

COMPLIANCE WEEK

The leading information source on financial compliance and disclosure for public companies.

Sarbanes-Oxley Act: Hidden Shoals for the Unwary

By Tim Leech, Special to Compliance Week — Nov. 11, 2003

Last year I began teaching my 16 year-old daughter to operate our 205 horsepower pleasure craft. During my new-boater indoctrination sessions, in addition to covering requirements such as running the motor compartment exhaust fan for four minutes prior to starting the engine, operating the boat's navigation lights and learning on-water navigation rules, I took Morgan on a tour around our lake to point out rock shoals that are either partly or totally submerged.

These shoals can cause serious harm to unwary boaters. Some of these shoals are marked with buoys and/or lights, some better than others. Others, like a number of rock shoals around our cottage, aren't marked at all.

This month I am taking readers on a tour of some of the nastier "shoals" capable of causing considerable harm to unwary companies that must comply with Sarbanes-Oxley, and in particular sections 302 and 404 of the law.

Failure to avoid the shoals could lead to the next generation of corporate shipwrecks.

Section 302 requires a firm's management to take steps to satisfy themselves their systems and controls are reliable. Under section 404 the firm's external auditors must report on the reliability of management's assessment of the controls.

Beyond the hazards discussed in this article, it is highly likely that there are even more SOX 302/404 submerged shoals that will only become known after some companies run aground and sink – an event best avoided.

Here are some important SOX 302/404 hazards:

1. **Procrastinator Rocks**

A survey released by IBM in October shows that only one in 10 US chief financial officers and financial executives view their internal controls as compliant with SOX 404.

What is fascinating is that all these companies are already making control effectiveness representations under SOX 302.

The vast majority of these companies continue to get clean audit opinions from their external auditors. This reminds me of playing poker with a not very good hand, but you bluff and bet anyway hoping your opponents won't call you.

ABOUT THE AUTHOR



Tim J. Leech is an enterprise risk management veteran who is considered a pioneer in the fields of collaborative assurance

and risk design, having developed software and training for dozens of global companies including Royal Bank, Shell, Georgia-Pacific, CIBC, Mobil, Chiquita Brands and others.

A former Control & Risk Management Services Director at Coopers & Lybrand Consulting Group in Toronto, Leech is currently the President of CARD®decisions in Ontario.

He has held a variety of audit and assurance positions at Gulf Canada Resources (now Conoco) including Manager Special Audit Services, and was also Managing Director of Hambros (UK) Bank subsidiary Network Security Management in Canada.

He is the author of several industry books, programs and studies, including "Control Self-Assessment for Risk Management and Other Practical Applications" (John Wiley), and is a regular contributor to London-based [Global Risk Regulator](#), for which this column was originally written.

Leech can be reached [via email](#) or at (905) 823-5518.

In the case of SOX, the risk is that some of the companies that aren't ready may have a big disclosure problem before they have demonstrable support for the SOX 302 control effectiveness representations they have been making religiously each quarter.

Negligence charges against the poker players and their external auditors will be quick to materialize.

2. **Conflict Shoals**

In many companies, external auditors have played major roles in helping to calculate tax provisions, deal with commodity tax issues, interpret complex accounting rules and often to propose major accounting entries.

If you were to ask one of these companies what's the main control used to ensure these things had been done correctly, the answer in most cases would be that they hired their external auditor to help them.

In other words, they view the external auditor as their key control in these areas. Under SOX 404, these same external auditors will be asked to give an opinion on the effectiveness of controls over external disclosure items, including tax provisions, interpretation of generally accepted accounting principles, commodity tax, intercountry transfer prices.

In essence, external auditors will be giving an opinion their own effectiveness as a key control – a breach of most auditor independence principles.

3. **Wrong Focus Light**

When confronted with potentially dangerous situations, people often fall back on strategies used in the past to deal with similar events. This holds true even when the strategies have consistently failed.

With SOX 302/404 many companies and their external auditors are currently focusing 90 percent of their assessment efforts documenting, assessing and testing controls that have historically been responsible for less than 10 percent of the financial disclosure fiascos.

This is because it's relatively easy to start flowcharting and documenting accounting processes and control points. What's often not done is to identify the top 50 or 100 most common reasons why companies have issued wrong or fraudulent financial statements in the past – and then working out the odds of those situations happening in-house.

4. **Adverse Tidal Flow On Standards**

Current interpretations of SOX 302/404 by the Securities and Exchange Commission and the new Public Company Accounting Oversight Board encourage companies to use the now very dated 1992 version of the Committee of Sponsoring Organizations ("COSO") control framework as the foundation for CEO and CFO SOX 404 control effectiveness reports.

This is akin to reverting to using the 80486 generation of computer processors that was state-of-the-art in 1992.

Other generally accepted control frameworks that can be used for SOX 404, such as the Canadian CoCo model and the UK Cadbury framework, are slightly newer than the vintage '92 COSO model. But they still date back to the mid-1990's.

To achieve value from this exercise, and increase the chances of preventing serious problems in the future, companies should use the principles in the new [COSO ERM \(Enterprise Risk Management\) Framework](#) released in exposure draft in July and expected to be finalised in February 2004.

Companies should be strongly encouraged, or even forced, to use the newer generation of assessment methods. The new approaches focus first on documenting end-result objectives and then on identifying and measuring the risks to those objectives. Only after those two steps have been documented should the controls mitigating the risks be documented, together with the residual risks remaining.

5. **Beneaped After Missing The Point**

My talks with companies large and small suggest many are focusing almost exclusively on assessing the accounting processes that feed the income statement and balance sheet.

This fails to recognize that SOX 302/404 covers all aspects of a company's external financial disclosures.

In addition to accounting line item disclosures, steps must be taken to document the risks and controls related to financial statement note disclosures, supplemental disclosures required in 10K (annual report) and 10Q (quarterly report) SEC filings and the reliability of the management discussion and analysis sections.

6. **Foul Ground At Material Weakness**

Many companies have had control weaknesses that fit the proposed definition of a "material weakness" for decades.

The [auditing standard proposed in October by the PCAOB for SOX 404 work](#) defines a material weakness as something which "by itself or in combination with other internal control deficiencies ... results in more than a remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected".

One only needs to look at the number of financial statements and restatements being filed, and the number of restatements in the past, to conclude many companies have had material weaknesses.

Many companies have scores of serious internal auditor "concerns" that have never been rectified. In many companies, external auditors routinely insist on significant accounting adjustments before they sign-off on the accounts. Sometimes the adjustments are to fix the "Gee I had no idea – this comes as a big surprise to me!" type problems.

In other situations, entries related to a strategy by senior executives to "push the envelope" and see how far their external auditor would go before calling a foul.

The PCAOB now says evidence of persistent gaming of this type indicates immediately that there is a material weakness in control systems – a weakness that has been around for years.

7. **Pilot Error**

The PCAOB's SOX 404 exposure draft proposes for the first time that external auditors "evaluate factors related to the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting, including whether audit committee members act independently from management."

Simply put, the external auditor will be asked to say whether the audit committee of a company is competently fulfilling its oversight responsibilities.

It's well documented that ineffective audit committees have been at the root of many of the biggest corporate disasters. So one must assume that if this requirement stands we can expect that:

- A great many audit committees will have to improve their composition and performance substantially;
- A large number of audit committees will be classified as a "material weaknesses";

- Some external auditors will refuse to report them but issue clean reports anyway.

The irony is that SOX makes it clear that the audit committee should play a key role selecting and overseeing the work of the external auditor — the same external auditor that is being asked to opine on the quality of audit committee oversight.

External auditors may soon be faced with hundreds of serious ethical dilemmas and with having to decide whether they ought, as the expression goes, to bite the hand that feeds them.

8. Independent Bearings

Many companies have relied on external auditors to identify and fix problems in the accounting statements.

Sometimes this is because the company doesn't have appropriately qualified and experienced staff. Sometimes it's because of major control breakdowns. Sometimes it's because executives in subsidiaries are getting overly aggressive in their interpretation of the flexibility in generally accepted accounting principles.

A simple question I encourage audit committees to ask is: what significant accounting entries were made, if any, after management prepared the accounts for review by the external auditors?

According to the draft PCAOB SOX 404 audit standards, it will be *prima facie* evidence of ineffective controls if the answer is that quite a few big adjustments were made.

If this interpretation holds, it will severely curtail the "catch-me-if-you-can" approach to profit manipulation and income smoothing.

9. High Chance Of Running Aground

Every day people all over the world break speed laws, violate municipal ordinances, drink under-age, steal copyright protected music over the Internet, break copyright laws, and commit countless infractions without suffering any consequences.

Managing corporate profits by playing games with the external auditors has been a time-honored tradition in countries around the world.

The new rules being proposed by the PCAOB suggest that this game, as least in the form that it has been practised in the past, will have to come to an end.

However, as the expression goes, talk is cheap. A number of legal analysts have already pointed out that although the SEC is hiring large numbers of new staff, no similar resources are being provided to the federal prosecutors necessary to take real, serious enforcement action. External auditors, co-conspirators in more than a few cases, have been assigned the primary role as chief enforcer and reporter, a role they have struggled with in the past and failed at in scores of situations.

Time will tell if there is a real will on the part of the SEC, the PCAOB and external auditors to change the rules of the game. What companies and their advisors need to keep firmly in mind is that there is a very real probability that the new sheriffs in town want to hang at least a few wrong-doers in the town square.

This column solely reflects the views of its author, and should not be regarded as legal advice. It is for general information and discussion only, and is not a full analysis of the matters presented. The column was written originally for publication in the November issue of [Global Risk Regulator](#).