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Mending SOX

Now into year two of compliance with Section 404 of Sarbanes-Oxley, where are we?

While large public companies should see costs dropping, small-capitalized public companies get another year of reprieve and could ultimately become completely exempt from complying with Section 404.

First, the Securities & Exchange Commission (SEC) last year gave public companies with market capitalizations under $75 million a one-year extension to comply with Section 404—the section of the Sarbanes-Oxley Act of 2002 that says external auditors must attest to and report on management's assessment of the adequacy of a public company's internal controls.

Then in late September 2005, the Commission gave these companies another year of freedom from Section 404.

In mid-December, the SEC's Advisory Committee on Smaller Public Companies recommended to the SEC commissioners that companies with a market capitalization of between $100 million and $125 million and revenue less than $125 million be exempted from 404 compliance.

> The SEC may exempt small-sized companies from Section 404 compliance.

Companies with a market capitalization of between $125 million and $750 million and less than $250 million in revenue would be exempt from having to hire an outside auditor to certify management's assessment of their internal controls. Together, these companies represent 80% of all U.S. public companies and 6% of the market's total capitalization.

Such a broad exemption may not be legal, and the SEC won't even formally consider the recommendations until the Advisory Committee submits its final report this spring.

Small public companies and their advocates have made several arguments in favor of relaxing Section 404 rules. One is that there shouldn't be uniform regulations that apply equally to companies of all sizes. Why should small companies, which have simpler business models and accounting that require less rigid internal controls, be subject to the same regulations as large companies?

Second is costs. The costs of Section 404 compliance make it difficult for smaller companies to compete and grow. Do the costs of compliance outweigh the intended benefits—at least for small firms? In other words, do the benefits to shareholders justify the costs? Even if they did, small-company management doesn't like how compliance costs shave profits. Development-stage companies with no profit certainly can't afford the compliance costs. Moreover, small companies must hire more people because Section 404 requires firewalls between certain types of internal duties.

The costs of complying with Section 404 in year one for companies with market capitalizations of $75 million to $700 million was an average of $1.5 million, according to a survey done by CRA International (formerly Charles River Associates) at the behest of the Big 4 accounting firms. For larger companies with market capitalizations of more than $700 million, Section 404 cost an average of $7.3 million, the survey showed.

Finally, small-company advocates say such onerous regulations as Section 404 discourage entrepreneurship and deter companies from tapping the U.S. capital markets. Those small companies that do might have to go private.

On the other hand, critics of the small-company exemption say small companies have disproportionately more accounting problems compared to large firms, have more SEC actions taken against them, and often have weak internal controls. Their investors, if anything, carry more risk than those of large companies, so why not hold small firms to an equal regulatory standard?

A survey by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) found that the typical company targeted by an SEC enforcement case from 1987 to 1997 had merely $16 million in assets, $13 million in revenue, and $5 million in shareholder equity. One of the study's authors, Joseph Carcello, a University of Tennessee professor, reportedly said that about 75% of companies that were the subject of SEC fraud allegations from 1998 to 2003 had market capitalizations of less than $700 million, and 40% had market capitalizations of less than $100 million.

These small companies restated their financial statements far more than others. Companies with less than $100 million in annual revenue restated earnings in 2004 at more than twice the rate of the largest companies, a survey by Glass Lewis & Co. found.

Meanwhile, for everyone else now into the second year of Section 404, things should ease up. Auditors are getting more up to speed, are less inclined to excessively scrutinize a company's controls, and are less concerned with being sued. And many people on the front lines are benefiting from efficiencies gleaned from year one: documentation completed, experience earned, and vastly remediated internal controls. All that translates into lower costs.

The survey from CRA International, released in early December, shows Section 404 compliance costs will fall by 40% on average, compared to 2004.

Large companies with market capitalizations of more than $700 million will see internal and external compliance costs fall 42% on average from $7.3 million to less than $4.3 million. Companies with a market capitalization of $75 million to $700 million will spend about 39% less, according to the survey, with costs dropping from about $1.5 million to $900,000. Last year, the total costs of Section 404 compliance for large companies were 0.09% of the company's revenue, with 26% of the total going to the auditors. (No data is available yet for this year.) Among the smaller-capitalized companies, compliance with Section 404 was 0.46% of their revenue, with 35% of the total for audit-related fees.

This year, audit firms and companies will test fewer controls and generate less documentation, and outside auditors expect to rely more on the work of others, including internal auditors, which should make the whole process less costly, the survey's authors said.

The survey predicted outside auditors will test fewer "key" controls at larger public companies, looking at an average of 540, down 19% from the average of 669 tested in the first year. Larger companies are expected to test about 867 of their controls, on average, down from 992 in year one. At smaller companies, auditors likely will test 206 controls on average, down about 22% from the 262 tested in year one. The small companies themselves will test about 298 of their controls, down 17% from last year's average of 359, according to the survey. ■