

Sarbanes-Oxley compliance costs soar for smaller firms

BY KIM CIOTTONE

Sarbanes-Oxley costs more money and takes more time than originally estimated in 2004, according to a recent government study. Worcester CPA Bob Benoit warns small companies to start early, despite a one-year extension of their compliance deadline, to July 15, 2006.

While the extension is a welcome reprieve for firms that have been scrambling in this first year of compliance, Benoit, founder and CEO of Worcester-based Lord & Benoit LLC, which specializes in Sarbanes-Oxley compliance, says "their SOX compliance is still due at the end of next year." If they wait and do it next year, and there are problems, he says, those problems have to be reported. Whereas, he explains, if those problems are identified and fixed this year, they will not get reported. "This is an excellent opportunity for companies to really aggressively fix their problems *this year*, and clean up their act so that next year will be perfect," says Benoit, who is also CEO of CPA firm Benoit, Benoit & Associates also in Worcester. "In general, we've found that our clients still want to address the issues this year. They view it like they've been given a second chance to make a good first impression."

The Sarbanes-Oxley Act was passed into law in 2002 requiring public companies to assess and sign off on the sufficiency of their internal auditing controls. It was designed to strengthen corporate governance and restore investor confidence following the high-profile corporate scandals of Houston, TX-based Enron Corp., Clinton, MS-based WorldCom, and others.

While a few finance professionals, such as Mark Beucler, CFO for Framingham-based Lifeline Systems Inc., debate the value of the law, which applies to small and Fortune 500 publicly-traded companies alike, a backlash is brewing among many smaller firms who say the high cost of compliance places an unfair financial burden on them.

The intent of SOX, "is right on," says Beucler. "It's good corporate governance, and it's the right culture to establish in a company." But, he says, the application of the law "was a disaster. If you are a small company that never spent much time thinking about internal controls, Sarbanes is probably a good thing for

you." But for smaller, well-run firms such as Lifeline Systems, where it's part of the corporate culture to have good financial controls and accurate financial reporting, Beucler says, it presents an unfair burden. "It's just another step in our cost structure," he says.

According to the federal Public Accounting Oversight Board — a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act to oversee the auditors of public companies — a recent survey found that for 217 public companies with average revenues of \$5 billion, first-year compliance costs were about \$4.36 million, nearly 40 percent higher than the \$3.14 million estimated in 2004, and required about 27,000 hours to complete. Those costs, industry experts say, are expected to drop significantly for some companies during the second year. On average, external auditing services costs for publicly held firms rose an average of 52 percent and as much as 81 percent for mid-sized companies with between \$200 million and \$1 billion in revenue since the launch of SOX.

"That is the big problem," says Beucler, who declined to disclose costs related to compliance for LifeLine. In light of the guidance from the regulatory bodies, Beucler asks, "How much work do you do? And when do you know when you are done?"

In Lifeline's most recent Form 10-K, the company reports it spent about \$1 million on the cost of reorganizing its holding company and on Sarbanes-Oxley compliance, but it's not clear how much Sarbanes-Oxley was responsible for that total.

The SEC defines smaller firms as those with less than \$75 million of stock held by insiders in the second quarter of their most recent fiscal year. These are the firms that usually lack large accounting and HR departments, but they need to complete the same reporting requirements, pay their own internal staff while also relying in most cases heavily on outside CPA firms to comply. They're the ones for whom the SEC has extended the deadline.

SEC also recognized the approximate 8 percent of the 2,500 companies that filed internal control reports in compliance with Section 404 by the end of March 2005 that identified material weaknesses in their internal controls.



Bob Benoit says the time is now for public companies to clean up their accounting practices.

On May 17, the PCAOB and the SEC also issued new guidance that essentially requires auditors to find ways to focus on the very most important or riskiest areas within a given company, creating tailored rather than standard approaches in an effort to cut costs.

In the bigger picture, Sarbanes-Oxley exists, Benoit says, "to hold the employees of publicly held companies more responsible for their financial integrity and transparency, which is basically having good internal control systems in place to help prevent fraud and mistakes." It's also, he explains, holding more corporate officers accountable personally and criminally for their actions.

While that sounds good to stockholders, on the other side of the fence, he adds, "are the people who work for these companies that now need to do all of this compliance work —

and many of them don't like it." The rate of CFO resignations increased from 20 percent in 2003 to 23 percent in 2004, largely, Benoit says, as a result of the increased compliance work.

"Our answer to that is let us take the monkey off your back," says Benoit. While that does come at a price, costs for non-compliance, he points out, can be greater in the form of adverse reports, disclaimer reports, and decreased stockholder perception of a company's financial integrity.

Attorney Michael Matraia, whose Northboro law practice specializes in assisting public firms in carrying out their responsibilities in compliance with SOX, says although compliance is not required for private companies, many are likely to comply with certain provisions. They'll do that, he says, to ensure their businesses are following "what will become the measuring stick for best accounting and corporate governance standards." Following SOX guidelines, he explains, is also important for private companies seeking to become or be acquired by public firms.

And Sarbanes is having an "amazing" ripple effect in countries such as Canada, China, Japan and others where subsidiaries of U.S. companies are based, says Bruno Santia, president of Buffalo, NY-based B2B Education Services Inc. Whatever subsidiaries are doing in terms of reporting, he explains, has to comply because the numbers get rolled up to the U.S. parent.

"It's like a new tax law. Everybody is trying to figure out what it means, and so everybody is learning through the process," says Benoit. While it will become more streamlined, that process, he predicts, will actually get even

tougher, because "CPAs will get tougher in their testing over the years as they improve their own means of satisfying themselves of the company's control structure."

High-tech firms such as Hopkinton-based EMC Corp. are being impacted by Sarbanes in more than one way, first as a matter of compliance, and secondly by the law's IT requirements, which spokesperson Ann Pace says are a "huge driver" for the company's business. "For the most part, we've found compliance to be a very valuable process because it causes you to sort of get your house in order," she adds.

A recent report by Framingham-based IDC estimates the global market for automating and accelerating SOX-related compliance will grow at a 22 percent compounded annual growth rate from 2005 to 2009, and exceed the \$20-billion mark for the first time in 2009. Between 2004 and the end of 2005, EMC anticipates its related data storage market size to grow 14.5 percent in the small-size enterprise category to \$6.9 billion, 7.6 percent in the mid-size enterprise to \$13.5 billion and, 4.8 percent in large enterprise to \$23.2 billion.

There are thousands of IT regulations that companies now have to keep up with. For example, they are being forced to keep e-mails for a certain amount of time depending on the regulation, explains Pace. High-tech solutions, such as EMC's Centera and Emailextender software solutions, allow companies to archive e-mail and establish policies and e-mail protocols. "So if you're a large financial services company and you need every e-mail saved for the next five years because that is what SOX says you have to do, this allows you to do that — and makes sure no one deletes or changes it." That, she says, is a good thing if you are

trying to prove your innocence, and helps companies by preventing people from doing the wrong thing.

While some have even argued that the law should be repealed in light of the high costs, Benoit and Matraia agree, that is unlikely. What's more likely, they say, is that a significant "tweaking" to help control those costs will still preserve the necessary achievements of the law.

The things companies are doing now are "major improvements" to their accounting and IT control structures, "so I don't see a repeal," says Benoit. A repeal of that, he says, would be like repealing the income tax. "No one really likes income tax, but we don't do it because we enjoy it, so there are flip sides to just repealing SOX." That, he says, would mean going back to the past, "and unfortunately there were situations in the past where ethics were not in place, so I don't see that happening."

The PAOB was very strong in its warning to the accounting firms, saying it needs to do this in a way that shows they are exercising caution and not doing too much work. "I don't think that's throwing the baby out with the bath water, but seeing if we can tweak it in a way that makes it better," says Matraia. "If that guidance is followed carefully, there is going to be a very significant decrease in price without a big sacrifice in quality. I think what they are trying to achieve is a real balance there."

*Kim Ciottone can be reached at:
kciottone@wbjournal.com.*

Sarbanes in a nutshell

The most sweeping piece of financial legislation since the 1930's, the Sarbanes-Oxley Act of 2002 seeks to protect public company shareholders from corporate fraud and scandal by demanding greater corporate responsibility from executives.

The Act is broken into 11 different parts called "titles". Each title is also broken into "sections" for a total of 66 pages outlining new restrictions for auditors, the Public Accounting Oversight Board formed by the act, and aspects of corporate law including increased penalties for jail and fines for committing fraud. Section 404 of SOX requires disclosure regarding the effectiveness of the "internal control structure" in a company's annual report and in the outside auditor's report. Section 301 requires an audit committee "to establish procedures for the receipt, retention and treatment of complaints ... regarding accounting, internal accounting controls or auditing matters," including

anonymous employee reports.

The IT Internal Control process includes the evaluation of the effectiveness of the company's data, networking, security, applications, email, systems, access, configuration, asset management, compliance monitoring, escalation, policies and procedures and reporting process. According to a recent survey by Netherlands-based KPMG International, nearly one third of all deficiencies and material weaknesses reported to the SEC were IT related.

Best bet advice for SOX compliance first timers:

- Start NOW! The first year requires a lot of documentation (flowcharts and procedures write ups - who, what, when, how often, to whom, and conclusions). This is the part most companies hate and it takes a lot of time the first year.
- Focus on IT controls NOW! IT functions take a long time to implement and train and those improvements need to be weighted

more heavily toward the beginning of the year in order to pass year round compliance.

- Look at entity-level controls such as high-level controls vs. activity-level controls, both manual and automated. In other words, the financial reporting and closing-process controls.
- Allocate enough resources to minimize the risk of non-compliance. In addition to an in-house resource supplemented by knowledgeable outside consultants, CFOs and controllers should be actively involved in the first year of compliance. Teamwork is key to minimizing risk of failure.
- Leave plenty of time for remediation. Remediation in year one is huge with best case scenarios taking six to nine months *after* the problems have been identified in Phase 1.

Source: Bob Benoit, Lord & Benoit LLC