The Lord & Benoit Report:

Do the Benefits of 404 Exceed the Cost?

Highest Returns were Companies with Good Section 404 Internal Controls:

Share Price Movements During the Implementation Period of Section 404 Requirements of the Sarbanes Oxley Act -An Empirical Study-

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Executive Summary

Since the enactment of the Sarbanes-Oxley Act (also nicknamed the Investor Protection Act) much has been written about the cost and benefits of one part of the Act, Section 404. Proponents say that effective internal controls are necessary for good financial stewardship. Opponents say that the costs are too high, particularly with respect to smaller companies, and that the costs exceed the benefits to investors.

Since there are ongoing deliberations about possibly exempting smaller public companies from SOX 404 reporting requirements, we studied the financial trends of nearly 2,500 companies to answer one timely question:

Do the costs of complying with SOX 404 outweigh the benefits

– not necessarily to the company - but to the investor?

Lord & Benoit, LLC a SOX Research and Compliance firm has conducted preliminary research comparing average relative share price movements between companies with material weaknesses in their internal controls over financial reporting as opposed to companies without material weaknesses in their internal controls over financial reporting. The data was compiled using www.AuditAnalytics.com, the leading provider of audit and internal control related due diligence information for public companies. This report presents results for all December year-end Accelerated Filers that were registrants one year before Section 404 was required and have submitted at least two Section 404 assertions (population of 2,481 companies). The research covers share price movements representing approximately half of the entire market capitalization of all publicly traded companies in the United States.

The research involved assembling three distinct data sets of share prices for all of the 2,481 December year-end publicly held Accelerated Filers that had filed at least two years of Section 404 assessments[1]. An average share price was calculated for each company on each of three dates: March 31, 2004, 2005 and 2006[2]. These dates represented pre-Section 404 compliance, post first year Section 404 compliance and post second year Section 404 compliance periods.

[1] Included in our analysis were 41 companies that had not filed their second year Section 404 report as of the date of this report and because of the serious delinquency associated with same were assured of receiving an adverse 404 report from their auditors.
[2] Bankruptcies were counted as having a zero share price.

This average share price was then separated into three categories:

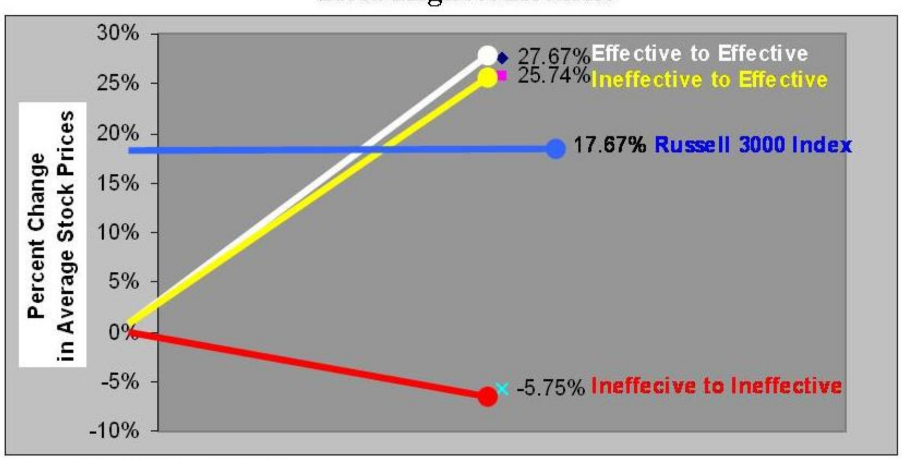
- Registrants filing <u>both an initial and subsequent year adverse</u> 404 assessment (125 companies);
- Registrants filing a <u>first year adverse 404 assessment followed by a clean</u> 404 assessment (264 companies) and;
- Registrants filing <u>clean assessments in both years</u> (2,092 companies).

The Russell 3000 Index increased **18%** during this same time frame.[3]

The research showed that over the two year period there was a:

- **27.67% increase** in the average share prices for companies that had <u>*effective* controls in both years</u> (8.92% increase in year one and 18.72% increase in year two)[4]
- **25.74% increase** in average stock prices for companies that <u>had *ineffective* 404 controls in year one but *effective* 404 controls in year two</u> (0.6% increase in year one and 25.14% increase in year two).
- **5.75% decrease** in average stock prices of companies that <u>reported ineffective 404 controls in both years</u> (9.85% decrease in year one partially offset by a 4.11% increase[5] in year two).

Sarbanes-Oxley Section 404 Internal Controls Yield Highest Returns



Source: Lord & Benoit, LLC

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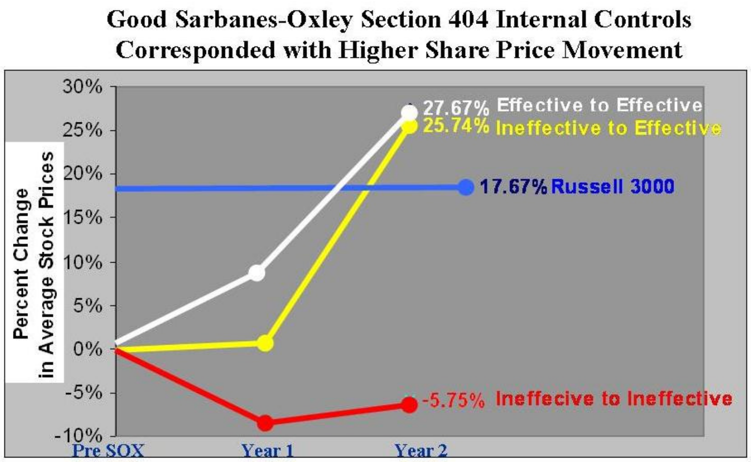
[3] This index will not compare directly to the returns in this analysis because it deals with the movement of the entire capitalization of the market as opposed to simply the share price movements.

[4] It is important to note that this is not an analysis of the overall market capitalization impact but an analysis of the relative impact on share price movements throughout the marketplace. This analysis does not present the overall market affect of the change in share prices because it does not factor in the relative number of shares outstanding that represent each public company. For example, if one company held half of all outstanding shares, and its shares had declined during the period in question that would affect the overall market capitalization to a large degree. However in this analysis this share price decline would only represent one share price movement out of the thousands included in this analysis. We believe the approach we have taken is instructive because it presents each company's share price movement as indicative of movements associated with forces affecting all public companies. Incorporating the relative market capitalization size of each company would have resulted in skewed results with respect to the relative affect on share price movements associated with each registrant's satisfying of Section 404 requirements.

[5] In nearly all year 2 adverse opinions, improvements were noted from the previous year indicating that a company is on track to correct their internal control deficiencies.

These historical statistics imply that companies that either historically operated organizations with no material weaknesses in their internal controls, or were able to identify and correct material weaknesses in a timely manner experienced much greater increases in share prices than companies that did not.



Source: Lord & Benoit, LLC

One could raise cause-and-effect questions with this analysis, but in retrospect, investors would have wanted to know which companies had material weaknesses in their internal controls over financial reporting as of March 31, 2004 and which did not. As of March 31, 2004 there was no clarity as to the status of a registrant's internal controls over financial reporting. As of March 31, 2006 there was ample clarity. An investor holding a portfolio of companies at March 31, 2004 who ended up reporting two straight years of adverse 404 assessments would not have been satisfied with those results. An investor holding a portfolio of companies that at first reported an adverse assessment but then remediated their control problems by the second year would have been much more satisfied with their results, but still would not have earned market returns. The only satisfied investor in this circumstance would have been the one that held a portfolio of companies that had two years of clean internal controls.

Of course there are many factors that affect the price of stocks, but the important point is the relative changes amongst the groups. When looking at the relative changes a number of inferences can be drawn that in the end may not be surprising, but are illustrative nevertheless:

1. Investors need to feel confident that the information being presented is accurate, timely and complete. This need manifests itself primarily in the discount rate that is used to value companies. This research identifies a difference in the overall rate of return of all companies that reported material weaknesses and those that did not. This difference provides an insight into how important that reliance is in driving values. Ineffective internal controls may also be a factor in the evaluation of management competency and financial reporting volatility, additional factors inherent in the discount rate as well as projections of free-cash-flow and growth rates.

2. The steep rise in share values that has occurred over the past two years has occurred during the precise period that Section 404 requirements have been introduced. At best, an opponent of Section 404 citing massive market inefficiencies would have to argue two points:

a. the overall return of shares in a non-404 compliance environment would have been higher than 27.67%, an assertion that would seem difficult to make in a 2% inflationary environment, with dramatically increasing energy prices and government deficits;
b. The relative movements of shares between the three category types (adverse-to-adverse, adverse-to-clean and clean-to-clean) can be explained by some global force(s), other than the knowledge that financial results being presented are reliable to a higher degree than in the past.

3. The relative changes in share price movements between the categories should not surprise anyone familiar with valuation methodologies. In particular, the relatively larger increase in share prices in year two for those companies reporting year one material weaknesses as compared to companies with no material weaknesses in either year ((.6% to 25.14%) vs. (8.92% to 18.72%)) indicates the relative benefit that a company can expect once an investor feels more confident in the processes in place to ensure accurate financial reporting. In short, one should expect an increase in valuation once one receives a clean bill of health with respect to financial reporting, just as a pro athlete coming off of an injury might expect higher compensation after proving through an in-depth physical that he is free from that suspected injury. This assertion is built on the concept of capabilities. A company with high levels of internal controls over financial reporting is more likely to be capable of taking on new challenges, acquisitions and/or new competition than one that has less ability. In the case of a company that has gone from material weakness to a clean assessment, one would also expect that some catch-up to peer company share price movements would occur.

Questions to consider:

- Could the improved reliability of financial controls and reporting have led to higher stock valuations?

- Was the reduction of "free cash flow" deriving from Section 404 marginal costs more than offset by improvements in cost of capital rates, growth rates or estimated free-cash-flow benefits when a company improved its financial reporting?

- Could the reliability of financial reporting in those companies that invested in strong internal controls have influenced and improved the decision-making and business risk assessment process within the company?

- Could the threat of PCAOB Standard Number 2 type internal control studies under Section 404 have possibly circumvented asset fraud, reporting fraud, employee waste fraud or other irregularities?

Perhaps this research raises more questions than it answers. One thing, however, is clear: average stock prices increased at a higher rate for companies that always had good internal controls over financial reporting compared to companies that either corrected their internal controls or remain unimproved.

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