

COMPLIANCE WEEK

THE LEADING INFORMATION SERVICE ON CORPORATE GOVERNANCE, RISK AND COMPLIANCE

Market Caps Tumble, but Audits Remain Costly

By Tammy Whitehouse — February 3, 2009

Smaller public companies with tumbling market capitalizations in 2008 may be able to enjoy a year of reprieve from an internal control audit—but that doesn't mean they should expect a break in the audit bill.

The internal auditor at one small technology company (who asked not to be identified for this article) tells the typical story. He watched his company's market cap nosedive last year to less than \$50 million, and according to compliance rules for Sarbanes-Oxley, that means his company is exempt from the Section 404(b) requirement to get an auditor's opinion on its internal controls over financial reporting.

The internal auditor then asked his audit firm what kind of savings he should expect in his audit costs this spring. "The auditors are saying we're only going to reduce the cost by a fraction of a percent," he says. "That just doesn't make sense."

It's a odd circumstance for some smaller public companies: They had to comply with Section 404(b) in prior years, will *not* need to comply with it this year because of the market crash, and then presumably will need to start complying again next year, because the rules are slated to change yet again and apply to all public filers regardless of size.

The Center for Audit Quality pointed out the predicament in a recent alert to auditors. Nobody knows precisely how many companies face this scenario, but it begs the question: In the single year when certain filers will be allowed to skip the internal control audit, should they expect their auditing firm to do the same and submit a smaller bill?

The internal auditor at the small tech company says tensions are simmering over the fee for several reasons. Auditors are seeing some pricing pressure on audit work generally, now that internal control reporting is becoming more routine. And auditors are still prone to err on the side of caution, given the constant threats of litigation or inspectors from the Public Company Accounting Oversight Board.

"Before we sign our engagement letter, this is an open issue," the internal auditor says. "Unless you can tell us why you need to bill us the same number of hours, we're not signing the engagement letter. We're going out to bid."

Audit firms counter with their own reasons why audit firms might be sticklers on the question of fees. Brian Croteau, a partner with PricewaterhouseCoopers, says it's difficult to generalize how much less audit work is necessary in an audit solely on financial statements and not internal control. Auditing standards require auditors to understand a client's internal controls and test them if they plan to rely on them, he says.

"Even in a financial statement audit, you have to understand the controls and decide the extent to which you're going to test and rely on controls to reduce substantive testing," he says. "This is why the PCAOB has worked the last few years to integrate the audits and to take advantage of the synergies between them." For example, he says, many of the risk-assessment procedures an auditor performs are the same whether for a financial statement audit or an integrated audit.

Bruce Webb, executive partner with McGladrey & Pullen, says the swift drop in a company's market cap may itself be reason for more audit scrutiny. Any dramatic plunge—especially below the company's book value—would probably indicate an impairment of goodwill or other long-lived assets, "and that would trigger additional audit procedures," he says.

"When a company drops in market cap, there likely are some reasons for that," says Gaylen Hansen, a partner with Colorado regional audit firm Ehrhardt Keefe Steiner & Hottman. "It's hard to generalize because it just depends on the situation."

Hansen also notes that swift drops in market cap can raise alarms about liquidity problems, difficulty raising capital, or repaying debt. Ultimately the auditor might wonder about the company's ability to continue as a going concern—a topic the PCAOB has told auditors to pay special attention to this year.

Gary Sturisky, a global practice leader at Jefferson Wells, says smaller companies in general still pay disproportionately higher audit fees than larger companies, in part because there's still some uncertainty in smaller settings about how to do the internal control assessment and how detailed it should be. More importantly, he says, smaller companies tend to challenge their auditors less.

"A lot has to do with the relationship you have with the external auditors," he says. "There should be an upfront discussion that there should be a trickle-down in reduction of audit fees. I'm not sure all these companies are necessarily having hard discussions with external auditors. We're encouraging our clients to do that."

In the first few years of SOX compliance, audit firms had companies over a barrel and could force through painfully high audit fees. Now, Sturisky says, companies have more leverage—and should use it.

"Things are pretty competitive out there right now," he says. "External auditors aren't doing anything inappropriate, but they're certainly open to explain and negotiate fees in today's environment moreso than a few years ago."

Cutting Compliance?

Another question is whether a company that already has a reliable Section 404 compliance process really should skip the internal control audit just because it can.

“There are some risks associated with saying, ‘No, we don’t want an auditor to audit our internal controls,’” says Jim DeLoach, managing director at the consulting firm Protiviti. DeLoach says he knows of at least one company in this quirky situation that decided to go ahead with the audit for 2008 since it will be required in 2009 anyway. The CFO reasoned if auditors were to find problems in 2009, that could lead to uncomfortable questions about the 2008 audit.

“Those are factors management needs to consider before reaching the obviously easy conclusion that we don’t want to spend money for an audit this year,” DeLoach says.

John McLaughlin, senior managing director at Smart Business Advisory & Consulting, also understands that many companies facing Section 404(b) audits of internal control for the first time in 2009 are worried that they will see the same sharp spike in audit fees that larger filers saw when they started compliance in 2004. He says those new filers should remain calm. “It’s going to be more, but it’s not going to be twice as much,” he predicts. “It’s not even going to be 50 percent.”

Some small companies also hope the Securities and Exchange Commission will delay the Section 404(b) requirement yet again. McLaughlin deems it unlikely, especially given remarks by newly installed SEC Chairwoman Mary Schapiro that she wants to see the audit requirement met by all public companies.

CAQ MEMBER LETTER

Section 404(b) Reporting by Non-Accelerated Filers After Exiting Accelerated Filer Status

As a result of the current market conditions, Center for Audit Quality (CAQ) member firms have raised questions regarding Section 404 compliance when an issuer exits accelerated filer status and becomes a non-accelerated filer. Specifically, members have inquired as to whether Section 404(b), which is the auditor’s attestation on the effectiveness of internal control over financial reporting, is applicable for issuers that have exited accelerated filer status and have become non-accelerated filers.

Based on our review of the September 26, 2006 CAQ SEC Regulations Committee discussion document (Discussion Document A), an issuer that exits accelerated filer status and becomes a non-accelerated filer is not required to comply with Section 404(b) for a fiscal year ending before December 15, 2009.

On September 26, 2006, the CAQ SEC Regulations Committee and the SEC staff met to discuss, among other topics, Section 404 reporting by non-accelerated filers after exiting accelerated filing status. A discussion document (Discussion Document A), entitled *Section 404 Reporting by Non-Accelerated Filers After Exiting Accelerated Filing Status ...* was issued to document the SEC staff's response. Even though this discussion document is dated September 26, 2006 and does not reflect subsequent changes to the SEC's transition provisions for Section 4042, the guidance is still relevant to determining Section 404(b) requirements after exiting accelerated filing status.

To further illustrate the fact pattern and response, we have developed the following example based on the guidance in Discussion Document A and the SEC's current Section 404 transition provisions:

Company X is a calendar year-end SEC registrant. For its fiscal year ended December 31, 2007, Company X was an accelerated filer and complied with all applicable SEC filings and Section 404 reporting requirements and deadlines. For the fiscal year ending December 31, 2008, Company X will qualify as a non-accelerated filer by virtue of its public float dropping below \$50 million as of the last business day of its second fiscal quarter (June 30, 2008). As a non-accelerated filer, Company X is not required to comply with Section 404(b) in its 2008 Form 10-K. However, Company X is still required to comply with Section 404(a) in its 2008 Form 10-K.

Source

CAQ Alert on Accelerated Filing Status (Nov. 25, 2008)

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