

Lord & Benoit Report: Fraud in U.S. Non-Accelerated Filer Companies

“Public companies have a sacred fiduciary duty to their investors and creditors to have strong internal controls that are verifiable and reviewed by well qualified, truly independent auditors.”

~ **Sam E. Antar**, convicted felon, former CPA, CFO of Crazy Eddie who helped Eddie Antar and other members of his family mastermind one of the largest U.S. stock market securities frauds of the 1980s.

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Background

On November 18, 2009, CFO Magazine published (on their website CFO.com) an article entitled “CFOs High-Five on 404 Rollback Bill.” An excerpt follows: “The news last week that the requirements of Section 404(b) of the Sarbanes-Oxley Act might never, ever come to bear for small companies had Jeff Klausner, CFO of InfoSonics, a wireless-equipment provider with a market cap of around \$14 million, “doing back flips,” he says. “This wouldn’t change anything that we do; it would just save us a bunch of money on audit fees.”¹

H.R. 4173, *Wall Street Reform and Consumer Protection Act* would permanently exempt companies with market caps of \$75 million or below from the Sarbanes-Oxley Act’s Section 404(b). The bill would also direct the SEC to study ways to cut the compliance costs for companies with market caps of \$75 million to \$250 million, including the possibility of an exemption. Section 404(b) requires a company’s auditors to document and test its internal controls over financial reporting (ICFR).

Many financial executives, like Klausner, say an exemption from auditor testing would equate to the same level of integrity in their financials but with less cost.² **[Disclaimer: Please note that the following section contains company-released information that is publicly available through the SEC Edgar Database and that no party is being cited for any wrongdoing].** In the case of InfoSonics, the company has since its inception, reported “clean internal controls” under both Sarbanes-Oxley Sections 302 and 404(a). This is confusing given the fact that the company had two material financial restatements (for year end 12/31/05 and quarter end 3/31/06) for different reasons, but both related to significant material weaknesses in internal controls over its Treasury financial reporting cycle.

- In Q1 2006, a restatement resulted in an adverse adjustment to net income decreasing it by 32% for its previously reported amount (\$564,342 decrease to net income). There was **no self reporting of any material weaknesses (no auditor attestation required)** in internal control over financial reporting over its Treasury cycle as required under Section 302.
- Additionally, in its 2005 Amended Form 10K, the company self reported a clean Section 302 report of internal controls over financial reporting under Section 302 despite a failure to disclose a two-for-one stock split. Again no outside auditor attestation was required.

¹ CFO.com CFOs *High-Five on 404 Rollback Bill* November 2009 <http://www.cfo.com/article.cfm/14456216>

² *Ibid.*

Fraud in U.S. Non-Accelerated Filer Companies

In reviewing a recent Form 10Q report (for quarter ending September 30, 2009)³ issued by InfoSonics, the following two legal proceedings were noted (condensed):

- *InfoSonics settled a securities class action suit for \$3.8 million to plaintiffs against the company and certain of its officers and directors, for alleged violations of Section 10(b) of the Exchange Act and associated Rule 10b-5, Section 20(a) and Section 20A in connection with the announcement of the Company's restatement of first quarter 2006 earnings and in connection with allegedly false and/or misleading statements related to the Company's distribution of the VK Mobile phone. The Securities Settlement further provides that defendants deny any liability or responsibility for the claims made and make no admission of any wrongdoing. On May 5, 2009, the Court entered an order finally approving the Securities Settlement as fair and reasonable, and directing the clerk to enter final judgment and dismissing the action with prejudice.*
- *InfoSonics settled the derivative action purportedly on behalf of the Company against certain of its officers and directors, following plaintiffs' consolidated complaints of alleged violations of Section 14(a) of the Exchange Act, Sections 25402 and 25403 of the California Corporations Code, disgorgement under the Sarbanes-Oxley Act of 2002, breach of fiduciary duty, abuse of control, gross mismanagement, waste of corporate assets, unjust enrichment, rescission, a constructive trust, and an accounting, in connection with the Company's restatement of first quarter 2006 earnings and in connection with allegations of wrongdoing with respect to granting, exercising, accounting and reporting of the stock options that the Company granted in December 2005. The settlement resulted in a payment by the Company or its insurer of up to a maximum of \$350,000. The Derivative Settlement further provides that defendants deny any liability or responsibility for the claims made and make no admission of any wrongdoing. On June 3, 2009, the Court approved the settlement and entered the final judgment and order of dismissal with prejudice of the case.*



Could a Section 404(b) inspection have actually saved money?

The question therefore arises: "How effective is self reporting without auditor attestation?" How can one claim to self report clean internal controls over financial reporting on its Treasury cycle in these instances⁴ (Section 302 is a lesser standard than Section 404)? Can Section 404(a) self reporting ever be effective without some level of external auditor involvement? Furthermore, is the risk of fraud more prevalent in smaller companies than in larger ones?

³ http://www.sec.gov/Archives/edgar/data/1274032/000110465909065197/a09-30899_110q.htm

⁴ Information was obtained using Audit Analytics <http://www.auditanalytics.com>

Summary Results: U.S. Non-Accelerated Filer Companies

A study was conducted by Lord & Benoit, a SOX Research and Compliance firm, of .5 percent⁵ of all U.S. non-accelerated filer companies (public float under \$75 million) that underwent SOX 404(a) for the first time. The study involved testing and documenting the Consideration of Fraudⁱ while performing a Sarbanes-Oxley Section 404(a) review of internal controls over financial reporting (ICFR). The 404(a) assessment was performed by an objective third-party in conjunction with company participants.

It is important to note that none of these companies had complied with SOX 404(b), the auditor attestation, at this point. Had their outside auditors also performed a review on internal controls over financial reporting (ICFR) under Section 404(b), the results could have in fact been worse.

✚ **100% (ALL of the companies) had two or more means of embezzling funds**

ongoingly without being detected except by chance. This included check signing, wire transfers, cash receipts and fictitious employees. One of these public companies had 28 ways of committing fraud.

NOTE: IT IS UNLIKELY OUTSIDE AUDITORS WOULD DETECT FRAUD WITHOUT DOCUMENTING AND TESTING INTERNAL CONTROLS.

✚ **95.8% had ability to commit fraud through IT Operations.**

✚ **79.2% had Financial Reporting fraud capabilities.**

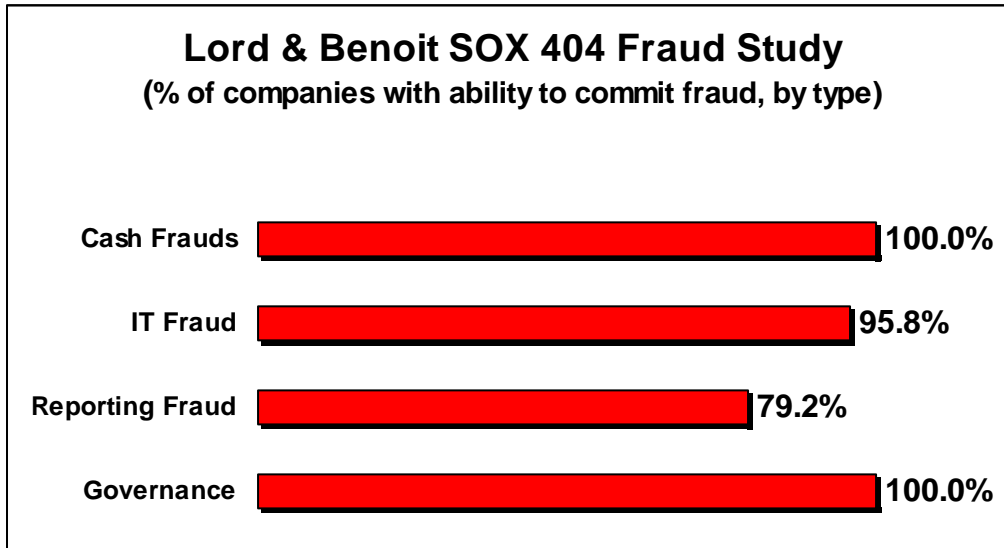
✚ **100% failed to regularly report deficiencies to their Audit Committee** prior to the study. Two of the twenty four company CFOs tried to *prevent the communication of control deficiencies to their Audit Committees* after the review was performed.

✚ **1,338 Control Deficiencies were found, an average of 56 per company.** An average of 8 fraud related instances were noted per company (from a low of 6 to a high of 28 per company), 15 IT deficiencies and 33 deficiencies from other accounting and company level controls per company.

⁵ The estimated number of non accelerated filer companies is 5,000, slightly more than the number of accelerated filers companies.

Fraud in U.S. Non-Accelerated Filer Companies

- ✦ **50% of the companies expressed “going concern” opinions PRIOR** to Sarbanes-Oxley Section 404(a) being required. Since, their outside auditors’ report questioned the Company’s ability to survive BEFORE SOX was required, one might argue against the theory that some companies left the U.S. market due to “costs of compliance”. These companies exhausted their investors’ resources PRIOR to the Sarbanes-Oxley Act.



Stock Exchanges in the study included NASDAQ, AMEX and OTCBB.

Companies included in this report followed the SEC Interpretive Guidance⁶, COSO Guidance for Smaller Public Companies⁷ including IT⁸ and Statement of Auditing Standards No. 99: Consideration of Fraud.

The Non-Accelerated Filer Companies included in the study varied in size and industries. The average revenues were \$48 million, ranging from zero to \$212 million). The market capitalization averaged \$16 million (ranging from \$7 million to \$89 million) using current market capitalization⁹ and revenue figures from Audit Analytics^{10 11}.

⁶ Commission Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934. <http://www.sec.gov/rules/interp/2007/33-8810.pdf>

⁷ COSO Guidance for Smaller Public Companies
http://www.coso.org/Publications/erm_sb/SB_EXECUTIVE_SUMMARY.PDF

⁸ Information Technology - using the COSO Guidance for Smaller Public Companies.

⁹ The market capitalization at the time of the study was below the \$75 million threshold.

¹⁰ Using Audit Analytics data as of Dec 9, 2009 for active companies. 8 of the 24 companies were no longer listed on the market, 2 due to sale of company and the remainder due to bankruptcy or pink sheet. The six companies all had going concern opinions expressed BEFORE Sarbanes-Oxley was required to be complied with.

Fraud in U.S. Non-Accelerated Filer Companies

Industries included a cross section of Banking/Mortgage, Biotech/Healthcare, Manufacturing/Distribution, Mining, Real Estate, Energy/Oil & Gas, Medical, Software, and Transportation.

Other Lord & Benoit studies showed that only a small majority of U.S. Non-Accelerated Filers were compliant with Section 404(a) which has been required since 2007 for all public companies. The research showed the preponderance of companies who were not required to conform to Section 404(b) auditor attestation refused to comply with 404(a).

“In 2009 only a small majority of U.S. Non Accelerated Filers were compliant with Section **404(a)** which has been required since 2007.

“Without **404(b)** auditor attestation, many companies refused to comply with Section **404(a)**.”

One might ask “If compliant companies experienced these fraud statistics, what might be happening with the majority of non-compliant companies which were excluded from this study?”

Latest Congressional Actions...

On December 11, 2009, Bloomberg.com reported the following: “The U.S. House moved a step closer to sparing small companies from complying with investor- protection rules imposed in the wake of accounting frauds at Enron Corp. and WorldCom Inc. Lawmakers today defeated 271-153 an effort to remove an exemption from legislation overhauling Wall Street regulation. The bill retains language letting companies with market values less than \$75 million avoid complying with the Sarbanes-Oxley Act’s audit requirements.

The amendment was offered by members of the Financial Services Committee but opposed by its Chairman Barney Frank and Representative Paul Kanjorski, who said giving companies a break from the 2002 Sarbanes-Oxley law erodes investor confidence. Proponents of the exemption said imposing compliance fees on small companies would hurt the fragile U.S. economy.

“This is an exemption that is unnecessary,” Frank, a Massachusetts Democrat, said yesterday during debate on the amendment. “It is a license for people who might want to be abusive, by guaranteeing them

¹¹ Audit Analytics is an online market research tool and leading provider of audit and internal control-related due diligence information for public companies. Audit Analytics obtains its information from the SEC Edgar data base.

Fraud in U.S. Non-Accelerated Filer Companies

that they'll never be audited." Sarbanes-Oxley was adopted seven years ago to impose checks on businesses after meltdowns at Enron and WorldCom shook faith in the accuracy of corporate financial statements.

The law requires companies to have adequate safeguards to prevent misstatements and make sure employees can't falsify numbers. Controls must be scrutinized and assessed by accountants." ¹²

Noted in an article published by the Washington Post on 11/9/09, Securities and Exchange Commission Chairman Mary L. Schapiro wrote a letter to the committee on Oct. 16 opposing an exemption, saying the law "leads management to better understand financial reporting risks, put in place appropriate controls to address financial reporting risks, and addressing internal control deficiencies in a more timely fashion."

Former SEC chairman Arthur Levitt was sharply critical of any efforts to roll back Sarbanes-Oxley. "Any member of Congress that supports the weakening of Sarbanes-Oxley is by definition anti-investor and will bear that responsibility for their legislative careers," Levitt said.

As it happens, the provisions of the law that require small companies to comply with audit requirements **have never been implemented** (emphasis added). The SEC has postponed the requirement multiple times to conduct studies of the costs associated with the provision. However, several weeks ago, the agency announced that, starting next year, small firms would have to pay auditors to review their controls and that there would be no more delays. ¹³

Additional Fraud Research...

It is curious to view the collision of two ideals: fraud prevention (and by extension, investor protection) versus the need to relieve the regulatory burdens of smaller public companies. While the purpose driving the current move to scuttle the Sarbanes-Oxley Act (SOX) is said to strengthen and boost job creation within the small business sector, this is just the latest in a series of reasons offered by SOX opponents as to why this regulation should be overhauled or eliminated entirely. Some of these reasons have included unjustified cost, over-reaction by Congress, the law's ineffectiveness in terms of stopping fraud and the shrinking of US capital markets. While there have been passionate arguments on both sides of the issue, the fact that fraud exists and hurts both businesses and the investor remains undisputed.

¹² For full article, see: <http://www.bloomberg.com/apps/news?pid=20601103&sid=a.l8GCzSWwRM>

¹³ For full article, see: <http://www.washingtonpost.com/wpdyn/content/article/2009/11/03/AR2009110303795.html>

Fraud in U.S. Non-Accelerated Filer Companies

According to the October 2009 press release by risk consulting firm Kroll, authors of the *Kroll Annual Global Fraud Report*, “**companies lost an average of \$8.8 million to fraud over the past three years**, an increase of seven percent over last year’s figure which stood at \$8.2 million.” It is important to note that smaller public companies, those with public float of under \$75 million were not subject to full SOX 404 compliance at this time. “*Traditionally every downturn brings about a rise in fraud, but what we are seeing in 2009 is something far more complex. Companies are seeing greater vulnerability due to reduction in internal controls, pay cuts and reduced revenue across the board...*” says Blake Coppotelli, senior managing director in Kroll’s Business Intelligence and Investigations unit. The report goes on to note that North America is “no longer the low fraud leader with seven out of 10 fraud incidences showing an increase over 2008 figures.” Companies experiencing internal financial fraud and financial mismanagement rose substantially...”¹⁴

But what is the relationship between fraud and smaller companies? Since the proposed change in SOX legislation is primary directed toward loosening regulation for small public companies, what are the risk factors involved in terms of this business segment? Numerous studies indicate that fraud is more prevalent in smaller companies by a wide margin. The Association of Certified Fraud Examiners (ACFE) publishes an annual *Report to the Nation on Occupational Fraud and Abuse*. The study attempts to define emerging fraud techniques as well as quantify the economic impact these crimes have on our economy. The current report indicates that frauds perpetrated against small businesses continue to cost more on average than those against larger firms.¹⁵

The Wall Street Journal also reports that **employee fraud tends to rise during tough economic times. And small companies are especially vulnerable because they often lack stringent internal controls to prevent fraud.** Sometimes, managers at affected companies attribute lost funds to lower sales—never even suspecting foul play. “A lot of times a small business will close its doors and may never know they were defrauded—that the problem wasn’t a declining economy, [but] that employees were stealing,” says James D. Rately, president of the Association of Certified Fraud Examiners.”¹⁶

“Small companies are the target of majority of the SEC’s financial fraud cases”

~ Institute of Management & Administration (IOMA)

¹⁴ <http://www.kroll.com/news/releases/index.aspx?id=22133>

¹⁵ Association of Certified Fraud Examiners, *2008 Report to the Nation on Occupational Fraud & Abuse*, Spring 2008 p.5

¹⁶ For full article, see: <http://online.wsj.com/article/SB123501158460619143.html>

Fraud in U.S. Non-Accelerated Filer Companies

In his paper entitled: *An Analysis of Small Company Frauds and Implications for Auditors in Detecting Frauds*, Michael Ulinski, PhD, CPA, Professor of International Business and Accounting at Pace University, remarks that “the related literature seems to indicate that small company frauds are as common as large company frauds and may have special characteristics because of the lack of internal control in smaller companies.”

In a study by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), an analysis of U.S. public companies was done to examine fraudulent financial reporting for the time period of 1987-1997. The study focused on “alleged violation of Rule 10(b)-5 of the 1934 Securities Exchange Act or Section 18(a) of the 1933 Securities Act given that these represent the primary antifraud provisions related to financial statement reporting. The search identified almost 300 companies accused of fraudulent financial reporting during the 11 year period, from which a final sample of 200 companies was taken. The COSO study found that most of the companies committing financial statement frauds were small companies and “the typical size of most of the sample companies ranged well below \$100 million in total assets in the year preceding the fraud period.” Fraud amounts in total were large in relation to the

The Committee of Sponsoring Organizations of the Treadway Commission study found...

“Most of the companies committing financial statement frauds were small companies.”

small sizes of the companies involved in the fraudulent financial reporting schemes. The average fraud was “\$25 million and the median was \$4.1 million.” The average company’s total assets were \$533 million and the median company had assets totaling at only \$16 million.¹⁷

One of the authors of the COSO fraud report, Joseph Carcello, a University of Tennessee professor, states that about 75% of companies

subject to fraud allegations described in SEC enforcement releases from 1998 to 2003 had market capitalizations of less than \$700 million, and 40% had market capitalizations less than \$100 million.

The April 2005 edition of the Institute of Management & Administration’s (IOMA) Report on Financial Analysis, Planning & Reporting also states that small companies are the target of majority of the SEC’s financial fraud cases. Only 20% of the cases brought forth by the SEC are high profile financial reporting fraud cases. The IOMA continues to report that the vast majority of frauds involving smaller companies *never make it to the press or general public.*

¹⁷ ABBS E-Journal Volume 3, No.1 2007: *An Analysis of Small Company Frauds and Implications For Auditors In Detecting Frauds* by Michael Ulinski p. 156-157

Fraud in U.S. Non-Accelerated Filer Companies

The COSO's fraud report discusses the implications of fraud for the companies involved. Since these companies are mostly small, there seems to be an unwillingness or incapability to implement internal controls, which leads to the opportunity for financial statement fraud. Just to name one possibility of weak internal controls in small companies that is infamous, **'the overriding of controls'** is easier in smaller public companies than in larger companies.¹⁸

Final Comments...

One of the most famous frauds committed by a smaller public company was that of the now-defunct Crazy Eddie, Inc. chain of consumer electronics stores in New York and New Jersey. Compared to today's billion dollar frauds, Crazy Eddie's scheme was smaller in size. However, the Crazy Eddie fraud was much more outrageous than most frauds committed because of its time span (18 years), its use of a combination of multiple methods, and the sheer impudence of its architects.

Sam E. Antar who was the former CFO of Crazy Eddie's helped mastermind the stock fraud. Crazy Eddie's \$40 million capitalization at the time of its initial public offering in 1984 grew to a \$600 million market capitalization and was according to Antar, completely built on fraud. Today, Sam Antar lectures on the very real dangers of fraud and white collar crime in the small business sector. His audiences have included government entities such the US Dept. of Justice, US Secret Service, FBI and the US Dept. of Treasury, major universities such as Stanford Business School and numerous professional organizations.

Traditionally every downturn brings about a rise in fraud, but what we are seeing in 2009 is something far more complex...

North America is "no longer the low fraud leader..."

~ Kroll Annual Global Fraud Report

According to Sam, "The culture of tax evasion was prevalent from the onset at Crazy Eddie. Our philosophy was that the government was not entitled to any taxes that we could hide from it. Crazy Eddie was engaged in a massive skimming fraud. We also perpetrated other forms of tax evasion, consumer fraud, and insurance fraud."¹⁹ From 1979 to 1984, Crazy Eddie gradually reduced its skimming each year to create artificial profit growth in the years prior to its initial public offering. It in effect created a fraud by "going legitimate." By 1984, Crazy Eddie had gone public and had hired the ninth largest accounting firm in the world to audit its records. We chose this firm because the company almost completely lacked

¹⁸ *Ibid*, p. 158

¹⁹ <http://seekingalpha.com/article/172061-advocates-to-repeal-sarbanes-oxley-forget-its-origins>

Fraud in U.S. Non-Accelerated Filer Companies

internal controls and had no chief financial officer. As a public company, we overstated our profits to increase our reported earnings to shareholders and inflate the market price of Crazy Eddie stock. During the period from 1984 to 1987, we overstated the values of our inventories, understated how much money we owed our creditors and even put some of the previously skimmed money back into the company to overstate the earnings of Crazy Eddie. We committed a host of other frauds too numerous to list here as well.²⁰

Anton continues, "Many critics of SOX have argued that internal controls are too costly for small companies. The auditors of Crazy Eddie tried to remedy the situation by doing a so called "substantive audit" with no reliance on internal controls since the company's internal controls were very poor. While in theory you can conduct an audit without reliance on internal controls, the absence of adequate internal controls poses the problem of making almost all companies difficult or virtually impossible to audit. Therefore, the review of internal controls of a company by independent outside auditors is crucial for effective auditing. It is evident that a company must have a viable system of internal controls to be auditable. Both items are not mutually exclusive. One simple lesson from the Crazy Eddie fraud that can be learned is that companies who get capital from the public markets (public companies) have a sacred fiduciary duty to their investors and creditors to have strong internal controls that are verifiable and reviewed by well qualified, truly independent auditors. Private companies, too, owe the same duty to their creditors and shareholders.

"Strong internal controls, auditor independence, accounting education, and the integrity of financial reporting are the four main pillars to the soundness of our financial reporting system. They must all work in conjunction for accounting standards to be properly implemented."²¹

About the authors...

Bob Benoit is the president of Lord & Benoit, LLC, a SOX Research and Compliance firm focusing on smaller public companies. In addition to his position with Lord & Benoit, Bob served on the COSO Monitoring Project Taskforce (Committee of Sponsoring Organizations of the Treadway Commission). He has served on the American Institute of CPAs Peer Review Acceptance Board in MA for ten years. He has taught Compliance with SOX 404 throughout the country through the State CPA Societies. 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 250 newspapers, magazines, legal, educational and trade journals. Bob is also the first evaluator to use the 2006 COSO Guidance for Smaller Public Companies, the inventor of Virtual SOX taught on the AICPA Technology website and research contributor to the SEC Subcommittee, SEC Concept Releases and SEC/PCAOB Internal Control Roundtables. For additional research, visit: <http://www.Section404.org>

²⁰ *Ibid.*

²¹ *Ibid.*

Fraud in U.S. Non-Accelerated Filer Companies

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¹The unique characteristics of smaller public companies were considered while documenting and testing controls under Sarbanes-Oxley Section 404(a) Management Assessment of Internal Controls over Financial Reporting: (a) Description and characteristics of fraud. (b) The importance of objectivity as stressed in SEC, PCAOB and COSO guidance.(c) The use of professional skepticism. (d) Discussion amongst management and internal audit regarding the risks of material misstatement due to fraud. (e) Importance of obtaining the information needed to identify risks of material financial reporting misstatements due to fraud. (f) Identification of internal accounting control and information technology risks that may result in a material misstatement due to fraud. (g) Assessing the identified risks after taking into account an evaluation of the entity's programs and compensating controls. (h) Governance requirements of public company Audit Committees.(i) Management's response regarding the results of the assessment. (j) Evaluating evidence to support conclusions. (k) Communicating about fraud to management and, the Audit Committee. (l) Developing remediation plans regarding the consideration of fraud.



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