



**Lord & Benoit**

Shining Light on Section 404 Compliance

## Sarbanes-Oxley Section 404: 10 Threats to Compliance for Smaller Companies

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Smaller public companies performing their first management assessment under Sarbanes-Oxley Section 404 may find their first year of compliance particularly challenging. To help unravel the maze of uncertainty, Lord & Benoit has gathered historical evidence of material weaknesses from companies with revenues under \$100 million. Since smaller public companies are uniquely transitioning from an entrepreneurial environment to a more controlled or structured growth, some companies may find that rather challenging.

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). Clients with clean internal controls were excluded from this study.

This list provides crucial data that you can use in developing your strategy to assess high level risks within your company. The following are the ten leading material weaknesses in Lord & Benoit's study:

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. Therefore we found that of the 148 companies we reviewed with material weaknesses, 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** The next level of material weakness noted was in the process level control area of Treasury. There were 92 findings noted in this category including accounting for stock, debt, investments, derivatives and cash controls. Common in the cash area were lack of separation of duties between signing checks and access to accounting records. Wire transfers with only one person involved was also noted in many instances.
3. **Competency and Training of Accounting Personnel** The third highest number of material weaknesses were in the area of 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** The fourth greatest threat facing smaller companies in their first year of compliance relates to Audit Committee effectiveness, lack of effective internal audit function, ineffective monitoring of code of ethics and ineffective technical review of financial statements leading to financial restatements. Nearly half of the companies fell into this category.
5. **Design of Controls/Lack of Effective Compensating 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.

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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. **Inadequate 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, ineffective application controls, and critical spreadsheet controls were some of the points contributing to 45 companies having material IT weaknesses.
10. **Consolidations, Mergers, Intercompany Accounts** Another 43 companies had material weaknesses in the mergers and acquisitions, intercompany accounting controls, consolidations and foreign exchange translation gains and losses.

In conclusion, our recommendation would be to use this list as a starting point for a macro level risk assessment within your company. We recommend that you review this list carefully, identify potential concerns that apply and develop an action plan to remediate these identified risks as quickly as possible. Quick action could minimize the likelihood of an adverse Section 404 report at the end of your first year of compliance.

For more information on industry specific risk assessment, go to the research section of [www.Section404.org](http://www.Section404.org)

**Bob Benoit** is the president of Lord & Benoit, LLC, a firm focusing on SOX compliance for small to mid-sized public companies. In addition to his position with Lord & Benoit, Bob serves on the COSO Monitoring Project Task Force and the AICPA Peer Review Acceptance Board in MA. 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 100 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](http://www.Section404.org)