February 27, 2007

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TREND ALERT

The Materially Weak

After two rounds of SOX 404 audits, large companies disclosed fewer problems in 2006 with their financial-reporting systems. However, at lots of companies, especially small ones, internal controls remain a mess. And regulators say there should be *less* testing?

When public companies disclose their financial statements, investors are entitled to assume they are accurate and can be relied upon for making investment decisions. When a company says it earned a billion dollars, or that it has a couple billion more in cash in the bank, we shouldn't have to wonder whether those numbers might be way off. And we certainly shouldn't have to wonder whether the company has the basic capability to make such calculations accurately.

But there's still reason to worry. Sure, independent auditors are there to lend an objective eye and to catch errors, but we know they don't catch every mistake. Auditors didn't prevent the billions of dollars of errors in the financial reports at WorldCom, Qwest, Fannie Mae, Tyco, or others. Ultimately, the accuracy of companies' financial statements is the responsibility of management. And for 30 years, federal law has required publicly held companies to maintain effective internal control over their financial-reporting systems to make sure they produce the right numbers.

As this report shows, however, thousands of companies haven't. The only reason we know this: The Sarbanes-Oxley Act of 2002 requires management and independent auditors to evaluate the effectiveness of companies' internal controls and report their findings to investors. If they find "material weaknesses," they are required to disclose them. For instance, 20% of all material weaknesses disclosed last year centered on personnel issues, such as a lack of competent accounting staff. As an investor, isn't that the kind of thing you'd want to know about?

In this report, we'll take an in-depth look at the material weaknesses disclosed by companies over the last three years. At a time when regulators are proposing less testing of internal controls – and, thus, less disclosure of weaknesses – we think you'll be left with the same question we have: What are they *thinking*?

2006 Material-Weakness Scorecard

	2006 (companies)	% of public companies
U.S.	1,118	8.8%
Foreign	90	7.3%
Total	1,208	8.6%

2005 Material-Weakness Scorecard

	2005 (companies)	% of public companies
U.S.	1,285	10.0%
Foreign	30	2.4%
Total	1,315	9.3%

In plain English…

Internal control over financial reporting: A process designed and maintained by company officers, directors and personnel to provide reasonable assurance to outsiders regarding the reliability and preparation of a company's financial statements.

Material weakness: A control deficiency that results in more than a remote likelihood that a material error in a company's financials won't be prevented or detected.

Why it matters: If a company has a material weakness, there's a greater risk that its numbers are wrong. It's also an indicator of poor relative stock performance.

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Important disclosure information at end of report.

Key Findings

- 1,118 U.S. companies and 90 foreign companies – one of every 12 companies with U.S.-listed securities – filed 1,342 material-weakness disclosures in 2006
- 2,260 companies with U.S.-listed securities, about 16%, disclosed 6,046 material weaknesses in their internal controls over financial reporting during 2005 and 2006
- The median stock return of companies that disclosed material weaknesses in 2006 underperformed the Russell 3000 stock index last year by 18 percentage points
- Number of SOX 404-compliant companies that disclosed material weaknesses in 2006 declined 35%; non-SOX 404 companies that disclosed weaknesses rose 20%
- Difference in audit fees between SOX 404 and non-SOX 404 companies pales in comparison to cost of corporate accounting frauds and executive compensation
- Most common types of weaknesses were equity-related and tax accounting; most weaknesses were pervasive and affected multiple accounting areas
- Lack of competent accounting staff, or other personnel issues, were behind one of every five material weaknesses
- First year of SOX 404 audits: 16% of companies received adverse opinions from independent auditors; Second year: 11% of companies' controls ineffective
- 165 companies received adverse internal-control audit opinions two years in a row; 55 companies received adverse opinions after receiving clean opinions in year one
- 1,495 companies with previously reported weaknesses haven't disclosed fixing them; only 152 of these companies currently are required to comply with SOX 404

In 2006, compared with 2005:

- Companies with $75M or more in revenue that disclosed weaknesses: down 22%
Companies with less than $75M in revenue that disclosed weaknesses: no change
- Big Four-audited companies that disclosed weaknesses: down 33%
Non-Big-Four-audited companies that disclosed weaknesses: up 24%
- Companies listed on national stock exchanges that disclosed weaknesses: down 36%
Companies listed on over-the-counter markets that disclosed weaknesses: up 22%

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A crash course in internal controls and the language of control deficiencies

Before we proceed with the rundown of last year's material-weakness stats, we thought it would help to explain what control deficiencies are and why they matter for readers who (unlike us) don't get to live accounting and auditing all day, every day.

In 1977, Congress passed the Foreign Corrupt Practices Act. The act requires public companies to maintain adequate internal accounting controls to provide "reasonable assurance" that their financial statements are materially accurate. Twenty-five years later, in 2002, Congress passed landmark legislation, the Sarbanes-Oxley Act, in response to a slew of corporate scandals.

Section 404 of SOX requires management of public companies to evaluate the effectiveness of their internal control over financial reporting, or ICFR. Section 404 also requires independent accounting firms to audit the effectiveness of companies' internal controls. Both management and auditors are required to report to investors whether those controls are operating effectively – that is, whether the controls are sufficient to ensure that companies' financial statements are accurate.

Importantly, SOX 404 does not require public companies to maintain adequate internal controls. That was required by the 1977 legislation. SOX 404 only requires management and auditors to test internal controls to see if they are working, and then to tell investors whether they are working or not.

Prior to SOX 404, auditors were required to gain an understanding of companies' internal controls in connection with their financial-statement audits. However, auditors weren't required to test those controls to validate management's representations or to evaluate whether controls were effective. Even at the largest U.S. public companies, auditors commonly tested controls only periodically, say a third of controls each year, in an effort to keep their audit fees low. The Public Company Accounting Oversight Board was instrumental in the design of internal-control audits. Its Auditing Standard No. 2 provides guidance to accounting firms on how they should go about testing companies' internal controls.

The Securities and Exchange Commission initially implemented SOX 404 for public companies with market capitalizations in excess of $75 million. Management teams of these companies were required to evaluate their internal controls and subject them to external audits, beginning with the companies' fiscal years that ended on or after Nov. 15, 2004. The first annual reports containing both management evaluations and auditor evaluations of companies' internal-control effectiveness were filed by calendar-year companies in March 2005. This set in motion a wave of hundreds, and ultimately thousands, of companies that reported serious problems in their internal controls. In connection with these disclosures, companies often revealed previous errors in their financial statements that required corrections.

The SEC, however, permitted thousands of companies to postpone implementation of SOX 404. These included companies that the SEC refers to as "non-accelerated filers" – specifically, companies with less than $75 million in market capitalization, as well as newly public companies. The SEC also postponed implementation of SOX 404 for foreign filers.

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"Control deficiencies" are problems in either the design or operation of controls that hinder the ability of companies to prevent or detect misstatements (i.e., errors) in their financial reports. There are two kinds of control deficiencies, based on the likelihood and severity of the potential misstatements.

The most severe type of shortcoming in internal controls is called a "material weakness." Material weaknesses are control deficiencies that result in more than a remote likelihood that *material* misstatements in annual or quarterly financial reports will not be prevented or detected.[1]

A less severe type of internal-control inadequacy is referred to as a "significant deficiency." Significant deficiencies are control deficiencies that result in more than a remote likelihood that *more-than-inconsequential* misstatements in annual or quarterly financial reports will not be prevented or detected.[2] In each definition, the term "more than a remote likelihood" means at least a reasonable possibility.

If companies determine their control deficiencies are material weaknesses, then they typically have to conclude that their internal controls over financial reporting are ineffective, and their auditors must issue adverse opinions on the companies' internal-control effectiveness. Companies that determine their deficiencies aren't as severe as material weaknesses still can conclude their controls are effective, even though they found deficiencies.

If companies discover material weaknesses, they are required to disclose them to investors. Companies aren't required to disclose significant deficiencies if they didn't find material weaknesses, though they are free to disclose significant deficiencies voluntarily. Regrettably, management teams often have not been forthcoming in notifying investors of control deficiencies on a timely basis. Many held off on disclosing the full extent of their companies' problems until independent auditors forced their hands by uncovering weaknesses during their internal-control audits.

SOX also requires the CEO and CFO of every public company to certify that their companies' quarterly and annual financial statements accurately portray their operating results and financial condition. CEOs and CFOs also are required to certify whether the companies' internal controls are operating effectively, and whether or not the companies made significant changes to those controls.

[1] The term "material weakness" is defined in the PCAOB's Auditing Standard No. 2. The board recently proposed a new standard for auditing internal controls, which includes revised definitions. For starters, the board proposed changing "more than a remote likelihood" to "a reasonable possibility." Strictly speaking, this should be a distinction without a difference, because the terms are synonymous under the accounting literature. For instance, FAS 5, *Accounting for Contingencies,* defines "reasonably possible" as "more than remote but less than likely." So, why did the PCAOB propose this change in language? To an ordinary reader, "more than remote" looks less probable than "reasonably possible," even though they mean the exact same thing under the accounting literature. We're concerned that this change in language could result in a reduction in the level of auditor testing and fewer disclosures to the investing public of material weaknesses. Indeed, that's the only motive we can see for making this change in language. This would have a negative impact on transparency. At a recent conference at Duke University, even one of the co-leaders of the so called "Paulson Committee" questioned this change.

[2] The board also has proposed changing the term "more than inconsequential" to "significant." The board would define "significant" as "less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

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Independent auditors only evaluate the effectiveness of companies' internal controls annually; they don't conduct quarterly audits. Auditors issue reports, which are included in companies' annual filings, that state whether or not, in the opinion of the auditor, the companies maintained effective internal control over financial reporting as of the end of the fiscal year.

Companies disclose internal-control deficiencies throughout their fiscal years, in quarterly reports, current reports, registration statements, and annual reports. In some cases, after reporting deficiencies, companies are able to correct their problems during the year and receive a "clean bill of health" from their auditors at the end of the year. Other times, the problems continue to linger uncorrected. In these cases, auditors qualify their reports if the problems amount to material weaknesses. Auditors are not required to qualify their reports for less severe control deficiencies that may exist.

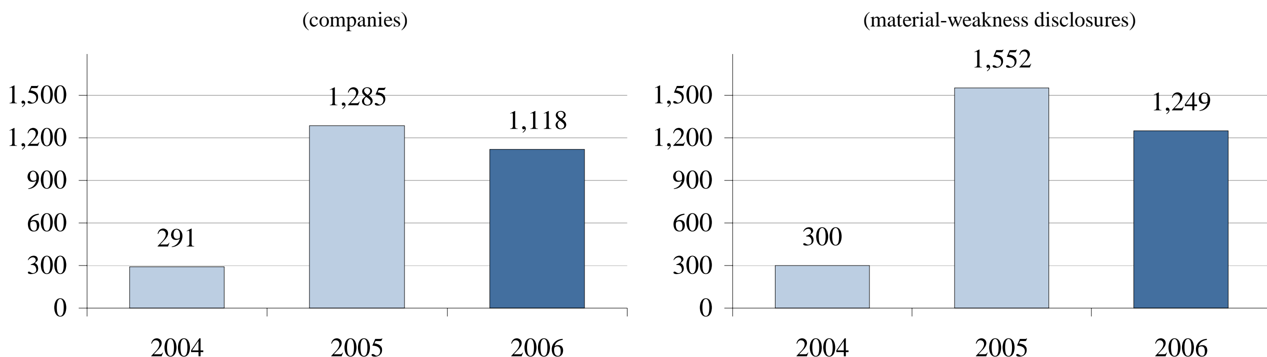
With that, here's an in-depth look at last year's material-weakness disclosures.

Early investments in financial-reporting controls now starting to pay off

Nearly all the public companies required to comply with SOX 404 have gone through two years of testing and auditing. During 2006, the second year of internal-control reports, we saw fewer companies disclose material weaknesses in their internal controls. Last year, 1,118 U.S. companies disclosed material weaknesses, down 13% from a year earlier. Some companies disclosed material weaknesses on more than one occasion. During 2006, U.S. companies filed a total of 1,249 new material-weakness disclosures, down 20% from a year earlier.[3] (Chart 1).

In addition to the material-weakness disclosures, 97 U.S. companies voluntarily disclosed in 2006 that they had identified significant deficiencies, rather than more severe material weaknesses, in their internal controls. That was down from 116 companies in 2005.

Chart 1: Number of U.S. companies that disclosed material weaknesses, and number of disclosures



Source: Glass Lewis, company filings.

[3] We counted material-weakness disclosures when companies disclosed material weaknesses that they had not previously disclosed in prior filings. Within the material-weakness disclosures, if companies also disclosed weaknesses that they had previously disclosed in prior filings, we only captured the new incremental information. In their material-weakness disclosures, companies may have disclosed just one weakness or multiple weaknesses in their internal controls.

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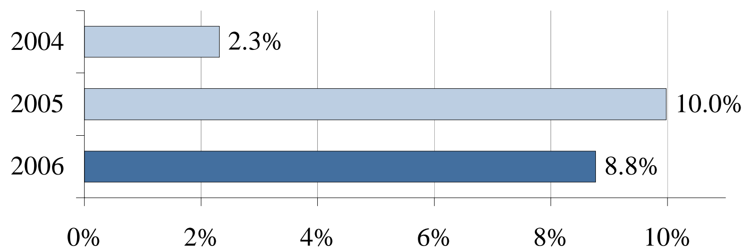
A total of 2,400 companies, or about 17% of all U.S.-listed companies, have disclosed at least one material weakness in the last three years. In 2006, the percentage of all U.S. companies that disclosed material weaknesses – the material-weakness rate – fell to 8.8% from 10% in 2005. (Chart 2). Put another way, about one of every 12 companies disclosed last year that their financial controls were not effective, compared with one of every 10 a year earlier.

Some of the biggest companies in the world have disclosed material weaknesses. They include the likes of **General Electric Co.** (NYSE:GE), **Bank of America Corp.** (NYSE:BAC), **Fannie Mae** (NYSE:FNM), **Starbucks Corp.** (Nasdaq:SBUX), **General Motors Corp.** (NYSE:GM), and **H&R Block Inc.** (NYSE:HRB). On an ironic note, H&R Block, which employs an army of tax-return specialists, "did not maintain sufficient resources in the corporate tax function … to ensure tax balances were appropriately stated." These weaknesses resulted in tax-related errors in H&R Block's financial statements, which the company restated in March 2006.

Chart 2: Percentage of U.S. companies that disclosed material weaknesses[4]



Source: Glass Lewis, 10k Wizard, company filings. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

Take a look at the monthly trend of material-weakness disclosures over the last two years. (Chart 3). Those spikes in March correspond to when calendar-year companies filed their annual reports. Those annual reports, for the most part, included both management's and auditors' reports disclosing the effectiveness of companies' internal-control systems. Investors were blindsided by 421 disclosures in March 2005 alone. (We'd show 2004's numbers in the chart, but they'd barely show up next to 2005's.)

Take note: March 2006's disclosures were preceded by a noticeable blip in November 2005, which corresponds to most companies' third quarter filings and the beginning of their year-end audits. A similar blip was noticeably absent in November 2006 – that's one reason we aren't expecting as many new disclosures in March 2007.

[4] Total number of companies based on the number of unique companies that filed at least one periodic report or effective registration statement with the SEC during the year. In 2006, that number was 12,754.

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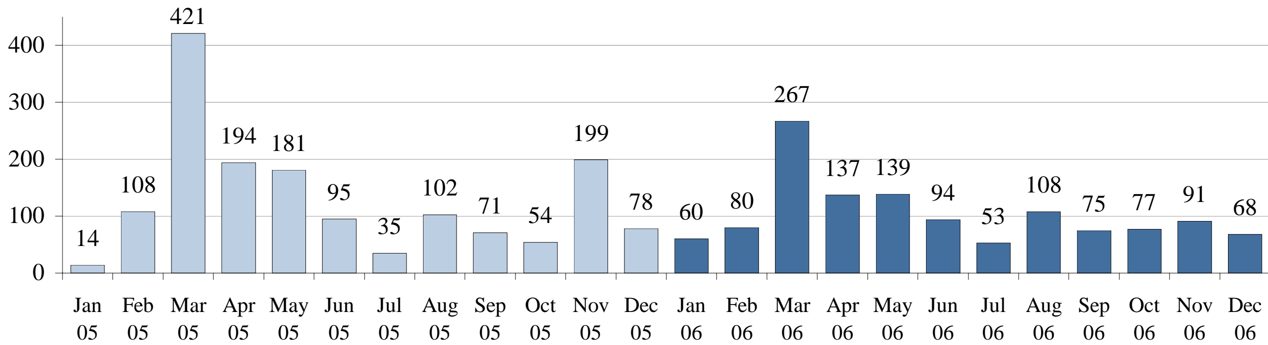
Chart 3: Number of material-weakness disclosures by U.S. companies, by month



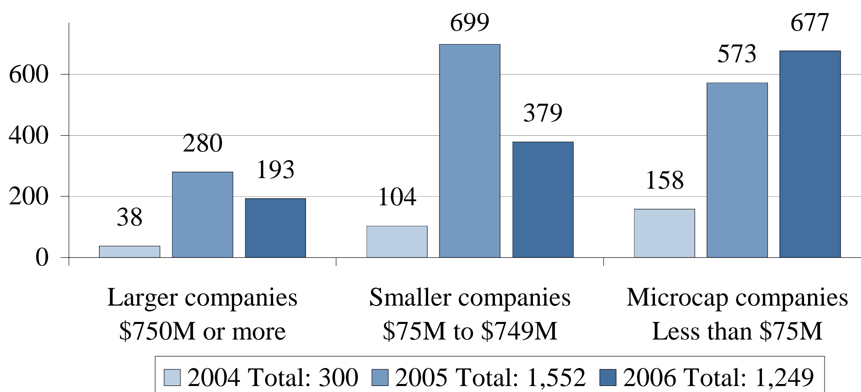
Source: Glass Lewis, company filings.

Companies that implemented SOX 404 two years ago disclosed fewer weaknesses last year

In 2006, material weaknesses were down among companies that had gone through at least one year of SOX 404 testing. This was especially true among companies with market capitalizations of $75 million to $749 million. These "smaller" companies filed 379 new material-weakness disclosures during 2006, down 46% from 699 a year earlier. (Chart 4).

Conversely, so-called microcap companies – those with less than $75 million in market capitalization – filed 677 new material-weakness disclosures last year, up 18% from 573 a year earlier. This raises an unsettling question: If these companies already have disclosed this many material weaknesses before they were required to comply with SOX 404, how many more material-weakness disclosures would there have been if independent accounting firms had audited these companies' internal controls? Twice as many? More? We can only speculate.

Chart 4: Material-weakness disclosures, by company size



Source: Glass Lewis, company filings, Reuters. Note: Company size determined by market capitalization as of filing date. Larger companies include those with $750M or more in market capitalization. Smaller companies include those with $75M to $749M in market capitalization. Microcap companies include those with less than $75M in market capitalization.

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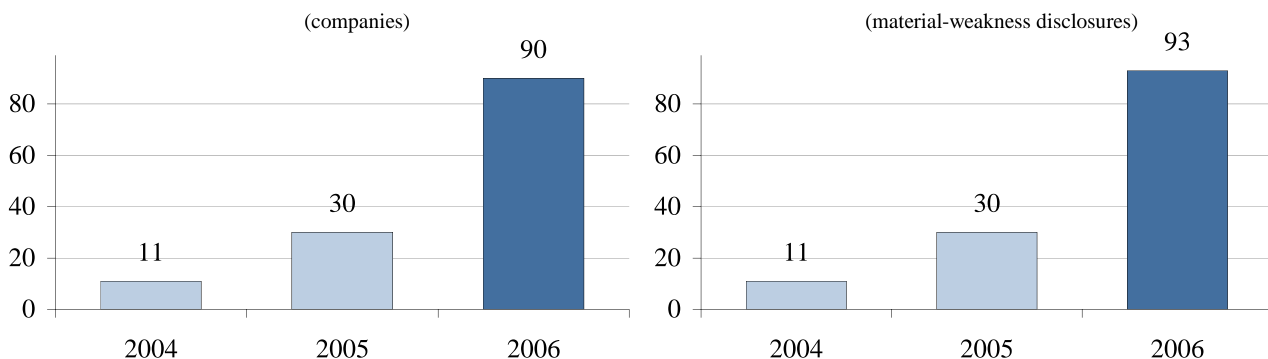
Material-weakness disclosures by foreign companies

In 2006, three times as many foreign issuers disclosed material weaknesses than did in 2005. These are foreign-based companies that have securities listed in U.S. markets. As Chart 5 shows, foreign companies last year filed 93 material-weakness disclosures, up 210% from 30 in 2005.

The reason for the jump in disclosures by foreign companies: SOX 404 compliance deadlines have gone into affect for the largest foreign issuers. Starting with their fiscal years ending on or after July 15, 2006, foreign companies that are "large accelerated filers" – meaning they have $700 million or more in market capitalization – had to comply with both the management-evaluation and independent-audit ICFR requirements. Even though this deadline didn't hit calendar-year companies until Dec. 31, 2006, for which annual reports are due by June 30, 2007, some of these companies disclosed weaknesses during 2006 as they prepped for their first round of testing.

Chart 5: Number of foreign companies that disclosed material weaknesses, and number of disclosures



Source: Glass Lewis, company filings, SEC list of foreign private issuers.

Here's an example of the importance of SOX 404 implementation, especially the audit requirements, at foreign companies. In August 2006, Japan-based **Hitachi Ltd.** (NYSE:HIT) said in its annual report with the SEC that it had a material weakness in the preparation of its financial statements. What makes this case interesting is that the company's president and principal financial officer concluded: "The company's disclosure controls and procedures were *effective* at the reasonable assurance level for gathering, analyzing and disclosing the information" required to be in its financial reports.

It was Hitachi's audit firm, Ernst & Young ShinNihon of Tokyo, that discovered the material weakness in the course of auditing the consumer-electronics company's financial statements as of March 31, 2006. E&Y noted the weakness as part of its regular audit; it wasn't required to perform an internal-control audit for this fiscal year. The weakness was related specifically to Hitachi's application of U.S. GAAP, which investors depend on to compare foreign companies' results with those of U.S. companies. Hitachi said it was working to "resolve the issue as part of its preparation for internal control over financial reporting under Section 404." It will be interesting to see if E&Y identifies any more material weaknesses when it conducts its first audit of the company's internal-control effectiveness in 2007.

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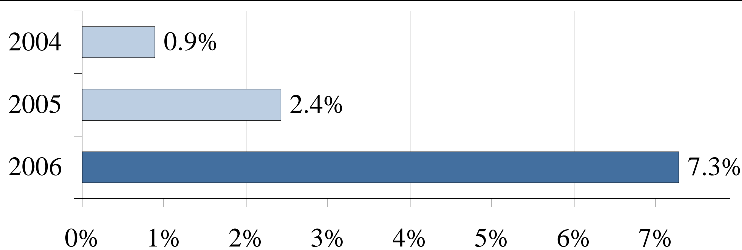
Including Hitachi, a total of eight material-weakness disclosures in 2006 were by Japanese companies. Companies based in China filed 10 disclosures. In addition, Taiwan-based and Hong Kong-based companies each filed four material-weakness disclosures. Companies based in Canada disclosed ineffective controls on 21 occasions last year. A total of 18 European companies disclosed material weaknesses in 2006, including seven by U.K. companies.

One of the real benefits of SOX 404 is that foreign companies, for the first time, are disclosing their internal-control shortcomings to investors. Most foreign-company regulatory regimes have been lax on company evaluations or disclosures of control deficiencies. The result: Such deficiencies have remained secrets of which only management and maybe the auditors were aware. Perhaps that is why foreign businesses and regulators would prefer an international regulatory approach of "mutual recognition," which would allow control deficiencies to remain secrets.

Last year, 7.3% of all foreign companies with U.S.-listed securities disclosed material weaknesses. That was up from just 2.4% in 2005. (Chart 6). We expect foreign companies' material-weakness rate to continue to climb in 2007, as all larger foreign companies report the results of their first annual internal-control evaluations and audits. Smaller foreign companies, with between $75 million and $700 million in market capitalization, currently are required to perform management evaluations of their controls, but won't be required to have their controls independently audited for another year – starting with their fiscal years ending on or after July 15, 2007.

Chart 6: Percentage of foreign companies that disclosed material weaknesses[5]



Source: Glass Lewis, company filings, SEC list of foreign private issuers. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

Some initial thoughts on the costs of SOX 404

Prior to the adoption of SOX in 2002, it was almost unheard of for a company or its independent auditor to report a material weakness in internal controls. Companies such as Enron, WorldCom, Rite Aid, Cendant, Qwest, HealthSouth and many others ultimately dispelled any notion that proper internal controls existed at the time of their accounting frauds.

[5] Total number of foreign private issuers based on the SEC's list as of Dec. 31, 2005. At the time of this report, the SEC had not yet published the number for Dec. 31, 2006.

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In 2003, when the SEC adopted its initial rule implementing SOX 404, it estimated "the aggregate annual costs of implementing Section 404(a) of the Sarbanes-Oxley Act to be around $1.24 billion (or $91,000 per company)." Clearly, the SEC underestimated the costs to be incurred.

However, those estimates in large part were based on the fact that, at the time, the vast majority of public-company CEOs and CFOs had certified that they had evaluated their internal controls and that they were working effectively. Such certifications first became required in August 2002. Few companies at the time had reported serious shortcomings in their internal controls. But reality was much different than the certifications portrayed. Over the past three years, 2,400 companies have reported 6,718 material weaknesses in their internal controls.

Most often, those weaknesses have stemmed from a lack of adequate financial-accounting systems, including a lack of adequate information-technology, or IT, systems. Many other companies have said they don't have enough personnel with adequate expertise in accounting and financial reporting, often leading to materially inaccurate financial statements upon which investors relied.

The lack of adequate IT systems is nothing new. In the late 1990s, many companies experienced similar issues as they prepared for Y2K. Corporate America spent untold billions of dollars to upgrade to systems that would allow for the appropriate date changes as the new millennium approached.

As the inadequacies of companies' systems and personnel become more apparent, we're seeing the true cost of deferred maintenance by thousands of management teams. Such costs aren't limited to audit-related expenses. They also include investments to ensure that management can get timely, relevant, accurate information upon which they can make informed decisions.

The costs to investors of inadequate internal controls run into the hundreds of billions of dollars. These include declines in the market capitalizations as a result of corporate scandals, from Enron and WorldCom to the latest revelations of backdated stock-option grants. But they also include underperformance by companies (compared with peers and market indexes) led by management teams that didn't have the right information to make the best possible strategic decisions. To date, the SEC and PCAOB have failed miserably to quantify and recognize the costs to investors of these shortcomings in internal controls, or the benefits they would reap from effective controls.

Types of material weaknesses disclosed

During 2005 and 2006, companies disclosed more than 6,000 material weaknesses in their financial-reporting controls. Some weaknesses were pervasive throughout the companies' systems of internal controls. Other weaknesses were isolated to one financial procedure or accounting area. The pervasive weaknesses tend to be embedded in companies' control environments. They are more severe than isolated weaknesses because they can be difficult to overcome or correct.

On the other hand, sometimes companies easily can remediate isolated weaknesses, and auditors can audit around weaknesses that are narrow in effect. For example, if the auditor knows a company didn't reconcile its cash balance at year end, the audit firm can increase substantive testing of cash. However, if

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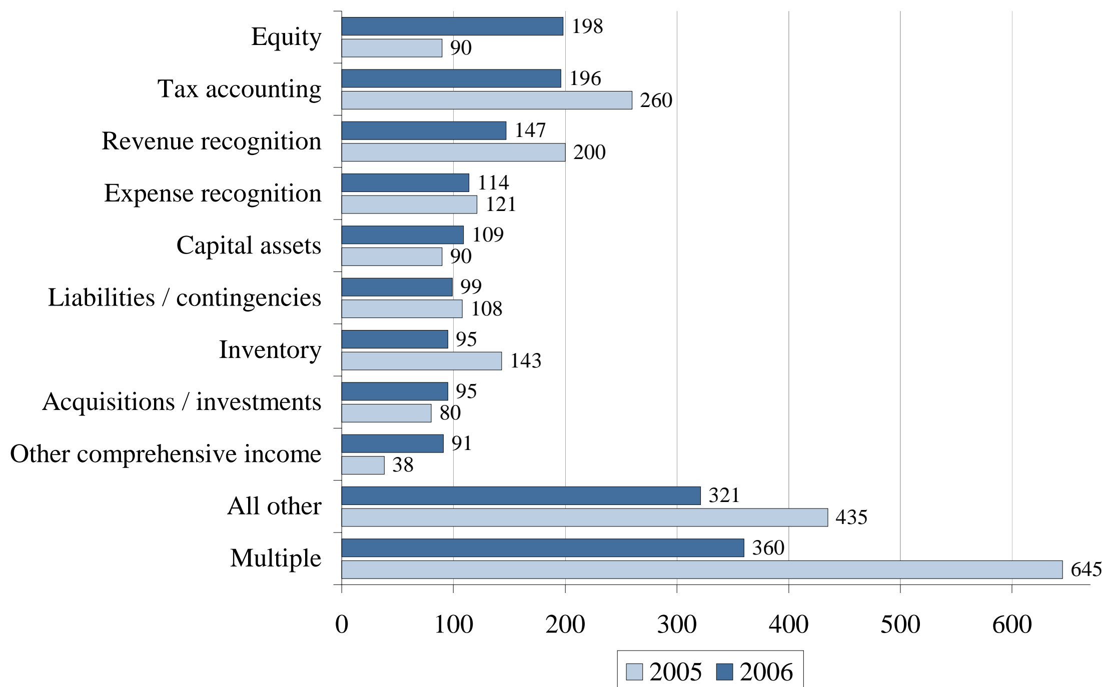
the company lacked an accounting system or didn't employ an adequately trained financial-accounting staff, it will be more difficult for the company and its audit firm to compensate for those weaknesses.

We grouped material weaknesses into two different sets of buckets – one set for accounting issues and one set for internal-control issues. For example, if a company disclosed that it didn't maintain adequately trained staff in its tax department, we classified that material weakness as a tax-accounting issue and as a personnel internal-control issue. Some material weaknesses affected more than one accounting area. Still others couldn't be pinned to any specific accounting area, such as weaknesses related to internal-control documentation or the inability of companies to file its reports on time with the SEC. But all material weaknesses fell into one of our internal-control issues.

Accounting issues

Chart 7 shows our classification of material weaknesses by accounting issues. In the last two years, tax accounting was the most commonly cited accounting area in which companies disclosed material weaknesses. Last year, companies disclosed 196 tax-accounting material weaknesses, which was down 25% from 260 a year earlier. In 2006, companies disclosed 198 equity-related material weaknesses, more than double the amount in 2005. Accounting for items in the equity portion of the balance sheet was an area of difficulty for many companies last year. We also saw more equity-related restatements to correct accounting errors in 2006 than any other kind.

Chart 7: Material weaknesses, by type of accounting issue



Source: Glass Lewis, company filings. Note: The total number of accounting issues exceeds the total number of material-weakness disclosures because some disclosures contained multiple material weaknesses. All other includes weaknesses related to cash flow, reserves and allowances, accounts receivable, and other areas.

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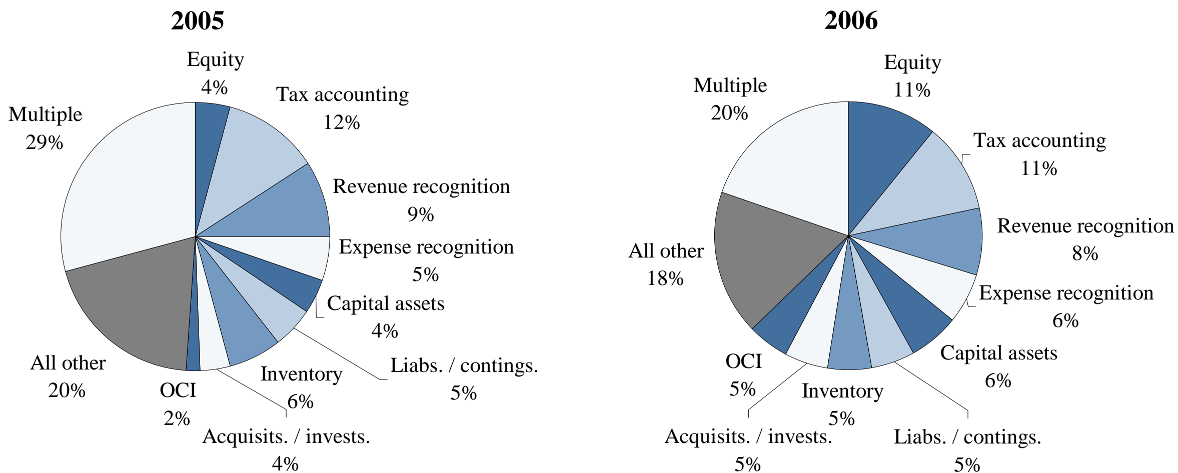
In the last two years, accounting for revenue was another area in which many companies said they had weak financial controls. However, that trend appears to be on the decline. In 2006, revenue-related material weaknesses declined 27%. In addition, restatements filed last year to correct revenue-accounting errors were down 4% – the first time we've seen a decline in revenue-related restatements.

The vast majority of material weaknesses disclosed by companies affected more than one accounting area. Last year, companies disclosed 360 material weaknesses that we categorized as affecting multiple accounting areas, down 44% from 645 in 2005. These weaknesses generally included companies' lack of competent accounting personnel, inadequate accounting systems or inability to perform reconciliations. The impact of these material weaknesses spans multiple accounts, and the deficiencies aren't as easy to audit around as those isolated to one accounting area.

As a percentage of all accounting issues, equity and tax weaknesses each made up 11% of all material weaknesses disclosed last year. (Chart 8). Expense recognition, an area for which we've seen many restatements over the last two years, accounted for 6% of material weaknesses in 2006. Still, the largest proportion of weaknesses disclosed over the last two years affected multiple accounting areas.

Chart 8: Accounting issue, as a percentage of total accounting issues



Source: Glass Lewis, company filings.

The number of material-weakness disclosures more than doubled last year in each of these categories: other comprehensive income, or OCI, cash flow and equity. (Table 1). The OCI-related material weaknesses primarily dealt with hedging activities, foreign-currency translations and accounting for employee benefits. Among material weaknesses that affected just one accounting area, last year the largest declines were in weaknesses related to inventory, cash, revenue, taxes, and reserves and allowances. Disclosures in each of those categories fell by more than 20%. Material weaknesses that affected multiple accounting areas fell by 44% last year.

Table 2 shows detailed descriptions of each of our accounting-issue categories for control deficiencies.

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Table 1: Year-to-year change in accounting issues

	2005	2006	Yr. to yr. change
Other comprehensive income	38	91	139%
Cash flow	24	57	138%
Equity	90	198	120%
Capital assets	90	109	21%
Acquisitions / investments	80	95	19%
Accounts receivable	30	32	7%
Expense recognition	121	114	-6%
Liabilities / contingencies	108	99	-8%
Reserves / allowances	44	34	-23%
Tax accounting	260	196	-25%
Revenue recognition	200	147	-27%
Cash	52	38	-27%
Inventory	143	95	-34%
Multiple	645	360	-44%
Other	285	160	-44%
N/A	1,109	902	-19%

Source: Glass Lewis, company filings.

Table 2: Descriptions of accounting issues

Accounting issue	Description
Revenue recognition	Deficiencies related to revenue accounting. This issue includes instances in which revenue was improperly recognized, questionable revenues were recognized, or any other number of related errors that led to misreported revenue.
Expense recognition	Deficiencies related to improperly recording expenses in the incorrect period or for an incorrect amount. This issue includes deficiencies in lease accounting and deficiencies related to misdated stock options.
Tax accounting	Deficiencies related to income tax accounting, including improper treatment of tax liabilities, deferred-tax assets and liabilities, tax contingencies, sales tax and other tax-related items.
Cash flow	Deficiencies related to the preparation or classifications of cash flows.
Cash	Deficiencies related to accounting for cash or controls over cash.
Accounts receivable	Deficiencies related to maintaining and evaluating accounts receivable balances.
Inventory	Deficiencies related to inventory-costing valuations or controls over inventory.
Capital assets	Deficiencies related to accounting for long-term assets, asset impairments, write-downs, depreciation and amortization, or controls over capital assets.
Acquisitions / investments	Deficiencies related to purchase accounting for business combinations, other merger- or acquisition-related accounting, and accounting for significant investments in other companies.
Reserves / allowances	Deficiencies related to accounting for bad-debt reserves, reserves for inventory, valuation allowances, provisions for loan losses, or other types of allowances and reductions of assets.
Liabilities / contingencies	Deficiencies related to accounting for estimated liability claims, loss contingencies, litigation matters, commitments, certain accruals, or other types of obligations.
Equity	Deficiencies related to accounting for EPS, equity effects of stock-based compensation and stock options, warrants, convertible securities, beneficial conversion features and other equity instruments.
Other comprehensive income	Deficiencies related to accounting for derivatives, hedge accounting, foreign-currency items, unrealized gains and losses on investments in debt and equity securities, other financial instruments, and pension-liability adjustments.
Other	Deficiencies not covered by the listed issues.
Multiple	Deficiencies that affected multiple accounting issues. These were more widespread and could not be pinned to just one area.
N/A	Deficiencies that did not affect any accounting issues. These deficiencies were company-specific internal-control issues that could not be pinned to any specific accounting area.

Source: Glass Lewis.

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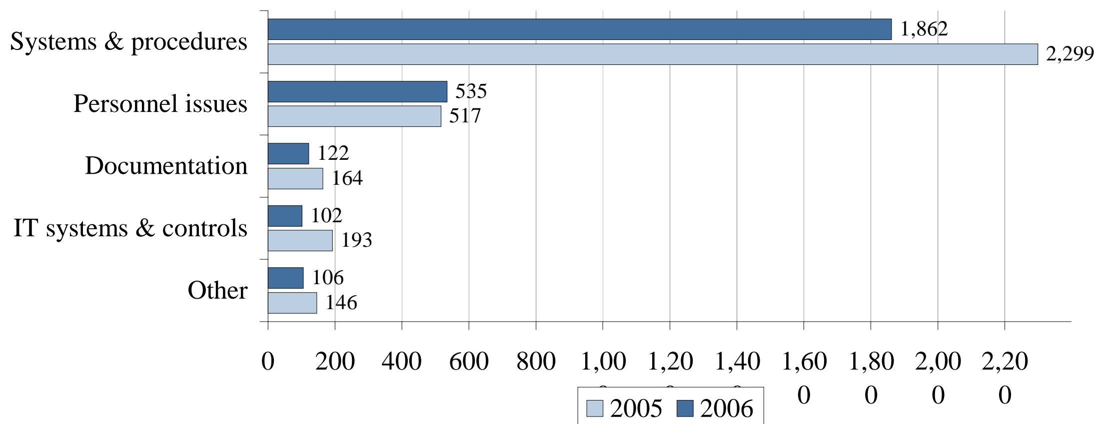
Internal-control issues

In addition to categorizing material weaknesses by accounting issues, we also grouped them into one of five internal-control-issue buckets. Last year, companies disclosed 1,862 material weaknesses related to financial systems and procedures. (Chart 9). That was down 19% from 2005. These weaknesses included improper applications of accounting standards, inadequate general-ledger systems, failures to perform account reconciliations, and failures to perform review procedures.

After systems and procedures, the next most common material weaknesses centered on personnel issues. These weaknesses related to inadequate staffing levels, incompetent staff, or inadequate segregation of duties. Companies disclosed 535 personnel-related material weaknesses in 2006, compared with 517 in 2005. Among our internal-control issue categories, personnel issues were the only type of material weakness in 2006 that surpassed 2005 levels.

Chart 9: Material weaknesses, by type of internal-control issue



Source: Glass Lewis, company filings. Note: The total number of internal-control issues exceeds the total number of material-weakness disclosures because some disclosures contained multiple material weaknesses.

In each of the last two years, systems-and-procedures weaknesses accounted for about 70% of all material weaknesses. (Chart 10). Last year, personnel issues were behind one of every five material weaknesses companies disclosed.

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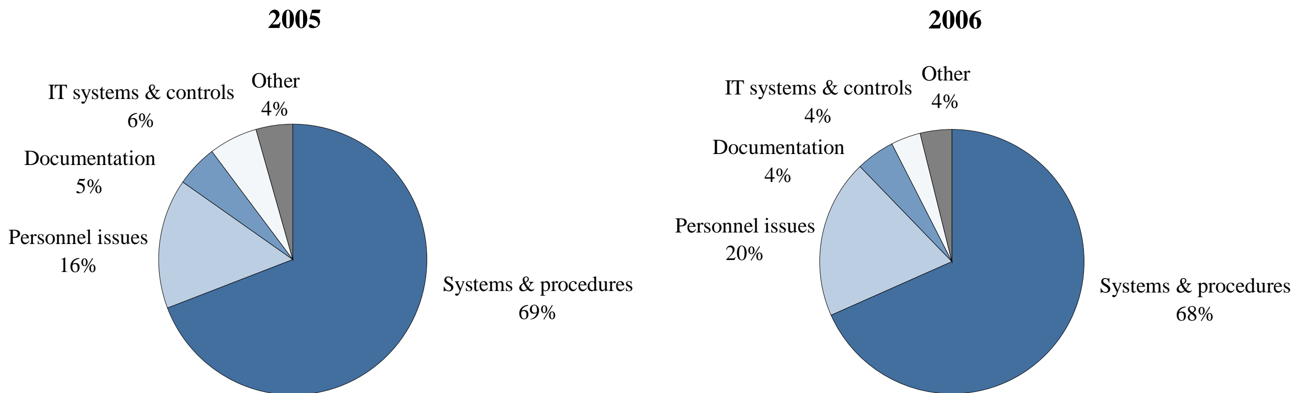
Chart 10: Internal-control issue, as a percentage of total internal-control issues



Source: Glass Lewis, company filings.

The largest decline in material weaknesses last year were those related to information technology, or IT, systems and controls. These deficiencies related to accounting-information systems, software used to keep companies' books, and enterprise-resource-planning systems. In 2006, IT-related weaknesses fell 47% to 102, from 193 in 2005. (Table 3). Documentation weaknesses – those related to companies' written internal-control policies and procedures – fell by 26% in 2006.

Table 3: Year-to-year change in internal-control issues

	2005	2006	Yr. to yr. change
Personnel issues	517	535	3%
Financial systems & procedures	2,299	1,862	-19%
Documentation	164	122	-26%
Other	146	106	-27%
IT systems & controls	193	102	-47%

Source: Glass Lewis, company filings.

Table 4 provides detailed descriptions of each of our internal-control issue categories for control deficiencies.

Table 4: Descriptions of internal-control issues

Internal-control issue	Description
Financial systems & procedures	Deficiencies related to fundamental accounting systems and procedures, including application of accounting policies, general-ledger systems, reconciliations, review and cut-off procedures, and estimation procedures.
Personnel issues	Deficiencies related to the competency of accounting and finance personnel and appropriate staffing levels. This issue includes deficiencies related to the segregation of duties.
Documentation	Deficiencies related to the adequacy of supporting information for accounting transactions and formal written control policies.
IT systems & controls	Deficiencies related to accounting information systems, accounting software, spreadsheets, and enterprise resource planning systems.
Other	Deficiencies not covered by the listed issues.

Source: Glass Lewis.

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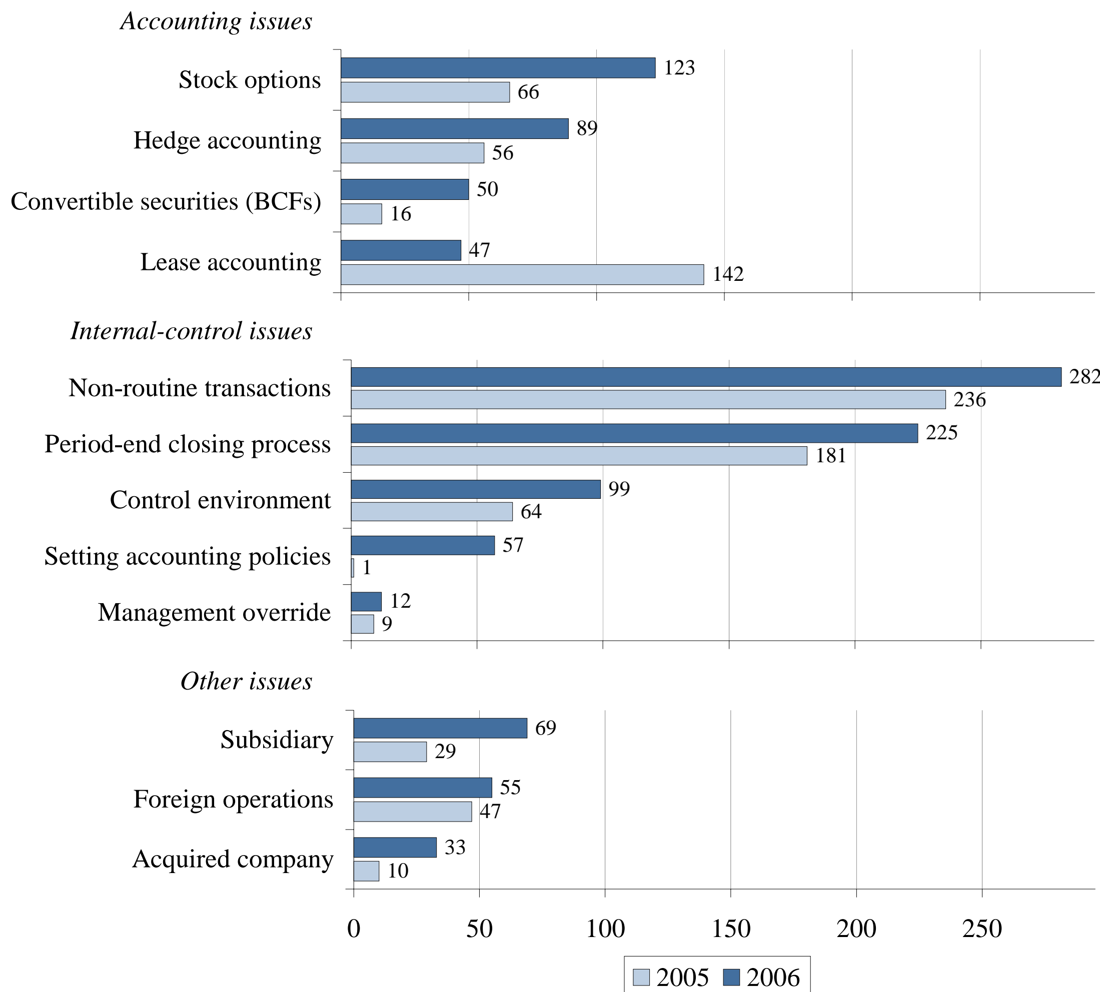
Drilling down into the issues

In addition to categorizing all weaknesses by accounting and internal-control issues, we also flagged certain specific kinds of material weaknesses. Chart 11 shows our tally for each of these specific issues. The chart includes accounting issues, internal-control issues, and other issues. Accounting for stock options and hedging activities were the most commonly cited accounting issues for which companies disclosed material weaknesses last year. In 2005, accounting for leases tripped up the most companies.

Chart 11: Material weaknesses, by specific issue



Source: Glass Lewis, company filings.

Looking at the most-common internal-control issues companies disclosed, we see that many companies said they had problems accounting for "non-routine transactions." These types of transactions often require separate journal entries that are not system-generated. In making those journal entries, employees of the company also are required to make the proper analysis of the transactions, pursuant to the appropriate accounting standards. We think any public company should have qualified accounting

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personnel on staff that are able to properly account for any transaction. Last year, companies characterized their weaknesses in this fashion 282 times.

In 225 material-weakness disclosures filed during 2006, companies said their weaknesses related to period-end closing processes. The term refers to the quarter-end and year-end procedures companies go through to close their books and prepare their periodic financial statements. These companies said their controls in this area were ineffective either because they couldn't close their books fast enough to meet the SEC's deadlines, or because the companies just didn't perform all the reviews they should have.

In this technological era, we find it striking that so many companies are unable to close their books and generate accurate financial statements within a couple months after the year ends – or in the case of abbreviated quarterly filings, within 40 days. This indicates many companies don't have the necessary systems and personnel to manage their businesses successfully.

In 1999, the Committee of Sponsoring Organizations published a report that found management override of controls was the number one way in which CEOs and CFOs had manipulated financial reports and hidden fraud. Often, this begins when an executive first generates a financial report that provides balance-sheet and income-statement data, commonly referred to as a "flash report."

A flash report details how a company has performed for the period and tells executives whether they have achieved the projected numbers or not. For those executives engaging in earnings management or fraud, this report identifies whether or not additional adjustments are required to achieve the desired results. All too often, executives have booked the additional adjustments so they can hit the Wall Street earnings targets to which they previously had committed.

Had auditors compared the initial computer-generated flash reports with the final financial statements, they may have detected the adjustments that contributed to many of the mega-frauds. Just a little more audit work, at a small amount of incremental cost, would have saved investors perhaps billions.

In the past, internal controls over the closing process, which would have prevented such management override, were nonexistent or weak. On many occasions, audit committees had no knowledge of this process and the related controls designed to prevent it. In addition, auditors often failed to test these internal controls adequately or carefully examine the fraudulent adjustments. With that in mind, here's a list of questions for investors to pose to management and audit committees:

1. What are the internal controls in place that prevent management override and inappropriate "top side" closing adjustments?
2. Are those controls working effectively?
3. What procedures does the audit committee perform to ensure the effectiveness of those controls?
4. Do the independent auditors test closing adjustments?
5. Does the company have a strong independent whistleblower program that (a) protects the confidentiality of the employee, and (b) uses an external source who reports complaints directly to the audit committee, all without any internal company filter that could impact the independence of the process?

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In 12 disclosures filed in 2006, companies said their controls were weak because management had the opportunity to override those controls. Internal controls aren't worth anything if higher-ups are able to bypass those controls and fudge the numbers as they see fit. Companies must have effective controls in place throughout the corporate hierarchy to ensure accurate financial reporting.

In addition, we flagged 99 material-weakness disclosures in which the companies said they didn't maintain adequate control environments. The control environment includes such controls as "tone at the top," the assignment of authority and responsibility, consistent policies and procedures, and company-wide codes of conduct. These are serious problems, because a company's control environment is the underlying foundation of its entire system of internal controls. Some companies specifically mentioned they had a poor tone at the top. That basically means their CEOs and CFOs failed to set good examples and did not emphasize effective controls over financial reporting.

Finally, looking at the other issues in the chart below, some companies disclosed material weaknesses in isolated portions of their businesses. These included ineffective controls at subsidiaries, foreign operations, or recently acquired companies. In general, we view these weaknesses as less severe. For instance, they might result in errors that would be material to a subsidiary's financial statements, but not necessarily the parent company's. Plus, companies and their auditors usually are able to compensate for these weaknesses more easily. Still, these deficiencies could lead to material misstatements if they aren't adequately addressed.

The SEC's and PCAOB's proposed guidelines for evaluating internal controls

To produce accurate financial reports on a timely basis, it's crucial that companies have effective internal controls in place. We believe this is a worthwhile investment that ultimately lowers companies' cost of capital by making companies' financial statements more reliable and transparent. Unfortunately, it seems regulators and some misinformed members of Congress are starting to move in the opposite direction. A substantial rollback of SOX 404 and an indefinite exemption for microcap companies could be just on the horizon. Recently, the SEC and the PCAOB proposed new rules that may relax SOX 404 testing requirements substantially. Regulators are considering a reduction in the level of internal-control testing at both smaller and larger companies, with a continued deferral of any testing at microcaps.

Supporters of the proposed changes tout them as part of a more scalable, top-down, "risk-based" approach. Under the SEC's new guidance, management wouldn't be required to identify or test all controls it has in place. Rather, management would focus its efforts only on controls it believes adequately address the risk of material misstatements. If management concludes such risks are addressed by broader entity-level controls, then there's no need to evaluate other controls. In addition, management would be able to spend less time evaluating controls in areas it perceives to be "low risk." The regulators provide few specifics with respect to exactly which controls management could skip over, and which to focus on.

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Unfortunately, areas that have often been considered "low risk," also have been manipulated in major frauds in the past. For example, at WorldCom and HealthSouth, part of the frauds perpetrated by management centered on how the companies accounted for fixed-asset purchases – widely viewed as a low-risk item. At WorldCom, inter-company accounts went unreconciled. And at Qwest, management manipulated such accounts as accrued payroll and accrued vacation in an effort to make the company look healthy, when in fact, it was performing abysmally.

While we believe there must be a reasoned approach and balanced testing of controls, we think now's a bad time to lighten the requirements for management's internal-control evaluations. Under the current rules, companies haven't always been transparent in disclosing control deficiencies, especially when they knew their auditors wouldn't be reporting their own separate conclusions. Consider the companies that disclosed material weaknesses immediately after SOX 404 took effect. About 95% of these companies had told investors that their controls were effective, right up through the last quarter before their auditors conducted their own independent internal-control evaluations.[6] That tells us that management either lied or just wasn't aware of the weaknesses, neither of which bode well for investors.

In either case, we don't think the SEC's proposed changes will help management identify any more material weaknesses than they did in the past. If anything, management will just look in fewer places. The PCAOB's proposed guidelines mirror those of the SEC. That is, the proposed PCAOB standard for auditing internal controls focuses more on entity-level controls than on process-level controls. It applies the same top-down, "risk-based" approach that has been used in audits for the past 20 years, with an eye toward eliminating unnecessary or duplicative audit work.

When it comes to assessing risk, however, auditors' historical track record has been horrible, especially in cases of corporate fraud where investors lost tens of billions of dollars. Commonly, the risk assessments were not completed by experienced audit partners, but rather were assigned to lower-level, less experienced staff that lacked the business know-how necessary to make these critical assessments. The proposed audit standards provide perhaps even less guidance to carry out these risk-assessment tasks than has existed in the past. Once again, the guidance doesn't require auditors with sufficient experience – the partners – to make the risk assessments. Regrettably, the accounting profession has a long track record of failing to learn from its past mistakes and, in so doing, failing to protect investors and capital markets.

Ultimately, while we care about management's process for evaluating controls – as important as this is – from an investor perspective, we care even more about the independent auditors' processes. Before SOX 404, management didn't tell investors very much, if anything, about their internal controls. It's the independent audit firms that drove material-weakness disclosures and the subsequent improvements of companies' financial controls. It won't help investors if regulators water down the rules so that companies and their auditors don't have to look as hard for control deficiencies and don't have to disclose as many.

[6] See our June 24, 2005, Trend Alert, "*Control Deficiencies – Finding Financial Impurities*: Analysis of the 2004 and Early 2005 Deficiency Disclosures." Also see a 2006 report prepared in association with Audit Analytics, "*The Lord & Benoit Report*: Bridging the Sarbanes-Oxley Disclosure Control Gap." http://www.section404.org/pdf/Lord_Benoit_Report_1_.pdf.

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Auditor opinions on internal controls

In addition to performing annual audits of companies' financial statements, independent accounting firms also are required under SOX 404 to perform audits of companies' internal control over financial reporting. The purpose of their audits is to provide an independent attestation to the effectiveness of companies' internal controls.

As we mentioned before, not all companies currently are required to have their internal controls audited. Some companies don't have to comply with SOX 404 at all yet, and others only are required to have management evaluate the effectiveness of their internal controls. The SEC originally granted an extension only to companies that are "non-accelerated filers." In subsequent extensions, the SEC also pushed back the compliance deadlines for foreign private issuers.

On Dec. 15, 2006, the SEC adopted additional SOX 404 extensions that not only pushed back the deadlines again, but also set different compliance dates for management's evaluations of internal controls and independent accounting firms' audits of internal controls. To keep these companies straight, we've replicated the SEC's matrix of SOX 404 compliance deadlines in Table 5. Keep in mind, most companies won't file their annual reports for these years until three months after the dates shown below.

Table 5: Compliance dates for the ICFR evaluation requirements

	Filer status	Management's evaluation	Auditor's attestation
U.S. issuer	Large accelerated filer OR accelerated filer ($75M or more)	Already complying (Nov. 15, 2004)	Already complying (Nov. 15, 2004)
	Non-accelerated filer (less than $75M)	Dec. 15, 2007	Dec. 15, 2008
Foreign issuer	Large accelerated filer ($700M or more)	July 15, 2006	July 15, 2006
	Accelerated filer ($75M or more and less than $700M)	July 15, 2006	July 15, 2007
	Non-accelerated filer (less than $75M)	Dec. 15, 2007	Dec. 15, 2008
U.S. or foreign issuer	Newly public company	Second annual report	Second annual report

Source: SEC Release No. 2006-10. Note: ICFR stands for internal control over financial reporting. The compliance deadlines are for annual reports for fiscal years ending on or after the dates shown in the table.

Accounting firms can issue three types of opinions on the effectiveness of companies' internal controls. An auditor issues a clean opinion, or "unqualified opinion," when it concludes that a company's controls operated effectively as of the end of the fiscal year. An audit firm issues an "adverse opinion" if it concludes a company's financial-reporting controls were ineffective because of the existence of one or more material weaknesses. The third option is for the auditor to issue a "disclaimed opinion."

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In some instances, especially for fiscal years that ended in 2004, management teams weren't able to complete their internal-control evaluations, or companies otherwise weren't ready for their inaugural internal-control audits. In these cases, accounting firms issued disclaimed opinions – meaning they didn't issue any opinions on the companies' controls – because they weren't able to perform audits.

Audit opinions for weakness disclosures – the clean, the adverse and the disclaimed

Table 6 shows the resulting audit opinions for each material-weakness disclosure in the last three years. In 2006, of the 1,342 total material-weakness disclosures (1,249 by U.S. companies and 93 by foreign companies), 349 resulted in the companies receiving adverse opinions on the effectiveness of their internal controls. Last year saw 943 material-weakness disclosures by companies that, so far, either haven't been required to undergo internal-control audits or haven't yet filed their annual reports.

To be clear: Not all material weaknesses result in adverse audit opinions. Indeed, there were 36 material-weakness disclosures last year by companies that received clean audit opinions. In other words, the companies' auditors concluded that the problems had been corrected by the time they completed their year-end audits, and that the companies' controls were effective for the year as a whole.

In 2005, 724 material-weakness disclosures resulted in adverse audit opinions. In 29 other instances, the companies' auditors said they couldn't complete their internal-control audits because the companies hadn't been able to finish their own evaluations.

Table 6: Internal-control audit opinions for companies that disclosed material weaknesses during calendar 2004-2006, by year

Description	2004	2005	2006
Adverse opinions	56	724	349
Expected adverse opinions	0	4	8
Disclaimed opinions	3	29	6
Total qualified opinions	59	757	363
Unqualified opinions	19	123	36
Non-accelerated filers	165	630	757
Foreign filers	8	20	86
Late filers	6	17	8
Interim disclosures*	0	0	91
Pre-SOX disclosures**	54	35	1
Total no auditor opinions	233	702	943
Grand total disclosures	311	1,582	1,342

Source: Glass Lewis, company filings. *Includes companies that disclosed material weaknesses in quarterly or other filings for which the relevant auditor opinions will not be disclosed until their current fiscal years are complete and they file their annual reports. **Includes companies that disclosed material weaknesses for fiscal years that ended before SOX 404 became effective.

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Table 7 breaks down the auditor opinions for each material-weakness disclosure in 2006 by accounting firm. We've included the six largest accounting firms (the Big Four firms plus BDO Seidman LLP and Grant Thornton LLP). During calendar 2006, PricewaterhouseCoopers LLP issued the most adverse opinions, followed by KPMG LLP. From the table, you also can see the majority of non-accelerated filers are audited by firms other than the six largest firms. Table 8 shows the same audit-firm breakdown of auditor opinions for each material-weakness disclosure in 2005.

Table 7: Internal-control audit opinions for companies that disclosed material weaknesses during calendar 2006, by audit firm

Description	PwC	KPMG	D&T	E&Y	BDO	GT	Other	Total	% of Total
Adverse opinions	78	74	66	55	25	14	37	349	26%
Expected adverse opinions	4	3	0	1	0	0	0	8	1%
Disclaimed opinions	1	0	0	1	2	1	1	6	0%
Total qualified opinions	83	77	66	57	27	15	38	363	27%
Unqualified opinions	15	1	12	4	0	1	3	36	3%
Non-accelerated filers	85	42	79	40	24	35	452	757	56%
Foreign filers	33	8	9	25	0	4	7	86	6%
Late filers	2	2	2	1	0	0	1	8	1%
Interim disclosures*	22	15	19	15	4	7	9	91	7%
Pre-SOX disclosures**	0	1	0	0	0	0	0	1	0%
Total no auditor opinions	142	68	109	81	28	46	469	943	70%
Grand total disclosures	240	146	187	142	55	62	510	1,342	100%

Source: Glass Lewis, company filings. *Includes companies that disclosed material weaknesses in quarterly or other filings for which the relevant auditor opinions will not be disclosed until their current fiscal years are complete and they file their annual reports. **Includes companies that disclosed material weaknesses for fiscal years that ended before SOX 404 became effective.

Table 8: Internal-control audit opinions for companies that disclosed weaknesses during calendar 2005

Description	PwC	KPMG	D&T	E&Y	BDO	GT	Other	Total	% of Total
Adverse opinions	179	149	105	149	31	39	72	724	46%
Expected adverse opinions	1	3	0	0	0	0	0	4	0%
Disclaimed opinions	3	4	2	3	5	7	5	29	2%
Total qualified opinions	183	156	107	152	36	46	77	757	48%
Unqualified opinions	39	28	22	20	2	8	4	123	8%
Non-accelerated filers	94	60	65	73	40	38	260	630	40%
Foreign filers	5	1	4	8	1	1	0	20	1%
Late filers	7	2	2	1	0	3	2	17	1%
Interim disclosures*	0	0	0	0	0	0	0	0	0%
Pre-SOX disclosures**	10	6	6	8	2	1	2	35	2%
Total no auditor opinions	116	69	77	90	43	43	264	702	44%
Grand total disclosures	338	253	206	262	81	97	345	1,582	100%

Source: Glass Lewis, company filings. *See note above. **See note above.

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Companies that received adverse opinions

The auditor-opinion tables we've shown you above include all material-weakness disclosures. In some cases companies' opinions may have been counted more than once. For example, if a company disclosed new material weaknesses during 2006 in two separate filings, we included both disclosures. If the company then disclosed in its annual report that it received an adverse opinion, the adverse opinion would be applied to each of its 2006 disclosures. So in the tables above, the company's adverse opinion would be counted twice.

The analysis below counts companies' internal-control audit opinions only once. In addition, instead of counting opinions by the calendar year in which they were issued, we counted them by the fiscal year to which the opinions applied. This is because companies with fiscal years that end on Dec. 31 don't file their annual reports until March of the following year. By counting opinions by fiscal year, we more clearly can see the internal-control trends for each annual round of SOX 404 testing and auditing.

Table 9 shows that in connection with their first rounds of internal-control audits, 420 companies received adverse opinions for their fiscal years that ended in 2004. Remember, SOX 404 went into effect for fiscal years on or after Nov. 15, 2004. So fiscal 2004 figures include only companies with fiscal years that ended between that date and Dec. 31, 2004. For fiscal year 2005, which includes some companies' first-round audits (those with fiscal years that ended between Jan. 15 and Nov. 15) [7] and other companies' second-round audits (those with fiscal years that ended between Nov. 15 and Dec. 31), auditors issued a total of 464 adverse opinions on companies' internal controls.

Table 9: Qualified auditor opinions on internal controls, by fiscal year

Description	FY 2004	FY 2005	FY 2006*
Adverse opinions	420	464	89
Expected adverse opinions	0	3	5
Disclaimed opinions	20	12	0
Total qualified opinions	440	479	94

Source: Glass Lewis, company filings.

So far, 89 companies with fiscal years that ended in 2006 have received adverse opinions on their controls. But the majority of companies – those with Dec. 31, 2006, fiscal years – won't file their annual reports including their ICFR audit opinions until March 2007. The large accelerated filers' due date is March 1, and the accelerated filers' due date is March 16.

[7] We didn't say fiscal years that ended between Jan. 1 and Nov. 15 because of the way we assign fiscal years to companies. For example, if a company's fiscal year ends on Jan. 2, we bump it back to Dec. 31 because we think that makes companies more comparable. For this reason, we bump companies' fiscal years back to Dec. 31 if they fall before the first 15 days of January.

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How bad was it? And when is it going to get better?

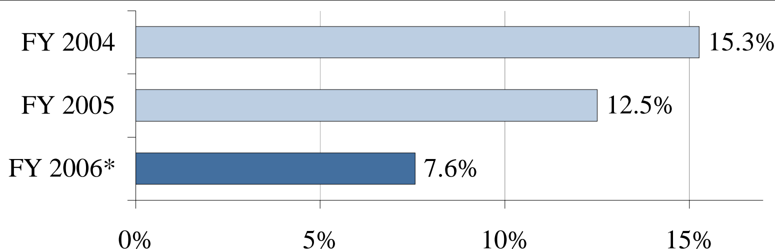
It can be difficult to measure the extent of poor financial controls at public companies by looking solely at raw numbers. That's because so many companies don't have to comply with SOX 404 at all. Or, most importantly, they don't have to subject their internal controls to independent audits.

Chart 12 shows the percentage of companies that received adverse opinions, as a percentage of all companies required to comply with both provisions of SOX 404 – that is, the number of accelerated and large accelerated filers that filed annual reports for fiscal years ending after SOX 404 became effective. In the first fiscal year of SOX 404 compliance, 15.3% of the companies where accounting firms performed internal-control audits had ineffective financial controls. That's two of every 13 companies.

In the next fiscal year, the adverse-opinion rate dropped to 12.5%. And so far for FY 2006, of the companies that have filed SOX 404-compliant annual reports, just 7.6% received adverse opinions on their internal-control effectiveness. What does this mean? SOX 404 is working. Companies are cleaning up their financial-reporting procedures to ensure they disclose accurate financial statements.

Once the rest of the companies file their fiscal 2006 annual reports, namely the Dec. 31 companies, we expect the adverse-opinion rate will drop even more. This will be the calendar-year companies' third round of SOX 404 audits. By now, we expect most of the problems at these companies have been fixed. Judging by the material-weakness disclosures so far in 2006, we have no reason to suspect otherwise. Then again, companies could surprise us with a slew of new disclosures come March. They may not have found any problems until their year-end evaluations and audits. We'll have to wait and see.

Chart 12: Internal-control adverse-opinion rate, by fiscal year[8]



Source: Glass Lewis, 10k Wizard, company filings.

How long will it take?

Just how many years of SOX 404 evaluations should it take for companies to clean up their problems? Well, nobody knows for sure. But we think companies should be able to fix the problems they or their auditors identified at least within one year. It wouldn't be a good sign to see companies disclose the

[8] Total number of companies based on the number of "accelerated filers" and "large accelerated filers" that filed an annual report for the fiscal years. We only included fiscal years that ended on or after Nov. 15, 2004. For FY 2004, the number was 2,751; for FY 2005, the number was 3,710; and for FY 2006 the number so far is 1,176.

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same weaknesses in consecutive annual reports. At the same time, many companies didn't discover any weaknesses until their second rounds of testing.

By our count, 165 companies received adverse or disclaimed opinions two years in a row, although they weren't necessarily due to the same weaknesses. In any case, these companies haven't been able to get their controls up to snuff, in their independent auditors' eyes, after two years of SOX 404 testing. Table 10 lists the 10 largest companies, by market cap, that received adverse or disclaimed opinions in each of their past two internal-control audits. In addition, there were 55 companies that received clean bills of health on their controls after their first audits, but then received adverse opinions during round two.

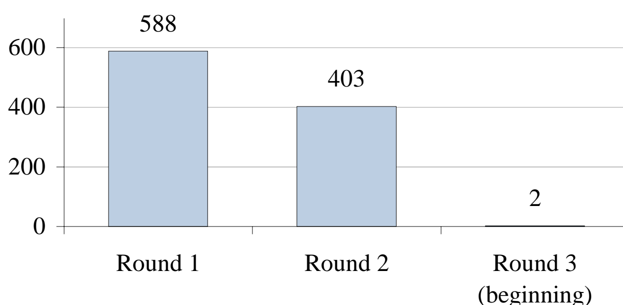
Table 10: Ten largest companies that received adverse or disclaimed audit opinions two years in a row

Ticker	Company	Auditor
AIG	American International Group Inc.	PricewaterhouseCoopers
CA	CA Inc.	KPMG
AES	AES Corp.	Deloitte & Touche
EK	Eastman Kodak Co.	PricewaterhouseCoopers
WFR	MEMC Electronic Materials Inc.	KPMG
RL	Polo Ralph Lauren Corp.	Deloitte & Touche
USM	United States Cellular Corp.	PricewaterhouseCoopers
IPG	Interpublic Group of Companies Inc.	PricewaterhouseCoopers
PDE	Pride International Inc.	KPMG
TDS	Telephone & Data Systems Inc.	PricewaterhouseCoopers

Source: Glass Lewis, company filings. Note: Companies' sizes measured by market capitalizations as of disclosure dates.

Chart 13 shows the number of adverse opinions that were issued by accounting firms in each round. In the second round of internal-control audits, the number of companies that received adverse opinions fell 31% to 403. By comparison, 588 companies received adverse opinions during the first round of audits.

Chart 13: Adverse opinions on ICFR, by round of SOX 404 audits[9]



Source: Glass Lewis, company filings.

[9] Round 1 included companies with fiscal years that ended between Nov. 15, 2004, and Nov. 15, 2005. Round 2 included companies with fiscal years that ended between Nov. 15, 2005, and Nov. 15, 2006. Round 3 will include companies with fiscal years that ended between Nov. 15, 2006, and Nov. 15, 2007. Companies with fiscal years that ended Dec. 31, 2006, aren't required to file their annual reports, which include their ICFR audit opinions, until March 1, and March 16, 2007.

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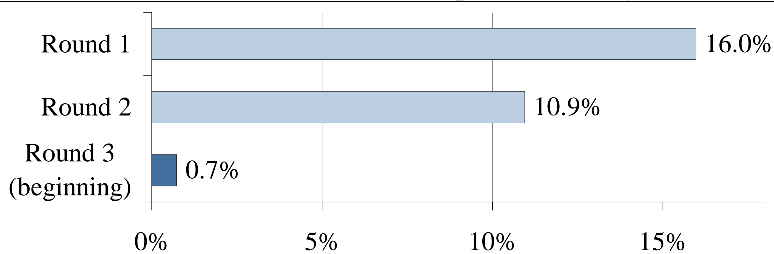
In the first round, 16% of all companies that were required to have their internal controls audited received adverse opinions. (Chart 14). In the second round, the percentage of companies with ineffective internal-control audit assessments fell to 11%. It's still too early how round three will go.

Chart 14: Internal-control adverse-opinion rate, by audit round[10]



Source: Glass Lewis, 10k Wizard, company filings.

Another encouraging sign is the number of companies that have fixed their problems. When companies receive unqualified opinions on their controls after previously disclosing weaknesses, it signals that they've put their financial-reporting houses in order. Non-accelerated filers don't have to subject their internal controls to outside audits. The way their executives signal they've fixed their problems is by filing subsequent reports in which they conclude their companies' controls are effective.

Of the 2,400 companies that disclosed 6,718 material weaknesses during the last three years, 905 companies subsequently said they fixed their problems.

That means there are still 1,495 companies, or about 11% of all U.S.-listed companies, that haven't yet indicated in their annual reports that they have remediated their previously disclosed weaknesses. The key point: Just 152 of these companies were required to comply with SOX 404. The remaining 1,343 companies haven't implemented SOX 404 yet.

The cost of SOX 404

Just about every argument we've heard against SOX 404 goes something like this: The cost of compliance is simply too high, and the burden is too great to justify the benefits, especially for smaller companies. Even opponents of SOX 404 would agree that, ideally, all publicly held companies should maintain robust systems of internal controls to ensure they produce accurate financial reports. The only question is: At what cost?

In performing a cost-benefit analysis, you would like to be able to assign numbers to the costs and benefits. Although it's difficult to quantify all the costs and benefits of SOX 404, one place we can look to start pinning numbers on the costs is audit fees – the amounts companies pay their independent accounting firms to audit their books, and in some cases their internal controls.

[10] Total number of companies based on the number of "accelerated filers" and "large accelerated filers" that filed an annual report for each audit round. For rounds 1 and 2, the number was 3,683; and for round 3 the number so far is 274.

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The difference in audit fees paid by SOX 404 and non-SOX 404 companies, in context

As expected, in the first year of SOX 404, audit fees increased in the aggregate by billions of dollars. For companies that had to comply with SOX 404, audit fees increased 66% in 2004. (This includes so-called audit-related fees, as disclosed in companies' proxy statements.) So was that the cost of SOX in terms of audit fees? Actually, it's less than that because the audit fees paid by companies not subject to SOX 404 increased 23% in the same year. (Table 11). Then in 2005, the second year of SOX 404, audit fees leveled off for companies that implemented SOX 404 a year earlier, while the companies that weren't subject to SOX 404 saw another 15% climb in audit fees.

Table 11: Audit fee comparison of SOX 404 and non-SOX 404 companies

	SOX 404 companies				Non-SOX 404 companies			
Year:	**Audit & audit related fees**	**Yr. to yr. % change**	**Cum. % change**	**% of revenue**	**Audit & audit related fees**	**Yr. to yr. % change**	**Cum. % change**	**% of revenue**
2003 (prior to SOX 404)	$5.12 B	-	-	0.05%	$2.24 B	-	-	0.04%
2004 (first year SOX 404)	$8.51 B	66.16%	-	0.08%	$2.77 B	23.48%	-	0.05%
2005 (second year SOX 404)	$8.51 B	-0.01%	66.15%	0.08%	$3.17 B	14.66%	41.57%	0.06%

Source: Audit Analytics. Table includes 3,160 SOX 404 companies and 2,532 non-SOX 404 companies.

The SOX 404 companies experienced a large, one-time pop in audit fees upfront, but now have seen their fees level off. In contrast, the non-SOX 404 companies experienced substantial increases in audit fees in each of the last two years. Comparing each group of companies' cumulative change in audit fees – that is from prior to SOX 404 to the second year of SOX 404 – the two groups are separated by just 25 percentage points. SOX 404 companies have seen a 25% larger increase in audit fees than non-SOX 404 companies since implementation.

Assuming that audit fees for non-SOX 404 companies would increase by roughly the same cumulative amount if they went ahead and implemented SOX 404, we can get an idea of what the remaining cost would be for these companies to become compliant. Judging by the increase in audit fees by companies that have implemented SOX 404, if the remaining companies also implemented SOX 404, we estimate the additional increase in audit fees would be approximately $550 million. Just to put this number in context, remember that the loss in market value at WorldCom was about $120 billion.

Before you say that's not a fair comparison – since WorldCom was a much larger company than the typical non-SOX 404 company – don't forget we've seen smaller companies cost investors billions of dollars in market-value losses, too. In one of our prior reports, we highlighted 50 companies, each with revenues under $100 million at their stock-price high, that individually lost more than $1 billion a piece in market value after regulators uncovered fraudulent activity, improper accounting and inadequate systems of internal controls at these companies.[11] If implementing SOX 404 at the companies that have yet to do so prevents just one more billion-dollar loss for investors, the $550 million seems like a very good investment to us.

[11] See our September 14, 2005, Trend Alert, "*Public Policy Alert*: Comment Letter to the SEC Advisory Committee on Smaller Public Companies," Appendix A: Market Capitalization Losses of "Smaller" Companies.

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Increases in audit fees were long overdue

We believe audit fees were kept artificially low throughout the 1980s and 1990s by competitive pressures brought to bear by CFOs, CEOs and, in some cases, even audit committees. Audit firms need to make a profit, too, so they can compensate their employees and partners. Audit firms reacted to this competitive pressure by keeping fees low. In turn, we believe auditors cut the extent of their audit testing to maintain their profit margins. We now know that auditors often did not test internal controls, or only tested, say, a third of them each year.

For example, at a large technology company, this may have resulted in revenue-recognition controls getting tested only once every three years. So it comes as no surprise that auditors repeatedly missed major frauds. The passage of the Private Securities Litigation Reform Act of 1995 gave auditors further comfort when deciding to reduce the level of work they were performing, because the act generally strengthened audit firms' protection from liability.

With or without SOX, audit fees were due for an increase once audit firms decided to increase their testing. The creation of the PCAOB, now the auditing profession's chief regulator, forced the issue. Since they knew the regulator would be looking over their shoulders, auditors decided to increase their testing to levels acceptable to the investing public. As the audit-fee statistics show, fees have increased even among those companies that have not implemented SOX 404 as they should have. These increases in audit fees are not going to disappear in the future. From an investor perspective, this is a good thing, as long as auditors are performing quality work for the money they're charging.

If companies have financial-reporting issues, audit fees will be higher

Another interesting point emerged when we took a look at the audit fees paid by companies with financial reporting issues. By "issues" we mean the companies had either restatements or material weaknesses, or both. Table 12 shows a slightly larger increase in audit fees for SOX 404 companies in 2004 and 2005, but a much larger increase for non-SOX 404 companies in 2005. The point is, whether or not companies have implemented SOX 404, they are paying more in audit fees if they experienced financial-reporting issues. The gap between SOX 404 and non-SOX 404 audit fees narrows if the companies have problems.

Table 12: Audit fee comparison of SOX 404 and non-SOX 404 companies with issues

	SOX 404 companies with issues				Non-SOX 404 companies with issues			
Year:	**Audit & audit related fees**	**Yr. to yr. % change**	**Cum. % change**	**% of revenue**	**Audit & audit related fees**	**Yr. to yr. % change**	**Cum. % change**	**% of revenue**
2003 (prior to SOX 404)	$1.88 B	-	-	0.06%	$0.36 B	-	-	0.04%
2004 (first year SOX 404)	$3.16 B	68.14%	-	0.10%	$0.44 B	24.65%	-	0.05%
2005 (second year SOX 404)	$3.25 B	2.59%	72.50%	0.10%	$0.55 B	24.48%	55.17%	0.07%

Source: Audit Analytics. Table includes 979 SOX 404 companies and 422 non-SOX 404 companies. Note: Issues are defined as financial restatements or material weaknesses in internal controls.

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Table 13 shows a smaller increase in audit fees for SOX 404 companies without issues in the first year and a larger decline in the second year compared with companies with financial-reporting issues. The non-SOX 404 companies without financial-reporting issues also experienced smaller increases in their audit fees than companies with issues, but their fees still continued to rise.

Table 13: Audit fee comparison of SOX 404 and non-SOX 404 companies without issues

	SOX 404 companies w/o issues				Non-SOX 404 companies w/o issues			
Year:	**Audit & audit related fees**	**Yr. to yr. % change**	**Cum. % change**	**% of revenue**	**Audit & audit related fees**	**Yr. to yr. % change**	**Cum. % change**	**% of revenue**
2003 (prior to SOX 404)	$3.24 B	-	-	0.04%	$1.88 B	-	-	0.04%
2004 (first year SOX 404)	$5.35 B	65.01%	-	0.07%	$2.32 B	23.25%	-	0.05%
2005 (second year SOX 404)	$5.26 B	-1.55%	62.46%	0.07%	$2.62 B	12.77%	39.00%	0.06%

Source: Audit Analytics. Table includes 2,181 SOX 404 companies and 2,110 non-SOX 404 companies. Note: Issues are defined as financial restatements or material weaknesses in internal controls.

Since the percentage change in audit fees between SOX 404 and non-SOX 404 companies isn't that far off, after a second consecutive year of double-digit increases among the non-SOX 404 companies, we think these companies might as well just go all the way and pay a little more to become SOX 404 compliant. At this point, we think these companies, and more importantly investors, could get a lot more bang for their buck by investing a little more to ensure they have SOX 404-quality financial controls.

Executives shouldn't make such a big stink about the cost of SOX 404

A final note on audit fees: We can't help but scoff when we think about all the fuss that's been made about the increased costs related to SOX 404. Look back at the last three tables and consider the amount of fees as a percentage of revenue. Sure, audit fees are only one component of the increased costs, but still, we are talking about a couple hundredths of a percent of revenue. Not even one percent of revenue, but a few hundredths of a percent of revenue. The difference, in terms of percent of revenue, in audit fees between SOX 404 companies and non-SOX 404 companies was 0.02% in 2005 – that's two hundredths of a percent. Aren't companies making much ado about nothing?

Corporate executives aren't quite as frugal when it comes to their own pay. In 2005, total compensation for the top five executives at Russell 3000 companies was equivalent to 0.31% of the companies' revenues.[12] That's about five times more than audit fees on a percentage-of-revenue basis. CEO compensation alone was equivalent to 0.13% of revenues, or twice as much as audit fees.

The 10 highest-paid CEOs in 2005 received a combined $549 million in compensation, including our estimates of the grant-date values of the equity-based compensation they received that year. The comparisons between audit fees and executive pay become even starker when you consider how much

[12] Total compensation figures include our estimates of the grant-date fair values of the equity-based compensation awards the executives received in 2005. To estimate these expenses, we used the Black-Scholes valuation methodology, taking into consideration the volatility of the stock and the time value of money. This model does not reflect the actual cash an executive may realize upon exercise of the options, which may vary significantly.

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cash some CEOs banked in 2005 from stock-option exercises. A case in point: **Capital One Financial Corp.** (NYSE:COF) Chairman and CEO Richard Fairbank realized $249.3 million from stock-option exercises in 2005, and still had $266.6 million worth of in-the-money exercisable options left at the end of the year.[13] Those amounts, by themselves, nearly would cover what we estimate it would cost for the roughly 2,500 non-SOX 404 companies in the previous three tables to implement SOX 404.

A final comparison: Capital One's audit and audit-related fees increased to $8.1 million in 2005 (post SOX 404) from $5.8 million in 2003 (pre SOX 404). That's an increase of just $2.3 million over the last two years.

We know, there's more to these costs than just audit fees

Of course, audit fees are not the only costs associated with implementing and maintaining effective internal controls. Audit fees represent the cost for outside evaluations of the financial controls companies already have in place. Other costs include implementation expenses, maintenance expenses, information-technology expenses, personnel expenses, and even opportunity costs. Companies spent a lot of money implementing enterprise-resource-planning systems, upgrading accounting-information systems, expanding their accounting-staff levels, and documenting their policies and procedures. The truth is, no one knows exactly how much money companies have paid to comply with SOX 404.

One thing we are fairly confident about: The costs companies incurred were long overdue. Companies already were supposed to have had effective controls in place. They've been required by law to do so since 1977. But as it turned out, many didn't. Nobody could have anticipated how far behind thousands of companies actually were. The costs of implementing SOX 404 were as high as they were because those costs represented the running tally of years of deferred maintenance. For too long, companies neglected to adequately keep up their internal controls over financial reporting.

Think of it this way: If you go five years without taking your car to the shop – no oil changes, tire rotations, or tune-ups – you're going to have one heck of a bill to pay once you do stop by the local auto-repair shop. You'd probably need a complete overhaul at that point. That's the same kind of bill thousands of larger companies were faced with two years ago. Now that they are owning up to their financial-reporting mistakes and getting their controls up to snuff, the costs of maintaining those systems and procedures shouldn't be anywhere near as high going forward.

Still, the financial-accounting world's equivalent of the auto-repair shop should be getting another wave of business in a few more years. There's a whole other group of companies – some 6,000 of them – that have deferred maintenance on their financial controls for an even longer time. That's assuming they even have any controls. And they continue to procrastinate, aided by multiple extensions from the SEC. Independent audit firms won't have to start auditing the effectiveness of these companies' controls until the end of 2008. But – who knows? – by then, the internal-control standards might be relaxed further. Or worse yet, those companies might not have to go the auto-repair shop at all.

[13] For more on executive-compensation data, see our Sept. 17, 2006, report, *Pay Dirt, A Review of 2005 Executive Compensation Practices*.

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Companies with material weaknesses and restatements underperform the market

Here's the real bottom line for investors: The median one-year stock return of companies that disclosed material weaknesses in 2006 was minus 4%. That was 18 percentage points lower than the return for the Russell 3000 stock index in 2006. In the last three years, the stocks of companies that filed restatements or disclosed material weaknesses underperformed just about every major U.S. stock index. (Table 14).

That should not come as a surprise. For a business to be successful and well managed, its executives must be able to obtain timely, accurate, relevant information on the company's operating results and key performance metrics. This requires effective internal controls, competent personnel and quality information systems. Without these, companies are far more likely to underperform, compared with their peers and the broader market.

Table 14: One-year stock price performance of companies with restatements and material weaknesses

Group of companies:	**Number**	**Median % total return**	**Dow % total return**	**S&P 500 % total return**	**Russell 3000 % total return**	**NYSE Composite % total return**	**Nasdaq Composite % total return**	**% underperformed Russell 3000**
2004 material weaknesses	263	-6.2	3.1	9.0	10.1	12.6	8.6	**-16.3**
2005 material weaknesses	1,126	-10.9	-0.6	3.0	4.3	7.0	1.4	**-15.2**
2006 material weaknesses	945	-3.9	16.3	13.6	13.7	17.9	9.5	**-17.6**
2004 mat. weak. with restatements	133	-9.8	3.1	9.0	10.1	12.6	8.6	**-19.9**
2005 mat. weak. with restatements	647	-9.2	-0.6	3.0	4.3	7.0	1.4	**-13.5**
2006 mat. weak. with restatements	537	-3.1	16.3	13.6	13.7	17.9	9.5	**-16.7**

Source: Glass Lewis, FactSet, company filings. Note: Total returns calculated over calendar years, from Dec. 31 to Dec. 31. Material weaknesses were associated with restatements if the disclosures occurred within one year of each other.

In our view, the SEC and the PCAOB in their proposals have failed to adequately quantify and consider the costs to investors highlighted above, as required. They have failed to consider the aggregate losses investors have borne from companies, both large and small, that failed to maintain adequate financial controls. They also have failed to quantify the cost to investors of the precipitous market-capitalization declines in 2001 and 2002 as a result of investors' lost confidence in the markets. Finally, they haven't considered the costs to thousands of employees that lost their jobs at companies involved in frauds.

In addition, we think a proper analysis of the costs of SOX 404 should exclude those costs incurred by companies to bring their people, policies, procedures and systems into compliance with the Foreign Corrupt Practices Act; after all, they were supposed to have implemented such improvements 30 years ago after the act was passed. Yet we've seen no studies in which the SEC has given even so much as a nod to this point. While we can sympathize with the shortcomings in the SEC's initial cost-benefit analysis – we don't know of anyone who expected 2,400 companies to report deficiencies – we cannot comprehend or defend the SEC's subsequent analysis.

<u>Note: Up through this point, the statistics cited in our report have included both U.S. companies and foreign filers. The remaining sections of this report will focus solely on disclosures by U.S. companies.</u>

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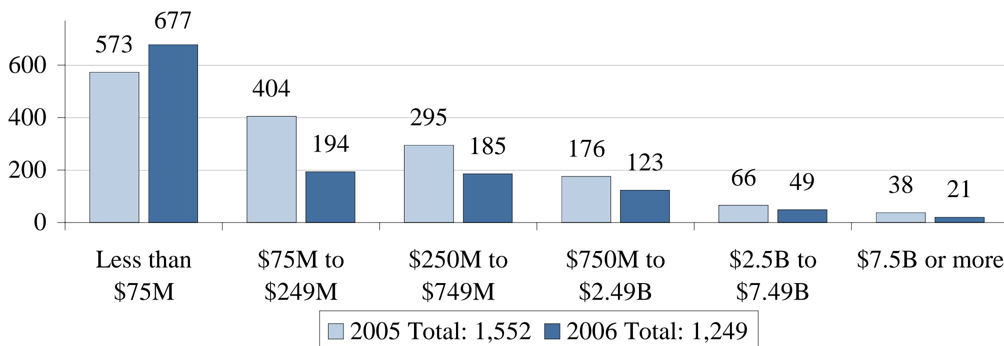
Material weaknesses, by company size

Chart 15 shows additional detail of material-weakness disclosures, broken down by companies' market capitalizations. Even though they aren't yet required to comply with SOX 404, companies with less than $75 million in market capitalization filed the highest volume of material-weakness disclosures in each of the last two years. In part, that's because half of all public companies are microcaps.

Companies with market capitalizations between $75 million and $250 million filed 194 material-weakness disclosures in 2006, less than half the 404 such disclosures those companies filed a year earlier. At the upper end of our scale, companies with $7.5 billion or more in market capitalization filed just 21 material-weakness disclosures last year, down 45% from 2005. In 2006, the volume of material-weakness disclosures was down among all companies with $75 million or more in market capitalization.

Chart 15: Material-weakness disclosures, by company market capitalization



Source: Glass Lewis, company filings, Reuters. Note: Market capitalization as of filing date.

In addition to measuring the volume of material-weakness disclosures, we think it's smart to consider material-weakness rates – that's the number of companies that disclosed material weaknesses as a percentage of all the companies within that category.

Chart 16 shows material-weakness rates for each of our market-capitalization categories. Even microcap companies had the highest volume of material-weakness disclosures, they did not have the highest material-weakness rate. Last year, 10.4% of companies with $75 or more in million in market capitalization disclosed material weaknesses, down from 16% in 2005. By comparison 8.5% of companies with market capitalizations below $75 million disclosed material weaknesses.

That includes a 9.7 point drop last year, to 10.9% from 20.6%, in the material-weakness rate of companies with market capitalizations between $75 million and $250 million. These are the smallest companies that had to implement SOX 404 beginning with their fiscal years that ended after Nov. 15, 2004. Their efforts appear to be paying off. After one of every five of these companies reported material weaknesses in 2005, only one of every nine found weaknesses in their controls during their second year of SOX 404 testing and auditing.

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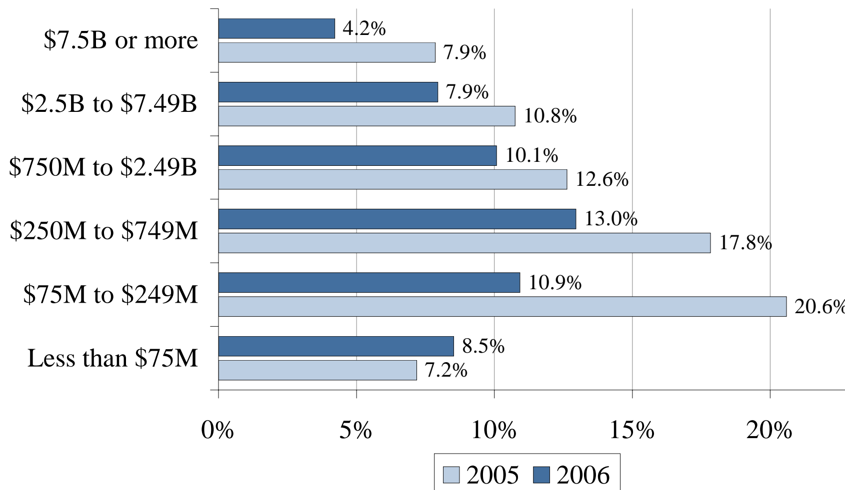
Companies with market capitalizations between $250 million and $750 million had the highest material-weakness rate last year at 13%. But that was down 4.8 points from 17.8% in 2005. Only one of every 25 companies with $7.5 billion or more in market capitalization disclosed material weaknesses last year, compared with one of every 13 in 2005.

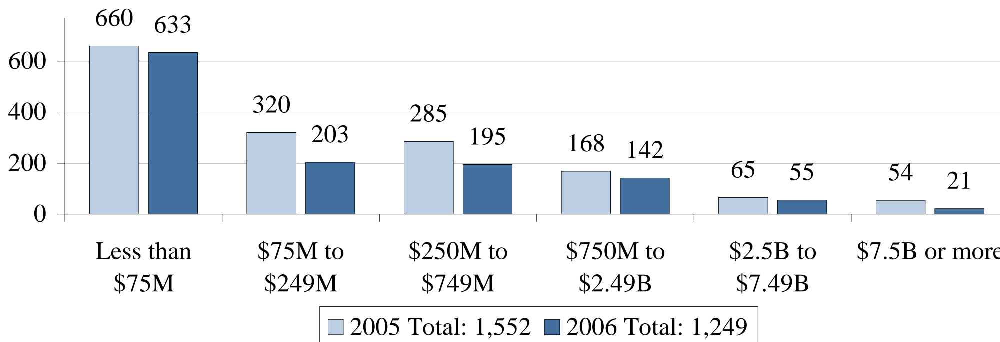
Chart 16: Material-weakness rate, by company market capitalization[14]



Source: Glass Lewis, company filings, Reuters, FactSet. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

The following two charts use revenue, instead of market capitalization, as the measure of company size for a similar breakdown of material-weakness disclosures. Last year, disclosures fell among companies in all of our revenue size categories, even the smallest companies. (Chart 17).

Chart 17: Material-weakness disclosures, by company revenue



Source: Glass Lewis, company filings, Reuters. Note: Revenue as of fiscal year end.

Judging by the material-weakness rates in Chart 18, the largest companies' internal controls underwent the most improvement in the last two years. Companies with $7.5 billion or more in revenues turned in a

[14] Total number of companies based on FactSet Research Systems universal screening. In 2006, that number was 12,263.

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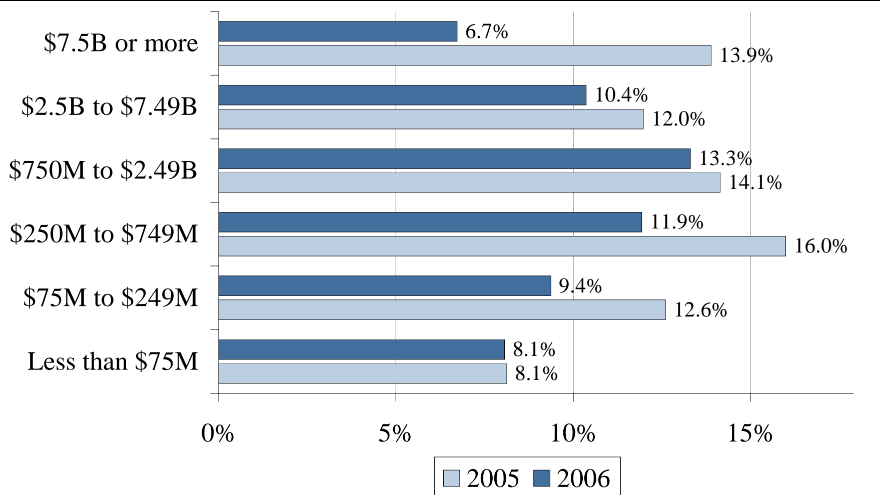
material-weakness rate of 6.7%. In 2005, those companies' material-weakness rate was more than double that, at 13.9%. They disclosed material weaknesses the least often in 2006.

Companies with revenue between $250 million and $2.5 billion continued to disclose their fair share of material weaknesses in 2006. Last year, 12.5% of those companies said their controls were ineffective, compared with 15.2% in 2005. A notch up on the revenue scale, one of every 10 companies with between $2.5 billion and $7.5 billion in revenue disclosed material weaknesses last year.

Chart 18: Material-weakness rate, by company revenue[15]



Source: Glass Lewis, company filings, Reuters, FactSet. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

Material weaknesses, by audit firms

In the last two years, companies audited by PricewaterhouseCoopers LLP filed more material-weakness disclosures than companies audited by any other accounting firm. Last year, PwC-audited companies filed 205 disclosures, down from 330 in 2005. (Chart 19). In 2006, companies audited by Ernst & Young LLP disclosed the fewest material weaknesses.

Last year, companies audited by Tier Two firms BDO Seidman LLP and Grant Thornton LLP filed 36% fewer material-weakness disclosures than in 2005. Meanwhile, material-weakness disclosures filed by companies audited by firms other than the six largest audit firms rose 46% to 502 disclosures from 344 a year before.

[15] Total number of companies based on FactSet Research Systems universal screening. In 2006, that number was 12,263.

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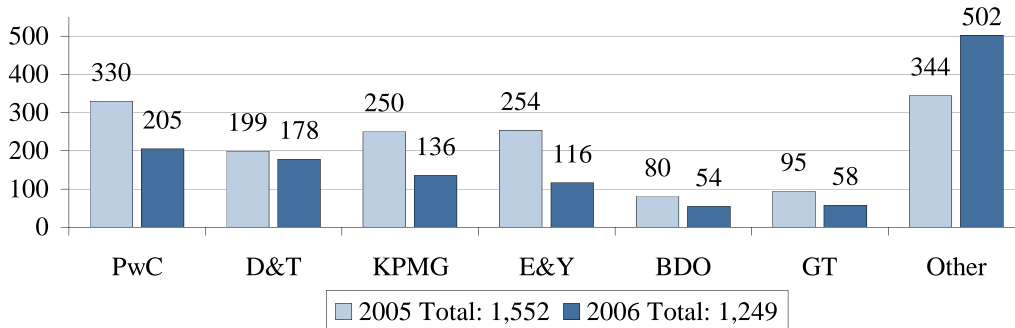
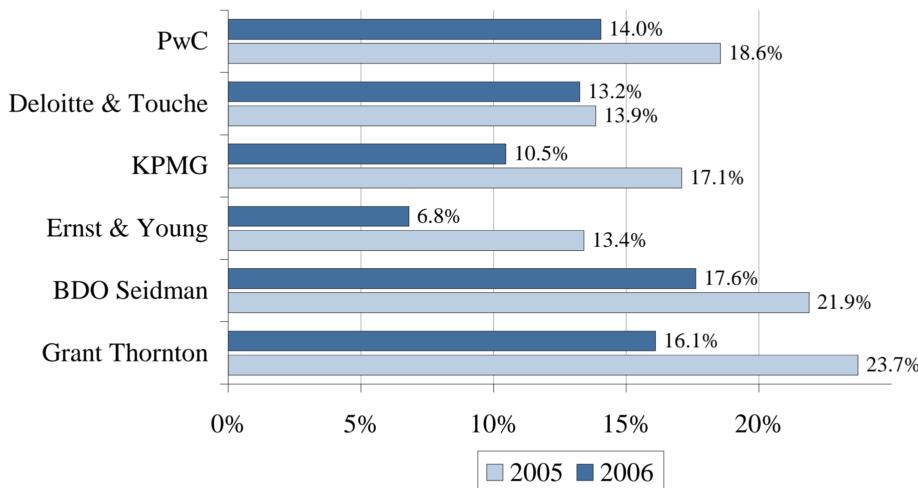
Chart 19: Material-weakness disclosures, by audit firm



Source: Glass Lewis, company filings. Note: Chart only shows the six largest accounting firms. The next two largest firms are Crowe Chizek & Co. and McGladrey & Pullen.

An auditor's material-weakness rate shows the number of companies it audited that disclosed material weaknesses, as a percentage of all the companies it audits. PwC at 14% last year had the highest rate among the Big Four firms, down from 18.5% in 2005. (Chart 20). E&Y had the lowest material-weakness rate in both 2005 and 2006. E&Y's rate was just 6.8% last year. Likewise, E&Y also recorded the lowest restatement rate in each of the last four years.

Chart 20: Material-weakness rate, by audit firm[16]



Source: Glass Lewis, Audit Analytics, company filings. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

Looking at the Tier Two firms, BDO's 17.6% material-weakness rate was 1.5 points higher than GT's 16.1%. But in 2005, GT's rate was 23.7% – meaning nearly one of every four companies that GT

[16] Total number of companies based on data provided by Audit Analytics, which excludes funds and trusts not included in our restatements study. In 2006, that number was 11,212. The number of SEC clients for each audit firm provided by other sources, such as the AICPA Center for Public Company Audit Firms, includes funds and trusts and would overstate the number of public companies that each audit firm audits if we were to use those numbers for the purpose of this report.

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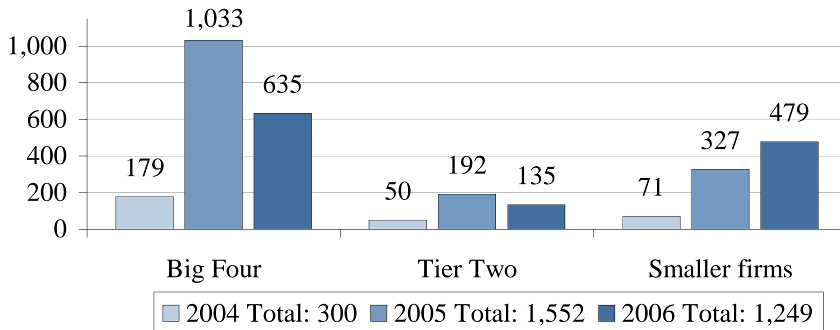
audited disclosed that its internal controls were ineffective. Remember, the overall material-weakness rate in 2005 was 10%, or one of every 10 companies. Lots of companies audited by GT appear to have cleaned up their financial controls, judging by the improvement in the audit firm's material-weakness rate. Last year, companies audited by KPMG LLP showed the greatest improvement.

In total, companies audited by one of the Big Four firms filed 39% fewer material-weakness disclosures in 2006 than they did in 2005. That was after those companies filed 1,033 disclosures in 2005 after their initial implementation of SOX 404. (Chart 21). Material-weakness disclosures by companies audited by one of the Tier Two firms fell 30% in 2006 to 135 disclosures. By comparison, the number of such disclosures rose 46% among companies audited by smaller firms.

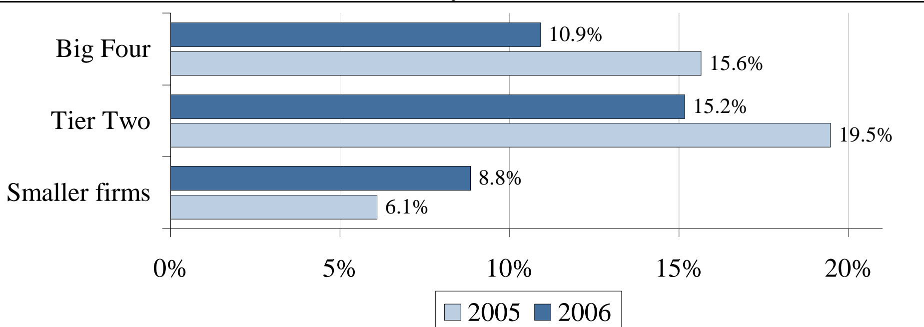
Chart 21: Material-weakness disclosures, by audit firm size



Source: Glass Lewis, company filings.

Chart 22 shows material-weakness rates by audit-firm size. In total, 10.9% of companies audited by the Big Four firms disclosed ineffective controls during 2006, down from 15.6% during 2005. By comparison, Tier Two firms posted material-weakness rates of 15.2% in 2006 and 19.5% in 2005. Material-weakness rates at smaller firms remained comparatively low during the last two years, because most of the companies they audit haven't yet been required to comply with SOX 404.

Chart 22: Material-weakness rate, by audit firm size[17]



Source: Glass Lewis, Audit Analytics, company filings. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

[17] Total number of companies based on data provided by Audit Analytics, which excludes funds and trusts not included in our material-weaknesses study. In 2006, that number was 11,212.

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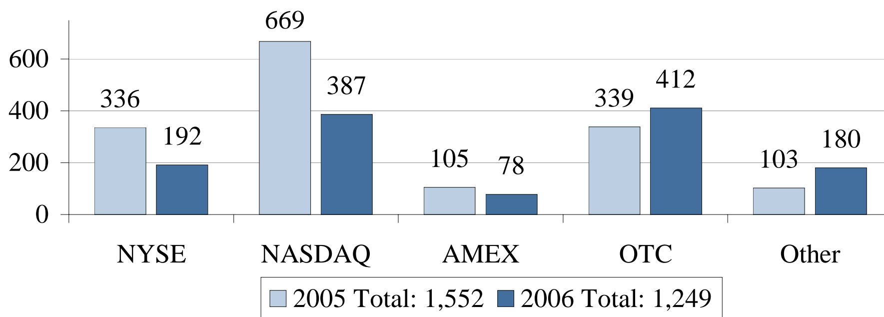
Material weaknesses, by stock exchange

Companies that listed their stocks on the New York Stock Exchange or Nasdaq reported far fewer weaknesses in their internal controls last year than in 2005. NYSE-listed companies filed 192 material-weakness disclosures, 43% less than their 336 disclosures in 2005. Nasdaq-listed companies filed 387 material-weakness disclosures, 42% below the 669 disclosures they filed in 2005. Companies that trade in the smaller over-the-counter markets – the Pink Sheets, OTC Bulletin Board and other OTC markets – filed 412 material-weakness disclosures during 2006, up 22% from 339 during 2005. (Chart 23).

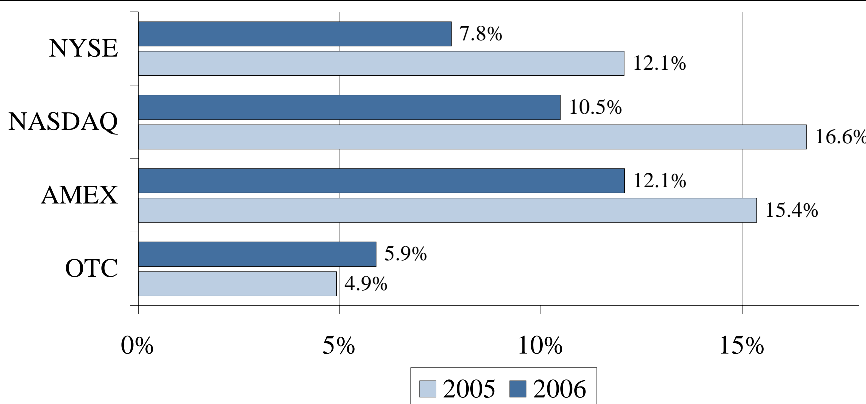
Chart 23: Material-weakness disclosures, by stock exchange



Source: Glass Lewis, Reuters, company filings.

In terms of material-weakness rates, companies listed on the American Stock Exchange disclosed material weaknesses the most often. Last year, 12.1% of AMEX-listed companies disclosed material weaknesses, down from 15.4% in 2005. The Nasdaq's material-weakness rate fell to 10.5% in 2006 from 2005's high of 16.6% following initial SOX 404 implementation. (Chart 24). In 2007, we expect the NYSE's and Nasdaq's material-weakness rates to continue declining as more and more of those companies get their financial controls up to par.

Chart 24: Material-weakness rate, by stock exchange[18]



Source: Glass Lewis, Reuters, FactSet, company filings. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

[18] Total number of companies based on FactSet Research Systems universal screening. In 2006, that number was 12,263.

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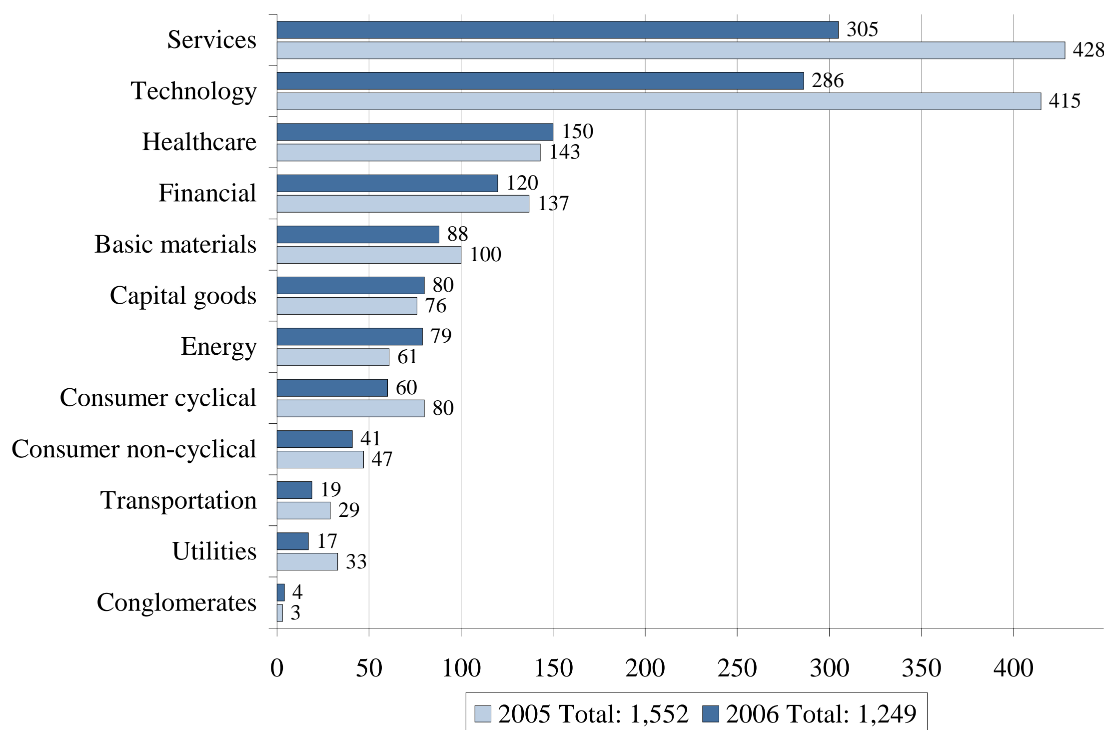
Material weaknesses, by sector and industry

In the last two years, services and technology companies filed the most material-weakness disclosures. However, it appears almost one third of those companies were able to clean up their problems after the first year of SOX 404. In 2006, services companies filed 305 disclosures, which was down 29% from 428 in 2005. Last year, technology companies disclosed material weaknesses 286 times, 31% fewer than the 415 disclosures the year before. Sectors where material-weakness disclosures were on the rise last year include healthcare, capital goods and energy. (Chart 25).

Chart 25: Material-weakness disclosures, by sector



Source: Glass Lewis, Reuters, company filings.

To see which companies disclosed material-weaknesses the most often, Chart 26 shows material-weakness rates by sector for the last two years. After the initial implementation of SOX 404 in 2005, about 15% of services companies and 15% of technology companies disclosed material weaknesses. Each sector's rate then fell by about four points in 2006.

Last year, capital-goods companies rang in the highest material-weakness rate at 12.1%, up from 10.2% the year before. Energy and basic-materials companies also disclosed material weaknesses more often in 2006 than they did in 2005. One of every nine energy companies disclosed material weaknesses in 2006.

In the last two years, financial companies disclosed problems with their internal controls the least often. Last year, just 4.5% of financial companies, or about one in 22, disclosed material weaknesses. Perhaps

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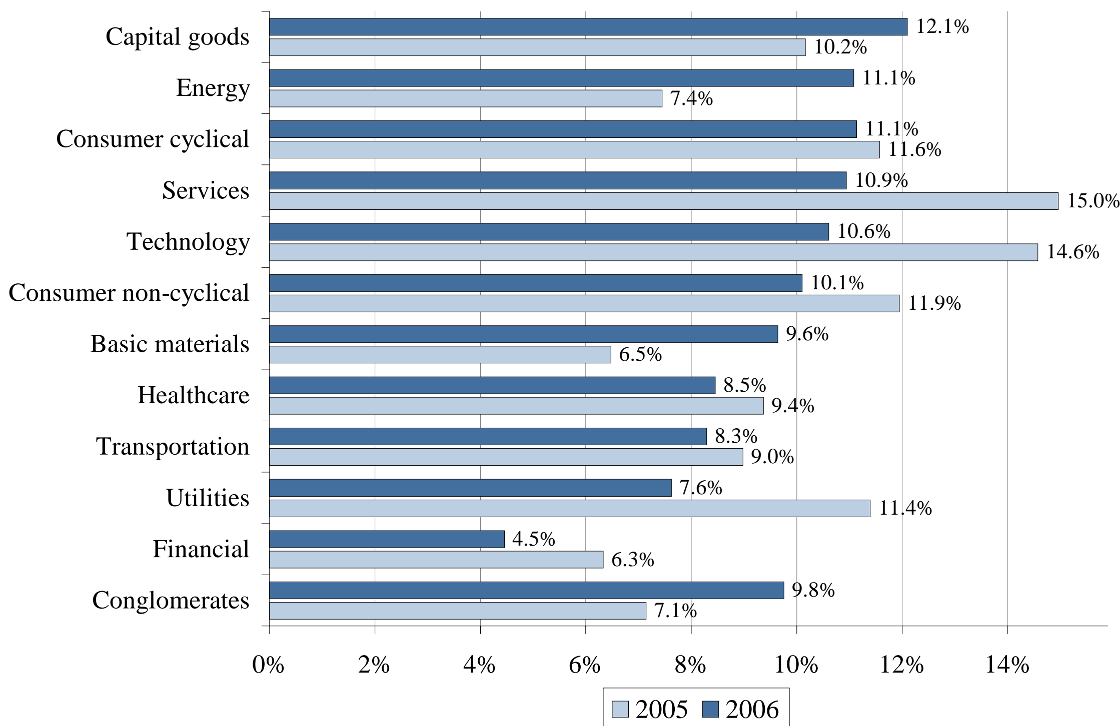
the business characteristics of banks, insurance companies and financial-services companies are more closely aligned with or dependent on maintaining effective internal controls. More financial companies appear to have recognized the need for strong controls before SOX 404 went into effect.

Chart 26: Material-weakness rate, by sector[19]



Source: Glass Lewis, Reuters, FactSet, company filings. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

Chart 27 shows the volume of material-weakness disclosures by selected industries included within the 12 sectors. Coinciding with the highest volume of restatements, software-and-programming companies also filed the highest volume of material-weakness disclosures. Last year, software companies filed 93 disclosures, down 30% from 133 in 2005. One quarter of all the material weaknesses that software companies disclosed were related to revenue recognition. It seems these companies business models, and perhaps the Silicon-Valley mentality, are most prone to improperly recording revenue.

Other companies that filed fewer material-weakness disclosures last year than in 2005 were communications companies, banks, medical-equipment companies, and semiconductor companies. But retail companies saw the largest decline in such disclosures after many cleaned up lease-accounting issues in 2005. Industries that disclosed more material weaknesses last year than in 2005 included biotechnology and drugs, oil and gas, and financial services.

[19] Total number of companies based on FactSet Research Systems universal screening. In 2006, that number was 12,263.

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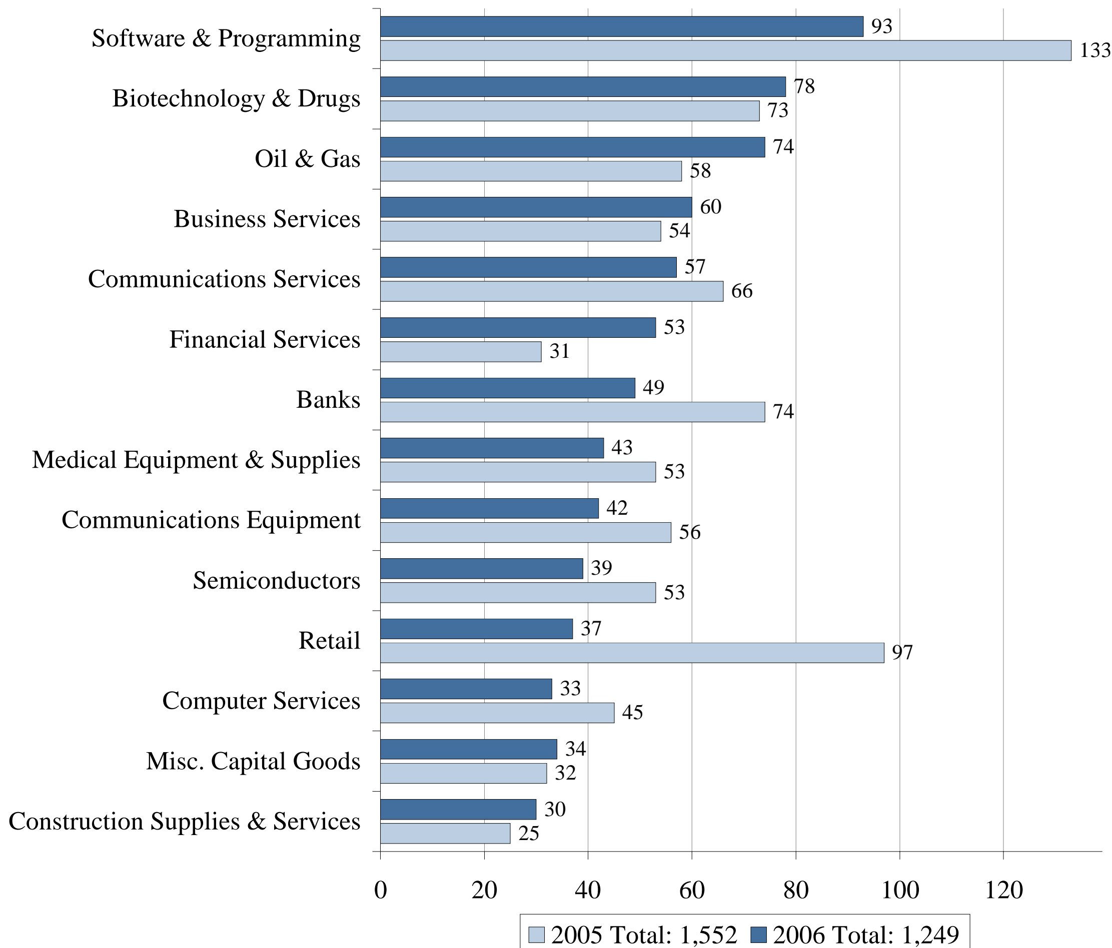
Chart 27: Material-weakness disclosures, by industry



Source: Glass Lewis, Reuters, company filings. Note: Includes industries with 30 or more disclosures.

In terms of material-weakness rates, companies that most often disclosed problems with their controls most often were in the miscellaneous-capital-goods, software-and-programming, and communications industries. Communications-services companies appeared to have fixed the most problems. Those companies' material-weakness rate fell to 11.9% last year from 19% in 2005. (Chart 28). At the bottom of the scale, just one of every 33 banks disclosed material weaknesses in 2006. This comes as no surprise. Since the passage of the Federal Deposit Insurance Corporation Improvement Act in 1991, banks have been required to have their internal controls tested. Of course, banks also have government auditors looking at their internal controls, a level of oversight public companies in general do not have.

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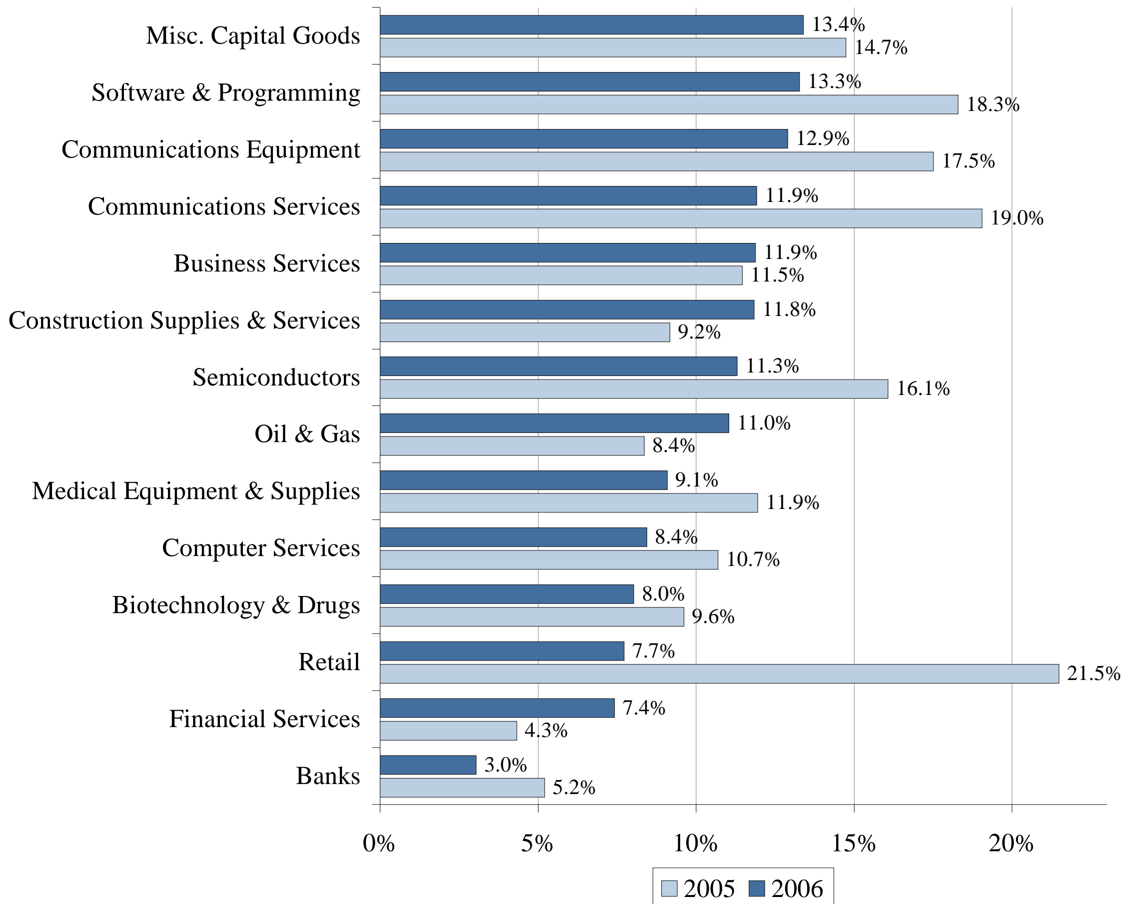
Chart 28: Material-weakness rate, by industry[20]



Source: Glass Lewis, Reuters, FactSet, company filings. Note: Includes industries with 30 or more disclosures. Rates based on number of companies that disclosed material weaknesses, as opposed to number of material-weakness disclosures.

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[20] Total number of companies based on FactSet Research Systems universal screening. In 2006, that number was 12,263.

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