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# Spring 2005 ProCognis Newsletter

***Late breaking SEC developments of interest to Public Filers and related parties***

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## SEC Delays FAS123(r) Implementation

The SEC has delayed the implementation of the rule that requires companies to expense stock options. The FASB rule (SFAS No. 123(r)) requires companies to begin expensing options as of the beginning of the first *period* after June 15, 2005. For most companies they would have to begin expensing as of July 1, 2005.

The SEC has allowed their registrants to delay implementation until the beginning of the next *fiscal year*. This would mean that a calendar year-end company could delay implementation from July 1, 2005 to January 1, 2006. The date conflict reflects the differing positions on the implementation of FAS 123(r) between the two organizations.

For many companies, options were granted under the old SFAS No 123, which allowed companies to choose between either expensing or disclosing the potential earnings impact. Most companies chose the disclosure method and issued options assuming this method would be available to them in the future.

The new FAS123(r) not only requires all future grants be expensed but also requires that expense be recorded related to options previously granted, to the extent they vest after the implementation date for FAS123(r). The additional time, will allow more of the old, pre FAS123(r) grants to become fully vested and thus minimize the amount of expense companies are required to recognize. Additionally, it eliminates the partial year expensing of options, allowing for more clear reporting of the earnings impact of the new rule.

## SOX 404 Lessons Learned from the Accelerated Filers

Now that the largest public companies have been through their first year of SOX 404 compliance, how can non-accelerated filers learn from their experience?

Firstly, many have been impressed with the restraint shown in the stock market. There was a general fear that any problem in the first year of implementation would lead to a precipitous downfall in the disclosing company's stock. Fortunately it appears that investors have shown the ability to distinguish isolated problems from significant or widespread problems.

Those companies with isolated problems have had only mild stock impact. However, those with disclosure indicative of widespread, systematic or management related weaknesses experienced significantly more

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volatility in their stock as a result of the disclosure.

Overall the costs and effort were *much* higher than anticipated—in many cases double or triple the initial estimates. The reason for these overruns was in part deferred maintenance, as companies had spent little time on improving or documenting their internal control systems, policies and procedures over the past decade. Additional reasons cited were lack of guidance and a steep learning curve.

Identified deficiencies were more frequent than previously anticipated, with many companies reporting well over 200 deficiencies. The time and effort to manage, correct and re-test these deficiencies was also a significant factor in the high cost of initial implementation.

> *…Both management and external auditors must bring reasoned judgment and a top-down risk-based approach to the 404 compliance process…*
>
> Quoted from SEC Release 2005-74

An unintended consequence of the implementation is that the quality of the communication between auditor and client suffered. Implementation of SOX 404 impaired open debate regarding accounting issues and many felt that this had a detrimental impact on the quality of financial reporting.

In some cases it created a combative environment and in other cases the lack of a free and open debate regarding issues had a negative impact on the timeliness of financial reporting.

The SEC has identified a number of possible areas for improvement. They include guidance on how to evaluate results, increased focus on a risk-based approach, the use of rotation plans, leveraging the testing performed by management to reduce duplication of effort, and promoting dialogue between auditor and client.

We anticipate action in these areas in the next few months and we will keep you informed as new guidance is provided.

## Are you SURE you're still a Non – Accelerated Filer?

Even if you didn't qualify as an accelerated filer in 2004, that doesn't guarantee you will keep this status until 2006. Each year your status must be evaluated on the last day of your second quarter (June 30, 2005 for calendar year end companies). Companies who meet the standard (generally over $75 million in public float) must meet the requirements for accelerated filers by their next fiscal year end (December 31, 2005 for calendar year-end companies). For companies who were non-accelerated filers in 2004, but became accelerated filers in 2005 they will have six months to achieve compliance with SOX404.

It doesn't end there, beginning with their 10-K, they will also have to meet the shortened filing requirements that apply to accelerated filers. As a result companies should monitor their shares outstanding and market price and document their market capitalization on the measurement date. Companies in risk of going over the $75 million in market cap should already be diligently working to achieve compliance with SOX 404.

If the company retains non-accelerated filer status (market cap less than $75 million) you will be able to use the work performed towards next year's

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compliance effort. If you do go over, you will be looking at a tough six months ahead of you and will be glad you got an early start.

It should be noted that the market cap limit of $75 million will not adjust for market valuation or inflation. This means that over time, more companies will become accelerated filers and diligence will be required to monitor your status.

## Why Use a Risk-Based Approach?

Our Sarbanes-Oxley 404 Compliance Tool utilizes a risk-based approach. Other products use a "controls" or "financial statement line item" approach.

Our concern with these approaches is that they focus on what is already in the financial statements, and not what should be there. This is like an auditor who tests for overstatement but not understatement.

It should be remembered that Enron failed to record liabilities related to certain off-balance sheet transactions. It was not what was on the books, but what should have been on the books that brought about their downfall.

Our approach starts with systems (such as Payables or Inventory). Each system has a series of associated steps or processes. Each step or process in turn has unique risks associated with it.

For each risk their must be at least one control in place to prevent that risk from occurring. Simply put, controls exist to prevent risks. Without risk, there is no need for controls.

The SEC has indicated a preference for a risk-based approach and we believe that this method will become a more integral part of the 404 compliance process.

Regardless of what tool or method you use to achieve compliance, you should find a way to integrate risk into your compliance process.

We feel that evaluating controls without considering the underlying risk(s) will result in an incomplete picture of your company or organization.

Additional information can be found at http://procognis.com/404.php

## About the Author

Lynda Radke is a graduate in Business Economics from UCSB with an emphasis in accounting. She is ex-Deloitte&Touche and entered the private sector and quickly rose as the CFO of a publicly traded Bank holding company. There she spearhead FDICIA compliance and has extensive experience with the COSO framework. Currently she is the co-founder of a software and professional services startup (ProCognis, Inc.) and specializes in financial reporting and SEC matters including Sarbanes-Oxley compliance.

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