

HOUSTON BUSINESS JOURNAL

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Week of February 4-10, 2006

SEC and SOX: A new look at compliance costs

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HOUSTON BUSINESS JOURNAL

Help may be on the way for public companies who are struggling with the cost of compliance with the Sarbanes-Oxley Act of 2002. At least, the complaints of the smaller public companies that are particularly hard hit, especially by requirements in the act's Section 404, are being heard.

Last December, the Securities and Exchange Commission established an advisory committee to examine the impact of SOX and other aspects of federal securities laws on smaller public companies.

"Congress did not take into consideration the impact on smaller public companies" when it established SOX to combat corporate scandals among many of the country's largest public companies, such as Enron Corp. and WorldCom Inc., says Bryan Brown, partner in the corporate practice of Porter & Hedges LLP and a member of the Texas State Securities Board.

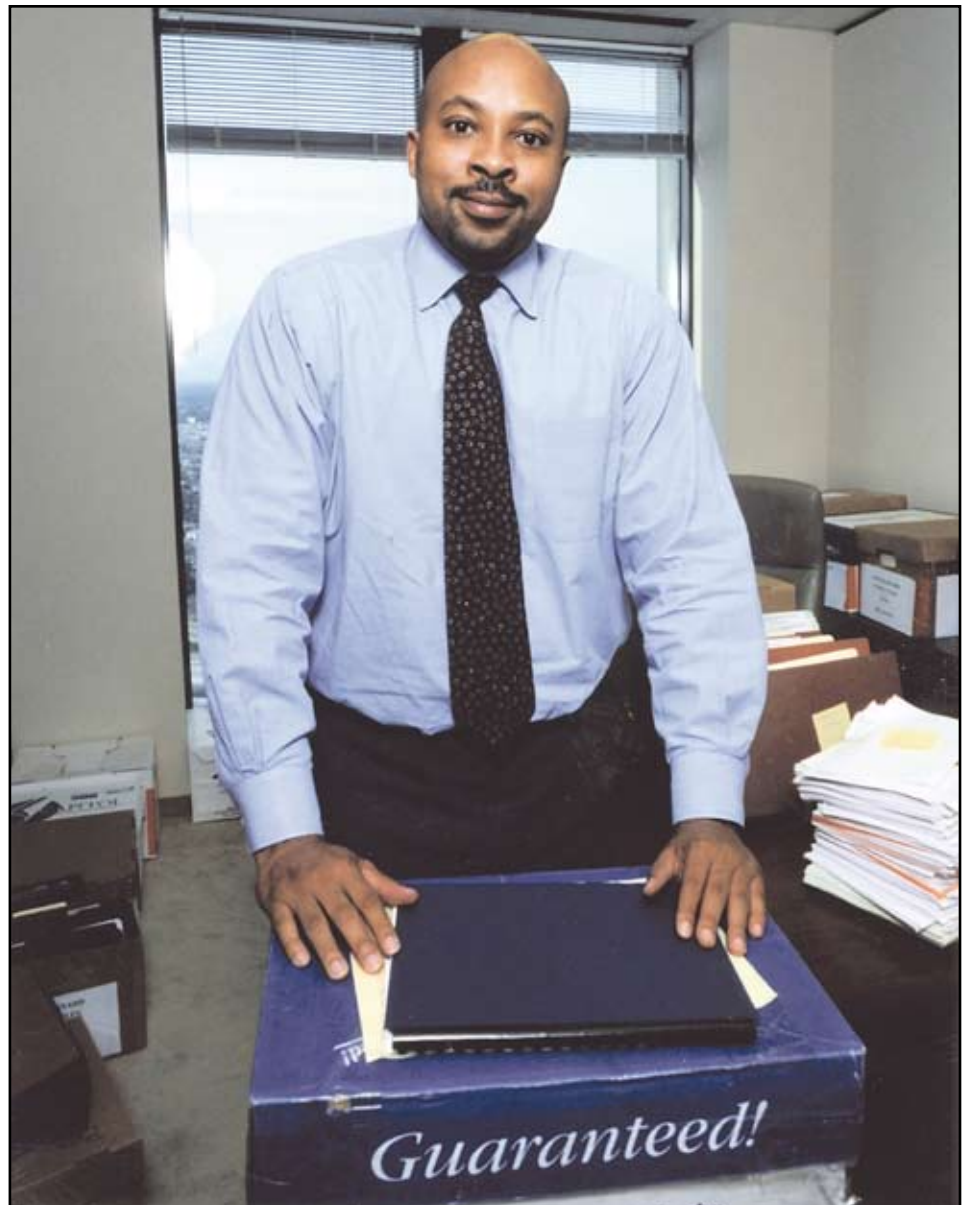
Brown says the SEC estimates that the annual cost of compliance to SOX is \$91,000 per company across-the-board, but for many companies, the cost is much more.

"The reality is that it is easy for a certain company's costs to go well over \$1 million to be compliant," he says. "That may not cause a company to cut any of its programs or budget, but it will decrease its earnings."

He adds that for smaller companies, a big concern is the impact on earnings, overhead and expenses, especially since at the time, it wasn't a cost that companies anticipated.

Currently, Sarbanes-Oxley groups all public companies together, but instead should have organized the companies into classes, according to Brown.

"Studies have found that there isn't nec-



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Bryan Brown of Porter & Hedges LLP: 'Congress did not take into consideration the impact on smaller public companies.'

essarily a correlation between size and cost," he says. "But, if you think about

the company that has \$90 million in revenue, paying out an additional \$1 million

is a pretty big hit, compared with a \$750 million company in which \$1 million may only be a nominal fee.”

NO ONE LIKES CHANGE

The first step in making sense of Sarbanes-Oxley is to realize that it is the law, and a company’s first priority is to comply. The second is to put together an appropriate board of directors, says Craig Kaiser, managing partner in the Houston office of Phillips & Reiter PLLC.

A board of directors is now required to be independent of the company. This is not a problem for large companies, but for smaller companies, it may be an issue.

“Sarbanes-Oxley charged companies to go out and find a more independent board that was also qualified,” he says. “Bigger companies can compensate well for their board members because they must be more involved, and the penalties are greater.”

Large costs can come in the form of new policies companies have to put in place.

Among them are a way for employees to report violations, developing a code of conduct in dealing with vendors, customers, delegation of authority and intellectual property, as well as setting up a compliance officer.

“Some companies assume this person should be their lawyer, but that is not recommended,” Kaiser says.

It will also take time and money for companies that set up anonymous employee hotlines, training on the new policies and a separate hotline for financial reporting, he notes.

Although Sarbanes-Oxley set the standards, some of the regulations may not need to be addressed by all companies.

Kaiser says a smaller company should look through the process and tailor it to its needs.

“When you prepare policies, the common element is to look at what the business is doing,” he says. “For smaller companies, it is a challenge to scale it down appropriately to their size.”

Once the new policies are in place, Kai-

ser recommends penning a letter explaining them to the supply base, communicating and educating the board and employees and setting up training.

The trick is to be sure the board has given its input before any training begins, so it doesn’t undermine what is already in place, he adds.

TAKING CARE OF BUSINESS

SOX compliance requirements have brought business to many consultants and technology companies that have produced software to help with the task.

The anxiety of companies to be compliant has flooded Bindview Corp. — a Houston-based provider of proactive business policy, IT security and directory management software — with business.

“There has been a flurry of activity in 2003 and 2004 to get things done,” says Shekar Ayyar, Bindview’s senior vice president of product marketing. “In 2005 and 2006, we expect companies to be looking beyond to institutionalize what they have done.”

He says that what most of the compliance involves is the company bringing in a consultant who looks at the business and its information technology controls to assess what it needs — which is where a cost comes into play.

One of the large expenses, he adds, is when auditors want reports on the entire company’s infrastructure.

“It is important for companies to be consistent in their IT controls and document management systems for all of the regulations,” Ayyar says. “Then, for all of the materials to be in one place that can be accessed.”

SOLUTION AHEAD

In the meantime, the fact that SEC formed an advisory committee to look into the impact of SOX on smaller public companies indicates, Brown says, that the SEC does see a problem and is concerned.

The SEC Advisory Committee on Smaller Public Companies is headed by

Herbert Wander, a Chicago lawyer at Katten Muchin Zavis Rosenman, and James Thyen, president and CEO of Jasper, Ind.-based Kimball International Inc.

The committee will address the following issues:

- Frameworks for internal control over financial reporting.
- Corporate disclosure and reporting requirements as well as federal imposed corporate governance requirements.
- Accounting standards and financial reporting requirements.

The process, requirements and exemptions relating to offerings of securities by smaller companies.

“With Congress adopting the act rather than the SEC, the organization’s ability to modify the act may be limited,” he says. “Instead, what we are probably going to see is companies taking very strong looks at strategic alternatives and exploring what is good for the company.”

Citing a 2003-2004 study done by Foley & Lardner LLP, Brown says, of 115 public companies surveyed, 21 percent considered going private or selling their company as a result of Sarbanes-Oxley.

Only time will tell if more small public companies opt to go private, he says.

“This may postpone a smaller company going public, but it won’t shy them away,” Kaiser adds. “The challenge may come with the big accounting firms who are moving away from smaller companies because Sarbanes-Oxley has increased their workload, so naturally they gravitate toward the more profitable company. This has created an opportunity for the next level of accounting firms to step up.”

However, Brown says that there are still questions among small public companies and the securities industry whether or not Sarbanes-Oxley was an appropriate solution to the problem.

Says Brown: “It is definitely a question we will be working at answering for quite a while.”

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