



# The Lord & Benoit Report:

## Bridging the Sarbanes-Oxley Disclosure Control Gap

This report was prepared by Robert Benoit, CPA  
of Lord & Benoit, LLC, [www.Section404.org](http://www.Section404.org)  
(a national Sarbanes-Oxley Research and Compliance firm)

in association with [www.AuditAnalytics.com](http://www.AuditAnalytics.com)  
(a premier on-line market intelligence service  
from the IVES Group, Inc).

## **The Lord & Benoit Report: Bridging the Sarbanes-Oxley Disclosure Control Gap**

### **EXECUTIVE SUMMARY**

The report compiles historical information that addresses both the likelihood of self reporting internal control deficiencies and the advancement of quality in financial reporting as it relates to the most recent recommendations of the Advisory Committee on Smaller Public Companies.

The SEC Subcommittee on Smaller Public Companies recently released a draft report containing recommendations that it believes will advance the goal of enhancing the quality of financial reporting while also reducing the cost of compliance to SmallCap and MicroCap public companies.

An important underpinning of these recommendations is that SmallCap and MicroCap companies, with the addition of several new corporate governance requirements, can be relied upon to self report material weaknesses in internal controls over financial reporting and maintain a high level of quality in financial reporting.

The Lord & Benoit Report examines the historic relationship between Section 404 (internal control over financial reporting) and Section 302 (self reporting of disclosure controls and deficiencies in internal controls) reporting and compiles research about historical financial restatements. The following is a summary of the results:

1. Only 1 in 12 companies with ineffective Section 404 controls self reported ineffective 302 controls in the *prior year*.
2. Only 1 in 8 companies with ineffective Section 404 controls self reported ineffective 302 controls in the *prior quarter*.
3. A full 9 out of every 10 companies with ineffective Section 404 controls self reported ineffective 302 controls in the *same period end* that an adverse Section 404 was reported.
4. Of all the first year *accelerated* filers reporting Section 404 ineffective controls over financial reporting, slightly more than half had revenues under \$250 million.
5. Financial restatements for both accelerated filers and non-accelerated filers have increased to record levels over each of the past three years, reaching 14% of 2005 filers in each group.

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The results of this research provide strong evidence of what the investing public can expect with respect to self-reporting of material weaknesses of internal controls and the quality of financial reporting by companies not required to comply with Section 404. Given that the Committees' recommendation is expected to eliminate both the self reporting and the independent audit opinion requirements deriving from Section 404 for 80% of all registrants, the following derivations should be considered in the overall analysis.

1. For those companies with ineffective internal controls, the expected rate of full and accurate disclosure under Section 302 will range between 8 and 15 percent.
2. The highest rates of material weaknesses in Section 404 internal controls over financial reporting will be SmallCap and MicroCap companies with revenue below \$250 million.
3. Although the change in the number of restatements cannot be readily forecasted. Historically, the number of restatements by both accelerated and non accelerated filers increased by similar percentages supporting the assertion that MicroCap companies, presumably with the aid of their outside auditors, have heightened their focus on financial reporting deficiencies. Alternatively, this analysis highlights that it is precisely this size company, MicroCap, which produces the greatest number of errors.

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### **POPULATION**

The Section 404 and 302 research is not based on a sample set, but on a complete evaluation of *all* public company accelerated filers that completed Section 404 self assertions and expressed their conclusions on their latest Form 10-K. The financial restatement data represents a complete dataset of both accelerated and non-accelerated financial restatements. The information covers filings from the EDGAR database up to February 25, 2006, using AuditAnalytics.com. The population:

- ⇒ Included *all* accelerated filers with year-ends after Nov. 15, 2004 and before Nov 15, 2005 who filed a self assessment of internal controls over financial reporting under Section 404.
- ⇒ Included all industries and all locations
- ⇒ Includes companies who are publicly registered but do not have active tickers and filed Section 404 reports.
- ⇒ Excludes the duplication of a parent/subsidiary relationship where both filed Section 404 reports
- ⇒ Excludes the potential double counting of restated Section 404 opinions.

### **BACKGROUND**

The Sarbanes-Oxley Act of 2002 (SOX) was created in response to a number of significant public registrants issuing financial statements and reports that were grossly misleading. These reports led to the two largest bankruptcies in US history and raised serious questions about the then current state of both corporate and outside auditor governance. The Public Company Accounting Oversight Board (PCAOB) was created as a result of the Act with its primary responsibilities to oversee the implementation of auditing standards and provide oversight of outside auditors. The essence of SOX is to establish standards and requirements for advancing activities associated with corporate governance (ethics, integrity, tone at the top, HR policies and procedures), company wide and activity level internal controls, IT controls over financial reporting and risk assessment. The overall goal of SOX is to improve transparency in financial reporting and advance the accuracy and timeliness of public company disclosures. The Act is broken down into various Sections. This report focuses on Sections 302 and 404.

SOX Section 302, among other things, is a quarterly self assertion by the CEO/CFO, under personal liability, disclosing significant material financial information to stakeholders and investors. The assertion is included in the company's Form 10Q (and 10K at year end). There is no supporting documentation or

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independent examination requirement under Section 302. Alternatively, Section 404 contains both a documentation and independent examination requirement. The following is an example of an *effective* Section 302 report recently issued by General Electric:

Under the direction of our Chief Executive Officer and Chief Financial Officer, we evaluated our disclosure controls and procedures and internal control over financial reporting and concluded that (i) our disclosure controls and procedures **were effective** as of September 30, 2005, and (ii) no change in internal control over financial reporting occurred during the quarter ended September 30, 2005, that has materially affected, or is reasonably likely to materially affect, such internal control over financial reporting.

The following is an example of an earlier *ineffective* Section 302 report they issued:

Under the direction of our Chief Executive Officer and Chief Financial Officer, we evaluated our disclosure controls and procedures and internal control over financial reporting and concluded that our disclosure controls and procedures **were not effective** as of March 31, 2005 solely because of the following material weakness in internal control over financial reporting with respect to accounting for hedge transactions: a failure to ensure the correct application of SFAS 133 when certain derivative transactions were entered into at GECC prior to August 2003 and failure to correct that error subsequently.

SOX Section 404, on the other hand, requires management to provide documented evidence of their self assessment of internal controls over financial reporting. Among other things, it includes testing for: integrity and ethical behavior, tone at the top, audit committee effectiveness, whistleblower programs, HR policies and procedures, IT controls relating to financial reporting, anti fraud provisions, evaluation of the design of controls and risk assessment. The self assessment is performed by management and reviewed by the outside auditors once a year. The outside auditors express two opinions: one on the design of the assessment and one of the effectiveness of the internal controls.

For most public companies, the first year was a difficult adjustment because policies and procedures were outdated if they existed at all. The pains of increased structure, changing the way things are done and lots of extra work took their toll on Corporate America, particularly on those with internal control deficiencies.

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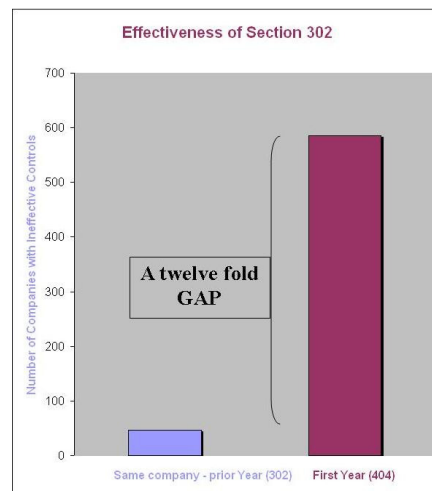
Now that a full year of results are in (*last filings were January 31, 2006 for year end Oct 31, 2005 filers*), we have undertaken a study of the relationship between Sections 302 and 404.

SOX requires all public companies to comply with all sections of the Act, except Section 404 which was delayed for smaller public companies. The effective date of compliance was extended twice. Companies now need to comply when their year ends after July 15, 2007. The SEC Advisory Committee to Smaller Public Companies has recommended either the elimination of Section 404 and/or the outside auditor review of Section 404 for smaller public companies with revenues and market caps under \$250 million in market cap and sales. Essentially the Committee believes the smaller public companies are immaterial to the overall stock market and the cost of self assessing internal controls exceeds the benefit. The recommendation would exempt companies with revenues under \$250 million from documenting and self assessing their internal controls over financial reporting. There is an estimated 6,000 public companies in this group. Reliance on self disclosing under Section 302 quarterly assessments is recommended instead.

### STUDY #1

The first study examined all accelerated filers who filed Section 404 reports. The research identified 586 companies with *ineffective internal controls under Section 404* in year one. These Section 404 reports were compared to the same company's *prior year* Section 302 reports. The expectation was that the prior year Section 302 reports would have been self reported as being *ineffective* as well. However, the results showed only 47 of the same 586 companies reported ineffective controls in the prior year Section 302.

- There was a twelve-fold disclosure gap.



Source: Lord & Benoit, LLC a SOX research and compliance firm  
www.Section404.org using AuditAnalytics.com

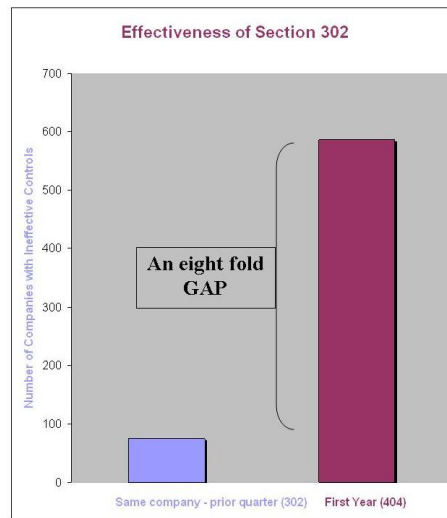
*Twelve times as many companies reported ineffective controls under Section 404 than the same companies a year earlier under Section 302.*

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### STUDY #2

The study continued to compare the Section 404 ineffective control reports to the same company's Section 302 report in the *prior quarter*. Since the time delay between filing Q3 Section 302 reports and the year end is typically about 45 days, the expectation was that the Section 302s would have been reported as ineffective. However, the data showed only 75 of the 586 companies reported ineffective controls in the *prior quarter* under Section 302.

- There was an eight-fold disclosure gap - just 45 days before the year end Section 404 disclosure.



Source: Lord & Benoit, LLC a SOX research and compliance firm  
www.Section404.org using AuditAnalytics.com

*Eight times as many companies reported ineffective controls under Section 404 than the same companies a quarter earlier under Section 302.*

When looking at the details of the Section 302 reports, we found 20 companies reported effective controls, yet listed material weaknesses in the same report. Perhaps this should be looked into as a separate project to examine the rationales utilized by companies to evaluate the relationship between material weaknesses and ineffective Section 302 controls. If we assume management should have reported their Section 302 as ineffective and we add these 20 companies to the 75 who reported ineffective controls, the gap would be reduced to a 6 fold disparity.

It may also be relevant to consider that most companies that ended up with ineffective Section 404 reports were well aware of this possibility during the quarter prior to such a conclusion.

Given that it is at least inferable under the Section 302 legislation that companies are supposed to report "significant deficiencies" (a lower standard than "material weaknesses" under Section 404 standards) in their quarterly and annual reports, one would have expected far greater numbers of Section 302 significant deficiency disclosures than have been observed to date.

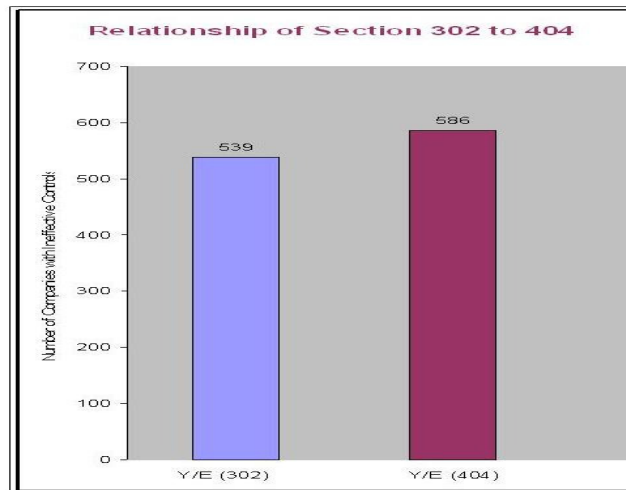
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### STUDY #3

A study was taken to determine if there is a correlation between Section 302 and 404. Of the 586 companies that reported ineffective controls under Section 404, 539 had reported ineffective disclosures under Section 302 for the same period end.

- There was a 92% consistency in reporting both ineffective disclosure controls under Section 302 and internal controls under Section 404 in the quarter both were performed.

This analysis provides evidence that it was only after a company was faced with having to report ineffectiveness under Section 404, part of which is the independent auditor assessment, that companies self reported deficiencies under Section 302. Under the legislation one would expect that most companies would first report deficiencies under Section 302, and then potentially never report under Section 404 because of remediation activities.



Source: Lord & Benoit, LLC a SOX research and compliance firm  
www.Section404.org using AuditAnalytics.com

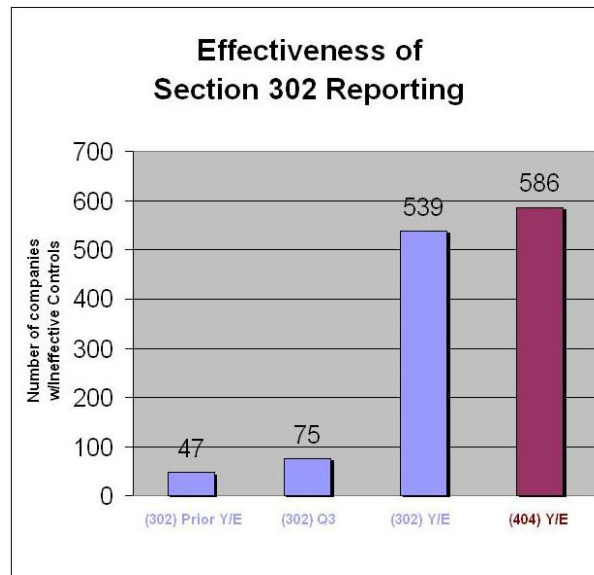
*Section 302 report and Section 404 report findings became consistent when the companies were subject to Section 404 reporting at year end*

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## STUDY #4

The following chart illustrates the four periods studied. The Section 302 and 404 reports are of the same companies that reported ineffective internal controls in their first year Section 404 report. The study illustrates that documenting the self assessment of internal controls under Section 404, along with the audit of internal control assessment by the outside auditors caused the companies to self report deficiencies under Section 302 properly and in accordance with professional standards.

- The results demonstrates that only after a company was faced with having to report ineffectiveness under Section 404, part of which is the independent auditor assessment, that companies self reported deficiencies under Section 302.



Source: Lord & Benoit, LLC a SOX research and compliance firm  
www.Section404.org using AuditAnalytics.com

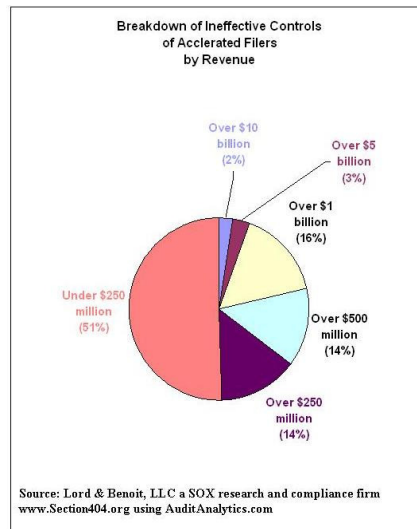
*It was not until 404 was required that companies self disclosed Section 302 deficiencies properly.*

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## STUDY #5

The study continued by breaking out the 586 companies with ineffective controls, by company revenue. Our expectation was that the larger companies with more complex accounting policies would experience the lion's share of the control deficiencies. This would be consistent with the recommendation to exempt smaller public companies from Section 404 self assessment of internal control over financial reporting. However, the results showed that fifty one percent (51%) of the accelerated filers that had ineffective controls were companies with revenues under \$250 million.

- 51% of accelerated filers with ineffective controls had revenue under \$250 million:



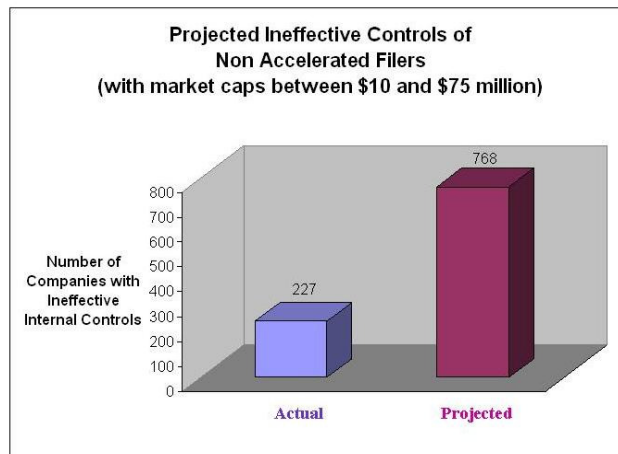
*Fifty one percent of all accelerated filers with ineffective controls had revenues under \$250 million.*

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### STUDY #6

Based on the gap identified between 302s and 404s of accelerated filers, we attempted to project the number of non-accelerated filers with market caps between \$10 million and \$75 million that should have reported control deficiencies in similar conditions of self assessment under Section 404. Using prior year 302s of non-accelerated filers, we projected the number of MicroCap filers that would have ineffective controls under Section 404. Our study found 64 companies with ineffective controls under Section 302 in the *prior year*. The current year showed 227 ineffective Section 302s. Using the same twelve to one gap that accelerated filers reported in their Section 302s and 404s, we estimated that for this group alone, 768 non-accelerated filers would have reported ineffective controls under Section 404.

- This analysis provides some evidence that in 2005 as many as an additional 541 MicroCap companies with market caps between \$10 million and \$75 million should have reported deficiencies under Section 302.



Source: Lord & Benoit, LLC a SOX research and compliance firm  
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*An estimated 541 additional non accelerated filers in this market cap group would have reported ineffective controls, if the same ratios applied.*



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### **SUMMARY**

The statistics raise questions for the Securities and Exchange Commission (SEC), Public Companies Accounting Oversight Board (PCAOB), investors and other regulators to consider:

- Can Section 302 disclosure requirements, alone, ever produce internal control deficiency disclosures in as an affective way as Section 404 requirements?
- With the company reporting under Section 302 alone, why did only 1 of 10 self report?
- Can Section 302 disclosure requirements ever be effective without some sort of outside auditor involvement?
- Can Section 404 disclosures be effective without an outside auditor's review?
- With auditor reporting alone and no company self assessments under 404, can the reporting of deficiencies expect to be effective?
- Was the co-dynamic of the outside auditors working together with the company the catalyst that brought out the maximum level of full disclosures of underlying issues?
- Are the financial and operational costs associated with Section 404 compliance worth the resulting disclosure of internal control or disclosure control weaknesses?
- Does the increase in financial restatements indicate a dramatic company driven increase in the quality of financial reporting or are other forces at work such as changes in the governance of auditing firms, perspectives about materiality or increases in the levels of auditor changes?

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**The Lord & Benoit Report** was written by Robert Benoit, CPA in consultation with Mark Cheffers from the IVES Group, Inc. (AuditAnalytics.com). Benoit has been teaching Compliance with Sarbanes-Oxley Section 404 throughout the U.S. through the State CPA Societies. He has been on Massachusetts AICPA Peer Review Acceptance Board for ten years, has performed over 400 peer reviews of CPA firms and is President of Lord & Benoit, LLC a national Sarbanes-Oxley Research and Compliance firm [www.Section404.org](http://www.Section404.org).

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