COMPLIANCE WEEK

404 Disclosure: Experts Say Get In Front Of The Issue

By Susan Schott Karr — February 15, 2005

Get in front of it while you can. That's the message from experts regarding the disclosures of potential adverse opinions stemming from Section 404 of The Sarbanes-Oxley Act of 2002.

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As we covered last week in our analysis of internal control disclosures made during the month of January 2005 (see box at right), companies are beginning to disclose that they have been informed by their auditors that they might fail their internal control assessments.

Though the numbers are still small, the fact that companies were beginning to warn of *potential* SOX 404 failures was met with raised eyebrows by many in the corporate disclosure community. We decided to ask some controls and disclosures experts what they were recommending to companies, and what regulators might expect.

DeLoach

"The overriding principle—to put it all in perspective, whether for Section 404, 202 [audit committee pre-approval of services], or 409 [new "real-time" 8-K rules]—is transparency," says Jim DeLoach, a managing director at Protiviti. "It's what the Sarbanes-Oxley Act is about."

DeLoach emphasizes the importance of the Act's mandate that companies provide full and fair disclosure of material information to their investors. The Act's stated mission is "to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws."

Beller

"Investors have every right to expect not only strong internal controls but also good disclosure about issues regarding those controls," said Allen Beller, SEC director of the Division of Corporation Finance, in a recent speech. "The importance of the law and the regulations issued by the SEC is to really put an emphasis on the underlying processes that companies have that support public reporting."

Full and fair reporting existed long before the Sarbanes-Oxley Act. It has always existed under SEC laws. "Companies have always had internal controls related to financial reporting and have been required to have them since the adoption of the Foreign Corrupt Practices Act," said Beller.

Disclosure Of Adverse Opinions?

Wolff-Reid

According to Maureen Wolff-Reid, president of investor relations firm Sharon Merrill Associates, companies should get ahead of the issue as quickly as possible, potentially by issuing a press release. "When faced with an adverse opinion in an internal controls report," says Wolff-Reid, "a company should respond in a timely manner as it would in any crisis situation: openly and honestly. We would recommend that the company issue a news release explaining any deficiencies and/or weaknesses in its internal controls and, most importantly, what actions management is taking to correct the problem."

That shouldn't be a surprise, as companies are already required under SOX 302 to disclose problems and material changes to controls; however, doing so via press release—instead of reporting the problem on Form 8-K or required periodic filing—is considered by some as unconventional or even unnecessary.

White

Others recommend disclosing problems in earnings releases. Wilmer Cutler Pickering Hale and Dorr partner Thomas White, for example, suggests taking the following steps when companies find their internal controls are not effective:

1. Provide advance disclosure, in earnings releases or an 8-K, once it's determined that an assessment or the auditor's will be that internal controls over financial reporting are not effective. Disclose as soon as you make a determination that's where you're going to come out, even when the disclosure is not required.

2. In the disclosures and in the 10-K reports, identify the weaknesses or deficiencies that that led to this

conclusion; explain how they could affect the accuracy of financial statements; and describe the steps taken to remediate them. Consider the following questions:
  - What's the nature of the deficiency or weakness?
  - How did it come about?
  - What is the impact on the financial reporting and flow through to revenues?
  - What's the company doing to remedy it?

3. Provide ongoing disclosure in subsequent reports about whether deficiencies have been remediated, or the progress made in that direction.

According to White, issuers also need to think about how material weakness disclosures might affect other parts of the filings, such as MD&A, risk factors and critical accounting. "These disclosures need to be thorough and careful," says White. "They should contain reasonable detail, but not be obfuscatory." Although the material covered may be technical in nature, "Companies need to avoid the temptation to hide the ball."

Regulatory Expectations

Those recommendations are line with comments made by Securities and Exchange Commission staffers, who in recent speeches have urged companies to provide clear and complete disclosures.

Bailey

Andrew Bailey, deputy chief accountant of the SEC, drove home this thought in a December speech at an accounting conference when he said, "I want to remind registrants that they need to provide complete, robust, and transparent disclosures—don't try to 'disguise' or 'pretty up' your material weaknesses—provide a full explanation of the weakness in question and any remedial action that have occurred or will occur so that investors can determine for themselves the severity of the weakness."

White at Wilmer Cutler Pickering Hale and Dorr believes the SEC is looking closely at the nature of the disclosure, and that the Commission wants to see a fairly careful and descriptive explanation of what the deficiency or weakness is. "This is new for everyone," says White. "The SEC is probably developing their views as they review." Since this is a new process, however, the SEC's approach is likely to be influenced by what they see in terms of disclosures across many companies.

Nevertheless, White stresses, they will be screening carefully.

Jim DeLoach at Protiviti adds that the Commission will likely be looking at all forms and disclosures utilized by public companies. "The disclosure model has a variety of different aspects to it: periodic reports—10-Qs, 10-Ks, and the rapid reporting model supported by Form 8-K," he says. "The elements of the disclosure model—annual and current—are the tools management uses, supported by their board, to fulfill that mandate to provide full and fair disclosure to the investing public. They [the SEC] expect to use elements of the disclosure model to provide full and fair disclosure," he adds.

And DeLoach believes regulators are dead serious about it. "Anyone who doesn't focus on full and fair disclosure to investors is in the wrong game," says DeLoach. The bottom line: "If you're a public company, you had better do it or get out of the game."

Wolff-Reid adds that, "By communicating in a straightforward and concrete manner about the corrective steps being taken, the company can maintain credibility with investors. Based on the type of deficiencies or weaknesses, the company should provide periodic updates, as appropriate, in its quarterly news releases and SEC filings."

Disclosure Controls Weigh In

How may internal control deficiencies or weaknesses relate to—and possibly call into question—the effectiveness of disclosure controls and procedures? According to White, that's one issue the SEC staff has raised, and it's one issuers have to consider.

"If they [the SEC] see there is a deficiency that's been disclosed, that may cause them to scrutinize prior-year financial reporting more thoroughly than they would have otherwise," says White.

And they may question if prior-period disclosure controls were effective, which could lead to a heightened degree of scrutiny from the SEC.

One practice White thinks the SEC staff has noted is that companies are adding to periodic reports "boiler plate" language to mitigate risk. In many cases, the new Risk Factors state that "no system of internal controls can guarantee there are not going to be financial statement misstatements, and there is a risk that will happen."

White adds the SEC is objecting to such stabs at disclaiming the importance of full disclosure. This tactic is perceived as an attempt to provide cover when controls don't prevent a misstatement. If there is a misstatement, it will in turn lead to an inquiry. And, says White, then the question becomes, "Why didn't your controls prevent that if your controls were effective?"

White recommends avoiding boiler plate at all costs, as well as going a step further by customizing statements to particular situations.

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