

## Sarbanes-Oxley Act

# Will cramming for SOX 404 exams be enough to get a passing grade?

As the Parmalat scandal unfolds in Europe and external audit firms begin to define pass/fail criteria, many US listed companies may still be overly optimistic about their chances of passing their Sarbanes-Oxley section 404 exams. The consequences could be serious, says *Tim Leech*.

My eldest daughter came home from university for the Christmas break complaining loudly about her last business exam in management sciences. She claimed the exam had been ridiculously hard and didn't think she had done very well. On the bright side however, she thought most of her classmates had also "tanked" the exam. The professor would probably have to apply a bell-curve approach - that is, base pass marks on the mean performance of the class rather than on an external standard - to improve grades, or fail most of the class. I still remember exams like that from my years in university in the 1970s. Some things in life don't change.

My daughter's claim that most of the class would probably fail the exam if a strict grading system were applied aptly sums up what might well happen to companies listed on US stock exchanges starting this year, unless the graders are prepared to be very lenient.

But it's abundantly clear from early warnings from the US Public Company Accounting Oversight Board (PCAOB), the Securities and Exchange Commission (SEC) and at least one of the big four international audit firms - PricewaterhouseCoopers (PwC) - that the corporate governance exam set by the Sarbanes-Oxley Act will be a hard one for the vast majority of public companies. So hard, perhaps, that the entire class might have to be placed on a bell curve and upgraded to achieve a respectable number of passes.

Chief executive officers and chief financial officers currently making claims in quarterly reports to the SEC, the agency that supervises US securities markets, that their companies have an effective system of

internal control should take these warnings very seriously.

The clearer the generally accepted understanding of what constitutes "effective" control, the higher the risks both personally and corporately, of failing the SOX 404 exam.

### Tough Standards

The US Sarbanes-Oxley Act of 2002 (SOX), which sets some of the toughest corporate governance rules in the world, is the response of US lawmakers to the succession of corporate scandals of recent years, best exemplified by the collapse of the Enron energy group. The SEC and the PCAOB, the new body set up to police the accounting industry, are both tasked with interpreting SOX's provisions. The two agencies give every sign they intend to set extremely tough external disclosure control standards.

If the regulators maintain their current course and interpretation of SOX it is likely that hundreds, even thousands, of companies whose shares are traded on US stock exchanges will fail their Sarbanes-Oxley section 404 tests starting this year. SOX 404 requires a firm's external auditors to report on the reliability of management's assessment of the firm's controls. Perhaps even more disturbing is that many companies currently claiming effective controls each quarter will be contradicted by their external auditors starting in 2004 or sooner. The consequences of a very high number of companies failing their external disclosure control effectiveness audit test are still largely unknown. But the penalties could include credit rating downgrades, increased insurance premiums, cancellation of officer and director insurance, as well as civil and criminal sanc-

tions and other nasty outcomes.

SOX 302 requires the CEO and CFO of a firm to acknowledge responsibility for internal controls over external financial disclosures, assess the effectiveness of those controls and report their conclusions in each quarterly filing with the SEC.

In essence, starting in 2004, external auditors will become the graders of management's claims they have designed and maintained internal controls that provide a high level of assurance that financial disclosures can be relied on by regulators and investors.

This is occurring in a world still reeling from the corporate governance scandals at Enron, WorldCom and HealthSouth in the US and which is now having to digest the Parmalat debacle in Europe. Italian dairy and food products company Parmalat collapsed in December with an estimated €8 billion (\$10.4 billion) hole in its finances. Among those held for questioning as GRR went to press were Parmalat's founder and chairman, its CFO and two staff from the firm's external auditors, the Italian arm of Grant Thornton.

### Early Signs

A December feature by Erin Klein in the *US Compliance Week* publication on disclosing material weaknesses in internal control is a wake-up call for companies that think they'll have little difficulty passing their SOX 404 exam. Klein researched a sample of disclosures related to internal control made in corporate filings to the SEC in November. It's clear that public accountants are now starting to issue "failing grades" on internal control to corporate America.

Klein cites multiple instances of external auditors, including KPMG, PwC, Grant

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Thornton, Deloitte, and others issuing failing-grade warnings to companies such as Metris Companies, a \$1.4 billion US sales credit card issuer, drilling contractor Pride International, computer hardware firm California Micro Devices and securities product manufacturer DHB Industries.

In the case of Metris Companies, for instance, the firm's financial statement notes says:

"The Company's outside auditors, KPMG LLP, issued a letter to the company's Audit Committee noting a material weakness involving internal control related to the Company's policies and procedures for valuing its retained interests."

The list of companies confessing to the SEC and the public that their external auditors think their internal controls have material weaknesses is significant and continues to grow in December filings with the SEC.

## Confessions under pressure

What is fascinating about the list is that in many of the cases reported the company does not appear to have voluntarily disclosed the control weakness. This despite these companies having filed control effectiveness representations from their CEO and CFO in quarterly 10Q filings with the SEC since SOX was passed last July. These SEC filers appear, in many instances, to have been pressured by their external auditors to disclose the control weaknesses. Some of the note disclosures related to internal control imply management didn't really agree with the external auditor's assessment of the state of their controls. In many cases the "material weaknesses" identified had likely existed for some time, and may also have been known about by the external auditors for some time. These financial statement note disclosures provide clear evidence that the rules of the corporate reporting game are changing and changing fast.

## Pass grade hard to achieve

An excellent White Paper titled *Key Elements of Antifraud Programs and Controls* issued by PwC in November provides one of the first clear signs of how hard the SOX 404 test is likely to be. Public

accountants are under tremendous pressure from the PCAOB and their own professional institute, the American Institute of Certified Public Accountants, to improve their track record in giving opinions on financial statements. Being a slack SOX section 404 grader will have severe, perhaps life threatening, consequences for public accountants trying to avoid becoming the next Arthur Andersen, Enron's now defunct auditor.

The SOX section 404 exam will be tough, the PwC paper makes clear. The key question most students want answered by their Professors, and what US listed companies should want to know as soon as possible, is just how tough will the exam be?

## Grounds for a fail

The PwC paper gives firms fair warning. PwC, for instance, will regard a company's failure to have a documented and effective code of conduct as "at a minimum, a significant deficiency and a strong indicator of material weakness".

A lack of an effective ethics hotline or whistleblower programme would be seen as a strong indicator of a significant deficiency in internal control over financial reporting, PwC says.

The failure of a firm to perform tough checks on the backgrounds of people holding sensitive jobs would also be a strong sign of significant weakness in internal control over financial reporting. A passive attitude toward fraud and anti-fraud programmes will also be seen as a major deficiency, PwC says.

A firm's failure to disclose significant deficiencies or fraud to the external auditor or its own audit committee, or to take appropriate action with regard to significant deficiencies, material weaknesses, actual fraud or suspected fraud would be a significant deficiency. It would be a strong sign of a material weakness as indicated in paragraph 126 of the PCAOB proposed auditing standard.

PwC's list is a long one. It implies that a failure on one part of the test may well be grounds for a failing grade on the whole effort. The criteria PwC sets in the paper for a pass on corporate governance controls are rigorous.

## How many can pass?

As a forensic accountant and global risk and control trainer and consultant with 25 years' experience, my conclusion is that only a small percentage of companies in the world will get a passing grade - if, and it is a big if, the criteria set out by PwC in their White Paper are strictly applied on all audits of US-listed companies. External audit partners will begin this year issuing written grades on US listed companies with fiscal years ending after June 15, 2004. Whether Ernst & Young, KPMG, Deloitte, Grant Thornton, BDO and other auditors will issue similar warnings on the grading criteria they intend to use in the SOX 404 final exams remains to be seen. At least one senior KPMG audit partner has said that she generally agrees with the pass/fail criteria for antifraud programs outlined by PwC.

## Remedial help needed fast

The control effectiveness reporting grades already issued to companies by their external auditors in the November SEC filings may be the start of a trickle that could soon turn to a flood of failing grades as external auditors turn up the heat.

Companies that are not currently achieving a true pass grade using the type of effective control standards illustrated in the PwC paper but which are nevertheless issuing "clean" control effectiveness opinions each quarter, need to seek remedial help as soon as possible or risk being called to task by their external auditors and regulators. That's not something any company wants in the current climate. **GRR**

(The PricewaterhouseCoopers' White Paper *Key Elements of Antifraud Programs and Controls* can be accessed through a link in the Industry Info/News section of [www.carddecisions.com](http://www.carddecisions.com))

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