Surviving Three SOX Opinions

SMALL BUSINESSES NEED TO RETURN TO ACCOUNTING FUNDAMENTALS AS THEY UNDERGO SCRUTINY OF THEIR INTERNAL CONTROLS.

By Wil Crawford; Bonnie K. Klamm, CPA; and Marcia Weidenmier Watson, CPA

Batter up! Small firms won't be able to dodge the triple threat much longer. On December 15, 2007, small firms (nonaccelerated filers with less than $75 million in public float) will have to comply with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). While accelerated filers (more than $700 million in public float) have been complying with SOX 404 since November 15, 2004, small firms have been exempt from these challenges. Smaller firms typically have weaker controls than larger firms do (most likely due to resource constraints), potentially making SOX 404 a huge challenge for their managers.

This article is designed to help small firms overcome the SOX challenge. To facilitate managers' understanding of the new requirements they face, we first provide an overview of the three required audit opinions. Then we analyze the deficiencies reported by a sample of accelerated filers. Understanding the deficiencies should help managers of small firms effectively and successfully plan their SOX compliance regimen.

THE THREE REQUIRED AUDIT OPINIONS

In the past, managers just had to sweat over achieving one unqualified audit opinion. Now the game has changed. Managers may be surprised to discover that SOX requires them to survive not one, not two, but *three* different audit opinions. To comply with SOX, a firm must endure the audit opinions shown in Figure 1:

New: Audit Opinion #1—Auditors express an opinion on management's assessment of the effectiveness of the company's internal controls over financial reporting.

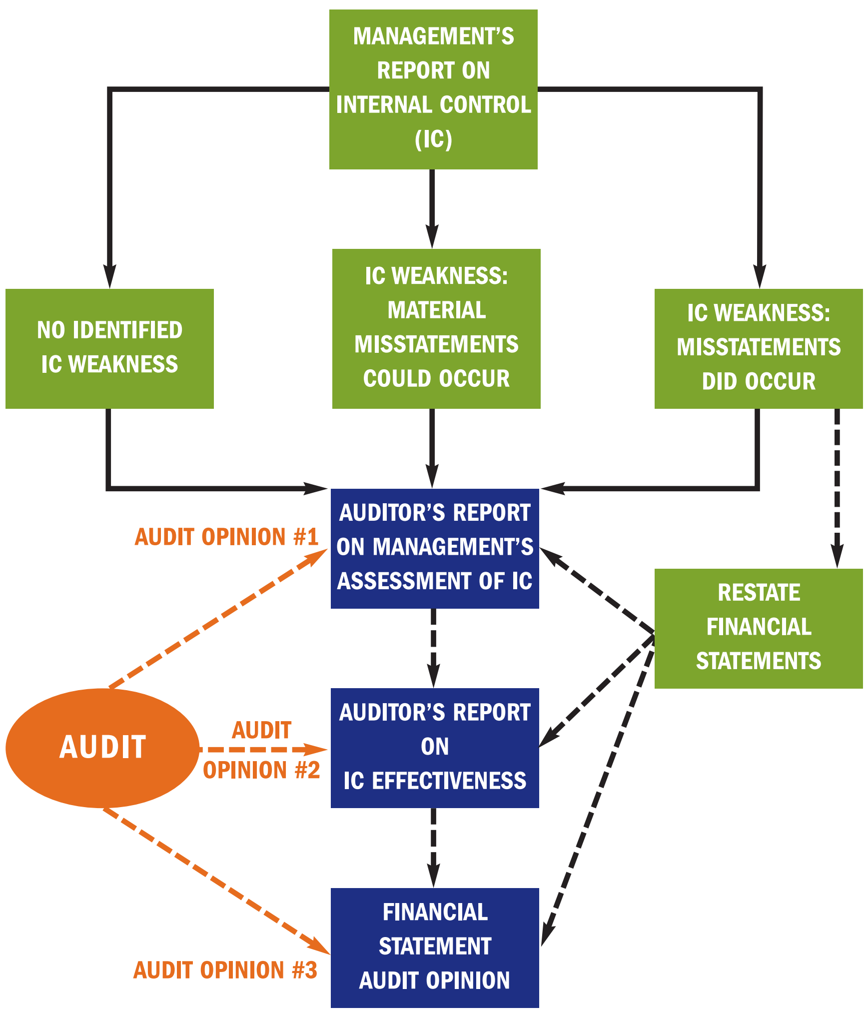
New: Audit Opinion #2—Auditors express an opinion on the effectiveness of the internal controls over financial reporting.

Old: Audit Opinion #3—Auditors express an opinion on whether the financial statements are fairly stated.

Managers must realize a very important point: The three opinions apply only to financial reporting; operational reporting is *not* included. Yet managers who aren't already doing so should extend their analysis of internal controls to operational controls with the goal of improving the efficiency, effectiveness, and reliability of internal operational reporting and business processes. The current SOX analysis of financial controls should help provide a streamlined and cost-effective process of evaluating operational controls.

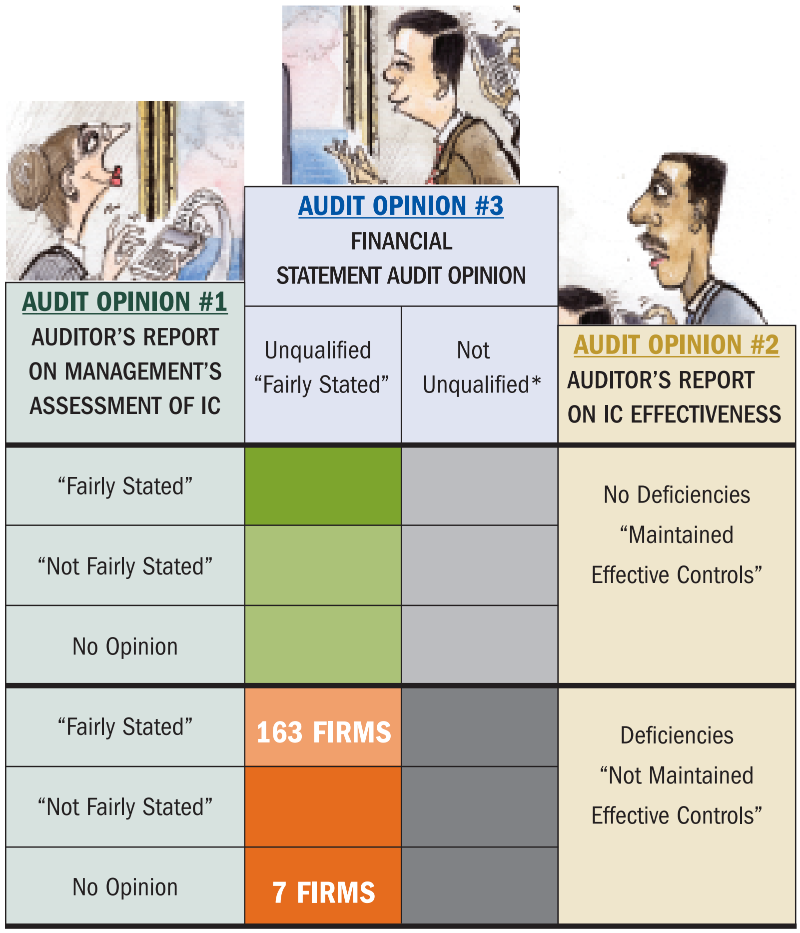
Along with managers, internal and external auditors also may be overwhelmed by the challenge of complying with SOX Section 404. Managers must understand their company's internal controls *and* report on the effectiveness of those controls, most likely with the help of internal auditors. External auditors then must attest to the accuracy of management's report as well as the effectiveness of the internal controls. If management identifies internal control weaknesses in its report, it will receive an unqualified opinion on the accuracy of the report (Audit Opinion #1) and an adverse opinion on the effectiveness of controls (Audit Opinion #2). Note, however, that the wording for Audit Opinions #1 and #2 isn't standard. Sometimes Audit Opinion #1 uses language such as management's report "is" or "is not fairly stated," while Audit Opinion #2 may attest that management "has" or "has not maintained effective controls." But regardless of the precise language used, the intent is clear. Furthermore, most managers believe that SOX 404 requires both Audit Opinions #1 and #2, but Audit Opinion #1 is required by SOX Section 404, and Audit Opinion #2 is really required by SOX Section 103.

Figure 1: SOX Audit Opinions



Thus, a company now has the opportunity to receive an adverse opinion three times! In fact, it can receive any combination of opinions as shown in Figure 2. Obviously, managers want their company to be in the dark green area, and they want to avoid the orange, gray, and dark gray areas of the figure because those indicate that the firm's internal controls aren't effective and/or their financial reports aren't reliable. To help managers pinpoint areas of concern, we examined a sample of firms that reported material internal control weaknesses. Figure 2 also shows those audit opinions.

Figure 2: Potential Audit Opinions



* *Qualified, Adverse, or Disclaimer*

FAILING AUDIT OPINION #2

Our sample consists of the first 170 firms that failed Audit Opinion #2 because they reported one or more material weaknesses in their internal controls over financial reporting. They also are accelerated filers with fiscal year-ends from November 24, 2004, through January 29, 2005. Table 1 provides an overview of the sample. Panel A indicates that all of the companies failed Audit Opinion #2 on internal controls. Yet despite these internal control problems, all companies received an unqualified Audit Opinion #3, and 163 received an unqualified Audit Opinion #1, indicating that their financials were prepared appropriately and that management's reports on internal controls were all accurate; i.e., management correctly reported the internal control deficiencies.

How do firms with internal control weaknesses receive an unqualified audit opinion? Anecdotal evidence suggests that when internal control weaknesses are found, external auditors expand substantive testing to help ensure that the financial statements are correct. Thus, it's possible to have an adverse opinion on controls and an unqualified opinion on the financial statements, but firms pay the price with increased audit fees. Therefore, managers must choose between spending money to establish internal controls now or pay the external auditor later.

How many internal control weaknesses did each firm identify? While one firm identified as many as 20, the average was two internal control weaknesses (Table 1, Panel B) even though most firms reported only one as indicated by the median value. On average, firms with internal control weaknesses misstated two accounts. The account most likely to be misstated was Other/Miscellaneous Expenses (Table 1, Panel C): 41% of our sample stated that this account had the wrong balance. Other accounts frequently misstated were Income Taxes and Leases. Most of the retail stores in our sample didn't implement Statement of Financial Accounting Standards (SFAS) No. 13, "Accounting for Leases," correctly, indicating that the standard is either too complex or not written clearly. The firms corrected their accounting based on a letter the Securities & Exchange Commission (SEC) issued to the American Institute of CPAs (AICPA) on February 7, 2005, for lease accounting in the restaurant and retail industries. To prevent future problems with new standards, managers need to ensure that a GAAP expert is reviewing new standards and the firm's implementation of those standards.

Did companies in our sample disclose their internal

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Table 1: Internal Control Weaknesses (170 firms)

Panel A: Overview

	Unqualified "Fairly Stated" "Effective"	Adverse "Not Fairly Stated" "Not Effective"	No Opinion
Audit Opinion #1: Management's Report on Internal Controls	163	0	7
Audit Opinion #2: Internal Controls	0	163	7
Audit Opinion #3: Financial Statement	170	0	0

*** No opinion indicates that a firm could not complete its assessment of internal controls.*

Panel B: Deficiencies and Misstatements

	Reported Internal Control Deficiencies	Accounts Misstated
Average	2.05	1.91
Minimum	1	0
Maximum	20	6
Median	1	2

Panel C: Account Misstatements

Other Expenses	41%	Derivatives	5%
Income Tax Payable	28%	Goodwill/Intangibles	5%
Leases	26%	Cash	4%
Other Liabilities	15%	Marketable Securities	4%
Fixed Assets	14%	Executive Compensation	2%
Inventory	12%	Retirement Benefits	2%
Other Assets	12%	Loan Loss Provision	1%
Accounts Receivable	10%	Research & Development	1%
Accounts/Note Payable	9%		

**** Percentages are rounded to the nearest integer and add up to more than 100% because a firm could have misstated several accounts.*

Panel D: Restatements

Prior Disclosure of Internal Control Weakness	5%
Restatement of Annual Financial Statement(s)	46%
Restatement of Quarterly Financial Statement(s)	33%
Restatement of Annual and Quarterly Financial Statements	24%
No Restatement but Accounts Misstated	36%
No Restatement and No Accounts Misstated	9%

controls weaknesses prior to the SOX implementation date? Approximately 5% of the sample said they did (Table 1, Panel D). And what impact did the identified weaknesses have on their overall financial statements? Forty-six percent of the firms had to restate their annual financial statement(s), 33% had to restate quarterly financial statement(s), and 24% had to restate both annual and quarterly financial statements. Thirty-six percent didn't have to restate their financial statements, but they did have to fix misstated accounts. Finally, 9% didn't have

Table 2: Explanations for Internal Control Weaknesses (170 firms)

Accounting Policies	77%
Supervision	40%
GAAP Expertise	26%
Account Reconciliation	21%
Technology Issues	21%
Insufficient Workforce	19%
Revenue Recognition	18%
Foreign Operations	15%
Period-End Policies	14%
Subsidiary	14%
Segregation of Duties	11%
Training	7%
Communication	7%
Documentation	7%
Business Combination	6%
Weak General Controls	6%
Spreadsheet Errors	5%
Weak Application Controls	5%
Senior Management Change	4%
Manual Processes	2%
ERP Design Issues	1%
Ineffective IAF	1%
Turnover	0.6%
No IAF	0.6%

* Percentages add up to more than 100% because a firm could have identified several reasons for the misstatements.

to restate their financial statements or fix misstated accounts, indicating that the identified control weaknesses weren't materially affecting their account balances. Thus, maintaining correct account balances won't necessarily save a company from receiving an adverse opinion on internal controls.

WHAT'S THE CAUSE?

Why do firms have internal control weaknesses? As shown in Table 2, the number one reason is inappropriate (or non-GAAP) accounting policies followed by lack of supervision. Surprisingly, basic accounting functions such as GAAP expertise, account reconciliations, revenue recognition, period-end policies (i.e., cutoff), and segregation of duties are also not properly implemented at many firms. This indicates that managers need to return to accounting fundamentals. If managers ensure that Accounting 101 principles are applied accurately, they reduce the chances of receiving an adverse opinion on internal controls.

Given the pervasive use of information technology via enterprise resource planning (ERP) systems and the Internet to conduct business, what impact does information technology have on internal controls? Twenty-one percent stated that they have internal control weaknesses in information technology (e.g., access and program

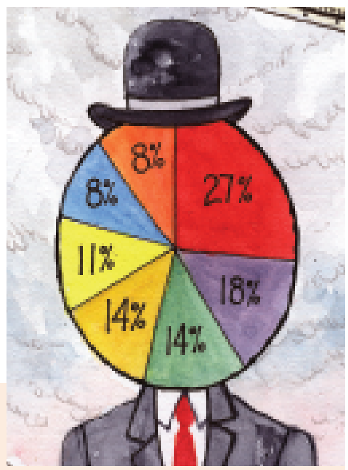

Table 3: Remediation Plans (170 firms)

Panel A: Stated Plans for Remediation in 2004 10-K

Hire new senior management (CFO, CAO, Controller, Financial Compliance, Treasurer, Tax Manager)	13%
Implementing new ERP module	6%
Implementing new ERP system	4%
Integrating existing ERP system	1%

* *A firm could be implementing more than just one remediation plan.*

Panel B: Self-Reported Correction of Internal Control Weaknesses

Reported Fixed Internal Control Weaknesses as of 2004 10-K report date	41%
Firms Reporting Internal Control Deficiencies in 2005 10-K**	19%
Firms that reported problems were fixed in 2004 but still had problems in 2005	6%

** *13 firms did not report 2005 information due to delisting and mergers.*

change control), 5% have errors embedded in spreadsheets, and 1% said that their ERP systems aren't designed appropriately. To reduce the chances of these types of internal control weaknesses, managers need to (1) extend segregation of duties principles to the systems function, (2) ensure that user access profiles are properly defined and maintained, and (3) apply documentation, verification, and security controls to spreadsheets. Even better would be to eliminate the use of spreadsheets.

How are firms planning to fix their internal control weaknesses? The most popular correction was to hire new senior management. This action supports the underpinnings of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) 1992 *Internal Control—Integrated Framework*. Specifically, COSO espouses the idea of "setting the tone at the top" or that knowledgeable, ethical management are more likely to create a sound internal control environment that in turn creates reliable financial statements. Other ways to improve the internal control deficiencies included implementing new ERP modules or complete ERP systems that support the business objectives. But managers need to remember that new ERPs should be acquired and implemented only after careful evaluation and appropriate planning because an inadequate or improper system leads to an unfavorable Audit Opinion #2. Also, managers should consider the "Guide to the Assessment of IT General Controls Scope Based on Risk" (GAIT) for evaluating IT in conjunction with business process risks (see www.theiia.org). The GAIT principles define a top-down, risk-based approach to evaluating IT controls. Thus, firms need to follow a two-pronged compliance approach: knowledgeable managers supported by sound information technology.

How did the firms perform in 2005, the second year of compliance? Well, 41% stated that their 2004 internal control deficiencies were fixed at the filing date, but a review of their 2005 internal control reports indicated that 6% of these "fixed" firms still had internal control deficiencies at the end of the next fiscal year. In addition, 18% still had internal control deficiencies during 2005.

For additional information, you can visit these websites:

www.sec.gov/spotlight/soxcomp.htm

www.sec.gov/rules/pcaob.shtml

www.theiia.org/guidance/technology/gait

Overall, these results indicate that obtaining and maintaining SOX compliance can be elusive. Just when firms think they are in compliance, new weaknesses can be uncovered. Therefore, firms need to install an embedded, continuous mechanism for evaluating their SOX compliance efforts.

BACK TO THE FUNDAMENTALS

Overcoming the SOX challenge can initially seem like an uphill battle, but the information we've just provided should help managers focus on areas that many companies are likely to overlook. Firms need to hire knowledgeable managers, and managers need to go back to accounting fundamentals: GAAP, supervision, segregation of duties, account reconciliations, and revenue recognition. Managers can also employ information technology (e.g., reconciliation software, continuous access and segregation-of-duties monitoring software) to help enforce these basic standards.

One out of every five firms was unable to correct its internal control deficiencies within the following year, indicating that some have pervasive internal control deficiencies. Fixing these deficiencies requires reformulating existing processes to incorporate needed controls. As nonaccelerated firms evaluate their controls, they may want to consider how to configure their business processes around the accounting fundamentals.

One simplification currently being considered by the Public Company Accounting Oversight Board (PCAOB) is to collapse Audit Opinions #1 and #2 into one Audit Opinion on the effectiveness of internal control over financial reporting (see www.sec.gov/rules/proposed/2006/33-8762.pdf). But whether firms are subject to one or two audit opinions on internal controls, they must implement sound accounting fundamentals to successfully overcome the SOX challenge. ■

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