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Section 404 Bridges the SOX Disclosure Control Gap

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Now that a full year of SOX Section 404 results are in (last filings were January 31, 2006 for year end Oct 31, 2005 filers), the [Lord & Benoit](#) Report: Bridging the SOX Disclosure Control Gap provides historical evidence of the relationship of Section 302 and 404 in reporting weaknesses in internal controls for first year filers. The research was not based on a sample, 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 information covers filings from the EDGAR database up to February 25, 2006, using AuditAnalytics.com - the same tool used by the SEC in some of their research.

The Report was written by Robert Benoit, CPA in consultation with Mark Cheffers, CEO of AuditAnalytics.com a premium on line market intelligence product from the IVES Group, Inc. 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 the past ten years and is President and Director of SOX Research at [Lord & Benoit](#), LLC a national Sarbanes-Oxley Research and Compliance firm www.Section404.org A full copy of the [Lord & Benoit](#) Report can be found at www.section404.org/pdf/Lord_Benoit_Report_1_.pdf

The same study of the prior quarter showed only 47 of the 586 companies with ineffective 404 controls reported ineffective controls in their Section 302 report, producing a eight-fold disclosure.

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 number, not lesser, of Section 302 significant deficiency disclosures than have been observed to date.

A year end study showed the number of ineffective Section 302 reports jumped to 539 of the 586 - a 92% consistency with 404. This research provides strong evidence that it was only after a company was faced with having to report under Section 404 (and independent auditor assessment) that companies self reported deficiencies under Section 302.

The following chart compares the prior year, prior quarter and same quarter ineffective Section 302 reports of the same companies to their year end ineffective Section 404 report.

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.

The statistics raise many questions:

Can Section 302 disclosure requirements alone (SEC Small Company recommendation) ever produce internal control deficiency disclosures in as an effective way that Section 404 does?

Why did only 1 of 12 of companies with ineffective controls under Section 404 self report Section 302 control deficiencies the previous year?

51% of all of the control weaknesses reported under Section 404 were companies with revenues under \$250. Is it prudent to exempt this group from the internal control monitoring?

Can Section 404 management self assessments alone produce effective reporting of internal control deficiencies without the outside auditor's assessment?

Or is it the co-dynamic of the outside auditors working together with the company's self assessment of controls the catalyst that brought out the maximum level of full disclosures of underlying issues?