

# COMPLIANCE WEEK

## Small Businesses Brace For Hurricane SOX

By Kathrine Schmidt — May 15, 2007

With revised Sarbanes-Oxley compliance guidelines due out by June and small businesses poised to enter the SOX fold at the end of this year, smaller public companies are resigning themselves to taking on the new regulatory hurdles.

At a hearing April 20 held by the Senate Committee on Small Business and Entrepreneurship, business leaders pleaded for another year to prepare for compliance with SOX Section 404, the onerous clause mandating reviews of a company's internal controls over financial reporting. Even committee Chairman Sen. John Kerry, D-Mass., agreed that another delay might be wise.

Securities and Exchange Commission Chairman Christopher Cox, however, said that while he wouldn't rule out the possibility of further extensions, the process had already been delayed long enough. And so, non-accelerated filers—the small public companies that comprise the majority of Corporate America—are gearing up to strengthen their financial reporting processes and internal controls.



Wander

"I think they are starting to prepare," says Herb Wander, chairman of the SEC's Advisory Committee on Smaller Public Companies, and a partner at the law firm Katten Muchin Rosenman. "What's going to be the hardest for them is, I think, trying to sift through the varying interpretations and new rules to try and come up with a workable system that works for them and will satisfy their auditors."

Much groundwork already has been laid by a climate of more intense audits in recent years, Wander adds.

"I think the fact is that most audit practices have become more vigorous anyway, and if they're already doing ... their 10-K and their quarterly [reports], I think they're well along the way," he says. "Those are really part and parcel with the process. You can't really do that unless you have some internal control."

While companies may have begun their march to SOX compliance, some may have a ways to go before passing muster, according to a survey by Bob Benoit, a partner at the accounting firm Lord & Benoit, which focuses on SOX accounting for small and medium companies.



In a recent survey he conducted of roughly 700 small companies, 148 came up with a material weakness, Benoit says. The top five material weaknesses he found: accounting and disclosure controls (chiefly, the expectation of no audit adjustments); treasury; accounting personnel training and competency; control environment; and design of controls.

"The goal was to try to help smaller public companies by creating some form of a checklist of potential areas that they could focus on early this year to help minimize the possibility of an adverse 404 report," Benoit says. "Unless companies have been working on it all along, there's a high likelihood that they're going to have the adverse reports."






But the structure and culture of small companies can make 404 compliance tough on the little guy.

"I think that it's tougher in smaller public companies, because they have typically been operating in entrepreneurial, fast-moving environments," Benoit says. "Internal controls don't always hold up as a high priority in an entrepreneurial environment."

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Zecca

As with the first year of SOX for accelerated filers back in 2004, there will likely be “a lot of confusion about exactly what the rules were calling for,” says Anthony Zecca, a partner at the Cohn Consulting Group. “It’s going to be the same type of confusion initially while everyone figures out what the real meaning of the words are.”

Still, CFOs at small companies should not climb onto the window ledge just yet. “Small non-accelerated filers are going to benefit significantly from the experience that all practitioners have been through in the last three to four years,” Zecca says. “The non-accelerated filers will not suffer from over-definition of controls that happened with accelerated filers.”

## What To Expect In Compliance

Small companies will grapple with challenges different from their larger counterparts. Chiefly, beefing up the internal audit function will be a challenge, since many small companies don’t have one at all. Instead, a few finance professionals must do the job that a whole department might handle at a larger company.

“I think that the root of this issue is generally in the competency of the finance department,” Benoit says. “It’s very difficult to attract a person or couple of people who understand as much as the outside auditors do.”



In a smaller company, the finance department can be “more in a reactionary mode and has less time to attend training courses, and less time to read new standards,” Benoit says. “In the past, they have relied on their outside auditors to understand those standards and be guided in terms of journal entries or adjustments. Now they need to know the standards themselves without adjustments.”

Benoit That is not to say the job isn’t being done, however. “I think what you’re finding is, despite the cost, many companies are initiating internal audit departments to beef up controls,” Wander says. With that function in place, “outside auditors can feel comfortable that [internal auditors] are both independent and competent and can carry much more of the 404 burden.”

With smaller companies, Zecca also foresees “a little more latitude” consulting with external auditors on tough points, as opposed to the “20-foot cement wall” between clients and auditors after SOX. “If there’s a tricky accounting issue where they’re not sure how to handle something [or how to apply GAAP], it’s not wrong for internal people to talk to external auditors,” he says.

Benoit also expects segregation of duties to be a major headache for non-accelerated filers. “It needs a much higher degree of thought to come up with a control environment with limited people,” he says. “It takes that creativity to come up with an effective design, and sometimes we accountants aren’t that creative.”

Many companies, Benoit suspects, secretly hoped that after two years of delays, they would somehow escape from SOX entirely and consequently haven’t taken any preparatory steps. Now, he says, “I think that there’s a very serious movement right to get these controls in place quickly.”

Other research shows a correlation in share price movement to healthy or adverse 404 reports, Benoit says. “I care about the economy of this whole thing and want companies to embrace good controls so it won’t have a general adverse effect on the stock market as a whole,” Benoit said.

Zecca argues that poor accounting and internal controls affect customer service and efficiency. “Especially with small businesses, [it’s like] all the windows are open, and there are fans blowing dollar bills out,” he says. Improving everyday processes might dip into revenues temporarily, but will pay off in the long run, he argues. “They should take advantage of this opportunity of making their processes more competitive.”

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