

S X Compliance for Smaller Public Companies



Bob Benoit



- President and Director of SOX Research at Lord & Benoit - a SOX consulting firm specializing in smaller public companies
- Serves on COSO Monitoring Project Taskforce
- Has served on the AICPA Peer Review Acceptance Board for 10 years
- Peer Reviewed the quality of over 100 CPA firms in past 17 years
- Author, The Lord & Benoit Reports referenced by SEC, PCAOB, SEC Advisory, SEC Staff, SEC Commissioners, Wall Street Journal, Big 4, U.S. Chamber of Commerce, AAA, AICPA, IIA and over 200 newspapers, magazines, legal, educational and trade journals.
- Taught Sarbanes-Oxley Section 404 compliance across the country through State CPA Societies and various other organizations
- Significant Contributor to SEC Interpretive Guidance – see SEC Concept Release and PCAOB websites
- Invented Virtual SOX compliance methodologies – AICPA Technology

Course Outline



- Regulatory Update
- Lessons Learned – First Year Smaller Public Co's
- Keys to Right Sizing the Compliance Effort
- Understanding *Virtual SOX* compliance
- Questions and Answers

S **X Compliance** for Smaller Public Companies

Regulatory Update



Regulatory Update



“The Sarbanes-Oxley Act Section 404(a) is required for ALL public companies (including non-accelerated filers) with fiscal years ending after December 15, 2007.

The requirements include a Management Assessment as well as a report on its system of Internal Controls over Financial Reporting (ICFR).

Regulatory Update



“It is the SEC Division of Finance's view that the failure to provide this management report **RENDERS THE ANNUAL REPORT MATERIALLY DEFICIENT.**”

“If management **DID NOT COMPLETE THE EVALUATION** and provide the report as required by Item 308T(a), the company would not be timely or current in its Exchange Act reporting

Regulatory Update



Failure to perform an assessment “would result in the company **NOT BEING ELIGIBLE TO FILE NEW FORM S-3 or FORM S-8 REGISTRATION STATEMENTS** and the loss of the availability of Rule 144.

Regulatory Update



Additionally, “because the filing of the Form 10-K constitutes the Section 10(a)(3) update for any effective Forms S-3 or S-8, THE COMPANY ALSO WOULD BE REQUIRED TO SUSPEND SALES UNDER ALREADY EFFECTIVE REGISTRATION STATEMENTS.”

Regulatory Update



For more information see [CAQ Alert #2008-94](#)

Regulatory Update



“Under Sarbanes-Oxley Section 404(b) outside auditors of ALL filers are required to test and express an opinion on internal controls over financial reporting under PCAOB (Public Company Accounting Oversight Board) Auditing Standards for years ending after December 15, 2009.

Regulatory Update



“Regarding SOX 404... right now, we have a system where some issuers are complying with 404 and others are still exempt from it. It’s time that we bring uniformity to the system so that investors know what to expect from companies, while being sensitive to the needs of small businesses.

Quote taken from questions from Senator Carl Levin for Mary Schapiro, now Chair of the Securities and Exchange Commission, January 8, 2009

SOX Compliance for Smaller Public Companies

Lesson Learned First Year Smaller Public Co's



Lessons Learned – Material Weaknesses

| Material Weaknesses Identified Management Report Disclosures | | |
|---|-----------------------------|-----------------------|
| Material Weaknesses Issue | Companies Disclosing | % of Companies |
| Ineffective accounting procedures | 555 | 96.5% |
| Issues with competency, training, tone at top, ethics | 449 | 78.1% |
| Departures from FASB/GAAP/Disclosures | 394 | 68.5% |
| Ineffective design of controls not mitigated with compensating controls | 311 | 54.1% |
| Reliance on outside auditors for material adjustments | 192 | 33.4% |
| Information technology, software, security & access issues | 118 | 20.5% |
| Audit Committee - Ineffective, non-existent or understaffed | 110 | 19.1% |
| Accounting for deferred, stock-based comp, debt, warrants, derivatives | 101 | 17.6% |
| General ledger close process | 96 | 16.7% |
| Foreign, related party, affiliate, merger, acquisition, consolidation issues | 93 | 16.2% |
| Untimely or inadequate account reconciliations | 80 | 13.9% |
| Accounting for Accounts/loans receivable, investments & cash issues | 76 | 13.2% |
| Accounting for Liabilities, payables, reserves and accrual est. failures | 65 | 11.3% |
| Revenue recognition issues | 62 | 10.8% |
| Controls over property, intangibles, deprec | 60 | 10.4% |
| Controls over inventory/cost of sales | 59 | 10.3% |
| Accounting for expenses (payroll, SG&A, leases) | 47 | 8.2% |
| Accounting for income tax expense (FAS 109) | 30 | 5.2% |
| Restatements, regulatory compliance | 29 | 5.0% |
| Insufficient or non-existent internal audit function | 22 | 3.8% |

SOX Compliance for Smaller Public Companies

**Latest Framework
SEC Interpretive Guidance**




Latest SEC Interpretive Guidance



“Under the Commission’s rules, management’s annual Assessment of the Effectiveness of Internal Control over Financial Reporting must be made in accordance with a suitable control framework...”

COSO (New! Monitoring Framework)



**Internal Control —
Integrated Framework**

**Guidance on Monitoring
Internal Control Systems**

**Volume III — Application
Techniques**

May 2008

Exposure Draft

**Committee of Sponsoring Organizations
of the Treadway Commission**

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Observers

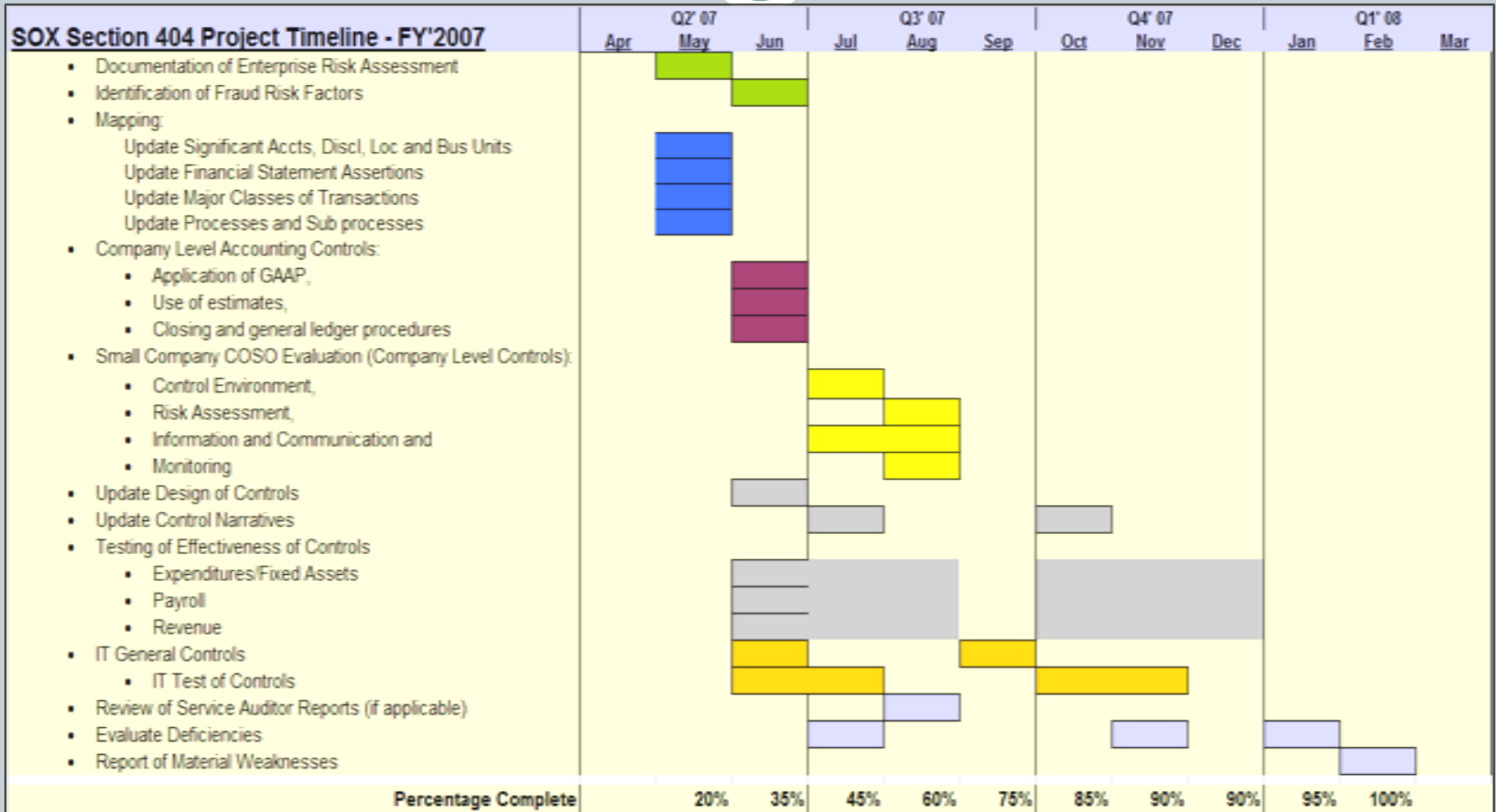
Securities and Exchange Commission

Josh K. Jones
SEC Observer
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Scalable Model to SOX Compliance



Establish A Timeline



COSO for Smaller Public Companies



American Accounting
Association



American Institute of
Certified Public Accountants



Financial Executives
International



Institute of
Management Accountants



The Institute of
Internal Auditors

www.COSO.ORG

Risk Assessment



Balance Sheet (partial)

| | Dec 31, | |
|----------------------------------|----------|-----------|
| | 2009 | 2008 |
| ASSETS | | |
| Current assets: | | |
| Cash | \$ 2,400 | \$ 11,700 |
| Accounts receivable | 1,700 | 1,300 |
| Inventory | 2,400 | 2,400 |
| Total current assets | | |
| Property, plant, and equipment | | |
| Land | | |
| Buildings | | |
| Equipment | | |
| Total assets | | |
| LIABILITIES | | |
| Current liabilities: | | |
| Accounts payable | \$ 117 | \$ 319 |
| Notes payable | 8,223 | 4,450 |
| Accrued liabilities | 1,100 | 2,100 |
| Deferred income taxes | 443 | 1,100 |
| Other liabilities | 473 | 1,100 |
| Total current liabilities | | |
| Long-term liabilities: | | |
| Notes payable | | |
| Total liabilities | | |

Top Down

| Enterprise Risk Assessment | Applicable? | Risk | | Comments |
|--|-------------|-----------|------------|----------|
| | | Magnitude | Likelihood | |
| 1. Major Assets and Liabilities | | | | |

| Fraud Risk Assessment | Applicable? | Fraud Risk | | | Comments |
|--|-------------|-----------------------------|------------------|--|----------|
| | | Reporting and Misstatements | Internal Control | Goodwill | |
| 1. Susceptibility of the client's financial statements | | | | | |
| Which accounts, transaction or locations might be susceptible to material misstatement due to fraud? | Y | H | L | See workpaper on significant accounts, locations and business units. Also: AR at practice level, AP (joint effort), PR (corp, except for LA) Insurance billing fraud | |

Risk Based

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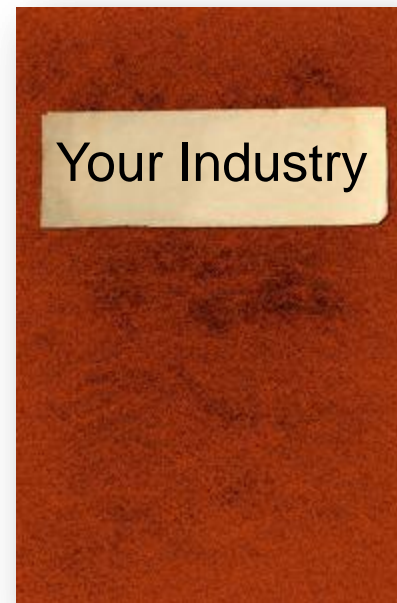


Free Industry Specific SOX Research:

YOUR INDUSTRY SOLUTION

Free Leading Edge SOX research of material weaknesses reported by accelerated filers, broken down by industry...

www.Section404.org



INDUSTRY RISK ASSESSMENT



| <u>Accounting Material Weaknesses</u> | <u># Co.s</u> | <u>%</u> |
|--|---------------|----------|
| Revenue recognition issues | 11 | 45.8% |
| Inventory, vendor and cost of sales issues | 8 | 33.3% |
| Tax expense/benefit/deferral/other (FAS 109) issues | 8 | 33.3% |
| Accounts/loans receivable, investments & cash issues | 7 | 29.2% |
| PPE , intangible or fixed asset (value/diminution) issues | 7 | 29.2% |
| Foreign, related party, affiliated and/or subsid issues | 5 | 20.8% |
| Liabilities, payables, reserves and accrual est failures | 4 | 16.7% |
| Debt ,quasi-debt, warrants & equity (BCF) security issues | 3 | 12.5% |
| Fin Stmt/ footnote/ US FASB, segment disclosure issues | 3 | 12.5% |
| Acquisition, merger, disposal or reorganization issues | 2 | 8.3% |
| Income statemt classification, margin and EPS issues | 2 | 8.3% |
| Lease, FAS 5, legal, contingency & commit issues | 2 | 8.3% |
| Deferred, stock-based or executive comp issues | 1 | 4.2% |
| Depreciation, depletion or amortization issues | 1 | 4.2% |
| Gain or loss recognition issues | 1 | 4.2% |
| Intercompany/Investment w/ sub/affil issues | 1 | 4.2% |

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

Data from Audit Analytics

Fraud Risk Assessment



“Management’s evaluation of the risk of misstatement should include consideration of the vulnerability of the entity to fraudulent activity.”

Fraud Risk Assessment

| Risk | Materiality | Likelihood | Comments |
|--|-------------|------------|----------|
| Susceptibility of the client's financial statements to misstatement | | | |
| Which accounts, transaction or locations might be susceptible to material misstatement due to fraud? | | | |

MAPPING – RISK ASSESSMENT



- Identify significant accounts and disclosures
- Identify significant business units and locations
- Indicate relevant financial statement assertions
- Determine major classes of transactions and account characteristics
- Map to significant processes and sub processes
- Map to IT Infrastructure over significant processes
- Impact on financial statements

COSO for Smaller Public Companies



| Control Environment Principles | Summary of Controls | | Design Effectiveness (Fully met, partially met, not met) | Summary Evidence of Control | Operating Effectiveness (Fully met, partially met, not met) |
|---|---------------------|---------------|---|-----------------------------|--|
| | Entity Wide | Process Level | | | |
| 1. Integrity and Ethical Values - Sound integrity and ethical values, particularly of top management, are developed and understood and set the standard of conduct for financial reporting. | | | | | |
| Information and Communication Principles | Summary of Controls | | Design Effectiveness (Fully met, partially met, not met) | Summary Evidence of Control | Operating Effectiveness (Fully met, partially met, not met) |
| | Entity Wide | Process Level | | | |
| 15. Financial Reporting - Pertinent information is identified, captured, used at all levels of the company, and distributed in a form and timeframe that supports the achievement of | | | | | |
| Risk Assessment Principles | Summary of Controls | | Design Effectiveness (Fully met, partially met, not met) | Summary Evidence of Control | Operating Effectiveness (Fully met, partially met, not met) |
| | Entity Wide | Process Level | | | |
| 8. Financial Reporting Objectives - Management specifies financial reporting objectives with sufficient clarity and criteria to enable the identification of risks to reliable financial reporting. | | | | | |
| Monitoring Principles | Summary of Controls | | Design Effectiveness (Fully met, partially met, not met) | Summary Evidence of Control | Operating Effectiveness (Fully met, partially met, not met) |
| | Entity Wide | Process Level | | | |
| 19. Ongoing and Separate Evaluations - Ongoing and/or separate evaluations enable management to determine whether the other components of internal control over continue financial reporting to function over time. | | | | | |

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lev

Done 1

Accounting Controls



Entity Level Accounting Controls

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

| Ref | FS Assent | Fraud | Control | Process Level Control | Key Control? | Design Deficiency? | Resp Person | Prev Date |
|------|-----------|-------|---------|-----------------------|--------------|--------------------|-------------|-----------|
| FS-1 | E | | | | | | | |
| FS-2 | E | | | | | | | |

Design of Controls



“Management then evaluates whether it has controls placed in operation that are designed to adequately address those risks.”

Design of Controls



**Control
Design**

**Policies,
Narratives**

**Control
Matrix, Inquiries,
Walkthrough**

Testing Operating Effectiveness



- Key controls
- Population
- Sample selections
- Document requests
- Test documents
- Retest if necessary

| Frequency of Control | Range of times to test controls |
|-----------------------------|--|
| Annually | 1 |
| Quarterly | 2 |
| Monthly | 2-5 |
| Weekly | 5-15 |
| Daily | 20-40 |
| Multiple times a day | 25-60 |

Multiple Locations – Virtual SOX



“Management’s consideration of financial reporting risks generally includes all of its locations or business units. When the controls necessary to address financial reporting risks operate at more than one location or business unit, management would generally evaluate evidence of the operation of the controls at the individual locations or business units.

Multiple Locations – *Virtual SOX*



Why Can *Virtual SOX* Be Done Remotely?

- Not an audit
- Management Self Assessment
- Local administrative personnel
- As long as objective
- Relationship of objectivity to size of business

Multiple Locations – *Virtual SOX*



What Are The Benefits of *Virtual SOX*?

- No travel time or travel costs
- Centralized “testers” are well trained and supervised
- Minimal management disruption
- Less Ad Hoc Meetings
- Communication and Project Management

Multiple Locations – *Virtual SOX*



Communication & Project Management

- Give Access to Outside Auditors
- Include Audit Committee
- Send and share documents
- Version controls
- Automatic notification of document updates

SOX IT Compliance



“The identification of risks and controls within IT should not be a separate evaluation. Instead, it should be an integral part of management’s top-down, risk-based approach...”

“Management only needs to evaluate those IT general controls that are necessary... to adequately address financial reporting risks.”

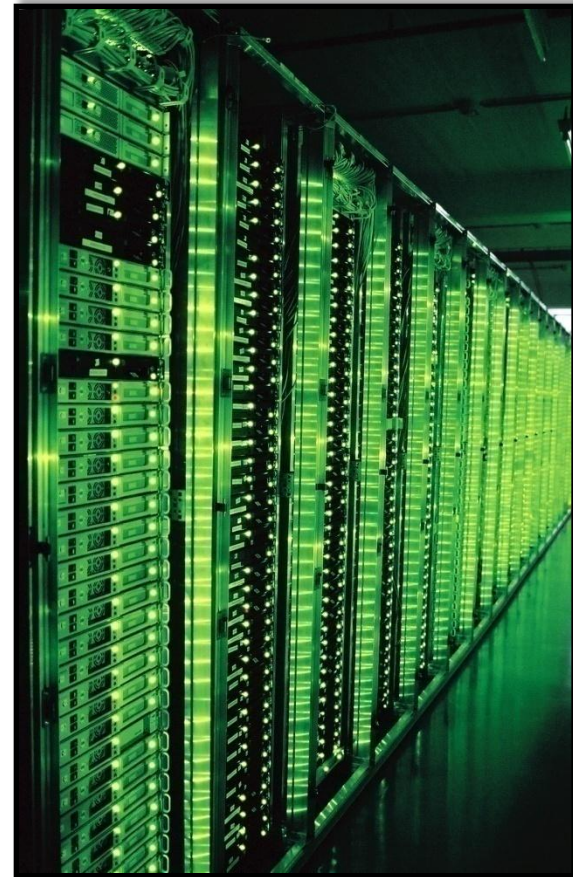
SOX IT Compliance

Company Level
Controls

Risk
Assessment

Design of
Controls

Test Operating
Effectiveness



SOX IT Compliance

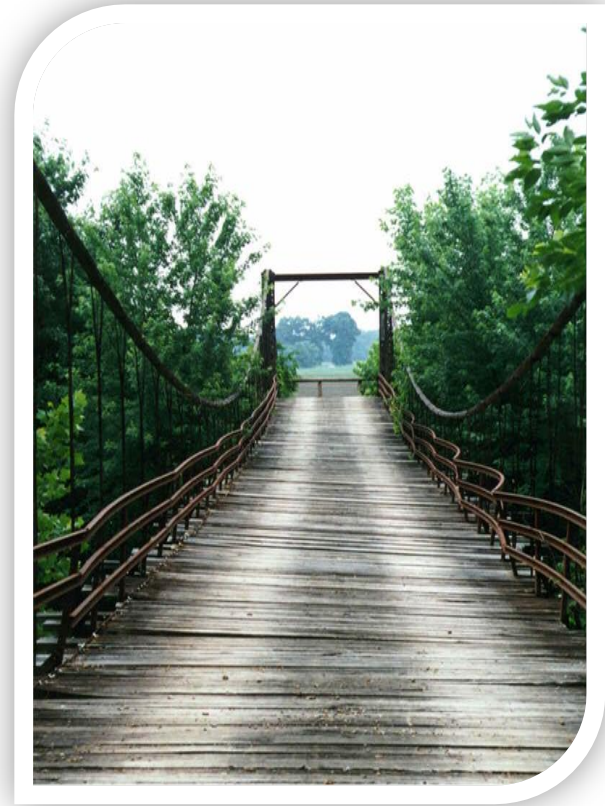


- ✦ Change Management
- ✦ Security & Access—Logical
- ✦ Security & Access—Physical
- ✦ Computer Operations (e.g. Backup)
- ✦ Third Party Vendor Management
- ✦ Application Controls
- ✦ End User Computing

The Path to Success



1. *A helpful* not adversarial approach
2. Focus on *compensating* controls
3. *Project management* ensures successful completion
4. Identify material weaknesses early
5. “Challenge” the finer points of internal controls



The Path to Success

Questions

SOX Compliance for Smaller Public Companies

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SOX Compliance for Smaller Public Companies



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