



# **Lord & Benoit Report: First Year SOX Results for Small Business**

## *Benefits of the Delays*

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## **Executive Summary**

The Sarbanes-Oxley Act of 2002 (also called SOX) was passed by Congress and signed by the President to provide among other things, investors with transparency in financial reporting, including financial statements, disclosures and Internal Controls over Financial Reporting (ICFR).

The Act was created in response to a number of corporate frauds that occurred in several larger public companies (Enron, WorldCom, Tyco, etc.). Sections 404 (a) and (b) of the Act requires public companies to self assess their internal controls over financial reporting and have another assessment of controls performed and reported by external auditors.

Section 404 (a) management self assessments are essentially documentation and testing of the quality assurance function of the financial reporting process.

However, for smaller public companies with a public float under \$75 million, the Securities and Exchange Commission (SEC) delayed Section 404 (a) and (b) requirements . The delays for complying with Section 404 (a) moved from year ends after July 2005, to July 2006, July 2007 and finally Dec 15, 2007.

Section 404 (b) however (auditor attestation) continues to be delayed. The current requirement of the auditor attestation to be submitted with a smaller public company's Form 10-K has been extended to years ending December 15, 2009 or later.

The stated rationale for the delays was to give smaller companies time to identify their internal control weaknesses and make the necessary corrections over four years rather than trying to clean up controls all at once in one year like their larger counterparts. Additionally, the costs of compliance could be smoothed over a four year period rather than all at once.

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For the year ended December 31, 2007, non-accelerated filers (smaller public companies) were required for the first time to file a Section 404 (a) assertion about the effectiveness of their Internal Controls over Financial Reporting (ICFR). This report analyses those results.

The timely questions are:

- “Now that more than 3,300 small public companies have filed their Section 404 (a) assertions, what can be ascertained about the four year delay?
- “And further, what can be asserted about the wisdom of additional Section 404 (b) – auditor attestation extensions?”

### **Summary Results**

Lord & Benoit, using data provided by Audit Analytics<sup>1</sup> conducted a study of ALL first time smaller public company (non-accelerated) filers with year ends between Dec 15, 2007 and Jan 31, 2008 to ascertain what could be gleaned from the four years of SOX 404 delays.

For a slight majority of non-accelerated filers (65.6%), the delay appears to have helped companies prepare, test and remediate compliance issues, to satisfy Section 404 requirements. Although as expressed earlier, none of these Section 404 (a) assessments of controls were subject to independent review by outside auditors as required under Section 404 (b).

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<sup>1</sup> Audit Analytics is an on-line public company intelligence service available from the IVES Group, Inc. a research provider focused on the accounting, insurance and investment communities [www.AuditAnalytics.com](http://www.AuditAnalytics.com). Lord & Benoit has no financial or other ties to Audit Analytics other than through a subscription arrangement.

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The following were the factual results:

1. **Last Minute Reporting** - For a *significant* minority of non-accelerated filer companies (34.4%), there is ample evidence that little or no consideration was given to the requirements of Section 404. For example, one study found that only one out of every eight small public companies disclosed an ineffective 302 (disclosure controls) assessment, in the quarter prior to asserting their controls being ineffective under Section 404.

Given the close relationship between these two disclosure requirements, this fact alone supports an assertion that most of these companies did little or nothing about assessing their internal controls until right up to the deadline thereby rendering the extensions of time fruitless.

This also raises serious questions about the appropriateness of the work that was done to even reach a conclusion about their internal controls prior to declaration because this kind of control testing takes a fair amount of time and is unlikely to have been completed successfully during the busiest time of year for small public company accounting and internal audit staff.

2. **Failure to File** - Additionally, for some non-accelerated filers, the continuous delays appears to have emboldened them not to do any work at all in either coming to an understanding of what was required and/or satisfying any of the Section 404 requirements. This fact is noted below in that 6.9% of all non-accelerated filers did not even file a 404 report at all (37.4% of the non-compliant companies).
3. **Failure to Comply: 18.6%** - Of the Section 404 (a) reports filed by first year non-accelerated companies<sup>2</sup> 18.6% were non-compliant. For purposes of this

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<sup>2</sup> With years ending after Dec 15, 2007 and up to Jan 31, 2008

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report, non-compliant means failure to file a report at all or filed a faulty report.

Of the companies that were non-compliant:

- 6.9% failed to file a Section 404 report at all
- 3.8% filed a faulty report (i.e., did not express an opinion on its internal controls over financial reporting)
- 7.8% disclosed “inadequate segregation of duties” without any evidence of complying or indicating in their report that they did not comply.

4. **Failure to Comply: \$25.9 billion market cap** - The market capitalization in question for non-compliant public companies totaled \$25.9 billion. The total revenue for these 575 non-compliant companies was \$33 billion (an average revenue of \$59 million per company).

Therefore, while it is unlikely that many institutional investors would have held investments in these companies, the exposure is significant enough to assert that tens of thousands of smaller investors have been deprived of understanding exactly what the nature of these small public company controls over assets and the accuracy of financially reporting information has been.

5. **Twice the Material Weaknesses** - In total 34.4% of non-accelerated filer public companies had an “ineffective controls” assertion, an amount more than double those of accelerated filers who filed their first time reports four years earlier (16.9%<sup>3</sup>) and approximately four times greater than those of accelerated filers today (8.6%<sup>2</sup>). These non-accelerated filers carried a market capitalization of \$42 billion. The total revenue for all 1,143 non compliant companies was \$50.1 billion (average of \$43.9 million per company).

The delay(s) for complying with Section 404 (a) were not successful. Internal control weaknesses were not identified and corrected within the extra four years.

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<sup>3</sup> The cost studies were obtained from a study performed by Audit Analytics (a subscription service) called the “404 Dashboard Year 3 Update” published Dec 2007.

The percentage of companies with internal control weaknesses should have been lower, but instead was twice as high.

6. **Inappropriate Conclusions** – A study of 242 late filers showed only 50 had submitted a Section 404 (a) report as of Sep 1, 2008. And of these only 19 (38%) disclosed ineffective internal controls over financial reporting. The remaining 62% said their controls were effective.

One needs to ask the question, how can such a large percentage (62%) of companies report effective controls when the COSO<sup>4</sup> framework requires timely and accurate reporting? Again, this raises serious questions about the appropriateness of the work that was done to reach a conclusion about their internal controls.

7. **The Disclosure Control Gap Widens** - An average of only one of eight smaller public companies filers had consistent reporting under Section 404 (a) and Section 302 the quarter before. In other words, 506 of the 575 companies with ineffective controls did not self disclose control weaknesses under Section 302 just weeks before the yearend. This was an 8 to 1 (800%) discrepancy in self reporting.

These results were very similar to those reported in an earlier “Lord & Benoit Report: The Sarbanes-Oxley Disclosure Control Gap<sup>5</sup>” of accelerated filers, except these first-time accelerated filers in the report had *auditor attestation*. Auditor attestation was not required for this year’s first time *non-accelerated filers*.

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<sup>4</sup> Committee of Sponsoring Organizations is a voluntary private-sector organization. COSO is dedicated to guiding executive management and governance entities toward the establishment of more effective, efficient, and ethical business operations on a global basis. It sponsors and disseminates frameworks and guidance based on in-depth research, analysis, and best practices.

<sup>5</sup> Lord & Benoit Report: The Sarbanes-Oxley Disclose Control Gap. A copy is available on the SEC website <http://www.sec.gov/news/press/4-511/bbenoit3806.pdf>

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It is likely the discrepancy would have been even greater if auditor attestation was not delayed.

8. **Audit Committee Non-compliance: Ten Times Worse** - Compared to accelerated filers, the rate of non-compliant audit committees in smaller public companies was ten times greater (19.0%) compared to the percentage of accelerated filers with adverse reports resulting from non compliant audit committees.

Again, considering the numerous time extensions granted, one would have expected to see better results had many of these issues been identified and corrected within the four years of additional delays.

9. **And More...** Of the smaller public companies filers that filed adverse Section 404 reports, the following were some of the more significant reasons reported (and the percentages of companies with ineffective controls for each category):
- Tone at top/Ethics, Competency/Training (78.1% of the companies)
  - GAAP departures (68.5%)
  - Ineffective design of controls (54.4%)
  - Reliance on outside auditors for material auditor adjustments (33.4%)
  - Information Technology (20.5%)

## Overview

Using data available through Audit Analytics, Lord & Benoit performed a study of the effectiveness of compliance for first-time Sarbanes-Oxley Section 404 (a) filers with a market float of less than \$75 million, and whose fiscal year ends were between 12/15/07 and 1/31/08.

The research identified 3,946 non-accelerated filers that met these criteria. From this population, 201 companies that were foreign filers were extracted because the results of their compliance efforts were not available at the time the data was compiled (foreign filers are given six months after year end to file rather than three months). In addition, there were 424 companies who were exempt from compliance. These were primarily initial public offerings during the year 2007.

The adjusted U.S based population totaled 3,321 smaller public company non-accelerated filers. The market capitalization of this population was approximately \$207 billion<sup>6</sup>. Another interesting statistic is that 120 of the companies had revenues over \$300 million, yet were still considered to be non-accelerated filers.

### SOX 404 Review of Non-Accelerated Filers (Management-Only Reports)

| Non-Accelerated Filer Population  |              |
|---|--------------|
| Total Non-Accelerated Filers with Year Ends from 12-15-07 to 1/31/08            | 3,946        |
| Less Subset of Foreign Filers (not required to report until 6 months after Y/E) | 201          |
| Less Newly Public Companies (exempt from filing first year)                     | 424          |
| <b>Non-Accelerated Filers Required to File by May 08 (Total)</b>                | <b>3,321</b> |

Note: The initial count of Total Non-Accelerated Filers does not include Registered Investment Companies as they are exempt from SOX 404.

Source: Lord & Benoit [www.section404.org](http://www.section404.org) with assistance of AuditAnalytics [www.auditanalytics.com](http://www.auditanalytics.com)

<sup>6</sup> Market capitalization numbers were obtained from the same Audit Analytics reports



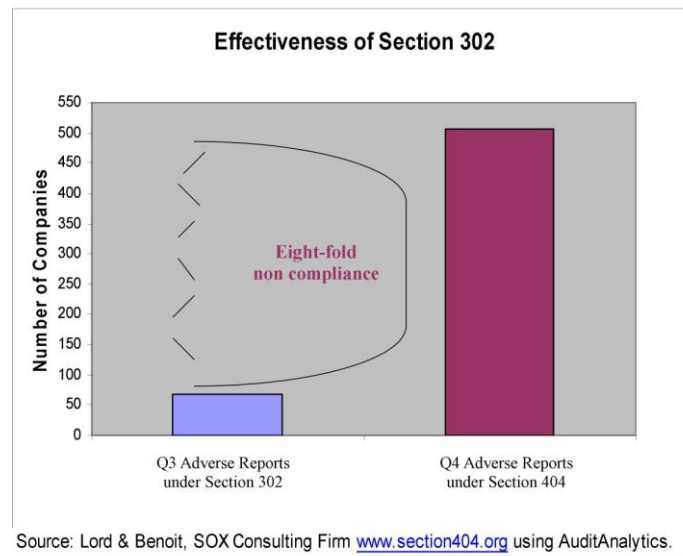
## **Study #1: Sarbanes-Oxley Disclosure Control Gap Widens**

Given the close relationship between Section 302 disclosure controls and Section 404 Internal Controls over Financial Reporting (ICFR), Lord & Benoit compared the Q3 Section 302 disclosure controls reports of smaller public companies to the Section 404 adverse reports of those same companies at year end.

An average of only one in eight companies had consistent reporting between Section 404 (a) and Section 302 (disclosure controls) assessment, in the quarter prior. In other words, 506 of the 575 companies disclosed *clean controls* under Section 302 (Form 10Q) just weeks before reporting an adverse Section 404 (a) report.

This is an 8 to 1 (800%) discrepancy in self reporting.

These results were similar to those of an earlier study—“Lord & Benoit Report: Bridging the Sarbanes-Oxley Disclosure Control Gap<sup>7</sup>” except that these accelerated filers had undergone *auditor attestation*. Auditor attestation was not required for this year’s first time *non-accelerated filers*, so it is unknown how much different the analysis would have been if auditor attestation was done. The difference would likely be even greater.



<sup>7</sup> Lord & Benoit Report: The Sarbanes-Oxley Disclose Control Gap. A copy is available on the SEC website <http://www.sec.gov/news/press/4-511/bbenoit3806.pdf>

## **Study #2: Last Minute Reporting**

Again, given the close relationship between Section 404 (a) and Section 302 disclosure requirements, there is ample evidence that little or no consideration was given to the requirements of Section 404 with only one out of every eight small public companies disclosed an ineffective 302 (disclosure controls) assessment in the quarter prior to asserting their controls being ineffective under Section 404.

| <b>SOX Section 404 and 302 Comparison</b>   |            |
|---|------------|
| Q3 Adverse Section 302 Reports Filed  | 69         |
| Additional Adverse Section 404 Reports Filed (last minute)  | 506        |
| <b>Total Adverse Section 404 Reports Filed after 12/15/07 thru 1/31/08</b>  | <b>575</b> |
| <small>Note: this table provides a list of issues identified by the 575 companies that disclosed in their Management Report that their Internal Controls over Financial Reporting (ICFRs) were ineffective.</small> |            |

Source: Lord & Benoit [www.section404.org](http://www.section404.org) using AuditAnalytics [www.auditanalytics.com](http://www.auditanalytics.com)

This fact also supports an assertion that many of these companies did little or nothing about assessing their internal controls until right up to the deadline thereby rendering the benefits of the extensions (i.e., additional testing and remediation time) fruitless.

It also raises serious questions about the appropriateness of the work that was done to even reach a conclusion about internal controls, due to the fact that this kind of control testing takes a fair amount of time and is unlikely to have been completed successfully during the busiest time of year for small public company accounting and internal audit staff.

For instance, the research revealed 242 Section 404 (a) reports that read something like the following; “our controls were not effective due to inadequate segregation of duties”. Segregation of duties is not a control problem in itself. It is a preventive control usually offset with a mitigating control in smaller companies.

More likely, an assessment was not performed.

### **Study #3: Failure to Comply**

The research showed that 18.6% (572 out of 3,321) of all the non-accelerated filers with year ends after 12/15/07 and up to 1/31/08 were non-compliant. Non-compliant companies either failed faulty reports or failed to file a report at all.

The market capitalization for non-compliant public companies totaled \$25.9 billion.

The revenues of the 575 non-compliant companies totaled \$33 billion (which averaged \$59 million per company).

Of the companies that were non-compliant:

- 37.4% (214 companies) failed to file a Section 404 report at all.
- 20.3% (116 companies) filed a faulty report. In other words, although there was some language about controls, these companies did not express an *opinion* on whether their internal controls over financial reporting were effective or not.
- Another 42.3% (242 companies) disclosed “inadequate segregation of duties” without any evidence of complying. In some cases they indicated they would not comply. In other instances there was no evidence that an assessment was performed, but just an opinion was issued.

Our understanding is that despite attempts by the House of Representatives<sup>8</sup> to eliminate funding for enforcement of non-compliant non-accelerated filers (not passed by the Senate), SEC regulators have been actively contacting non-compliant companies. This could have implications to outside auditors and other advisors as well.

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<sup>8</sup> Rep. Scott Garrett (R-NJ) and Rep. Tom Feeney (R-FL)) sought to use the often more reliable “power of the purse” to give smaller companies additional time for digesting new SEC and PCAOB guidance. H.R. 2829 (Source: The Corporate Counsel <http://www.thecorporatecounsel.net/blog/archive/001518.html>)

**Study #4: Overall Assessment**

Of the total population of 3,321 smaller public companies, 1,143 (34.4%) had ineffective internal controls over financial reporting.

| SOX 404 Management Report Breakdown<br>Non-Accelerated Filers                      |                       |                 |                    |
|--|-----------------------|-----------------|--------------------|
| Management Report Status   | Effective Disclosures | Adverse Filings | % of Total Filings |
| Management Report Declares Effective Internal Controls over Financial Reporting    | 2,178                 |                 | 65.6%              |
| Management Report Discloses Ineffective Internal Controls over Financial Reporting |                       | 575             | 17.3%              |
| Registrant Provides Section 404 Report but No Management Opinion Expressed         |                       | 116             | 3.5%               |
| Registrant Filed an NT (Late Filing)   |                       | 238             | 7.2%               |
| Section 404 Report Completely Omitted  |                       | 214             | 6.4%               |
| <b>Column Total</b>  | <b>2,178</b>          | <b>1,143</b>    |                    |
| <b>Total Number of Non-Accelerated Filers Required to File</b>                     | <b>3,321</b>          |                 |                    |

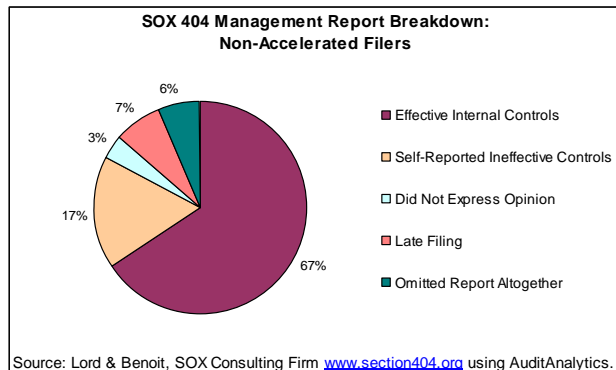
Note: based on the totals above, 34.4% of non-accelerated filers provided the SEC with an annual report that was flawed (i.e., late, no opinion, or no SOX 404 report whatsoever) or that gave a SOX 404 Management-Only Report disclosing ineffective Internal Controls over Financial Reporting: (1143/3321) x 100 = 34.4%.

Source: Lord & Benoit [www.section404.org](http://www.section404.org) with assistance of AuditAnalytics [www.auditanalytics.com](http://www.auditanalytics.com)

Other facts: The non-accelerated filers with *ineffective* controls represented a market capitalization of \$42 billion. Total revenue of the companies with *ineffective* controls was \$50.1 billion (an average of \$43.9 million per company).

The following were the reasons, percentages and # companies with ineffective controls:

- 6.4% (214 companies) failed to file a 404 report at all
- 3.5% (116 companies) filed a faulty report
- 17.3% (575 companies) self reported ineffective ICFR
- 7.2% (238 companies) failed to file on time

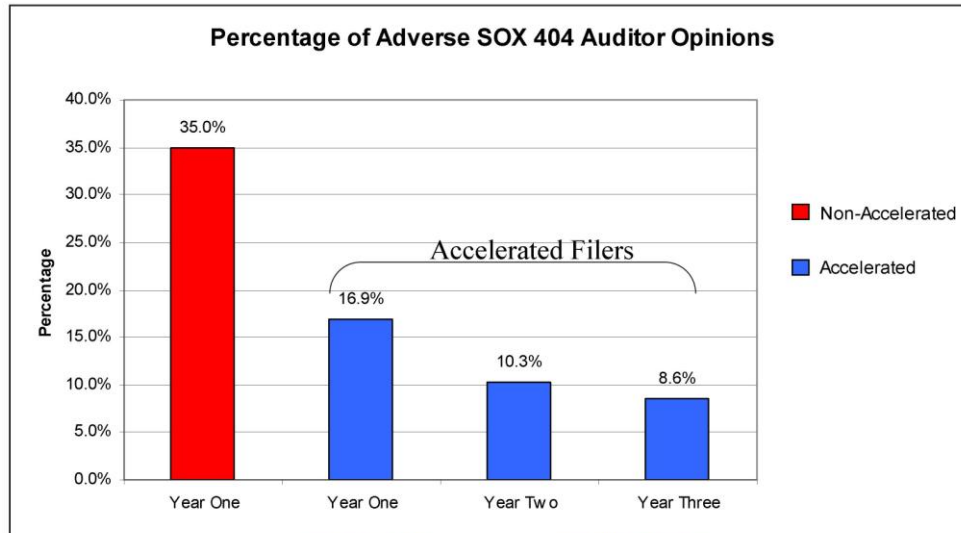


## **Study #5: Double the Number of Ineffective Controls**

The percent of ineffective controls (34.4%) of *non-accelerated* filers was then compared to an earlier analysis of first-year *accelerated* filers who did not benefit from the delays.

The analysis by Audit Analytics<sup>9</sup> of ALL prior year accelerated filers, showed that accelerated filers reported 16.9% ineffective controls in year one. In year two, the number dropped to 10.3% and in year three to 8.6%. These facts showed that Internal Controls over Financial Reporting became more effective over time.

The following graph compares the percentage of first time non-accelerated filers' material weaknesses (shown below in red) to accelerated filers (in blue over three years of historical results). It showed 34.4% of non-accelerated filers had ineffective control assertions, an amount more than double those of accelerated filers who filed their first time reports four years earlier (16.9%) and approximately four times greater than those of accelerated filers today (8.6%).



Source: Lord & Benoit [www.section404.org](http://www.section404.org) and AuditAnalytics [www.auditanalytics.com](http://www.auditanalytics.com)

*Smaller company ADVERSE 404 REPORTS DOUBLE those of first time accelerated filer  
(and FOUR TIMES GREATER than current accelerated filers)*

<sup>9</sup> The cost studies were obtained from a study performed by Audit Analytics (a subscription service) called the "404 Dashboard Year 3 Update" published Dec 2007.

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The delays for complying with Sarbanes-Oxley Section 404 (a) were therefore not successful in these instances. Extensions were granted to give companies four additional years to identify and correct control weaknesses, yet the percentage of internal control weaknesses doubled instead of decreasing.

Additionally, it is important to note that non-accelerated filers only filed a self assessment of internal controls under Section 404 (a) without the auditor attestation requirement of Section 404 (b). The percent of adverse reports is likely to be even greater if/when auditor attestation is required.

## **Study #6: Audit Committee Non-Compliance**

According to the Committee of Sponsoring Organizations (COSO) Internal Control — Integrated Framework of 1992, the responsibility of internal controls *ultimately* rests with the Board of Directors and Audit Committee. The facts were:

- 19% (110 of 575 companies) self reported a materially ineffective, nonexistent or understaffed audit committee.
- 18.6% (572 of 3,321 companies) of non-accelerated filers were non-compliant indicating ineffective review of financial reporting by the Board and/or Audit Committee.
- 34.4% (1,143 of 3,321 companies) had materially ineffective controls illustrating issues with an effective Control Environment (tone at the top).

Compared to accelerated filers, the rate of non-compliant audit committees in smaller public companies was *ten times* greater (19.0%) compared to the percentage of accelerated filers with adverse reports resulting from non-compliant audit committees.

Again, with all the extensions granted one would have expected many of these issues to have been identified and corrected during the four years of additional delays. Certainly one would not have expected a tenfold percentage increase.

The following are excerpts from the COSO Guidance for Smaller Public Companies:

- Does the board of directors actively evaluate and monitor risk of management override of internal control and consider risks affecting the reliability of financial reporting?
- Does the audit committee actively monitor the effectiveness of internal control over financial reporting and financial statement preparation?
- Does management's philosophy and operating style emphasize reliable financial reporting?
- Has management established and clearly articulated financial reporting objectives including those related to internal control over financial reporting?
- Does the board of directors oversee management's process for defining responsibilities for key financial reporting roles?

## **Study #7: Late Filers: Inappropriate Conclusions**

We performed another study<sup>10</sup> of the 242 late filers that had not issued a Section 404 (a) on time, to determine what type of report was subsequently issued.

The study showed that only 50 of the 242 late filers had filed a Section 404 (a) report as of 9/1/08. The remaining 192 filers still had not filed a Section 404 (a) report.

Of the 50 that did file, only 19 (38%) reported ineffective internal controls over financial reporting. The remaining 62% reported effective controls.

One needs to ask the question, how can such a large percentage (62%) of companies report effective controls particularly when a series of questions in the COSO<sup>11</sup> framework require timely and accurate reporting? The following are excerpts from the COSO Guidance for Smaller Public Companies:

- Does management maintain an organizational structure that facilitates effective reporting and other communications about internal control over financial reporting?
- Is data underlying financial statements captured (optimally, at the source) completely, accurately, timely?
- Does the company identify competencies that support accurate and reliable financial reporting?
- Do information systems produce information that is timely, current, accurate, and accessible?

Again, this point raises serious questions about the appropriateness of the work that was done to even reach a conclusion about their internal controls.

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<sup>10</sup> As of Sept 1, 2008

<sup>11</sup> Committee of Sponsoring Organizations is a voluntary private-sector organization. COSO is dedicated to guiding executive management and governance entities toward the establishment of more effective, efficient, and ethical business operations on a global basis. It sponsors and disseminates frameworks and guidance based on in-depth research, analysis, and best practices.



## **Study #8: Composition of Ineffective Controls**

As indicated earlier, there were 575 companies that reported ineffective Internal Controls over Financial Reporting in their recent Form 10K disclosures under Section 404 (a).

Using another Audit Analytics tool called “Peer Reporter”<sup>12</sup> we delved into the reasons for the adverse reports.

The following were the results of the study:

| <b>Material Weaknesses Identified Management Report Disclosures</b>          |                             |                       |
|--|-----------------------------|-----------------------|
| <b>Material Weaknesses Issue</b>   | <b>Companies Disclosing</b> | <b>% of Companies</b> |
| Ineffective accounting procedures  | 555                         | 96.5%                 |
| Issues with competency, training, tone at top, ethics                        | 449                         | 78.1%                 |
| Departures from FASB/GAAP/Disclosures  | 394                         | 68.5%                 |
| Ineffective design of controls not mitigated with compensating controls      | 311                         | 54.1%                 |
| Reliance on outside auditors for material adjustments                        | 192                         | 33.4%                 |
| Information technology, software, security & access issues                   | 118                         | 20.5%                 |
| Audit Committee - Ineffective, non-existent or understaffed                  | 110                         | 19.1%                 |
| Accounting for deferred, stock-based comp, debt, warrants, derivatives       | 101                         | 17.6%                 |
| General ledger close process   | 96                          | 16.7%                 |
| Foreign, related party, affiliate, merger, acquisition, consolidation issues | 93                          | 16.2%                 |
| Untimely or inadequate account reconciliations                               | 80                          | 13.9%                 |
| Accounting for Accounts/loans receivable, investments & cash issues          | 76                          | 13.2%                 |
| Accounting for Liabilities, payables, reserves and accrual est. failures     | 65                          | 11.3%                 |
| Revenue recognition issues   | 62                          | 10.8%                 |
| Controls over property, intangibles, deprec                                  | 60                          | 10.4%                 |
| Controls over inventory/cost of sales  | 59                          | 10.3%                 |
| Accounting for expenses (payroll, SG&A, leases)                              | 47                          | 8.2%                  |
| Accounting for income tax expense (FAS 109)                                  | 30                          | 5.2%                  |
| Restatements, regulatory compliance  | 29                          | 5.0%                  |
| Insufficient or non-existent internal audit function                         | 22                          | 3.8%                  |

Note: this table provides a list of issues identified by the 575 companies that disclosed in their Management Report that their Internal Controls over Financial Reporting (ICFRs) were ineffective. Because some disclosures identify more than one material weakness, the same company can be listed for more than one issue. As a result, the aggregate of percentages displayed above is over 100%.

Source: Lord & Benoit [www.section404.org](http://www.section404.org) using AuditAnalytics Peer Group Builder

<sup>12</sup> Audit Analytics Peer Reporter is an online subscription that allows users to create custom reports based on financial reporting issues in a Peer Group (such as non-accelerated filers); Financial Restatements, Internal Controls, Disclosure Controls, and Non-Timely Filings

The following are some selected comments regarding the material weaknesses reported:

1. Competency, Training, Tone at top, Ethics (78.1%): Seventy eight percent of CFO's with adverse 404 reports reported lack of competency, training and/or effective tone at the top.
2. GAAP Departures (68.5%): 68.5% of the CFO's disclosed ineffective controls systems due to their misunderstanding or misapplication of generally accepted accounting principles (GAAP). Four years earlier, smaller accelerated filers reported similar results as indicated in "Lord & Benoit Report: 10 Threats to Compliance for Smaller Public Companies"<sup>13</sup>. In that report 94 of the 148 (63.5%) of the companies had material weaknesses in accounting and disclosure controls. Included were a number of departures from GAAP, income tax accounting and inadequate or inaccurate financial statement disclosures.

Should the same statistics have appeared four years later for non-accelerated filers who were given extensions?

3. Ineffective Design of Controls not Mitigated with Compensating Controls (54.4%): More than half of smaller companies reported design of control problems. *The Ten Threats to Compliance for Smaller Public Companies* indicated 60 of the 148 (40.5%) companies reported issues with regards to proper segregation of duties. When we drilled down however, we found the cause was not only segregation of duties but the breakdown in the compensating controls that were designed to mitigate the preventive control. In other words, what management thought was happening was different than what was really occurring.
4. Reliance on Outside Auditors (33.4%): It appears that management of smaller public companies still rely on the outside auditors for proper accounting and

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<sup>13</sup> For a full copy of the report go to [Lord & Benoit Report SOX 404 - 10 Threats to Compliance for Smaller Public Companies.pdf](#)

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disclosures, thereby impairing auditor independence and causing companies to report adverse Section 404 reports rather than a separate outside party (independent of the outside auditors) to assist with complex accounting standards.

5. Information Technology (20.5%): The study of smaller public companies who complied in 2004 indicated material weaknesses were associated with access controls, change controls, ineffective application controls, and critical spreadsheet controls were reported in 45 of the 178 companies reporting material IT weaknesses.

## Conclusion

Many issues still remain outstanding with regards to SOX 404 compliance for non-accelerated smaller public company filers:

- Why was there such a high rate of non-compliant companies (and ineffective controls), particularly considering the additional time given to non-accelerated filers (i.e., the delays) to evaluate/remediate their control environment?
- What can be done about the high percentage of ineffective Audit Committees?
- Why did only one of eight companies with adverse 404 reports report adverse 302 reports one quarter prior to year end?
- Is external auditor review necessary under the circumstances and given the rather large number of non-compliant companies?
- Can 404 disclosures be effective without outside auditor review?
- If so, how can auditors effectively communicate non-compliance with Section 404 other than through a 10A Illegal Act violation?
- Are SOX 404 self assessments in fact being executed for smaller public companies or is just an opinion being expressed?
- How did the quality of reporting escape auditors and attorneys?

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