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Proposed Small-Cap SOX 404 SEC & PCAOB Guidance

This SOX 404 Update is a follow-up publication to the July 12, 2006 White Paper titled: "Sox & Small-Cap Company Compliance".

Small businesses have consistently complained that the cost of Sarbanes-Oxley Act ("SOX") compliance is too high, and the Securities and Exchange Commission ("SEC") seems to have finally gotten the message. SEC Chairman Christopher Cox and the agency's other four commissioners tentatively adopted revisions to the antifraud law in mid-December 2006 that would allow smaller companies to "scale and tailor" their compliance procedures.

The proposed changes would also reduce requirements for testing internal controls and providing documentation for companies with market capitalization values ranging from \$75 million to \$700 million. In a statement, the SEC indicated that smaller companies deserve more flexibility because their operations are typically not as massive and complex as larger enterprises. Smaller companies have been the most vocal about the significant cost of complying with Section 404 of SOX, which requires businesses to file reports detailing the strength of internal financial controls and noting any problems that have been fixed. The following bullet points highlight the key elements of the proposed changes:

- ❖ The SEC's proposed guidance does not require that a company use a particular framework for evaluating internal control over financial reporting.
- ❖ The proposed guidance is also intended to permit management to exercise judgment in designing an evaluation process that provides management with "reasonable assurance" for its assessment.
- ❖ The SEC rules define "reasonable assurance" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."
- ❖ Management may determine that the risk of material misstatement is adequately addressed by a single entity-level or process-level control. In such circumstances, management would not be required to identify and evaluate additional controls related to that risk.

If you require assistance with SOX 404 compliance we have some advise. The MacLellan Group has developed relationships with, and can introduce you to, various cost-effective small-cap SOX 404 compliance advisory firms, which provides companies with various recommendations on meeting their SOX 404 compliance needs.

Mr. Douglas MacLellan holds significant expertise in developing and financing businesses in emerging markets and industries, particularly in the pharmaceutical telecommunications, software and media industries. Over the past fifteen years, Mr. MacLellan has helped to develop and finance businesses in Bulgaria, Cambodia, Canada, Chile, China, Hungary, India, Korea, Madagascar, Russia and the United States. Mr. MacLellan is currently a member of the PCAOB of Directors and Chairman of the audit committees of two publicly listed companies.

Proposed SEC & PCAOB Guidance: The SEC proposed interpretive guidance for management on evaluating internal control over financial reporting and postponed the compliance deadline on internal control over financial reporting for non-accelerated filers and newly public companies. In a related step, the Public Company Accounting Oversight PCAOB (“PCAOB”) proposed a revised standard for audits of internal control over financial reporting. All these actions are intended to make compliance with Section 404 of SOX more cost-effective.

New SOX 404 Compliance Deadlines: Newly public companies, including foreign private issuers listing on a U.S. exchange for the first time, are also given relief under the new rules. These issuers need not comply with the SOX 404 requirements until their second annual report after going public or listing in the U.S. This relief also applies to foreign private issuers that become subject to the Exchange Act reporting requirements through a transaction with a reporting company, for example, the acquisition of a smaller U.S. public company. Companies taking advantage of these transition rules must include a statement to that effect in their first annual reports. The new compliance dates for all filers are noted below. The SEC also indicated that it may consider further extensions of these new deadlines if there are delays in the implementation of the revised PCAOB and SEC rules and guidance.

	Accelerated Filer Status	Revised Compliance Dates and Final Rules Regarding the Internal Control Over Financial Reporting Requirements	
		Management's Report	Auditor's Attestation
U.S. Issuer	Large Accelerated Filer OR Accelerated Filer (\$75MM or more)	Already complying (Annual reports for fiscal years ending on or after November 15, 2004)	Already complying (Annual reports for fiscal years ending on or after November 15, 2004)
	Non-accelerated Filer (less than \$75MM)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
Foreign Issuer	Large Accelerated Filer (\$700MM or more)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2006
	Accelerated Filer (\$75MM or more and less than \$700MM)	Annual reports for fiscal years ending on or after July 15, 2006	Annual reports for fiscal years ending on or after July 15, 2007
	Non-accelerated Filer (less than \$75MM)	Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008
U.S. or Foreign Issuer	Newly Public Company	Second Annual Report	Second Annual Report

Proposed Auditing Standard: The PCAOB released for public comment a proposed standard on auditing internal control over financial reporting that would supersede the current standard on the same subject (Auditing Standard No. 2, also known as “AS No. 2”). The proposal is intended to facilitate a more efficient, risk-based, and scalable audit approach. The proposed changes are designed to achieve four primary objectives:

- ❖ **Focus on the matters most important to internal control,**
- ❖ **Eliminate unnecessary procedures,**
- ❖ **Scale the audit for smaller companies, and**
- ❖ **Simplify the requirements.**

The SEC's Proposed Guidance: The SEC's proposed guidance focuses on matters that it believes will help management design and conduct its assessment of internal control over financial reporting in accordance with an Company's selected internal-control framework (ie: "Internal Control-Integrated Framework" created by COSO). The key items to this new guidance include:

- ❖ **The SEC's proposed guidance does not require that a company use a particular framework for evaluating internal control over financial reporting. The proposed guidance is also intended to permit management to exercise judgment in designing an evaluation process that provides management with "reasonable assurance" for its assessment. The SEC rules define "reasonable assurance" as, "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs".**
- ❖ **The proposed guidance states that a company that complies with the SEC's interpretive guidance would meet the requirements in Rules 13a-15 and 15d-15 for an annual evaluation if the proposed guidance and a companion release are adopted.**
- ❖ **The proposed guidance is organized around two overriding, related principles. The first is that management should evaluate the design of the controls to determine whether they adequately address the risk that a material misstatement in the financial statements would not be prevented or detected. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial-reporting risks and the adequacy of controls. This approach focuses attention on those controls necessary to prevent and detect material misstatements in the financial statements. The guidance explicitly states that there is no requirement to identify every control in a process or to document the operating activities affecting internal control over financial reporting.**
- ❖ **The second overriding principle is that management's evaluation of the operation of its controls should be based on its assessment of the risk associated with those controls. The guidance provides an approach to obtain evidence to support the effective operation of the controls consistent with an assessment of risk associated with those controls. This approach allows management to align the nature and the extent of its procedures and the evidence it obtains with the financial-reporting areas that pose the greatest risk to reliable financial reporting.**
- ❖ **Therefore, Management may be able to use more efficient procedures in obtaining evidence, such as performing self-assessments in low-risk areas and performing more extensive testing in high-risk areas. Management can apply these two principles in scaling and tailoring their evaluation methods and procedures to the risks that pose an "reasonable possibility" that a material misstatement in the financial statements would not be prevented or detected.**
- ❖ **By following these two principles, the SEC expects that Companies of various sizes and complexities will be able to comply with the internal control requirements more effectively and efficiently. The proposed guidance explains the application of its approach to four areas: identifying risks to reliable financial reporting and the controls that address those risks, evaluating the operating effectiveness of the controls, reporting, and evidence to support the assessment.**

Identifying Risks and Related Controls: The proposed guidance would direct management to begin its evaluation by identifying those areas in financial-reporting that are both material and pose a risk to the financial statements, which include the following:

- ❖ **Management would evaluate whether it has controls in operation that are designed to address those risks and whether it considers the company's entity-level controls both in its assessment of risk and in identifying which controls adequately address the identified risk. Management would then identify the controls in each area that address the related risks, including the risk of material misstatement due to fraud. In identifying controls, management may determine that the risk of material misstatement is adequately addressed by a single entity-level or process-level control. In such circumstances, management would not be required to identify and evaluate additional controls related to that risk.**
- ❖ **The guidance individually addresses entity level controls, automated or IT dependent controls, and multiple-location environments. In considering entity-level controls when identifying and assessing financial-reporting risk and related controls for a financial reporting element, management would consider the nature of the entity-level controls and how they relate to the specific financial reporting element. The proposal points out that certain entity-level controls operate at the process, transaction, or application level and may adequately prevent or detect on a timely basis a material misstatement that could occur in the financial statements. However, other entity-level controls may be designed to identify issues in lower-level controls, but not in a manner that would, by itself, provide adequate timely prevention or detection of a material misstatement.**
- ❖ **When management identifies controls that are automated or dependent on IT functionality, management's evaluation process generally considers the design and operation of the automated controls or IT systems and the relevant general IT controls over the applications that provide the IT functionality. General IT controls ordinarily do not directly prevent or detect material misstatements in the financial statements. However, the effective operation of an automated or IT dependent control depends on effective general IT controls. Management would ordinarily consider the extent to which general IT control objectives related to program development, program changes, computer operations, and access to programs and data apply to its facts and circumstances. For purposes of evaluating internal control over financial reporting, management would need to evaluate only those general IT controls that are necessary to address financial-reporting risks. Management's consideration of financial reporting risks typically includes all locations or business units. If management determines that financial-reporting risks are addressed by controls that operate centrally, the evaluation process is consistent with that of a business with a single location or business unit.**
- ❖ **If the controls necessary to address financial reporting risk operate at more than one location or business unit, management would fail to operate effectively. The likelihood that a control will fail may depend on the type of control (i.e., automated vs. manual), the complexity of the control, the risk of management override, the level of judgment required to operate the control, the level of precision at which the control operates in preventing and detecting misstatements, and the degree to which the control depends on the effective operation of other controls.**

Evaluating Deficiencies and Reporting: After management obtains evidence of control effectiveness, it would determine whether any control deficiencies are material weaknesses. The SEC expects its definition of material weakness to be consistent with that proposed by the PCAOB. The proposed guidance provides a framework for evaluating the severity of these deficiencies that is separate from the auditing literature. Under the framework, management

would evaluate both quantitative and qualitative factors. The framework provides guidance for considering the likelihood that a control will fail to prevent or detect a misstatement and the magnitude of the error that might result from the deficiency. It also cites several factors that affect the likelihood that a deficiency will result in a misstatement not being prevented or detected in a timely manner. These factors include:

- ❖ **The nature of the financial-statement elements, or components of the elements, involved;**
- ❖ **The susceptibility of the related asset or liability to loss or fraud;**
- ❖ **The subjectivity, complexity, or extent of judgment required to determine the amount involved;**
- ❖ **The interaction or relationship of the control with other controls;**
- ❖ **The interaction of the deficiency; and**
- ❖ **The possible future consequences of the deficiency.**

Evaluating Operating Effectiveness: After management determines which controls to evaluate, it would obtain sufficient evidence to evaluate the effective operation of internal control over financial reporting. The evaluation would generally focus on the operating effectiveness of controls in those financial reporting areas that present the highest risk to reliable financial reporting. The following are the key elements of the evaluation process: The evaluation procedures that management would use to gather evidence about the effective operation of internal controls should be based on management's assessment of the risk characteristics of both the financial reporting elements and the related controls. The proposed guidance would allow management to obtain evidence and support its evaluation from directly testing controls and from ongoing monitoring activities. The guidance illustrates that, in some circumstances, management may obtain evidential support through daily interaction with its controls, self-assessment procedures, and other monitoring procedures. The guidance on determining the sufficiency and adequacy of evidence needed to support the operating effectiveness of internal control over financial reporting takes the position that the higher the risk of misstating a financial reporting element or the risk of control failure, the more persuasive the evidence that is needed to conclude on the effective operation of the related control. Conversely, the lower the risk of misstating a financial reporting element or the risk of control failure, the less persuasive the evidence that is needed to conclude on the effective operation of the control. In all cases, management's assessment must be supported by evidential matter that provides reasonable support for its assessment. Under the proposed guidance, management would consider both the materiality of the financial reporting element and the susceptibility of the underlying account balance, transaction, or other supporting information to material misstatements. Generally, as the materiality of a financial-reporting element increases, the risk of misstatement of a financial reporting element increases. In addition, the risk of misstatement of a financial-reporting element generally increases if the underlying account balance, transaction, or other supporting information involves significant judgment, susceptibility to fraud, complexity in the underlying accounting requirements, or potential effects from technological or economic developments.

An Ineffective Control Environment: The nature of any material weakness, is its impact on financial reporting and the control environment, and management's current plans, if any, for remediating the weakness. The proposed guidance also states that the disclosure will be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive effect on internal control over financial reporting from those material weaknesses that do not. Circumstances that may indicate that a company's control environment is ineffective include:

- ❖ **The identification of fraud of any magnitude on the part of senior management;**
- ❖ **Significant deficiencies that have been identified and remain unaddressed after some reasonable period of time; and**
- ❖ **Ineffective oversight of an Company's external financial reporting and internal control over financial reporting by the Company's audit committee.**

Evidence to Support the Assessment: The proposed guidance addresses the nature and extent of the evidence that management must obtain to support its assessment. The guidance states that management's assessment must be supported by evidence that provides "reasonable support" for its assessment. The evidence may take various forms and need not address all controls within every process that affects financial reporting. The nature and extent of the evidence will depend on the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial-reporting area. In some circumstances, the documentation management creates specifically for the evaluation of internal control over financial reporting may be limited. In these instances, management should consider whether reasonable support for its assessment is contained in other internal documentation and would ordinarily include documentation explaining how management supported its conclusion. The proposed guidance recognizes situations in which management may rely on its knowledge of the effectiveness of controls based on its general interaction with its business processes or a self-assessment process as the basis for its conclusion and therefore may have limited documentation beyond a description of how the interaction or self assessment provided sufficient evidence to support its assertion. Management should also consider the need to maintain documented evidence of the entity-wide and other pervasive elements of its internal control over financial reporting that it believes address the elements of internal control that its chosen control framework prescribes as necessary to support an effective system of internal control. The proposed guidance recommends that, after a restatement of its financial statements, management should consider whether its original disclosures regarding effectiveness of internal control over financial reporting and effectiveness of disclosure controls and procedures need to be modified or supplemented to include any other material information that is necessary for such disclosures to not be misleading.

Focusing on Internal Control: The proposed standard is designed to increase the auditors' ability to detect a material weakness before it results in a material misstatement by requiring a top down, risk-based audit approach. The auditor would focus on the most important controls, a point emphasized in the PCAOB's May 16, 2005, guidance on applying current requirements. If company-level controls are effective and link directly to process-level controls, or if they are sufficiently precise to prevent or detect material misstatements to relevant financial statement assertions, auditors likely will be able to reduce the testing of controls at the process level. The proposed standard would require the auditor to perform a risk assessment at each of the decision points in a top-down approach, from the initial evaluation of the risk of material weakness at the company overall, to the analysis of risk at the individual account, assertion, or control level. The persuasiveness of evidence necessary to conclude on the effectiveness of a control would depend on the risk associated with that control, consistent with the PCAOB's May 16, 2005 guidance.

Revised Definition of Material Weakness: The proposed standard would retain the existing framework for evaluating deficiencies, in which significant deficiencies and material weaknesses are identified by assessing the likelihood and magnitude of a potential misstatement. Yet, Certain terminology within the current definitions would be revised to clarify the PCAOB's intent with respect to the meaning of these terms, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

A Significant Misstatement: is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting. The term "reasonable possibility" replaces the term "more than remote likelihood" within both definitions. This makes the terminology for evaluating of the likelihood of a misstatement analogous to the concepts from the Financial Accounting Standards PCAOB's Statement No. 5, Accounting for Contingencies. The reference to "significant deficiency" within the definition of material weakness would be removed to eliminate inference that the scope of the auditors' procedures should be at a level of detail necessary to detect a significant deficiency. The proposal would retain a list of strong indicators of a material weakness. However, it would remove the requirement to consider the circumstances described as strong indicators as at least significant deficiencies to ensure that auditors are not forced to conclude that a deficiency exists when one does not, and would reaffirm the degree of judgment required to make these evaluations. The proposal would clarify the role of materiality (including interim materiality) in the audit. It emphasizes that auditors should use the same consideration of account-level materiality in determining the nature, timing, and extent of their procedures in an audit of internal control as is used in a financial-statement audit. It would incorporate previous guidance that the reference to interim financial statements in the definition of material weakness and significant deficiency relates only to the evaluation of deficiencies, not to the scope of the auditors' testing.

Eliminating Unnecessary Procedures: The PCAOB evaluated the audit procedures and eliminated those that were considered unnecessary in the internal-control portion of an effective integrated audit, which include:

- ❖ **The current requirement to evaluate management's process for assessing the effectiveness of internal control, includes the requirement to evaluate management's process, coupled with the requirement to opine on management's assessment (not assessment process).**
- ❖ **Under the proposed standard, auditors would have to obtain an understanding of management's process as a starting point in understanding company's internal control, assessing risk, and determining the extent to which they will use the work of others, but the work necessary for these purposes would be limited.**
- ❖ **The proposed standard would specifically permit auditors to consider the nature, timing, and extent of procedures performed in prior years, and the results of those procedures, in determining the risk associated with a particular control. This would enable auditors to reduce testing in some areas using knowledge gained from audits in prior years and its effect on risk assessment.**
- ❖ **The proposed standard would not permit rotation of testing (which would permit reliance on procedures performed in prior years, with refreshing of testing every few years). Multi-location testing requirements would be refocused on risk rather than coverage.**
- ❖ **The proposed standard omits the requirement to test controls over a "large portion" of the company by directing auditors to use a risk-based approach to determine the testing strategy for multiple locations.**
- ❖ **The proposed standard would attempt to remove barriers to using the work of others in the audit.**
- ❖ **The proposed standard would retain the requirement for the auditor to perform walkthroughs, but would reduce the effort required for these procedures.**
- ❖ **The proposed standard would allow auditors to use the direct assistance of others when performing required walkthroughs.**

Scaling the Audit for Smaller Companies: The proposed PCAOB standard would require auditors to evaluate the size and complexity of a company in planning and performing the audit. The PCAOB expects that the previously described proposed changes will particularly affect audits of smaller companies. The PCAOB believes that focusing on company-level controls and relying on principles will enable the auditor to scale the audit approach to efficiently test controls at smaller companies.

Simplifying the Requirements: The PCAOB's intent in proposing the new standard is to simplify the requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal controls. The objective in drafting a proposed standard was to achieve three key improvements:

- ❖ **Reduce the level of detail and specificity to encourage auditors to apply more professional judgment under the facts and circumstances. The proposals place more reliance on general principles than on detailed instruction.**
- ❖ **Organize the standard to better reflect the sequential flow of an audit of internal control. Articulate the requirements in a more readable manner that should be understandable to both auditors and Companies.**
- ❖ **The proposal would incorporate guidance previously issued by the PCAOB and staff of the PCAOB, including guidance focused on efficiencies.**

Reporting and Communication Requirements: The auditors' report would express only one opinion on internal control, an opinion on the effectiveness of the company's internal control over financial reporting. Auditors would express no opinion on whether management's assessment is fairly stated. Auditors would be permitted to issue a report disclaiming an opinion on internal control over financial reporting as soon as they concluded that a scope limitation would prevent them from obtaining the reasonable assurance necessary to express an opinion. Thus, auditors would not be required to perform further work upon concluding that they will not be able to obtain sufficient evidence to express an opinion and may issue a disclaimer of opinion. The auditors' responsibility for communicating material weaknesses, significant deficiencies, and deficiencies would not change from what is currently required by AS No. 2. For example, material weaknesses and significant deficiencies identified during the audit would continue to be communicated, in writing, to management and the audit committee, and deficiencies identified during the audit would be communicated, in writing, to management.

Related PCAOB Proposals: The PCAOB is also proposing amendments to several of its existing interim standards. Some of the amendments would conform the terminology, definitions, and concepts in other standards to changes in the proposed auditing standard. Other amendments would move information to other existing standards. The PCAOB proposed a new rule on auditors' responsibilities when they seek audit committee pre-approval of internal-control-related non-audit services.

SEC & PCAOB Comment Period and Effective Dates: The PCAOB seeks comment for a 70-day period ending on February 26, 2007. Its final standards and rule will be submitted to the SEC for approval. The PCAOB intends to set an effective date at the time the proposals are adopted that reflects the PCAOB's commitment to minimizing disruption to ongoing audits. The SEC requests interested parties to submit comments to the SEC on specific issues related to this proposed guidance. Comments on the proposed rule are due by February 26, 2007.

Effective-Date Postponements: A new SEC rule postpones the effective date for compliance with Sections 404(a) and 404(b) of SOX for all non-accelerated filers, including non-accelerated foreign private Companies, and changes the rules for compliance with Section 404 for newly public companies. Section 404(a) requires an Company's management to evaluate and report on

internal control over financial reporting. Section 404(b) requires a Company's auditors to report on internal control over financial reporting. Under the new rule, non-accelerated filers must comply with the management-assessment requirement for the first fiscal year ending on or after December 15, 2007. The requirement to provide an auditors' report on internal control over financial reporting now applies to the first fiscal year ending on or after December 15, 2008. These changes are consistent with the SEC's proposal issued in August 2006.

SEC & PCAOB Disclaimer: Companies should not treat the descriptive and summary statements included herein about proposed and final rules as a substitute for what might be adopted or for any other SEC or PCAOB requirements. They should refer to the texts of the SEC requirements, consider their particular circumstances, and consult their accounting and legal advisors. The rule also affects requirements for officers' certifications referring to the signatories' responsibility for designing, establishing, and maintaining internal control over financial reporting.¹¹ The rule permits a non-accelerated filer to omit the portion of the introductory language in paragraph 4 and language in paragraph 4(b) of the certification that refer to that responsibility, until the registrant files an annual report that includes management's report on the effectiveness of internal control over financial reporting. The new rule clarifies that in the first year of compliance with Section 404(a) the SEC will deem management's report to be "furnished" rather than "filed" for purposes of Section 18 of the Exchange Act, unless the Company specifically states that the report is to be considered filed. A non-accelerated filer who furnishes management's assessment in accordance with Section 404(a) only, must make two statements about its attestation in the document it furnishes. It must state that no attestation report is included from the company's registered public accounting firm regarding internal control over financial reporting and that management's assessment in the furnished document was not subject to attestation by the company's registered public accounting firm as allowed under the new rule.

Communications with Auditors: The SEC rule release encourages "frequent and frank dialogue among management, auditors and audit committees" in the initial year of compliance with Section 404(a). This recognizes that some auditor involvement will be necessary during management's initial year of compliance in order to plan effectively for the first-year audit of internal control over financial reporting and to discuss the implementation of the PCAOB's coming new auditing standard on internal control over financial reporting.

Newly Public Companies: The rule permits newly public companies to delay compliance with the requirements to file management assessments and the related auditors' report until they file their second annual report with the SEC following going public. A newly public company also need not comply with the periodic requirements to conduct an evaluation and disclose changes to internal control over financial reporting, or the requirements related to the maintenance of internal control over financial reporting, until after filing the first annual report that management must include its report on internal control over financial reporting. For example, assume XYZ, Inc. becomes a public company following an IPO on November 30th, 2008. XYZ, Inc. has a December 31 calendar-year-end reporting date. XYZ, Inc. will file management's assessment and the related auditors' report on internal control over financial reporting for the first time in its Form 10-K for the year ended December 31, 2009. However, a newly formed public company that chooses to rely on its public parent's reporting history in order to qualify for Form S-3 eligibility (for example, a spun-off entity or a newly formed holding company) would be considered an accelerated filer and therefore would be required to comply with items 308(a) and 308(b) of Regulation S-K in the first annual report that it files.

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