"Permanent exemption" from SOX 404(b) for smaller reporting companies

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On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as the Wall Street Reform Act), which represents an overhaul of the regulation of US financial markets. The Dodd-Frank Act includes a number of specific provisions that are applicable to Securities and Exchange Commission (SEC) registrants. One of the provisions of the Dodd-Frank Act permanently exempts small public companies with less than $75 million in market capitalization (non-accelerated filers) from the requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX) which requires the company to obtain an external audit and provide an attestation report by the external auditor on management's assessment of the company's internal controls over financial reporting. However, management of a smaller public company is still required to evaluate the company's internal control over financial reporting under existing Section 404(a) of SOX and to disclose the results of that evaluation. Disclosure of management's report, signed by the CEO and CFO, must still be made each time that the company files a Form 10-K or 10-Q.

So if Section 404(b) is out for these non-accelerated filers, but 404(a) is still in, what does this rule change really mean to a smaller public company? The answer is: not as much as you would expect.

Although the Dodd-Frank Act eliminates the requirement that the external auditors provide an opinion about the internal control over financial reporting, they are still required to perform a "risk based" audit of the financial statements. This means that during their audit of the financial statements, the external auditors should perform an assessment of the control environment, IT general controls (as part of SAS-94), and fraud risks (as part of SAS-99). They should also request to see the actual documentation of the assessment performed by management per Section 404(a) and used by management to reach their conclusion.

During this risk based audit, if the external auditors come across any control weaknesses that they deem to be material weaknesses that have not been disclosed by management in their assessment, or if management has not performed an assessment of internal controls altogether, or their assessment is clearly inadequate, the external auditors must discuss this matter with management and the Audit Committee. If the external auditors continue to have a substantive disagreement with management, the external auditors are required to disclose this in their audit report to shareholders.

In summary:

- The CEO and CFO of a smaller public company must still certify regarding their internal controls over financial reporting.
- The external auditor must still evaluate a smaller public company's internal control over financial reporting in connection with its audit, even though no actual audit or audit opinion is required.
- If the external auditors determine that management's assessment is incorrect or that management did not perform any assessment, the external auditors must report or disclose that determination.
- Notwithstanding the evaluation of internal controls over financial reporting by the external auditors, the CEO and CFO will still be responsible to the SEC and the company's stockholders for the accuracy of their certification regarding those controls.

Consequently, notwithstanding the permanent exemption from Section 404(b) for smaller public companies, these companies will still need to maintain and assess their internal controls over financial reporting. ✦

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