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The roadmap to implementing SOX compliance

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Whether you look at Sarbanes-Oxley as excessive and Orwellian, or as much-needed enforcement of industrial checks and balances, you're ol' buddy SOX isn't going anywhere. SOX has moved into the spare bedroom, watches movies until late at night, and raids the fridge on a nightly basis–and there's not a thing you can do about it.

Of course, most of the older public companies are used to their compliance guest that eats the good leftovers at 2 am, despite them being well hidden underneath romaine lettuce and old(ish) celery deep within the vegetable crisper. They've become accustomed to SOX's eccentricities and have adapted to them.

Companies new to SOX, however, are a much different story and might have a steep learning curve ahead of them if not deliberate and patient. In other words, if you think section 404 is a new sci-fi thriller rather than an immensely important component of SOX compliance, we urge you to continue reading.

As you've probably already surmised, the financial gurus here at Embark are ready, willing, and able to help companies new to SOX compliance find their footing, establish sound processes and procedures, and learn to live with a permanent, often annoying, but well-intentioned house guest. We might not be able to help you evict SOX but, with an organized approach, the good leftovers will never be swiped from you again.

Section 404(b) and you: a cautionary tale

No matter if you view Sarbanes-Oxley as a necessary system or an example of excessive regulation, SOX is an incredibly important part of compliance for every public company and must be given proper attention. One of its pillars, section 404(b), establishes an internal set of checks and balances that, at least in theory, helps keep the industrial machine as smooth, consistent, and equitable as humanly possible.

Specifically, 404(b) establishes procedures that allow public companies to gauge the effectiveness of their internal controls for financial reporting purposes. To accomplish such a task, SOX mandates that auditors for all publicly held companies must attest to, and report on, management's assessment of internal controls. Those controls must be documented, tested, and maintained to ensure lasting effectiveness.

If you're a new public entity with your first 10K hot off the presses or an emerging growth company (EGC) that just passed your five-year mark, Embark has some good news and bad news. Assuming you want the bad news first–you are expected to comply with 404(b), and that's all there is to it. But now the good news–it's not nearly as overwhelming as it might sound if you pay close attention and let your friends here at Embark walk you through the paces.

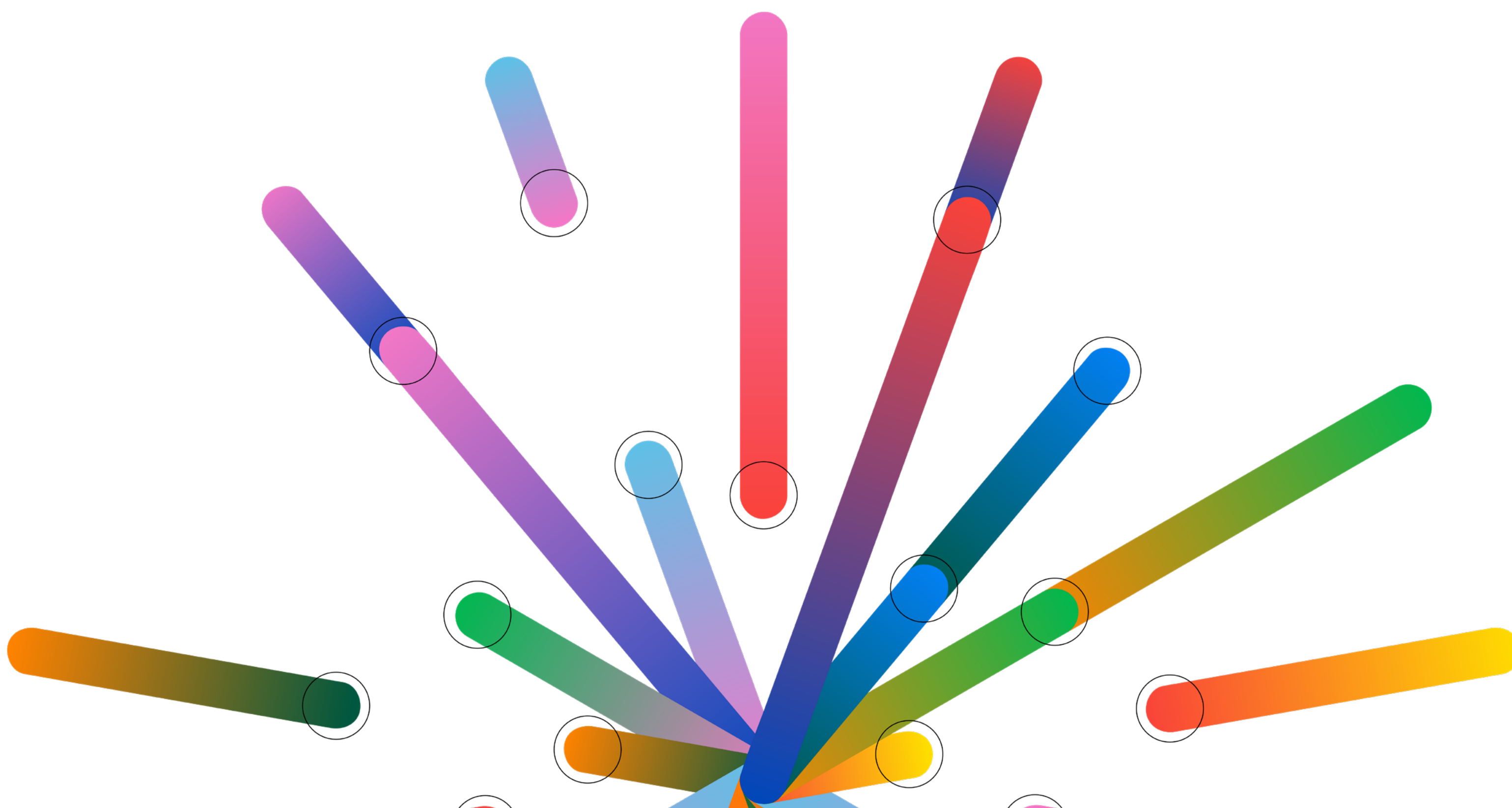
Determine materiality

As an essential first step towards SOX compliance, you must first get an accurate lay of the land. Of course, it's always important to understand your own business but, from a SOX perspective, that understanding becomes an absolute necessity. If your company has different locations or segments, you must first figure out which of those would be material enough to require a control environment that is SOX compliant.

From there, establish your materiality marks. While they are often dependent upon the industry you operate within, common benchmarks are revenue, operating cash flow, total assets, or profit before taxes. Hypothetically, ask yourself if $200,000, for instance, is going to make a substantial difference to the company overall. If the answer is no, you might only test for line items over $400,000.

Since the entire process has a distinct murkiness to it, Embark strongly encourages you to sit down with your auditors since they, above all others, understand the ins and outs of materiality better than anyone else and can advise you what benchmarks to use for your own SOX compliance. Taking this approach would also help you avoid a worse case scenario–scoping out your own materiality only to have your auditor disagree and decide that something you believed wasn't material actually is.

If something is too close to call and you don't want to risk your auditor coming to a different conclusion than your own, sandbag the item and bring it into the scope to avoid that unsavory predicament. Along the way, always make sure you have a direct line of communication with your external auditors that can establish and maintain a sense of trust between you, your work, and those ever-important auditors. Without that trust, the wheels can come off quickly and catastrophically.



Scope line items

Once you've completed the highest level of scoping, proceed with a more granular approach and scope each line item individually, including fixed assets, AR material, and other essential line items. Determine which of the line items are considered material to become even more focused on your material environment. This is an instance where getting it right the first time will save you mountains of time, resources, restlessness, and general irritability on the backend.

Identify the risk of material misstatements

Once you've completed both the higher level and granular reviews of the line items, the next step is to identify the risk of material misstatement for each of them. In a perfect world, misstated line items never occur, gas never rises above $2.50 per gallon, and jalapeno poppers don't liquefy your intestines. Unfortunately, this is not a perfect world and line items can and do get misstated. Maybe you accidentally skip a couple of entries on a listing of fixed assets. Obviously, this is not ideal but still a distinct possibility. Try to identify the possible sources of such misstatements to minimize the chances of them occurring in the first place.

Identify controls

You scoped your line items, identified the risk of material misstatements, and are ready to proceed into SOX nirvana. Your next step is to identify controls that would mitigate those sources of risk. Remember, this doesn't necessarily mean you need to reinvent the compliance wheel–one control could very well mitigate a single risk, 20 risks, or anything in between. No matter how simple or complex your controls end up being, you'll always need buy-in from the top of the organization to ensure you have everything you need for your plan. Without that buy-in, people simply won't adhere adequately enough to the controls.

Be deliberate with your steps and go through the different walk-throughs with all of the process owners, so you fully understand all of the necessary processes within the organization and document each one sufficiently, identifying all needed controls for every process. To use a previous example, let's say you find a risk of material misstatement around the thoroughness of a fixed asset process, identifying a needed control to verify the completeness of that fixed asset listing to the subledger.

Without that control added to your risk assessment, you would have a gap in the control environment and expose the process–and entire organization–to unnecessary risk. Along the way, you must also decide if the control is designed appropriately and precise enough to mitigate the risk. If you do in fact end up with gaps in your control environment, you must create sufficient controls to close those gaps–something that will take some time and patience.

Once your risk assessment is complete, all line items appropriately scoped, risk of material misstatements identified, and controls mitigating those risks of material misstatement in place. Depending on the number of line items you have or how complex your organization is, this could take months or maybe even years. Given that significant investment in time, it's incredibly important to have auditors concur with your choices and decisions as you proceed.

Likewise, the prolonged process makes it crucial to start as early as possible. Interim testing can typically occur throughout june and july, while year-end testing occurs during the third and fourth quarters, carrying over into the next year. This timeline allows for better coverage of the control environment and testing procedures.

To that point, testing operating effectiveness–OE testing–makes certain controls are performing as they should. Remember, once all of the new controls are in place for the first time, control owners will inevitably make some mistakes, so it is incumbent upon you to identify where the issues are so control owners can promptly fix them. Life will be much easier if you can get a healthy head start on your OE testing and take advantage of the time you have to fix ineffective controls before SOX compliance becomes an official, heavy-handed way of life for your company. You don't want your first go around with OE testing and your auditors to take place once you're officially SOX compliant because there will inevitably be bumps in the road.

SOX compliance is somewhere between a walk in the park and digging ditches beneath a sweltering summer sun. Granted, that probably doesn't do much to soothe your fears but, as with many things in business, your results are entirely dependent on how meticulous and organized you are with your preparation. Start your planning as soon as possible, particularly with your line item scoping, and plan ahead as far as you can. Be smart, be careful, and precise with the steps you take, and pesky ol' SOX will be a slightly annoying but eminently agreeable house guest that you can easily learn to live with. Scout's honor.

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