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SEC to small business: Drop dead on audit delay

Relief granted this year doesn't amount to much, yet neither the commission nor Congress is likely to do more

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DRY RUN Shannon Greene, Tandy Leather Factory CFO, says auditors will have to assess whether her efforts have met compliance standards.

The Securities and Exchange Commission dismissed suggestions by Congress last week that further relief from the Sarbanes-Oxley Act is necessary for small companies. Yet interviews with some small company finance chiefs suggest that the relief that the SEC has provided so far from the law's most onerous provision, Section 404, won't amount to as much as the regulators expect.

Last-ditch legislation introduced by Rep. Scott Garrett (R-N.J.) in mid-June to extend the year-end 404 compliance deadline was approved by the House last Thursday, but the odds of a Congressional reprieve from the internal controls assessment still look slim.

True, the SEC's inability or unwillingness to provide its own analysis of how much 404 will cost small businesses has upset some lawmakers. In response to a question about this at a hearing held by the House Financial Services Committee last Tuesday, SEC chairman Christopher Cox said the SEC is not required to provide cost estimates. And all five SEC commissioners said further legislation is unnecessary and may alter the purpose of the regulation. "Sarbanes-Oxley is a great asset for this particular economy, and I think that Congress needs to be very careful before any changes are looked at," said commissioner Roel Campos. "It is attracting capital, it is a magnet for capital."

That suggests that the approximately 6,000 public companies with less than \$75 million in market capitalization that have yet to experience the Section 404 process will get their first taste of it this year.

Technically, they only have to comply with half the 404 mandate—404a—which requires companies to make their own assessment of their internal controls systems. They don't have to get an external audit opinion on the control systems until the end of next year.

While the staggered compliance schedule for small filers may seem like a break from the SEC, executives and small business advocates don't see it as much of a concession.

“We'll still ultimately have to get the approval of the auditors, and unless they look at our dry run in 2007, I'm not sure what we've accomplished,” said Shannon Greene, CFO of Tandy Leather Factory, a specialty retailer in Fort Worth, Texas, with revenue of \$55.2 million in 2006 and a current market cap of \$78 million. “I just hope I'm doing enough and emphasizing the right things, because at the end of the day, the auditors will judge whether or not I did.”

Indeed, some fear that the SEC's compromise could leave companies liable for assessments that their auditors ultimately don't agree with the following year.

“We think there's huge liability potential for companies and their auditors,” said Jeffrey Thomson, director of research at the Institute of Management Accountants. Hal Scott, director of the Committee on Capital Markets Regulation, who recently testified before the House Committee on Small Business, agreed with Mr. Thomson. “Managers of small companies still have to certify their financial statements for this year, and they'll be making their assessment without the requirement of an outside audit,” he explained. “If I were managing a small public company, I would be worried about it.”

Small company executives, still hoping for a further extension of the compliance deadline, may not be worrying enough, said Amy Daly, a managing director for consultant Solomon Edwards Group who helps companies prepare for SarbOx compliance. “I think a lot of managers are still in denial and it concerns me,” she said.

At first glance, new SEC guidance for corporate managers making the assessment looks like a godsend for small companies. Until its arrival, managers depended on the much maligned Audit Standard 2, issued by the Public Company Accounting Standards Board four years ago for auditors conducting the internal controls audit. With no other guidance to work from, accelerated filers had been using that standard to make their assessments as well, with the predictable result being that they were spending too much time, energy and money on the effort.

The new guidance provides far greater flexibility to corporate managers making their assessments. It encourages them to take a top-down, risk-based approach and to focus their efforts and testing of controls—if they believe any is required—on the most important areas of the company. Again, the SEC felt it was doing companies, particularly small ones, a favor with the more flexible guidelines. Small companies, however, aren't particularly grateful.

While virtually everyone in the business community agreed that the original PCAOB standard (which has now been replaced) was too prescriptive, the SEC guidance, according to small company executives and business advocates, isn't prescriptive enough. “The guidance is a step in the right direction, but it's not as helpful as we'd hoped,” said Ms. Greene. “They talk around a lot of the issues and don't get specific about what they want.”

And in the absence of specifics, companies are likely to err on the conservative (and expensive) side to make sure they're in compliance. That means hiring consultants and getting at least some input from their auditors as to what they have to do.

"The SEC says to focus on the most important matters, but it provides no framework to do so. We think that's a cop-out," said the IMA's Mr. Thomson. "They can be principled and still provide practical guidance without being prescriptive."



DOING THE MATH Nexsan CFO Philip Black is preparing early to meet Section 404 requirements.

Philip Black, CFO of disk storage manufacturer Nexsan, is getting on the Section 404 job early. His venture-capital-backed firm expects to go public or merge with a larger company within 12 to 18 months, meaning his first Section 404 assessment and audit would be at the end of next year at the earliest. He hired a consultant four months ago to help map out what the company needs to do to be compliant. "The ideal for us is to have everything done before we go public," he said. "That would help protect us from liability."

Unfortunately, many of his small company brethren, heading into their first assessment at year-end, may not be able to say the same. FW