Ten Steps to SOX Compliance for Smaller Public Companies

Source: Lord & Benoit, LLC  www.Section404.org
Objective

The following presentation was prepared to assist with the SEC with its Concept Release for helping Smaller Public Companies comply with the requirements of Sarbanes-Oxley Section 404. We believe this framework meets all of the PCOAB of Auditing Standard #2 – Internal Controls over Financial Reporting, however it is prudent for company management to have their outside audit firm approve frameworks in advance.

“Having met with and spoken to partners of smaller PCAOB registered CPA firms and CFOs of smaller public companies, the main concern with complying with Sarbanes-Oxley Section 404 seems to be a lack of understanding of the requirements.” says Bob Benoit, President and Director of SOX Research at Lord & Benoit, LLC. Lord & Benoit is a SOX compliance and research firm focused on smaller public companies.

In the public interest and in the interest of continuing to be a thought leaders in SOX 404 compliance and research for smaller public companies, Lord & Benoit is sharing its summary outline of the requirements of the Act (from SEC, PCOAB, AICPA, COSO and IT perspective). Please feel free to contact Bob should you have any questions at (508) 853-6404 x204.

Source: Lord & Benoit, LLC  www.Section404.org
Background

Bob Benoit has been teaching Complying with Sarbanes-Oxley Section 404 throughout the country and through the State CPA Societies. He has also served on the AICPA Peer Review Acceptance Board for the past ten years in Massachusetts.

Bob’s research on smaller public companies has been quoted by the Wall Street Journal and over one hundred other influential SOX trade journals, legal organizations, educational institutions, SEC Staff, Commissioners and Advisory Committees, PCOAB Board members and all of the Big 4 CPA firms.

Links to some of Bob’s teachings and research are in the Appendices section of this presentation.

Source: Lord & Benoit, LLC  www.Section404.org
The following are ten steps that a smaller public company could follow to implement a complete a SOX 404 project.

Source: Lord & Benoit, LLC  [www.Section404.org](http://www.Section404.org)
What comprises SOX Section 404?

The practical application of SOX 404 requires an understanding of many different frameworks and auditing standards. For instance, it requires and understanding of all of the following:

- Sarbanes-Oxley Act
- PCOAB Auditing Standard #2
- SEC Q&A Standards
- AICPA/FASB Standards
- CoBIT or ITGI or SAS 55 for IT
- COSO or Small COSO for Internal Control

Source: Lord & Benoit, LLC  [www.Section404.org](http://www.Section404.org)
The first step is to “Line Up Your Team”

- In house team and their resumes
- External and their qualifications
- Include the outside auditors in the control concepts, but not testing
- Ensure management and upper management are on board
- Prepare audit committee
- Expect much improvement and redesign in year one. Consider starting soon

Source: Lord & Benoit, LLC  www.Section404.org
Step 2

The second step is to “Establish a Timeline”

Source: Lord & Benoit, LLC  www.Section404.org
The third step is to “Select the Frameworks”

Internal Control Frameworks:
- COSO
- COSO for Smaller Public Companies

IT Frameworks:
- CoBIT
- ITGI Control Initiative for Sarbanes-Oxley
- SAS 55

Source: Lord & Benoit, LLC  [www.Section404.org](http://www.Section404.org)
Although not required by professional standards, we recommend a **Macro Level Risk Assessment**. It summarizes ALL of the adverse Section 404 weaknesses that peer companies reported in their compliance efforts. This is a sample of all of the first year adverse reports of companies in the Biotech, Pharm and Life Science industries. Macro Level Risk Assessment helps us understand the risks in our peer industries with the end goal in mind.

<table>
<thead>
<tr>
<th>Accounting Material Weaknesses</th>
<th># Co.s</th>
<th>%b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognition issues</td>
<td>11</td>
<td>45.8%</td>
</tr>
<tr>
<td>Inventory, vendor and cost of sales issues</td>
<td>8</td>
<td>33.3%</td>
</tr>
<tr>
<td>Tax expense/benefit/deferral/other (FAS 109) issues</td>
<td>8</td>
<td>33.3%</td>
</tr>
<tr>
<td>Accounts/banks receivable, investments &amp; cash issues</td>
<td>7</td>
<td>29.2%</td>
</tr>
<tr>
<td>PRE, intangible or fixed asset (value/diminution) issues</td>
<td>7</td>
<td>29.2%</td>
</tr>
<tr>
<td>Foreign, related party, affiliated and/or subsid issues</td>
<td>5</td>
<td>20.0%</td>
</tr>
<tr>
<td>Liabilities, payables, reserves and accrual est failures</td>
<td>4</td>
<td>16.7%</td>
</tr>
<tr>
<td>Debt, quasi-debt, warrants &amp; equity (BCF) security issues</td>
<td>3</td>
<td>12.5%</td>
</tr>
<tr>
<td>Fin Stmt/ footnote/ US FASB, segment disclosure issues</td>
<td>3</td>
<td>12.5%</td>
</tr>
<tr>
<td>Acquisition, merger, disposal or reorganization issues</td>
<td>2</td>
<td>8.3%</td>
</tr>
<tr>
<td>Income statement, margin and EPS issues</td>
<td>2</td>
<td>8.3%</td>
</tr>
<tr>
<td>Lease, FAS 5, legal, contingency &amp; commit issues</td>
<td>2</td>
<td>8.3%</td>
</tr>
<tr>
<td>Deferred, stock-based or executive comp issues</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td>Depreciation, depletion or amortization issues</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td>Gain or loss recognition issues</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td>Intercompany/Investment w/ sub/affil issues</td>
<td>1</td>
<td>4.2%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Internal Control Material Weaknesses:</th>
<th># Co.s</th>
<th>%b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting documentation, policy and/or procedures</td>
<td>22</td>
<td>91.7%</td>
</tr>
<tr>
<td>Material and/or numerous auditor /YE adjustments</td>
<td>14</td>
<td>58.3%</td>
</tr>
<tr>
<td>Accounting personnel resources, competency/training</td>
<td>12</td>
<td>50.0%</td>
</tr>
<tr>
<td>Restatement or nonreliance of company filings</td>
<td>12</td>
<td>50.0%</td>
</tr>
<tr>
<td>Segregations of duties/ design of controls (personnel)</td>
<td>10</td>
<td>41.7%</td>
</tr>
<tr>
<td>Untimely or inadequate account reconciliations</td>
<td>6</td>
<td>25.0%</td>
</tr>
<tr>
<td>Information technology, software, security &amp; access issues</td>
<td>4</td>
<td>16.7%</td>
</tr>
<tr>
<td>Restatement of previous 404 disclosures</td>
<td>3</td>
<td>12.5%</td>
</tr>
<tr>
<td>Senior management competency, tone, reliability issues</td>
<td>3</td>
<td>12.5%</td>
</tr>
<tr>
<td>Ethical or compliance issues with personnel</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td>Ineffective or understaffed audit committee</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td>Insufficient or non-existent internal audit function</td>
<td>1</td>
<td>4.2%</td>
</tr>
<tr>
<td>Scope (disclaimer of opinion) or other limitations</td>
<td>1</td>
<td>4.2%</td>
</tr>
</tbody>
</table>

Source: Lord & Benoit, LLC using AuditAnalytics.com
The following risk assessments are required. Enterprise Risk Assessment and Fraud Risk Assessment should be performed in the early stage of SOX 404 compliance. We recommend starting here to focus our attention to the high risk areas early in the project.
The fifth step is “Mapping”

“Mapping” requirements are defined in PCAOB Auditing Standard No. 2.

- Identify significant accounts and disclosures
- Identify significant business units and locations
- Indicate relevant financial statement assertions
- Determine major classes of transactions
- Document significant processes and sub processes
- IT Infrastructure
- Identify internal controls over major classes of transactions
- Evaluate likelihood, magnitude and other controls.
- Determine which controls should be tested

Source: Lord & Benoit, LLC  www.Section404.org
Another Look of “Mapping”

We provided this template to help you visualize the mapping process for a typical smaller public company...

Source: Lord & Benoit, LLC  www.Section404.org
The sixth step is evaluating “Company Level Controls”

COSO “Control Environment”

- Integrity & Ethical Values
- Commitment to Competence
- Board of Directors/Audit Committee
- Management’s Philosophy and Operating Style
- Organizational Structure
- Assignment of Authority & Responsibility
- HR Policies and Procedures

We start the company level control documentation process early by looking at COSO requirements.

Source: Lord & Benoit, LLC  www.Section404.org
8. Financial Reporting Objectives - Management specifies financial reporting objectives with sufficient clarity and criteria to enable the identification of risks to reliable financial reporting.

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Do financial reporting objectives align with the requirements of generally accepted accounting principles?</td>
<td></td>
</tr>
<tr>
<td>Are the accounting principles selected appropriate in the circumstances?</td>
<td></td>
</tr>
<tr>
<td>Are financial statements informative of matters that may affect their use, understanding, and interpretation?</td>
<td></td>
</tr>
<tr>
<td>Is information presented classified and summarized in a reasonable manner, neither too detailed nor too condensed?</td>
<td></td>
</tr>
<tr>
<td>For each significant account and disclosure, are financial reporting objectives supported by financial statement assertions that underlie a company's financial statements?</td>
<td></td>
</tr>
<tr>
<td>Does the financial statements presentation reflect the idea of materiality?</td>
<td></td>
</tr>
</tbody>
</table>

9. Financial Reporting Risks - The company identifies and analyzes risks to the achievement of financial reporting objectives as a basis for determining how the risks should be managed.

<table>
<thead>
<tr>
<th>Question</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does the company's risk identification include consideration of the business processes that impact financial statement accounts and disclosures?</td>
<td></td>
</tr>
</tbody>
</table>
Company Level Controls

COSO “Information & Communication”

COSO “Monitoring”

Source: Lord & Benoit, LLC  www.Section404.org
The seventh step is testing “Company Level Accounting Controls”

Company Level Accounting Controls

- Period End Closing Activities
- Significant Estimates
- Application of GAAP
- General Ledger
- Significant Disclosures

Source: Lord & Benoit, LLC  www.Section404.org
The eighth step is the “Design of Internal Controls”

1) Assessing Design of Controls

2) Documenting Control Narratives

This is the area we think of most when we think of internal controls.

Although in a smaller public company this area often represents the least risk.

However, it needs to be documented to satisfy SOX 404.

Source: Lord & Benoit, LLC  www.Section404.org
Step nine is “Testing Operating Effectiveness” (also called Activity Level Controls)

This is what accountants would affectionately call the “test of transactions”. It includes testing of expenditures, treasury, revenue, payroll, property, debt/equity, etc. Activity level control tests should be tested after controls are re-designed. However the company must be sensitive to the sustainability aspect of SOX 404, so activity level control testing should not be completely ignored at the outset. Conversely, documenting activity level control tests before addressing design deficiencies leads to redundancy, because the controls will need to retested after the redesign.

Source: Lord & Benoit, LLC  www.Section404.org
Sample sizes and significant controls should be identified at the risk assessment process level mentioned earlier. It is also wise to coordinate and determine what constitutes a significant control with outside auditors to minimize both over and under testing.

**Testing of Controls**

- Daily
- Weekly
- Monthly
- Quarterly
- Once a year
- Establish sample size
- Test Key Controls

Source: Lord & Benoit, LLC  [www.Section404.org](http://www.Section404.org)
The final step is “IT Controls”

Although presented last in this ten step process, IT should be assessed concurrently with the other tests, including the IT risk assessment process.

Two areas need to be tested and documented in the area of IT; general computer controls and application controls.

General IT Controls
- Design of IT environment

IT Application Controls
- Effectiveness of controls

Source: Lord & Benoit, LLC  www.Section404.org
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for Smaller Public Companies

Source: Lord & Benoit, LLC  www.Section404.org
Appendix: Bob Benoit’s Education & Training classes

- KPMG’s SOX 404 Institute (coming this fall)
- Center for Business Intelligence (Sept 28, 2006): SOX Conference – Biotech/Pharm
- Marcus Evans (Nov 14-15, 2006): (Miami) COSO for Smaller Public Companies
- Marcus Evans (Dec 7-8, 2006): (San Jose) COSO for Smaller Public Companies
- Compliance Online (Aug 2, 2006): 10 Pre-SOX Tips for Smaller Public Companies
- Compliance Online (Jul 18, 2006): Risk Assessment for Biotech/Pharm/Life Science
- Ohio Society of CPAs (2005): Cleveland
- Ohio Society of CPAs (2005): Columbus
- Ohio Society of CPAs (2005): Cincinnati
- Arizona Society of CPAs (2005)
- Texas Society of CPAs (2005): Dallas
- Texas Society of CPAs (2005): Houston
- Wisconsin Institute of CPAs (2005)
- New Jersey Society of CPAs (2005)
- Michigan Association of CPAs (2005): Troy
- Michigan Association of CPAs (2005): Grand Rapids
- Michigan Association of CPAs (2005): Detroit
- Nevada Society of CPAs (2005)

Source: Lord & Benoit, LLC  www.Section404.org
Appendix: Recent Lord & Benoit Research referenced in Newspapers, Research & Trade Publications

- **BNA** (May 2006): Sarbanes-Oxley and Small Business
- **ADP** (2006) "HR’s Role in Ensuring Compliance and Driving Cultural Change”
- **BNA** - Article about restatements research
- **FEI** (May 8, 2006): “Cost, Benefits of 404 to Investors”
- **RIA Thomson/Southwest Learning**: reprint of WSJ article
- **Sarbanes-Oxley Compliance Journal** (April 25, 2006):
- **Sarbanes-Oxley Compliance Journal** (May 12, 2006): “Share Price Increases”
- **FEI** (June 13, 2006): AuditAnalytics Presentation
- **Top 40 Accounting Firms** (2007 Edition): Lord & Benoit SOX research
- **CFO.com** (April 14, 2006): “A Question of Scale Not Exemption”
- **SOX First** (April 25, 2006): “Getting Even with Accountants”
- **Securities Fraud Monitor** (2006): “Strong Internal Controls Benefit Shareholders”
- **CMA Conference** (June 1-2, 2006): “Internal Control - SOX Certifications”
- **Counsel of Institutional Investors** (May 17, 2006): letter to Chairman SEC and PCAOB
- **CFO.com** (May 16, 2006): comment about “Do Benefits Exceed Cost?”

Source: Lord & Benoit, LLC  [www.Section404.org](http://www.Section404.org)
Appendix: Recent Lord & Benoit Research referenced by “Big 4”

- PWC Training Materials (May 16, 2006): “Navigating the New World”
- Ernst & Young (June 2006): “Finance-Magazine, Risk Matters”
- KPMG website (May 30, 2006): requested both research reports on their client website
- Grant Thornton (June 20, 2006): Trent Gazzaway, at Capital Hill in Washington, D.C.
- Deloitte (June 1-2, 2006): Presentation materials at CMA Conference
- Protiviti (May 12, 2006): Their Newsletter
- Ernst & Young: “Key S404 Events and Releases” (April/May 2006)
- Deloitte (April 3, 2006): Their letter to SEC Advisory Committee
- Deloitte LINK (April 14, 2006): Bridging the Sarbanes-Oxley Disclosure Control Gap
- PWC: CFO Direct Website (May 10, 2006) transcript of “2006 Internal Control Roundtable”
- Ernst & Young Ireland (May 25, 2006): Steering Committee Meeting of Bank of Ireland
- Big 4.com (May 2006): Volume 1 “Bridging the SOX Disclosure Control Gap”
- Deloitte (May 11, 2006): newsletter about PCAOB/SEC Internal Controls Roundtable
- Big4 Alumni Magazine (May 2006) Volume 1 Issue 5
- Deloitte Canada (May 2006): posted report on their website

Source: Lord & Benoit, LLC  www.Section404.org
Appendix: Recent Lord & Benoit Research
references by SEC and PCOAB

- **SEC Commissioner Glassman’s** (May 8, 2006): "CFO Summit: Putting Sarbanes-Oxley Section 404 in Perspective"
- **PCAOB Standing Advisory Group** Meeting (June 13, 2006): “Implications of ICFR Reporting”
- **PCAOB Board Member Neimeier** (May 4, 2006): "Confronting the Challenges of Change"
- **SEC Staff** (April 7, 2006): their letter to SEC Advisory Committee
- **PCAOB/SEC Internal Controls Roundtable** (May 10, 2006): Mr. Johnson from Calpers mentions research about share price movement
- **AICPA - Center for Public Company Audit Firms** (May 15, 2006): mentioned report in Summary of SEC 404 Roundtable
- **PCAOB/SEC Internal Controls Roundtable** (May 10, 2006): unedited transcript
- **SEC Advisory Committee** (April 18, 2006): Discussion Draft
- **SEC Advisory Committee** (April 12, 2006): Proceedings
- **SEC Advisory Committee** (April 23, 2006): Final Report

Source: Lord & Benoit, LLC  [www.Section404.org](http://www.Section404.org)