls are effective. This puts a significant premium on knowing what constitutes a material weakness.

Simply put, a material weakness is one or more control deficiencies that create a reasonable possibility of a material misstatement in your company's annual or interim financial statements. This does not necessarily mean that a material misstatement has occurred, but only that the controls might not be good enough to detect or prevent a material misstatement on a timely basis.

The SEC's new guidance highlights the factors that you should consider in deciding whether a control deficiency is a material weakness. For example:

- How susceptible is the related financial reporting element to loss or fraud?
- How significant are the financial statement amounts or the transaction totals that are exposed to the deficiency?

If you identify any material weaknesses, you must describe them in your assessment of the internal controls that appears in your annual report. You should also consider including the following in your assessment:

- An analysis of how the material weakness affects the company's financial reporting and internal controls
- Your current plans (or the actions you've already taken) to address the material weakness

Finally, you should describe these material weaknesses to the audit committee and your external auditor, along with any control deficiencies you've found that didn't rise to the level of a material weakness, but which you think are important enough to merit their attention. Control deficiencies of this kind are defined as "significant deficiencies" in the SEC's rules.

What Kind of Records Do I Need?

Management is responsible for maintaining reasonable support for its assessment. The SEC's guidance doesn't make this decision for you — because we recognize that what's reasonable will depend on the nature, size, and complexity of each company. It will also vary based on the internal control risk that management has identified.

A smaller company's management might determine that what already exists in the company's books and records is sufficient for its assessment. Alternatively, management may decide that it is better to keep separate copies of the evidence it evaluates. In all cases, the support that you rely on should include written records of the following:

- The design of the controls
- The way you gathered and evaluated the evidence
- The basis for your assessment of effectiveness

Other Sources of Guidance

The SEC has published many other sources of useful guidance that can help smaller companies perform the management assessment of internal controls under Sarbanes-Oxley Section 404. You should start with the SEC's website at http://www.sec.gov/spotlight/soxcomp.htm. Other good sources are:

- The SEC's June 2003 Implementing Rules (http://www.sec.gov/rules/final/33-8238.htm)
- The SEC's June 2007 Interpretive Guidance (http://www.sec.gov/rules/interp/2007/33-8810.pdf)
- The SEC's Rules Defining Material Weakness and Regarding Voluntary Use of the Interpretive Guidance (http://www.sec.gov/rules/final/2007/33-8809.pdf)
- The SEC's Rule Defining Significant Deficiency (http://www.sec.gov/rules/final/2007/33-8829.pdf)
- The SEC Staff's FAQs (http://www.sec.gov/info/accountants/controlfaq.htm)

Contacting the SEC

The SEC's Office of the Chief Accountant is happy to assist smaller companies with Section 404 questions. You can submit a question by email to 404smallbusiness@sec.gov. We will study it and then set up a conference call with you to discuss it. More information on this can be found at: http://www.sec.gov/info/accountants/ocasubguidance.htm.

For help with other compliance issues of importance to smaller companies, visit the Division of Corporation Finance's Office of Small Business Policy website at http://www.sec.gov/info/smallbus/reachsec.htm, or email us at smallbusiness@sec.gov.