

Lord & Benoit

Lord & Benoit, LLC, a SOX compliance firm focused on small to mid-sized public companies. Bob Benoit served on the most recent COSO Monitoring Project Task Force. He also served on AICPA Peer Review Acceptance Board for ten years. He is the author of the Lord & Benoit Reports, which have been referenced by the SEC, PCAOB, Wall Street Journal, Business Week, all Big 4 firms and over 150 newspapers, magazines, legal, educational and trade journals. Bob is also the first evaluator to use the 2006 COSO Guidance for Smaller Public Companies, and the inventor of several affordable SOX frameworks which can be downloaded from the SEC and PCAOB websites or at www.Section404.org

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Ten Threats to SOX 404 Compliance for Smaller Public Companies



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The literature contained herein is not intended to substitute authoritative literature published by the respective regulatory agencies. Professionals are advised to consult with legal and accounting authorities on all matters before implementing professional standards.

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Education, Training & Seminars

Today's Webinar

Regulatory Update on SOX 404

- SEC
- PCAOB
- COSO

Ten Threats to Smaller Company Compliance SOX 404 Research Report – *Updated*

Recent Developments SOX IT for Small Companies

Last Minute Tips

Lessons Learned

Update on SOX 404

▶ SEC



▶ PCOAB

PCAOB[®]

▶ COSO



Update on SOX 404



“Since there will be no further Commission extensions, it is important for all public companies and their auditors to act with deliberate speed to move toward full Section 404 compliance.”

SEC Chairman Mary L. Schapiro

Update on SOX 404



“The Commission is for the first time resolving that uncertainty by making it clear that all public companies, regardless of size, will be required to comply with Section 404(b) of the Sarbanes–Oxley Act.”

Commissioner Luis A. Aguilar

Update on SOX 404



The amendments also mean the management reports on internal controls filed under Sarbanes–Oxley Section 404(a) will be classified as filed rather than furnished to the SEC.

This will cause non compliance with 404(a) to become a legal liability.

Tax & Accounting of Thomson Reuters

Update on SOX 404

“In its latest summary of its inspections of the eight largest audit firms — covering four years of reviews — the Public Company Accounting Oversight Board pings the auditors for failing to use enough professional **skepticism** in their audits of companies' financial statements...

CFO Magazine

Update on SOX 404 **PCAOB**[®]

“A second area reviewed, actually a subset of the first, was the assessment of **fraud risk.**”

“In a minority of audits, the board found failure to do more rigorous testing in areas of greater risk, and **failure to test compensating controls.**”

CFO Magazine

Update on SOX 404 PCAOB[®]

“The board also evaluated auditors' use of the work of others to cut down on their own work, a practice that AS5 specifically allows. But some audits didn't sufficiently assess the **competency or objectivity** of others' work, particularly when the work was performed by company personnel other than internal auditors.”

Competency & Objectivity

Smaller companies have a harder time performing SOX inhouse, because evaluators must be competent AND objective. Objectivity requires a person to be uninvolved in the process altogether. Otherwise they would be reviewing their own work, which is not considered a valid monitoring evaluation. Competence and objectivity are required by COSO, SEC Interpretive Guidance and PCAOB Standard 5.

PCAOB[®]



Competency & Objectivity

Smaller companies rarely have competent repeat skill sets in house. This is particularly apparent in Information Technology. A complete review of the IT function is required each year. Smaller companies typically have only one or two internal IT staff. Therefore it is difficult if not impossible to effectively objectively assess IT, since the assessor is probably the one doing the work.

PCAOB[®]



Competency & Objectivity



Ten Steps to SOX Compliance *for Smaller Public Companies*



Competency & Objectivity



www.sec.gov

Smaller Companies are Unique

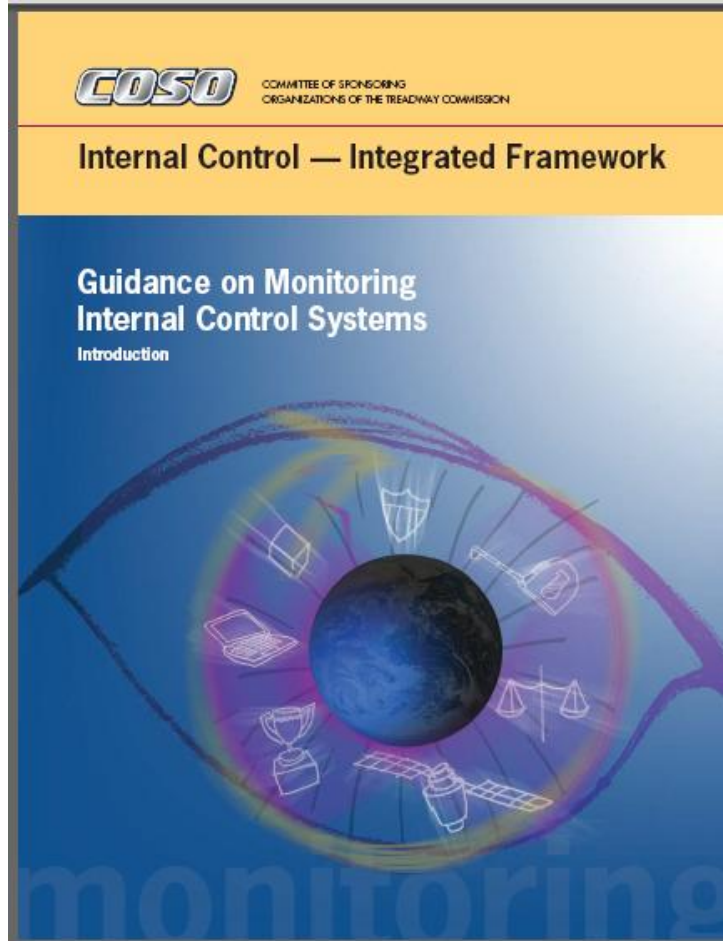
Sparsely Staffed

404(b) for First Time

Multiple Skill Sets



Update on SOX 404



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Achieving a Clean SOX 404 Report

The research was compiled aggregating the results of 148 first time companies with revenues under \$100 million (using Audit Analytics and our experience in assisting smaller public clients).

#1 Accounting and Disclosure Controls

Perhaps the biggest surprise to smaller public companies may be that they are expected to have no significant auditor adjustments.

#1 Accounting and Disclosure Controls

Nearly two thirds or 94 had issues relating to accounting and disclosure controls. Included were a number of departures from GAAP, income tax accounting and inadequate or inaccurate financial statement disclosures.

#2 Treasury

Of the 148 companies, there were 92 findings noted in this category including accounting for stock, debt, investments, derivatives and cash controls.

- Check signing and access to accounting records
- Wire transfers
- Payroll
- Cash Application
- Credit and Debit Cards
- Table of Authorities

#3 Competency of Accounting Personnel

Adequate training and competency of accounting personnel.

The lack of management commitment to the competency and formal training program were described as the root cause for 85 instances of improper accounting and disclosures.

#4 Control Environment

Audit Committee ineffectiveness, lack of effective internal audit function, ineffective monitoring of code of ethics and ineffective technical review of financial statements leading to financial restatements.

#4 Control Environment

Nearly half of the companies fell into this category.

- **Lack of Board Participation**
- **Background Checks**
- **Failsafe Mechanism**
- **Ethics Training**
- **Audit Committee Overlooked**

#5

Design of Controls

About 60 companies reported issues with regards to proper segregation of duties. When we drilled down, 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 happening.

#6

Revenue Recognition

About one third of the companies in the study had improper revenue recognition. The issues mainly dealt with proper cut off and timing of transactions.

#7 Financial Closing Process

About a third of the companies struggled with weaknesses in their financial closing processes.

For a number of reasons the financial closing processes did not identify non-recurring and adjusting journal entries that should have been made.

Consequently material audit adjustments were necessary leading to material weaknesses in internal controls over financial reporting.

#8

Account Reconciliations

In addition to the closing process mentioned in item 7 above, a number of account reconciliation deficiencies were noted in our study. There were 47 instances of material inadequate account reconciliations noted.

#9 Information Technology

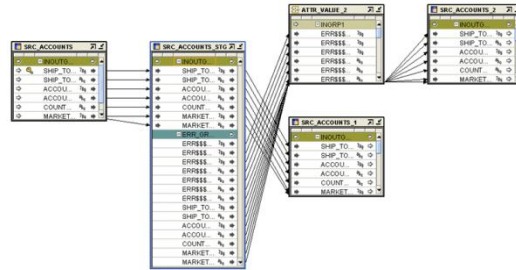
Access controls, change controls and critical spreadsheet controls were some of the points contributing to 45 companies having material IT weaknesses.

SOX IT—6 Basic Steps

- ▶ IT Mapping
- ▶ IT Risk Assessment
- ▶ Establishing the Control Environment
- ▶ Design and Operational testing
- ▶ Remediation
- ▶ Monitoring



1. IT Mapping



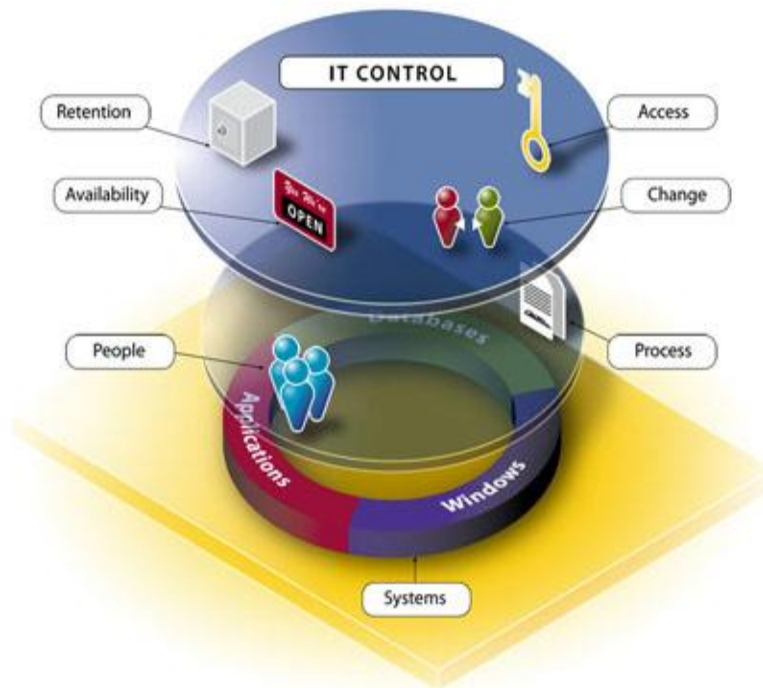
Business Process and Sub-Process	Overall Rating	Application Name	Database	Operating System	Critical Spreadsheet Name	Supported by a Third Party	Hosted by a Third Party Provider
Cash Management	H	MS Dynamics	MS SQL	Windows 2008	N/A	Yes	Yes
Investment Securities							
Order Processing							
Credit and Collections							
Revenue Recognition							
Purchasing to Payables							
A/P and Cash Disbursements							
Employee Master File Maintenance							
Process Payroll							

2. IT Risk Methodology

- ▶ Identify and focus on critical information assets (processes, systems, staff)
- ▶ Consider the relationships among critical assets
- ▶ Evaluate risks in operational context
- ▶ Establish control objectives & key controls to reduce risks to an acceptable level



3. Control Environment



- Company Level Controls
- Key Operational Controls

4. Control Testing

- ▶ After establishing key IT controls, a “design test” should be performed.
- ▶ Primarily accomplished through inquiry, observation and “walk-through’s”
- ▶ Operational Testing



5. Remediation

- ▶ A summary of deficiencies should be compiled that outlines the deficiency found, its severity and a remediation plan to address.



- ▶ Remediation solutions can/should be re-tested to ensure proper operation prior to year-end.

6. Monitoring

- ▶ The performance of ongoing and/or separate evaluations that are critical in determining whether internal controls function over time.
- ▶ To identify internal control deficiencies and communicate them in a timely manner to those parties responsible for taking corrective action and to management and the board as appropriate.

#9

IT Findings

- ▶ Lack of Change Management process
- ▶ Segregation of Duties issues
- ▶ Access Controls (network & application)

#10

Consolidations, Mergers, Interco Accts

Another 43 companies had material weaknesses in accounting for the mergers and acquisitions, intercompany accounting controls, consolidations and foreign exchange translation gains and losses.

Last Minute Tips – Lessons Learned

Start with the end in mind.

- ▶ Focus on company level controls
- ▶ Test compensating controls
- ▶ Don't forget control environment
- ▶ Look at *financial reporting* portion of ICFR
- ▶ Don't forget to look at fraud
- ▶ Evaluators must be objective and competent
- ▶ Be creative in redesign
- ▶ Test company level controls early
- ▶ Avoid big company approach
- ▶ Use a proven framework – avoid surprises

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We will send you:

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What's Next...



**"Rebuilding our Economy:
How SOX Helps to Build Trust"**