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Opinion: What Was The SEC Thinking?

By Thomas A. Basilo [Compliance Pipeline](#)

Another year? Why did the Securities and Exchange Commission give small public companies with a market capitalization of up to \$75 million yet another year to comply with the internal-controls rule, required under Sarbanes-Oxley?

I believe the SEC has done the country a grave disservice by buckling under the political pressure of corporate America. If we go back in time to just about 3 years ago, everyone was up in arms about the deterioration of trust in corporate America. What began as "Enron" evolved into a larger corporate credibility issue and provided political impetus for corporate and accounting reforms.

On July 25, 2002, Congress passed the Sarbanes-Oxley Act of 2002 (SOX) by a vote of 423-3 in the House, and 99-0 in the Senate. On July 30, 2002, President Bush signed the Act into Law. The support was overwhelming. Investor concerns were fueled by almost daily revelations about perceived corporate misbehavior and occasional accounting irregularities, including the situations at Adelphia, Tyco, ImClone, and WorldCom, just to name a few. It is incredible how soon we forget!

The rule requires that companies assess the controls they have in place to prevent accounting mistakes and fraud and have their external auditor attest to the effectiveness of those controls. The assessment must be included in the company's annual report, along with a description of any "material weaknesses" found.

It is hard to disagree that the cost of compliance was much higher than expected, but given the tone of the SEC and the Public Company Accounting Oversight Board (PCAOB) at the time, it is not surprising that the external auditors reacted as they did and strictly interpreted the rules. I wonder how the SEC and PCAOB would have reacted if the external auditors had allowed a broad interpretation of the rules and only a few dozen rather than a few hundred companies received qualified opinions on the state of their internal controls. This is the second reprieve that the small companies have received. The deadline to comply with Section 404 of Sox for companies with less than \$75 million in market capitalization was initially for fiscal years ending on or after April 15, 2005. This deadline was postponed to fiscal years beginning on or after July 15, 2006 and now to July 15, 2007.

What have the small companies been doing during that time? Have they started to document their internal controls so they could spread their costs over a period of time? Well, companies with a strong management team and Board of Directors certainly have started the process, but the vast majority of the companies have done very little and by delaying compliance without any requirement to adhere to at least some of the rules, no one can be sure how much documentation the small cap companies have created to this point.

The first year of compliance with any new accounting rule is traditionally both time-consuming and expensive. Companies and their external auditors undergo a learning curve and a significant amount of resources are expended to get the compliance process right. Why should Sox be any different?

Year two costs for accelerated filers will be down significantly due to completion of initial documentation. I expect that first-year costs for non-accelerated filers will be much less than what was experienced by accelerated filers, even on a relative basis. First of all, lessons have been learned from the experiences of the accelerated filers and they will be applied to the non-accelerated filers.

The regulatory agencies have backed off and said that the external auditors need to apply some judgment on the significance of the internal controls and definition of what constitutes a material weakness. Testing and documentation standards are being streamlined. Technology is being utilized to help companies rein in the costs of compliance.

Competition, especially in servicing the middle market companies, has increased, which will drive costs down. The larger service providers, such as the Big 4 firms and major consulting companies that were used by the major multi-national corporations will be too pricey for the smaller companies. It is anticipated that high quality middle market CPA firms will dominate the small capitalization companies Section 404 compliance market. In other words, costs will decrease because of market demands and efficiencies.

So why was it necessary for the SEC to reach the conclusion that a delay was the right decision? An even bigger question (and somewhat more disturbing) is why does the SEC believe that smaller companies should not be held to the same standards of compliance as large companies? Aren't small public companies accepting investor money? Shouldn't these investors also have confidence that their money is being properly deployed and that the risks of fraud and financial statement misrepresentations are being addressed by the company through the institution of internal controls? I think so.

Despite the fact that smaller companies pose minimal risk to the overall capital markets, SOX was instituted to regain investor confidence. That means all investors, not just those that invest in major companies. What would happen to our economy if investors believe that the risks are too high to invest in small companies? Where would growth occur? Would we have success stories such as Dell or Apple? Think about that.

So, what do I think the SEC should have done? Here are my thoughts:

1. The SEC should have thought the problem through before creating the rules and setting the timing. Everyone knew the requirements were onerous, but the political pressures and the mood of the country demanded swift action to regain investor confidence. This was unfortunate.
2. The SEC should have reacted sooner to the small company issues. In my opinion, the SEC had no choice but to delay compliance because the small companies were lobbying and waiting for answers. By the time they put the problem to committee, it was too late for most small issuers to comply by fiscal 2006. It takes at least a year to get ready and more likely 18 months.
3. Instead of a full reprieve, the SEC should have required a phase-in process to see that progress is being made. If such an approach had been instituted, small capitalization companies could have spread the costs over a period of time and allowed for companies to gradually comply. It is obvious that complete compliance with the rules was difficult and time-consuming and required significant resources from both the company and their outside consultants and that this situation created higher than expected costs.
4. The SEC should consider penalties against the CEO's/CFO's who, prior to coming clean about their company's internal control problems in their Section 404 management opinion, stated in their prior quarter's Section 302 report that they had an effective system of internal control. There were more than 360 companies that received qualified opinions on the effectiveness of internal controls through May 2005. Of that number, over 94 percent of these companies reported their controls as effective in the previous quarter. This is quite revealing and does not provide a great deal of confidence that the CEO's and CFO's have a solid basis for making these quarterly assertions, thus making the delay in compliance even more disturbing.
5. Before concluding that a delay was required and that the cost of compliance was too high, the SEC should have done a more thorough investigation as to why costs were so high. From what I have observed, a significant portion of the costs have come from the fact that many of the companies had inadequate or outdated documentation. The requirements to have a documented system of internal control were not created by the Sarbanes-Oxley Act. They have always been part of the accounting standards. However, with the advent of risk-based auditing in the early nineties, external auditors

did not test internal controls in detail since they were not relying on them. As a result, companies did not keep up with documentation. I would argue that this is not a SOX cost, but a cost to bring their documentation up to standards.

Companies need to resign themselves to the fact that SOX, as a concept, is here to stay! I believe that compliance with the internal control provisions of SOX should be extended to all companies that accept invested capital, not just public companies and certainly not just large market capitalization companies. Risks are not discriminatory and can impact companies regardless of size or industry. Even though the risk of smaller public companies is minimal in terms of the capital markets (per the SEC), it certainly is not minimal to the individual investor who fuel the growth of these companies through invested capital. They should have the same comfort level as large company investors.

Our economy is dependent on small and middle market companies for employment and growth. If the investment community loses confidence in the ability of these small cap companies to maintain an effective system of internal control to deter fraud, how will the economy grow? Wasn't the need to regain investor confidence the reason for Sarbanes-Oxley in the first place? I think we should all remember that fact.

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