

Board Issues Final Standard for Sarbanes-Oxley

by C. Travis Webb, BKD, LLP
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In a March 9 meeting, the Public Company Accounting Oversight Board (PCAOB) finalized the standard for public companies to assess their internal control over financial reporting. The revised Section 404 standard from the *Sarbanes-Oxley Act of 2002* (the Act) was a response to comments received from investors, registrants, auditors and others and provided answers to questions created by the quick passage of the Act and related rules in 2002.

Sarbanes-Oxley Revisited

The Act created new management challenges designed to prevent the next Enron or WorldCom. Section 404 of the Act requires public company management to provide an assessment of internal control over financial reporting as an early-warning indicator of potential financial problems. Section 404 compliance is one of today's corporate hot-buttons for public and nonpublic companies.

The original proposed Section 404 guidance was directed at the auditors of public companies but forced management to establish documentation and perform tests to meet those requirements.

Original SEC estimates put the average cost of compliance with the Act at \$91,000. Revised company estimates put the cost of Section 404 compliance by itself in the hundreds of thousands or millions of dollars.

Highlights of the Changes

The final rules from the PCAOB on Tuesday reaffirm certain positions and relax others. Highlights of the changes include:

- Relaxed provisions allow auditors to rely more on the work of others (such as internal auditors). The principal evidence must come from the auditor's own work, but the overall work (and cost) of new audit efforts may be reduced.
- Cost considerations of the original proposed rules caused some companies to consider reducing internal audit staffing to avoid overlap with external auditors. The PCAOB compromised on some of these issues, recognizing internal audit can be an important and effective safeguard for the company and the public.
- Auditor "walk-throughs" of transactions from start to finish as control tests are still required, but the extent of those walk-throughs is reduced. The final rules establish a minimum threshold of one walk-through for each major class of transactions.

- Audit committee effectiveness is fair game as well, but the final rule narrows the scope. The auditor’s evaluation of the audit committee is part of the overall evaluation rather than a separate test of the committee’s functions.

Impact of Final Standard

Some companies may receive adverse opinions on internal control as a result of the final standard. How the markets will react to such opinions is difficult to predict.

The impact of the Act and these standards on small and medium-sized companies is of significant concern to the public at large. The final rule actually removes preliminary guidance for small and medium-sized companies and replaces it with a reference to other documents the PCAOB felt did a better job of describing differences.

Management teams of all companies should recognize that several of the Act’s regulations are applicable—public or not. Increased fines and jail time for document destruction, whistle-blower retaliation and other corporate wrong-doings are high on the radar. Entities with aspirations of going public or being acquired by a public company, take note: failure to comply ahead of time may create difficulties.

While the PCAOB approved the new standard, the Act requires approval by the Securities and Exchange Commission before it becomes effective.

C. Travis Webb is a partner in BKD’s Indianapolis office. He consults with clients on a broad spectrum of assurance, fraud and information technology issues, including Section 404.

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