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Why Sweat the Small Stuff?

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The Securities and Exchange Commission recently announced a roundtable to discuss Section 404 of the Sarbanes-Oxley law, which requires an annual assessment by public companies of their internal controls over financial reporting. Critics question whether its benefits outweigh its costs, which have been much higher than originally estimated; because of these concerns, an SEC advisory committee recently proposed total or partial exemptions from Section 404 for small companies (with market capitalizations less than $787 million). However, some commentators have strongly opposed such exemptions, since these small companies constitute 80% of all publicly listed firms and are the ones most susceptible to financial frauds.

I take a middle ground: The current rules on assessing internal controls for all public companies should be revised, greatly reducing the costs of these assessments while preserving most of their benefits. Specifically, the management of every public company would be required to publish an annual assessment of the company's internal controls, attested to by the company's auditors. But such assessments would be focused on the company's internal controls over material information contained in the company's financial reports to the SEC.

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The SEC has adopted two different requirements for internal controls. First, it has defined "internal control structure and procedures . . . for financial reporting" under Section 404 to include more items of information with more details than those ordinarily included in the financial reports of public companies. In the commission's view, internal controls must provide reasonable assurance not only that material information in the company's financial statements is accurate, but also "that receipts and expenditures of the company are being made only in accordance with authorization of management and directors of the company." By unlinking "internal controls" from "financial reporting" in Section 404, the SEC encourages management and auditors to scrutinize detailed procedures for controlling ordinary expenditures -- e.g., reimbursing travel expenses and handling petty cash -- even in cases where they are clearly immaterial to the company's financial reports.

Second, the SEC requires management to assess a public company's "disclosure controls" -- defined as "controls and other procedures . . . designed to ensure that information required to be disclosed by the issuer in the reports it files" with the commission "is recorded, processed, summarized and reported" in a timely manner. This rule on "disclosure controls" is very confusing since it overlaps with the rule on "internal controls." The SEC should end this confusion by combining both into one rule on "internal controls" over "financial reporting," which would cover the accuracy and timeliness of "material" information submitted by public companies in their financial reports to the commission.

The concept of "materiality" is traditionally judged by whether information is significant to a company's overall financial situation. However, a much broader concept of "materiality" is applied to Section 404 by the Public Company Accounting Oversight Board (PCAOB), which oversees all auditors of public companies. According to its Auditing Standard No. 2, an auditor must apply materiality "in an audit of internal controls over financial reporting at both the financial-statement level and at the individual-balance level" (emphasis added). This extension of materiality to individual balances tends to lead management and auditors to incur tremendous expense by examining controls over balances that are not financially significant for the company as a whole -- for example, reserve balances in a minor subsidiary, or inventory balances in a small factory.

The PCAOB's unduly expansive definition of materiality is exacerbated by its unduly expansive standard for assessing the likelihood of a problem occurring. According to Auditing Standard No. 2, "reasonable assurance" that internal controls are effective means that there is only a "remote likelihood that material misstatements will not be prevented or detected on a timely basis." This standard of "a remote likelihood" can easily lead to auditor concerns about internal controls based on hypothetical situations that have not occurred and are not very likely to occur. A more appropriate standard for determining that internal controls are effective would be that a problem is "unlikely to actually happen."

Suppose one employee signature is required for customer refunds under $100 and two signatures above that amount. The auditors may maintain that mishandling of small customer refunds is not "remote" because the one employee signing could, in theory, conspire with the customer to defraud the company. Yet the mishandling of small customer refunds is "unlikely to actually happen" because the one employee knows that his or her signature can easily be traced if any problem becomes evident on customer refunds.

Furthermore, Auditing Standard No. 2 states categorically: "There is no difference in the level of work performed" by the auditors when attesting to management's assessment of the company's internal controls, versus when the auditors express an opinion directly on the effectiveness of the company's internal controls. This approach leads to a high degree of redundant work: Management must test all of the company's internal controls; and the auditors can rely in part on management's testing, but only for less important areas of internal controls. A more efficient approach would be for the auditors to evaluate the design of the control systems, review the testing plan of management, and test a reasonable sample of internal controls.

In formulating their current rules, the PCAOB and the SEC were heavily influenced by an internal controls framework established in 1992 by COSO (a committee of sponsoring audit organizations). While its framework is excellent for many purposes, even the regulators recognize that, because it covers compliance with all laws and effectiveness of corporate operations, it is too broad for Section 404. COSO is now developing for small companies a control framework limited to financial reporting -- which should be extended to all public companies.

In short, instead of exempting small companies from Section 404, the SEC and the PCAOB should apply to all public companies narrower rules on internal controls. Management's assessment of internal controls should focus on the material information contained in the company's reports to the SEC, and the auditors should attest to management's assessment by reviewing its processes and sample testing. Both should apply the traditional concept of materiality -- financial significance relative to the whole company. In this manner, Section 404 will be very helpful in preventing material misstatements in a company's reports to the SEC, but at a much lower cost.

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