BNA INC.

CORPORATE ACCOUNTABILITY REPORT

BNA Employee-Owned Since 1947

VOL. 8, NO. 44 | NOVEMBER 12, 2010

Internal Controls

SOX 404 Compliance Is Proving Beneficial To Small Cap Companies, Research Suggests

Public companies that are wary of the criticisms expressed by many businesses over compliance with the 2002 Sarbanes-Oxley Act's Section 404 should take heed of recent research that shows that SOX 404 compliance efforts are helping certain companies produce higher-quality financial reports, Albert L. Nagy, an accounting professor at John Carroll University in University Heights, Ohio, told BNA Nov. 5.

According to Nagy, the results of a study on financial reporting quality and SOX 404 compliance—published September 2010 in the American Accounting Association's journal, Accounting Horizons—show that the SOX 404 compliance effort reduces the likelihood of issuing materially misstated financial statements.

The study was conducted on a sample of companies that surround the SOX 404 compliance threshold—a market capitalization of about $75 million, so the results of this specific study may not extend to larger companies, Nagy said. ''However, I do not see why the results would not apply to organizations with larger market caps,'' he said.

Compliance with SOX 404 requires companies to document and report on their internal controls over financial reporting. Sarbanes-Oxley also requires auditors to report on corporate managers' assessments of a company's internal controls. This year's Dodd-Frank Act permanently exempts a significant number of public companies—with less than $75 million cap—from a key provision of SOX 404 that requires an outside auditor to attest annually to the internal control evaluations of an organization.

The Securities and Exchange Commission Oct. 14 requested public comment on a study on how it can reduce the compliance burden under SOX 404 (8 CARE 1148, 10/22/10).

Compliance Is Boosting Financial Reporting. The study on SOX 404 compliance suggests that the SOX 404 regulation is meeting its objective of improving the quality of financial reports, Nagy said. The study found that 20 percent of the financial reports from noncomplying companies had to be reissued because of material misstatements compared to only 14.5 percent of the reports from compliers, he said.

The results of the study show that noncomplying companies were almost 40 percent more likely than compliers to restate their financial reports, Nagy said.

The difference between the number of misstatements between non-compliers and compliers can also be attributable to factors other than purely SOX 404 compliance, Nagy said. ''Companies that had four successive quarters or more of earnings growth, firms that recently experienced losses, and companies that acknowledged material weaknesses in their internal-control systems all were especially prone to misreporting,'' he said.

Compliance with SOX 404 was phased in over time, with companies below $75 million cap initially exempt from the rule, even while subject to other provisions of SOX, Nagy said. ''This temporary exemption created a group of complying companies, with capitalizations above the threshold, and a second group of noncomplying companies, with capitalizations below that line,'' he said.

''The study's sample included about 1,000 firms capitalized within $50 million of the threshold—one group capitalized at $25 million to $75 million and the second at $75 million to $125 million. Firms were observed over two years from 2005-2006, when they issued a total of 1951 financial statements—375 of which had to be restated,'' Nagy said.

Costs Are Still Problematic for Companies. Many companies still struggle with whether the benefits of SOX compliance outweigh the costs of implementation, Nagy said. ''Whether improvements justify the expense companies incur as a result of compliance is something that this study cannot answer,'' he says.

''However, given the progress that regulators have made over time in enforcing the rule efficiently, the findings in this study may serve to moderate the controversy and criticism that SOX 404 has faced since its adoption,'' Nagy said.

According to Nagy, the study suggests that enforcement of SOX 404 compliance is necessary because evaluations of internal controls are subjective. It is questionable whether companies will perform quality assessments without the auditor-attestation requirement, he said. The fact that Dodd-Frank permanently exempts small companies from having an independent auditor attest to their internal-control assessments may prove to be problematic in the future, he said.

The Dodd-Frank small firm exemption will require regulators to keep a sharp eye on the financial reporting of small cap companies, Nagy said. ''Although these

COPYRIGHT © 2010 BY THE BUREAU OF NATIONAL AFFAIRS, INC. ISSN 1542-9563

companies do not dominate the market in terms of capitalization, it is significant that they represent the largest number of public corporations,'' he said.

''These companies have the potential of harming investors if the financial information they report is inaccurate or even misleading,'' Nagy said.

BY TINA CHI

Professor Nagy's study is available upon request at http://link.aip.org/link/ACHXXX/v24/i3/p441/s1.

COPYRIGHT © 2010 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

ISSN 1542-9563