



Section 404 Overview For Small Businesses (non-accelerated filers)

Presented to
The SEC Government-Business Forum on
Small Business Capital Formation

by
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New Requirements - Section 404

- **Company Management** - now required to both assess and report on the effectiveness of Internal Control Over Financial Reporting (ICOFR).
- **Independent Auditors** - required to audit and report on the effectiveness of internal control over financial reporting, including management's assessment process. Thus, the company's independent auditors will now be evaluating and testing the company's internal control differently and in much greater depth than previously required for their audit opinion.

Definitions of Internal Control

General - a process designed to provide reasonable assurance regarding the achievement of company objectives in the areas of;

1. Financial reporting
2. Operating efficiencies and effectiveness, and
3. Compliance with applicable laws and regulations.

Internal Control over Financial Reporting (ICOFP) - consists of a company's policies and procedures that are designed and operated to provide reasonable assurance that the company's financial statements are both reliable and fairly present the financial results of its operations for the period.

Responsibilities under 404

- **Company Management**
- **Independent Auditors**
- **Company Board of Directors**

Management Responsibilities

Company management is responsible for;

1. **Establishment** of effective Internal Control Over Financial Reporting (ICOFR).
2. **Evaluation** of the effectiveness of internal controls over financial reporting using suitable control criteria (e.g. Committee of Sponsoring Organizations standards – COSO standards).
3. **Developing evidence** (including documentation) for outside auditors to review & test the financial reporting internal controls
4. **A written assessment** (to be included in the company's annual report) about the effectiveness of internal control over financial reporting as of the end of the company's fiscal year.

Auditor Responsibilities

The Company's independent auditors are responsible for;

1. **Evaluating** management's assessment process.
2. **Understanding** management's internal controls policies and procedures.
3. **Testing and evaluating** the design and operating effectiveness of management's controls.
4. **Issuing an opinion** (or disclaiming an opinion) on the effectiveness of management's controls.

Board Responsibilities

Section 404 does not impose any specific additional responsibilities on a company's Board of Directors.

However, the Board has general responsibilities for oversight of company management and, through its Audit Committee, the direct responsibility for the engagement and oversight of its outside auditors*. Thus, Board members must have an understanding of Section 404 requirements in order to perform these oversight duties.

*The independent auditor's evaluation process is required to include an evaluation of the effectiveness of the Board's Audit Committee.

Management's Report under 404

Management's report (included in its annual 10K filing) is required to include the following;

1. A **statement of management's responsibilities** for internal control over financial reporting.
2. A **statement identifying the internal control framework** used to conduct the effectiveness of internal controls.
3. **An assessment** of the effectiveness of internal controls as of the end of the company's most recent fiscal year, including an explicit statement as to whether internal controls are effective.
4. **A statement** that the auditors have issued an attestation report on management's assessment of the company's internal controls.

Auditors Report under 404

- **Disclaimer of Opinion** – Auditor can not form an opinion due to lack of supporting evidence for Internal Control policies and procedures.
- **Qualified Opinion** – when internal controls deficiencies or weaknesses are judged by the auditors to not have the potential to result in material errors in the company's financial reports.
- **Unqualified Opinion** – when there are no identified material weaknesses and when there have been no restrictions of the scope of the auditor's work.
- **Adverse Opinion** – The existence of a material weakness results in an adverse opinion (i.e. internal controls are not adequate to prevent material errors in the company's financial reports.)

404 Compliance Timeline

Most small businesses (“non-accelerated” filers) have the following reporting deadline

- Report on effectiveness of internal controls as of the end of the company’s first fiscal year ending after April 15, 2005* (e.g. fiscal years ending April 16, 2005 or after)
- Report (and accompanying independent auditor’s report) is to be included as part of the of the company’s 10K filing.

* “accelerated” filers: fiscal year after June 15, 2004

Non-accelerated Filers

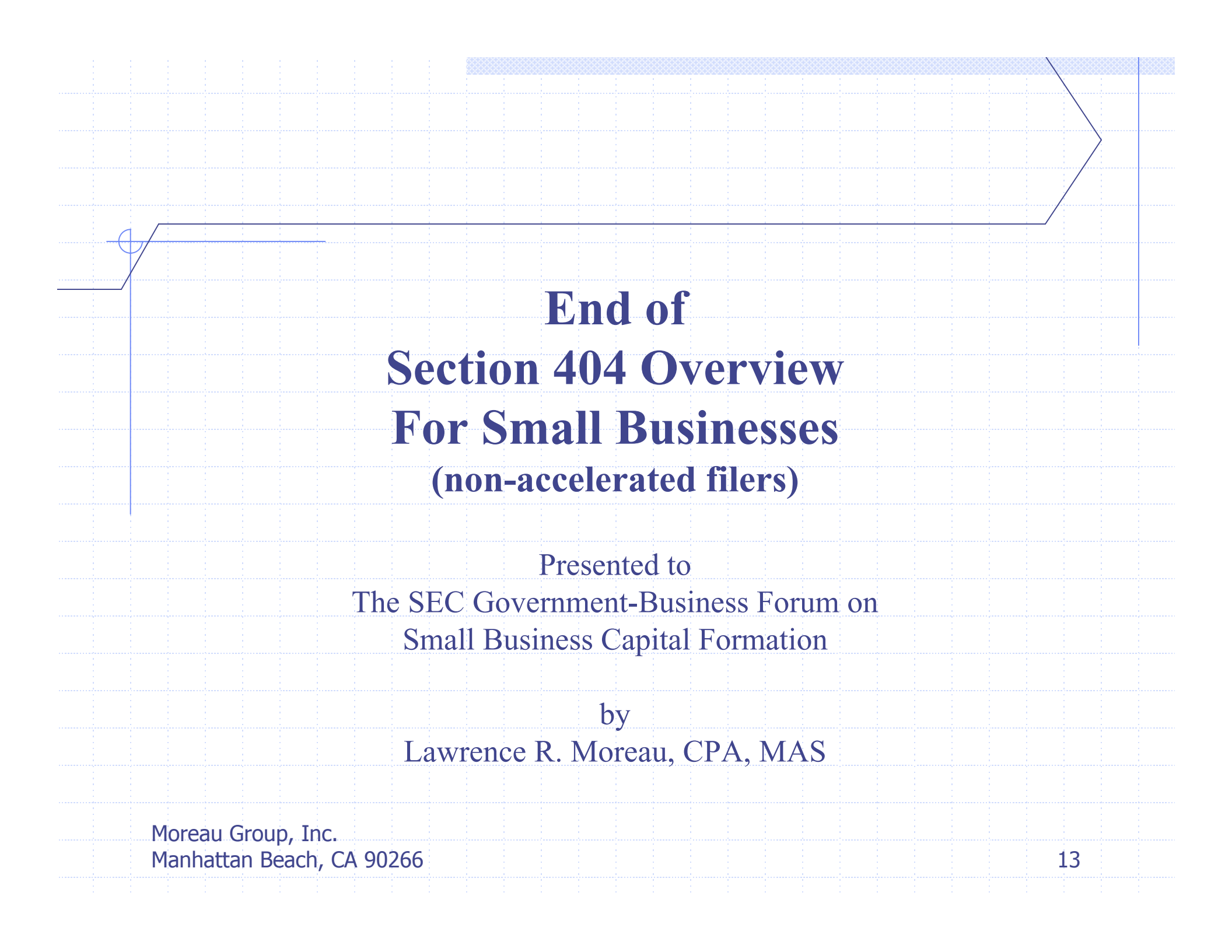
A company is not an accelerated filer if:

- Common equity float is under \$75 million; or
- Been public less than 12 months; or
- Not yet filed at least one annual report on Form 10K

Penalties for Noncompliance

•At present, although companies are required, by law, to comply with Section 404 there are no specific penalties if a company is not compliant. However, there are implied penalties, among these are;

- Sanctions by the SEC
- Delisting by SOR's
- Assignment of higher risk, thus lower stock market value by investors.
- Investors lawsuits for mismanagement.



**End of
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