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FOR SMALL,  
PUBLICLY HELD  
COMPANIES

ROBERT J. SONNELITTER

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**MILLER**

# **SOX 404**

## **For Small, Publicly Held Companies**

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**Internal Control Assessment and  
Reporting under Sarbanes-Oxley**

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**ROBERT J. SONNELITTER, CPA**



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# Preface

The Sarbanes-Oxley Act of 2002 (the Act) was signed into law on July 30, 2002. *Miller SOX 404 for Small, Publicly Held Companies* is intended as a guide to help the management of publicly held companies to fulfill the requirements of the Act.

The most challenging or time-consuming requirement that company management likely will encounter is the Act's Section 404 requirement that annual reports contain an internal control report from management. This book therefore focuses on assisting management in assessing the effectiveness of the company's internal control structure and its procedures for financial reporting. In making the required internal control assessment, management may identify situations where internal controls can be improved in a cost-effective manner; so, it is hoped that this book also will help management bring about such improvements.

*Miller SOX 404 for Small, Publicly Held Companies* comprises nine chapters as well as a CD-ROM that address all that is necessary to perform an assessment of internal controls over financial reporting as well as an assessment of disclosure controls. Practice points and practical considerations are provided throughout so that management can address the task of making its assessments thoroughly and efficiently. This book focuses on the Securities and Exchange Commission's (SEC's) rules for an assessment of internal controls and looks carefully at the requirements of the Public Company Accounting Oversight Board (PCAOB) for independent auditors because of the need for management to both comply with the SEC requirements and satisfy its external auditors. Checklists, questionnaires, and other such aids are provided throughout the book.

Chapter 1, "Overview of Requirements," provides an overview of the Act and its Section 404 requirements along with background commentary to enhance the reader's understanding of the requirements. A discussion of internal control frameworks, which are emphasized by the SEC, is included, and the basics of the SEC's requirements are discussed along with the PCAOB's requirements for auditors. The CD-ROM provided with this book includes the PCAOB's Auditing Standard No. 2 as well as three PCAOB Q&A releases.

Chapter 2, "Planning the Assessment," provides a basis for planning the assessment activities with practical aids for decisions about how to proceed. This chapter sets the stage for continuing with the assessment of internal controls and includes a discussion on documentation to help management ensure it keeps track of and documents what is necessary.

Chapter 3, "Mapping the Organization," is a guide for identifying all of the procedures that are part of the financial reporting process and provides the groundwork for linking internal controls

with procedures. The CD-ROM accompanying this book includes a case study of mapping the organization.

Chapter 4, "Tentative Risk Assessments," provides a starting point for the consideration of risk and materiality to help ensure that enough, but not too much, is taken into account. This chapter lays the groundwork for identifying deficiencies in internal control.

Chapter 5, "Making Tentative Internal Control Assessments," provides a guide to analyzing internal control design in terms of the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) internal control framework as it relates to identified risks for error or misstatement. This chapter directly links COSO's internal control framework components with risks for errors.

Chapter 6, "Testing Internal Control Assessments," focuses on testing internal control design analysis and operating effectiveness related to procedural activities. This chapter provides suggested guides for making tests as well as suggested testing procedures.

Chapter 7, "Completing the Assessment," focuses on general control matters—those matters not specifically related to particular accounting or financial reporting activities—and provides guides for evaluating the effectiveness of such matters.

Chapter 8, "Concluding and Reporting Management's Assessment," provides some concluding thoughts and Chapter 9, "Other Sarbanes-Oxley Act Compliance Matters," briefly covers the requirements of some other sections of the Act. The free companion CD-ROM includes related SEC Releases, as well as the complete text of the Act.

This edition of *SOX 404 for Small, Publicly Held Companies* reflects the requirements in final SEC releases concerning Section 404 of the Act issued through December 2004.

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Mr. Sonnelitter has published articles on accounting and has provided comments concerning proposed accounting or audit standards to the FASB and the Public Company Accounting Oversight Board (PCAOB).

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## CHAPTER 1

# OVERVIEW OF REQUIREMENTS

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### ABOUT THE SARBANES-OXLEY ACT

The Sarbanes-Oxley Act of 2002 (the "Act") was signed into law on July 30, 2002. It applies to "issuers," as defined in the Securities Exchange Act of 1934 (the "Exchange Act"). Generally, "issuers" are companies with securities that are registered so that they may be traded on any type of national securities exchange. Companies with more than \$10 million in assets and 500 security holders are generally required to file reports under the Exchange Act. Issuers also include companies that have filed a registration statement that has not yet become effective under the Securities Act of 1933 (the "1933 Act"), and has not been withdrawn.

Generally, those issuers are U.S. publicly held companies, investment companies, foreign companies that trade securities in the United States on a national securities exchange or NASDAQ, and companies that must file reports with the Securities and Exchange Commission ("SEC") for other reasons. Issuers also include U.S. companies that do not have publicly traded stock but have public debt securities and are reporting companies under the Exchange Act.

The Sarbanes-Oxley Act comprises eleven Titles. Title I establishes the Public Company Accounting Oversight Board ("PCAOB") as an independent private entity, amends the 1933 Act, allows the

SEC to recognize accounting standards established by a private entity such as the Financial Accounting Standards Board ("FASB"), and provides funding for both the PCAOB and FASB from annual support fees paid by all issuers.

Title II establishes auditor independence requirements. Title III establishes corporate responsibilities. It specifically designates the issuer's audit committee as being responsible for the appointment, compensation, and oversight of the independent auditors. Title III also designates management as being responsible for corporate internal controls and financial reports, and it imposes personal penalties against an issuer's chief executive and chief financial officers in the event that an accounting restatement is required due to material noncompliance with any financial reporting requirement caused by misconduct.

Title IV requires enhanced financial disclosures. It requires the SEC to issue rules about the disclosure of off-balance sheet transactions and pro forma information. Section 402 under Title IV prohibits personal loans to executives and Section 403 requires directors, officers, and principal shareholders to file statements of beneficial ownership of the company's equity securities. Section 404 under Title IV requires that annual reports contain an internal control report in which management states its responsibility "for establishing and maintaining an adequate internal control structure and procedures for financial reporting," and which provides management's "assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." Section 404 also requires the company's external auditors to attest to management's internal control assessment.

In addition to the Section 404 requirements, Title IV has a code of ethics disclosure requirement for senior financial officers, a disclosure requirement about whether the company's audit committee has a member who is a financial expert, and a so-called "real-time issuer" disclosure requirement concerning material changes in financial condition or operations.

Title V of the Act addresses conflicts of interest of securities analysts. Title VI addresses SEC funding and provides the SEC with the authority to censure persons from the privilege of appearing or practicing before it. Title VII requires that studies be conducted about (1) the consolidation of public accounting firms, (2) credit rating agencies, (3) violations and violators of securities laws, (4) SEC enforcement actions, and (5) the conduct of investment banks.

The studies mandated by Title VII have been completed and are available as follows: (1) in July 2003 the General Accounting Office since renamed the Government Accountability Office ("GAO") issued its report entitled "Public Accounting Firms: Mandated Study on Consolidation and Competition," GAO-03-864; (2) in January 2003 the SEC issued its report entitled "Report on the Role and Function of Credit Rating Agencies in the Operation of the Securities Markets"; (3) in response, the SEC issued a "Study and

Report on Violations by Securities Professionals,” which addresses violations during the calendar years 1998, 1999, 2000, and 2001; (4) in response, the SEC issued its report entitled “Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002,” which summarizes enforcement actions from July 31, 1997, through July 30, 2002; and (5) in March 2003, the GAO issued its report entitled “Investment Banks: The Role of Firms and Their Analysts with Enron and Global Crossing” (GAO-03-511).

Title VIII addresses corporate and criminal fraud accountability. It provides for fines and imprisonment of those persons who alter or destroy documents. It also provides whistleblower protection for employees of public companies who provide evidence of fraud and imposes criminal penalties against persons who defraud shareholders of public companies. Title IX increases the penalties for white-collar crimes including attempts or conspiracies to commit criminal fraud, mail and wire fraud, and violations of the Employee Retirement Income Security Act of 1974 (“ERISA”). Section 906 mandates that chief executive and chief financial officers certify periodic financial reports and it imposes stiff penalties against those who knowingly certify reports that do not comply with the requirements. Title X states that the sense of the Senate is that chief executive officers should sign corporate tax returns.

Title XI imposes fines or imprisonment against individuals who tamper with records or impede official proceedings. It gives the SEC temporary freeze authority, under which the SEC can request that the courts require a company to escrow “extraordinary payments” to directors, officers, partners, controlling persons, agents, or employees. Title XI also gives the SEC authority to prohibit someone from serving as a company officer or director, increases criminal penalties under the Exchange Act, and imposes fines or imprisonment against individuals who retaliate against people who aid the SEC.

## FRAMEWORKS OF INTERNAL CONTROLS

A control “framework” generally relates to how extensively it addresses controls over risks. For example, a broad control “framework” might address all or nearly all aspects of risk that an organization faces, whereas a narrower framework would be limited to specific aspects of risk. The SEC discusses the nature of internal controls in Release No. 33-8238 and concludes that the Act is concerned with internal control frameworks as they relate to financial reporting, as discussed below.

### The COSO Framework

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) published its “Internal Control—Integrated Framework,” which defined internal control in a broad

fashion that can be described as a process or set of processes designed to address operating efficiency and effectiveness, reliability of financial reporting, and compliance with laws and regulations.

The COSO internal control framework approaches the subject from a management perspective. It divides internal control into five interrelated components (AICPA Professional Standards, AU Section 319). AU 319 incorporates key concepts found in “Internal Control—Integrated Framework,” authored by COSO:

- a. *Control environment* sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.
- b. *Risk assessment* is the entity’s identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how risks should be managed.
- c. *Control activities* are the policies and procedures that help ensure that management directives are carried out.
- d. *Information and communication* systems support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.
- e. *Monitoring* is a process that assesses the quality of internal performance over time.

Publications by the Canadian Institute of Chartered Accountants (“CICA”) and the Institute of Chartered Accountants in England & Wales (“ICAEW”) are cited as examples of other suitable frameworks in the SEC’s final rules. According to the SEC’s criteria, a suitable internal control framework must:

be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company’s internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company’s internal controls are not omitted; and be relevant to an evaluation of internal control over financial reporting. (SEC Release No. 33-8238, Item II.B.3.a.)

The CICA’s *Guidance on Assessing Control* and the ICAEW’s *Turnbull Report* are suitable frameworks; the preferred internal control framework for U.S. reporting companies, however, is the COSO Framework. The SEC allows the management of foreign companies to rely on internal control evaluation frameworks used in their home countries. Regardless of the framework, management must make an

affirmative statement about whether or not the company's internal controls are effective.

## The CICA's Guidance on Assessing Control

The CICA criterion for a control framework provides a definition of control, 20 criteria for effective control, and four groupings of the criteria.

*Control* comprises those elements of an organization (including its resources, systems, processes, culture, structure, and tasks) that, taken together, support people in the achievement of the organization's objectives.

The CICA's four groupings and 20 related criteria may be described as follows:

1. *Purpose*—This groups criteria that provide a sense of the organization's direction. The criteria in this group relate to these objectives:
  - a. Mission, vision, and strategy
  - b. Risks and opportunities
  - c. Policies
  - d. Planning
  - e. Performance targets and indicators
2. *Commitment*—This groups criteria that provide a sense of the organization's identity and values. The criteria in this group pertain to ethical values, including:
  - a. Integrity
  - b. Human resource policies
  - c. Authority, responsibility, and accountability
  - d. Mutual trust
3. *Capability*—This groups criteria that provide a sense of the organization's competence. Criteria in this group address:
  - a. Knowledge, skills, and tools
  - b. Communication processes
  - c. Information
  - d. Coordination
  - e. Control activities
4. *Monitoring and learning*—This groups criteria that provide a sense of the organization's evolution. The type of criteria within this group address:
  - a. Monitoring internal and external environments

- b. Monitoring performance
- c. Challenging assumptions
- d. Reassessing information needs and information systems
- e. Follow-up procedures
- f. Assessing the effectiveness of control

## The ICAEW's Turnbull Report

Listed companies in the United Kingdom are expected to adhere to the Combined Code on Corporate Governance. That Combined Code includes the Turnbull Guidance on internal control. The ICAEW's booklet, "Internal Control: Guidance for Directors on the Combined Code," is available from its website at [www.icaew.co.uk](http://www.icaew.co.uk). The Turnbull Guidance contains some high-level internal control requirements of the Combined Code, along with descriptions of the elements of a sound system of internal control. Five main elements described are:

1. A statement of what is included in an internal control system. An internal control system is said to encompass the policies, processes, tasks, behaviors, and other aspects of a company that, taken together:
  - a. Enable a company to appropriately respond to significant business, operational, financial, compliance, and other risks to achieving its objectives and thus facilitate effective and efficient operations. This would include safeguarding assets from inappropriate use or from loss and fraud, and ensuring that liabilities are identified and managed.
  - b. Help ensure the quality of internal and external reporting; recognizing that this requires the maintenance of proper records and processes that generate a flow of timely, relevant, and reliable information from within and outside the organization.
  - c. Help ensure that the manner by which business is conducted provides for compliance with applicable laws and regulations, as well as with internal policies.
2. A statement that a company's system of internal control should reflect its control environment, which encompasses its organizational structure. Such a system should include:
  - a. Control activities.
  - b. Information and communications processes.
  - c. Processes for monitoring the continuing effectiveness of the internal control system.

3. A description of some of the attributes that a system of internal control should have, including requirements that it:
  - a. Form part of the company's culture and be embedded in its operations.
  - b. Be able to respond quickly to evolving business risks arising from factors within the company and from changes in the business environment.
  - c. Include procedures for immediately reporting any significant control failings or weaknesses that are identified, together with details of corrective action being undertaken, to appropriate levels of management.
4. A statement acknowledging that a sound system of internal control reduces, but cannot eliminate, the possibility of poor judgment in decision-making, human error, control processes being deliberately circumvented by employees and others, management overriding controls, and the occurrence of unforeseeable circumstances.
5. Statements about the practical limitations of a sound system of internal control which acknowledge that (a) a sound system of internal control provides reasonable, but not absolute, assurance that a company will not be hindered in achieving its business objectives, or in the orderly and legitimate conduct of its business, by circumstances which may reasonably be foreseen; and that (b) a sound system of internal control cannot, however, provide protection with certainty against a company failing to meet its business objectives or all material errors, losses, fraud, or breaches of laws or regulations.

On June 16, 2005, the Turnbull Review Group issued a Consultation Paper containing proposals to update the guidance in the Turnbull Report. Consultations with companies and investors has lead this review group to conclude that the guidance in the Turnbull Report has been effective and has had a positive influence on the understanding of risk management and on improving internal controls. Consequently, the proposals for updating the guidance are limited changes to those parts of the guidance dealing with maintaining and reviewing the internal control system. In general, the proposed amendments would not change the basic framework of internal control but they would:

- Reinforce the idea that the guidance should help companies comply with internal control and maintain or improve sound business practice;
- Require boards of directors to exercise reasonable care, skill and diligence in forming views on the effectiveness of internal controls;

- Remove the section relating to internal audit and incorporate it into the guidance for audit committees; and
- Require boards to confirm that actions have been or are being taken to remedy identified significant failings or weaknesses in the effectiveness of internal controls and include information considered necessary to assist shareholders' understanding of the main features of the company's risk management processes and system of internal control in the annual report.

Significantly, the Review Group concluded that "it is not appropriate to require boards to make a statement in the annual report and accounts on the effectiveness of the company's internal control system."

A comparison of these internal control frameworks is in the two tables below.

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**Table 1-1: Comparison of Internal Control Frameworks Definitions**

<i>COSO</i>	<i>CICA</i>	<i>Turnbull</i>
<p><i>Internal control</i> is a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:</p> <ul style="list-style-type: none"><li>• Effectiveness and efficiency of operations;</li><li>• Reliability of financial reporting; and</li><li>• Compliance with applicable laws and regulations.</li></ul>	<p><i>Control</i> comprises those elements of an organization (including its resources, systems, processes, culture, structure and tasks) that, taken together, support people in the achievement of the organization's objectives. Elements include four categories:</p> <ul style="list-style-type: none"><li>• Purpose;</li><li>• Commitment;</li><li>• Capability; and</li><li>• Monitoring and Learning.</li></ul>	<p><i>An internal control system</i> encompasses the policies, processes, tasks, behaviors, and other aspects of a company that, taken together:</p> <ul style="list-style-type: none"><li>• Facilitate its effective and efficient operation;</li><li>• Help ensure the quality of internal and external reporting; and</li><li>• Help ensure compliance with applicable laws and regulations, and also with internal policies with respect to the conduct of business.</li></ul>

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**Table 1-2: Comparison of Internal Control Frameworks**  
**Internal Control Components**

COSO	CICA	Turnbull
<p><i>Control environment</i> sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.</p>	<p><i>Commitment</i> includes ethical values including:</p> <ul style="list-style-type: none"> <li>• Integrity;</li> <li>• Human resource policies;</li> <li>• Authority, responsibility, and accountability; and</li> <li>• Mutual trust.</li> </ul>	<p>A company's system of internal control will reflect its <i>control environment</i>, which encompasses its organizational structure.</p> <p>The system of internal control should be embedded in the operations of the company and form part of its culture.</p>
<p><i>Risk assessment</i> is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how risks should be managed.</p>	<p><i>Purpose</i> groups criteria that provide a sense of the organization's direction. They address objectives including:</p> <ul style="list-style-type: none"> <li>• Mission, vision, and strategy;</li> <li>• Risks and opportunities;</li> <li>• Policies;</li> <li>• Planning; and</li> <li>• Performance targets and indicators.</li> </ul>	<p>The system of internal control should be capable of responding quickly to evolving risks to the business arising from factors within the company and to changes in the business environment.</p>
<p><i>Control activities</i> are the policies and procedures that help ensure that management directives are carried out.</p>	<p><i>Capability</i> groups criteria that provide a sense of the organization's competence. They address:</p> <ul style="list-style-type: none"> <li>• Knowledge, skills, and tools;</li> <li>• Communication processes;</li> <li>• Information;</li> <li>• Coordination; and</li> <li>• Control activities.</li> </ul>	<p>The system will include <i>control activities</i>.</p>