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Looking for a Loophole in Reform Legislation

By Cyndia Zwahlen
Los Angeles Times

Will small public companies - many already dragging their feet on complying with important parts of the Sarbanes-Oxley corporate accounting reform legislation -- get their wish for a permanent exemption? That's the concern of some investors and accountants after Securities and Exchange Commission Chairman Christopher Cox surprised them last week when he proposed another delay -- the fifth so far -- in requiring the smallest public companies to follow one of the law's key reforms called Section 404. "This could be the death of 404 by a thousand deferrals," said Ann Yeger, executive director of the Council of Institutional Investors in Washington.

The additional one-year delay, which the five-member commission probably would approve, would give the 5,000 or so of the smallest U.S. public companies until 2010 before they had to comply with Section 404's requirement to use an outside auditor to attest to the strength of their internal financial controls. That requirement, spelled out in Section 404 of the law, is considered a core part of the reform enacted in 2002 in the wake of the billion-dollar accounting scandals at Enron Corp., WorldCom Inc. and Tyco International Ltd., among others. The small public companies, which under SEC rules are those with a market capitalization of less than \$75 million, didn't get another reprieve from the section's other requirement that they include a self-assessment of their internal controls in annual reports filed after Dec. 15. But some fear that a small public company will have little incentive to create or carry out the relevant checks of internal controls needed for the self-assessment because they don't have to worry about an outside auditor report for at least two more years, if ever.

More delays may encourage those in Congress who support an exemption for small public companies as well as those who want to rework the entire law. "I'm concerned at this point a perpetual delay turns into a belief that it's going to be repealed," said Trent Gazzaway, managing partner of corporate governance at Grant Thornton, a major accounting and auditing firm based in Chicago. The longer the delay in implementing the rules, the longer small businesses have to lobby against it, said Matt Kelly, editor in chief of Compliance Week, a corporate governance newsletter based in Boston. "The small companies hate this," Kelly said. "Most have been doing nothing and hoping it will go away."

In a survey of 500 certified public accounting firms published in the October newsletter of Lord & Benoit, a Worcester, Mass.-based firm active in Sarbanes-Oxley compliance issues, 67% said most of their smaller public clients had not started working to comply with the new rules. Almost 90% said they were not satisfied with their small clients' overall progress on compliance. Cox, who served as a Republican congressman from California for 17 years, also said last week in his testimony before the House Small Business Committee that the SEC was preparing to conduct a study on the costs and benefits of 404 compliance under the relaxed Sarbanes-Oxley guidelines it issued last summer. The results won't be ready until sometime after June, he said. The new guidance allowed all companies to focus on the riskiest areas rather than a laundry list of internal control checks. When the ruling came out, Cox said the way was paved for small firms to meet the existing deadlines: Annual reports filed after Dec. 15 had to include a self-assessment of internal controls; a year later, those reports would have to include an outside auditor's stamp of approval.

The smallest public companies have won several delays because of the disproportionate cost

they say they will bear to comply with the accounting reform rules. Some estimates say small public companies that have a market capitalization of more than \$75 million but that are still small would have to pay up to 3% of their revenues on compliance. "I think they are just trying to be careful now and make sure they have had a cycle [under the relaxed guidelines] and take a look at the cost -- if not for the micro-cap companies -- for the smaller of the accelerated filers to make sure if they push this down to the smallest companies it will not be burdensome," said Rick Brounstein, director of the CFO Network in Fremont, Calif., and a member of the SEC's small-business advisory council.

Even the largest companies have spent far more than regulators first estimated they would on Sarbanes-Oxley. But the investment seems to be paying off, Kelly said. He pointed to research that his newsletter finished last month with Audit Analytics showing the number of internal control weaknesses reported under Section 404 by public companies dropped 44% -- to 348 from 624 -- in the three years since the rules took effect for large public companies. The numbers of adverse Section 404 opinions from outside auditors are also down, he said. And restatements of financial reports, which accounted for more than half of the adverse opinions in the first year, accounted for only 19% in the third year.

Yeger and others believe small companies may need more work on improving the accuracy, reliability and transparency of their financial reporting than larger companies. "Statistically, there have tended to be more problems on accounting issues on smaller companies," she said. "You could argue that if any kind of company needs this, it's the small businesses."

A proposal in the works looks to boost the use of the daily monitoring of operations a company does anyway as a way to improve internal controls and the financial reporting on which they are based. Monitoring is one of the five parts of the framework to evaluate internal controls developed by the Committee of Sponsoring Organizations of the Treadway Commission, a private group of accounting and financial executives that works to improve the quality of financial reporting. Making better use of monitoring wouldn't alleviate the need for an outside auditor to attest to the strength of a company's internal controls but it could make the process more streamlined and less costly, backers said. "If you are monitoring correctly, it would reduce the work that one would need to do to assess or an auditor would do to attest," said Brounstein, who is on the task force that hopes to get phase 2 of the proposal issued early next year. That could result in the transparency and credibility investors and regulators want "in a more logical, more cost-effective" way, he said.

Small companies have come in for special concern under Sarbanes-Oxley in part because, though they account for a tiny share of total market capitalization, they make up roughly 40% of all public companies. Ensuring the accuracy and quality of their financial reports is important for their access to capital and for the safety of their investors. "The truth is, even before Sarbanes-Oxley there was a difference in the quality of financial reporting and reliability between large and small companies," Gazzaway said. "That gap has now widened and will continue to widen unless the smaller companies take steps to evaluate their internal controls and make changes where necessary." If they don't, he said, "ultimately, that is going to hurt the smaller companies and it's going to hurt their investors."

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