A FAIRER CLIMB:

IMPROVING SARBANES-OXLEY

Greater Boston Chamber
The Hub of Business

Study prepared by: Abt Associates Inc.

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A FAIRER CLIMB:
IMPROVING SARBANES-OXLEY

EXECUTIVE SUMMARY

Key Findings

Designed to protect investors and restore confidence in the U.S. financial system after scandals at firms like Enron and WorldCom, the Sarbanes-Oxley (SOX) Act is having positive effects on corporate America. Board independence has been strengthened, accountability is moving back to shareholders, and difficult questions are once again being addressed.

But Section 404 of the legislation, which calls for public companies to establish and maintain an internal control structure for financial reporting, has resulted in implementation costs that have far exceeded original expectations. Because its compliance framework is designed for large, well-established organizations, its costs have hit smaller companies much harder than others, hampering competitiveness and job growth in a vital segment of the economy. SOX has become yet one more burden in the steep climb towards an initial public offering (IPO) that is especially difficult for small companies. Many firms are now choosing to remain or become private, others are considering being acquired, and yet others are turning to international stock exchanges for their IPOs.

Recommendations

To create a fairer climb to the top, SOX's disproportionate compliance costs for smaller public companies need to be addressed. In large part, this can be handled by streamlining the implementation framework and testing requirements for Section 404. Further clarification of SOX's rules and intentions is needed to ensure that management and auditors alike feel comfortable using good judgment and common sense without fear of liability.

The Chamber will work with business groups and public officials to advance the following five recommendations with the Securities and Exchange Commission (SEC):

1. **Establish small company criteria:** The SEC should clearly define what constitutes a smaller public company by using market capitalization and revenue breakpoints that are well understood.

2. **Revise compliance requirements for small companies:** The SEC should address today's overly burdensome compliance procedures by exempting smaller public companies from certain aspects of Section 404.

3. **Provide guidance to small companies:** The SEC should provide additional guidance to smaller public companies by outlining approaches and best practices for conducting a cost-effective self audit of internal controls.

4. **Improve audit efficiencies:** The SEC and Public Company Accounting Oversight Board (PCAOB) should work for the widespread adoption of top-down, risk-based audits of internal controls by the accounting industry.

5. **Streamline accounting industry standards:** The SEC should work formally with the Financial Accounting Standards Board (FASB) and the PCAOB to develop streamlined accounting standards and reduce complexities faced by smaller companies, while providing benefits to all.

These actions will help clear many of the rocky paths that can inadvertently cause problems for smaller public companies, and ensure they meet the requirements of better corporate governance in an efficient and cost-effective manner.

INTRODUCTION

Just as climbing a formidable mountain requires skillful direction and presents unexpected obstacles, reaching the pinnacle of success as a publicly traded company is challenging for many smaller companies. Questions have been raised about whether SOX has placed too many rocks along the climb to the top. In an effort to ensure a fairer climb, the Greater Boston Chamber of Commerce commissioned in-depth interviews with more than 35 industry executives, financiers, and accounting and legal professionals in the region to hear their views on the impact that the Sarbanes-Oxley (SOX) Act is having on the entrepreneurial segment of the economy. This report summarizes the findings and makes recommendations for addressing some of the unintended consequences of the legislation on smaller public companies.

In December 2004, the SEC Advisory Committee on Smaller Public Companies (Advisory Committee) was established to assess the current regulatory system for smaller companies under the securities laws, including the impact of SOX. The Advisory Committee is charged with advising the SEC on how best to assure that the costs of regulation for smaller companies are commensurate with the benefits, and will be presenting a set of final recommendations this spring. A draft report was published in February of 2006 followed by a 30-day period for public comment. The Chamber will be presenting its recommendations to the SEC as part of this process.

THE NEED FOR SARBANES OXLEY

A Call for Action

When large financial scandals involving companies like Enron and WorldCom hit the press in the early part of the decade, there was a call for quick action to protect investors and restore confidence in U.S. capital markets. Many agreed there was an urgent need to heighten awareness of what constitutes good corporate governance, to eliminate rubber-stamping by board members, and to reinforce a strong sense of personal accountability. In response, the Sarbanes-Oxley Act, sponsored by U.S. Senator Paul Sarbanes and U.S. Representative Michael Oxley, was signed on July 30, 2002, bringing about some of the largest changes to federal securities laws since the Securities Act of 1933 and the Securities Exchange Act of 1934.

SOX aims at preventing, detecting, and punishing corporate fraud in publicly traded companies by outlining significant new responsibilities for directors and management teams, and establishing more stringent guidelines for corporate oversight, financial reporting, and auditing. The legislation also enhances the powers of the SEC and created the Public Company Accounting Oversight Board (PCAOB) to help 'audit the auditors.'

Many Positive Impacts

"Everyone is taking corporate governance responsibilities much more seriously now, and SOX is making boards ask hard questions again." [President, Consulting Firm]

SOX has accomplished many of its original objectives. It has brought about nominating, compensation, and audit committees comprised of independent directors, along with more stringent requirements for individuals serving in these capacities. It calls for CEOs and CFOs to certify that financial statements fully comply with SEC requirements. It requires accelerated reporting of trades by insiders and levies more severe criminal penalties for white-collar crime. And, it prohibits certain services from being offered by accounting firms to their audit clients to reduce potential conflicts of interest.

THE OBSTACLES CREATED BY SARBANES OXLEY

Hindering the Ascent

Despite these positive developments, the cost of implementing SOX has far exceeded original expectations for companies of all sizes. In particular, an implementation framework designed for large, well-structured organizations is imposing disproportionately higher compliance and financial burdens on firms at the smaller end of the market. Limited resources—including staff time as well as money—are being diverted away from innovation and business development to the documentation of internal procedures, many of which have little impact on financial statements and potential corporate fraud.

There is a general view that SOX is yet one more reason why it costs too much to be a smaller public company in today's environment, driving some firms to stay or become private, others to seek an acquisition partner, and yet others to turn to offshore trading markets for their IPOs.

"SOX is affecting capital markets and the ability of smaller firms to get to the next stage — while we are spending money on things that don't grow the business." [Managing General Partner, Venture Capital Firm]

Hurting Competitiveness

Many smaller entrepreneurial companies are generating revenues but limited profit, and funds are needed for R&D, marketing, and sales initiatives to stay ahead. Large compliance costs are hampering competitiveness and profitability in the very segment of the economy that is the engine of job growth.

"If we could get the benefits of better governance, a CEO and CFO who need to be aware of things—and do this for less—that would be good. Maybe there is value for the first 50 percent of what is being done, but not the next." [VP, Internal Auditor, Small Telecom Firm]

The global dynamic is changing dramatically, and U.S. firms will continue to feel increased pressure from lower-cost countries like India and China that are taking full advantage of new technologies to spur economic activity. Legislation like SOX needs to meet the intended goals of protecting investors without imposing unintended burdens that hinder competitiveness, capital formation, and the ability of smaller firms to climb the mountain of success.

"The stakes are high and other countries are playing for keeps as we make moves that adversely affect our competitive advantage." [Partner, Venture Capital Firm]

These unintended burdens must be reversed to ensure continued job creation and economic well-being for the longer-term. As one business executive stated, "Innovation is the differentiator in smaller entrepreneurial companies, not process. It is creativity and taking chances. That's what we need to be focused on."

Cost-Benefit Imbalance

Improved corporate governance has been shown to enhance longer-term business performance, but the large cost of implementing SOX for smaller firms is overshadowing these positive effects.

According to work presented by the Advisory Committee in December of last year,[1] smaller firms represent significantly less risk to U.S. capital markets since their aggregate market capitalization is eclipsed by larger firms. The market for smaller companies is also less efficient as shown by lower trading volumes, less coverage by analysts, and a lower percentage of institutional ownership. Yet they are shouldering a substantially heavier load in terms of compliance costs as a percentage of revenues. The intent of the legislation was to make costs proportional for all firms; adjustments are clearly needed to address this imbalance.

"We have a powerful economic engine of smaller tech companies and we are hurting them. It's as if we are handcuffing our gazelles so they don't run faster than anyone else." [Partner, Venture Capital Firm]

[1] "Preliminary Report of the Internal Controls Subcommittee the Advisory Committee of Smaller Public Companies," December 2005.

SECTION 404 - THE LARGEST OBSTACLE FOR SMALL BUSINESSES

Unintended Consequences

"SOX works well if you are a multi-national firm. But in New England, we are mid-cap companies, many that went public in the last 10 years. Now these firms are being asked to increase the size of their organization and this is viewed as a big drag on the business." [Partner, Big 4 Accounting Firm]

Section 404 of SOX requires public companies to establish and maintain an internal control structure for financial reporting, and to report on the structure's effectiveness at the end of each fiscal year. Its overall purpose is to ensure that financial statements are accurate and to identify important weaknesses that have more than a remote likelihood of leading to a material misstatement. While companies have been required to have internal controls over their accounting since Congress enacted the Foreign Corrupt Practices Act in 1977, SOX has imposed additional requirements for annual management assessments and auditor attestations.

Many agree that inexperience with the process, and the overly conservative approach taken by auditors and management fearful of liability, have resulted in much more extensive procedures than were originally intended. This has led to enormous workloads and unwarranted expenses—substantially beyond what was anticipated by those designing the legislation.

In an effort to address this, both the SEC and the PCAOB issued guidelines in May 2005 attempting to clarify the spirit of the legislation and help avoid a mechanistic, check-the-box exercise. Still, the SEC's decision not to prescribe the scope, testing, and documentation required by management, but rather to stress that management's assessment should be reasonable, left many concerned about potential penalties from taking this interpretation too liberally. "Guidelines are good in theory," said one business executive, "but you still worry that if you do something wrong you will get in trouble."

Unnecessary Procedural Burdens

"It's like wearing two belts plus suspenders," said one business executive. Vagueness in the guidelines has resulted in many firms testing hundreds of controls, regardless of the level of risk they impose on the business, and having overly large sample sizes to prove the point. In addition, these controls must be tested twice, once during the year and once for fiscal year-end. Each external accounting firm that prepares or issues an audit report on a company's annual financial statements must then attest to management's assessment in accordance with standards set by the PCAOB. This results in controls being tested four times per year.

While time-consuming and expensive for all firms, the number of controls, extent of testing, and duplication of work effort is especially burdensome for smaller companies running 'lean and mean.'

"Testing quantities and testing times need to change, and we need to ignore things that are low risk. Otherwise we have really overdone it and spent way too much time and money." [VP Internal Auditor, Small Telecom Firm]

The entire process is designed for larger organizations with more developed structures and numbers of employees. Smaller companies by nature are less reliant on systems and detailed controls, and more reliant on oversight by their senior management team. While this can be very effective, it is hard to document and test this hands-on approach. In addition, since smaller companies by definition have smaller line items in their financial statements, they have a lower scale for "materiality." This may cause perceived control deficiencies in areas that would be overlooked in larger firms where such deficiencies may fall below specified thresholds. Other areas are also problematic for smaller companies, such as segregation of duties required for internal checks and balances. "For segregation of duties, you need people to segregate," said one individual.

"It's like wearing two belts plus suspenders," said one business executive.

Large Unanticipated Costs

The SEC's July 2003 release adopting the internal control rules estimated the aggregate annual cost of implementing Section 404 at approximately $91,000 per registrant. The reality has been much different. For large firms, total costs for year one compliance averaged $4.36 million, according to a survey of 217 public firms with average revenues of $5 billion conducted by Financial Executives International (FEI),[2] a leading professional organization of CFOs and other senior financial executives. This included an average of $1.34 million for internal costs, $1.72 million for external costs, and $1.30 million for auditor attestation fees—which were in addition to companies' financial statement audit fees.

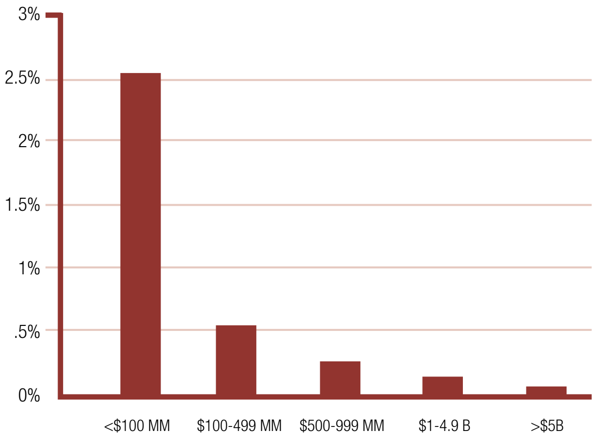
For smaller firms, the final average first year cost will likely approach well over $1 million, according to the American Electronics Association (AeA),[3] the largest high technology trade association in the U.S. And although the legislative intent was to have costs be proportional for all firms, with the burden increasing relative to the size of the firm, the reverse has been true as shown in the graph to the right.

[2] "FEI Survey: Section 404 Costs Exceed Estimates," March 2005.

[3] "Sarbanes-Oxley Section 404: The 'Section' of Unintended Consequences and its Impact on Small Business," AeA, February 2005.

"It just wasn't worth it. Our costs were about 2.5 percent of revenue, and we were losing money in that time period." [VP, Internal Audit, Small Telecom Firm]

Section 404 Costs
For Smaller Public Companies



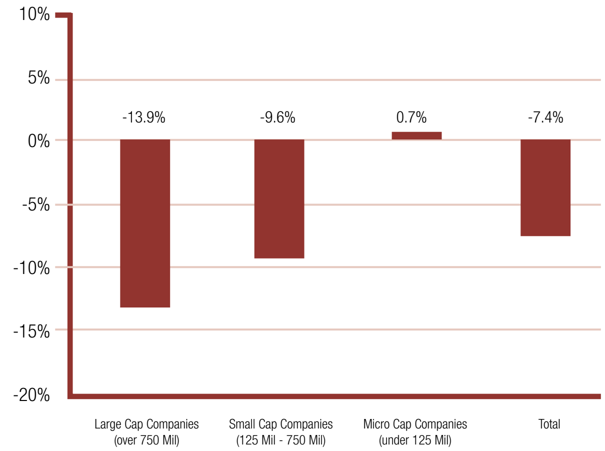
Source: "Sarbanes-Oxley Section 404: The 'Section' of Unintended Consequences and its Impact on Small Business," AeA, February 2005; <$100MM accelerated filers only.

The non-dollar costs for smaller firms are also substantial. Extensive meetings and related activities have absorbed a significant amount of time from senior management as well as finance and IT departments.

A further survey conducted by AeA in conjunction with NASDAQ in October 2005[4] looked again at the issue of costs of Section 404. The survey indicated that companies expect to see a decrease in year two, but only by 7.4 percent on average. Smaller companies felt they would see less of a decline than larger firms as shown in the chart to the right.

[4] "NASDAQ and American Electronics Association Sarbanes-Oxley Act Cost and Compliance Survey," October 2005.

High Compliance Costs
Persist After Year 1



Projected Change in Year 2 Total Cost of Section 404 (Weighted Average, Market Cap)

Source: "NASDAQ and American Electronics Association Sarbanes-Oxley Act Cost and Compliance Survey," October 2005.

A Dampening Effect on IPOs

Clearly many factors are affecting today's IPOs, including uncertainty in the equity markets. But SOX, on top of everything else, has had an impact. Many blame the $1 million-plus cost of compliance for smaller companies, accompanied by increased personal liabilities, for dampening the desire of many to go public.

According to a study by the national law firm Foley & Lardner LLP,[5] the average cost of being public in 2004 for a company with annual revenue under $1 billion increased 33 percent over the previous year, and 233 percent from the enactment of SOX through 2004. Audit fees account for a large portion of this, and they increased an average of 84 percent in fiscal 2004 for companies in the Standard & Poor's Small-Cap Index, and 92 percent for Mid-Cap companies. The firm also reports that it continues to be increasingly expensive for companies of all sizes to attract and retain qualified directors. Over the past four years director fees have increased approximately 45 percent for both S&P Small- and Mid-Cap firms.

"There is no point in being a public company if it makes you take a step or two backward. Biotech has the biggest impact, as we have more firms that go public when they aren't profitable." [CEO, Small Biotech Firm]

The number of IPOs in the United States plunged nearly 40 percent in 2005, according to recent figures released by the National Venture Capital Association (NVCA). The organization attributed the lackluster results to a mix of factors, including the uneven technology recovery and higher costs of being a public company imposed by SOX.[6]

NVCA's predictions for 2006 suggest the IPO market is unlikely to rebound considerably. "Companies will continue to rely on the acquisitions market as an easier, safer exit strategy but will also search for more innovative opportunities. More companies will consider going public on foreign exchanges or soliciting offers from private equity firms."[7] Others agree. "Until the regulatory pendulum swings back," says Paul Bork, a Boston-based partner with Foley Hoag LLP, "emerging technology businesses are finding some comfort in remaining private and accessing capital in the private capital markets and from financial and strategic partners."

[5] "The Cost of Being Public in the Era of Sarbanes-Oxley," Foley & Lardner LLP, June 2005.

[6] "Venture-Backed IPOs and Acquisitions Q4 05," NVCA, January 2005.

[7] "2006 Is Predicted To Be Critical Transition Year in Venture Capital Lifecycle," NVCA, December 2005.

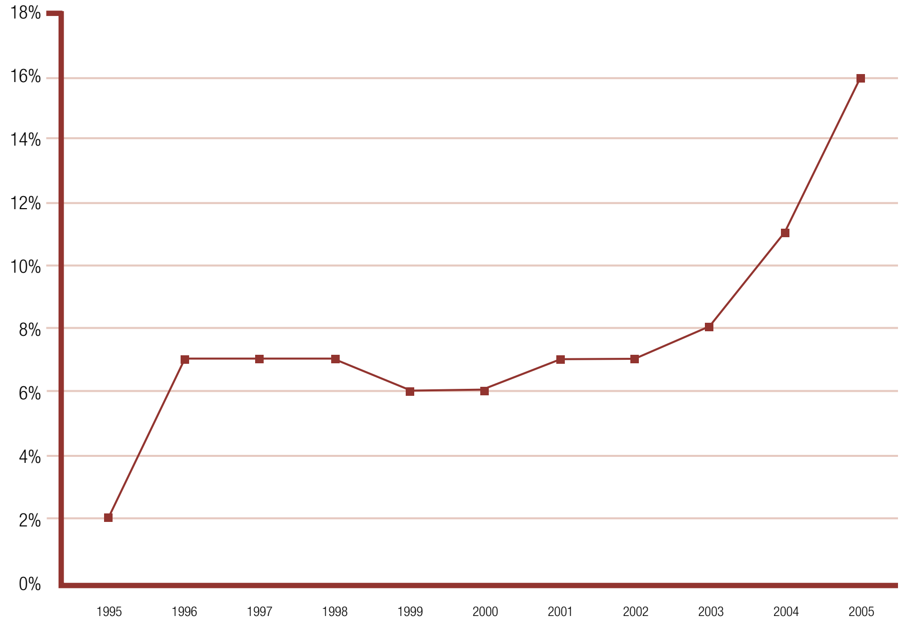
"We believe Sarbanes-Oxley, and the waves of enhanced regulation that have cascaded from it, have appreciably dampened the IPO market—beyond the weakness engendered by the dot.com bust." [Partner, Law Firm]

It appears that companies are in fact turning to alternative exchanges to launch their IPOs. "NASDAQ is dead and, thanks to SOX, I believe that it is due to companies now requiring $70-plus million in revenues before they can even think of going public," said Charles Lax, managing general partner with GrandBanks Capital in Newton, Mass. "In 2005, only 56 U.S. venture-backed companies achieved a successful listing, a statistic that leaves us with no choice but to discuss launching IPOs with three of our promising start-ups on the London Stock Exchange's AIM market."

In 2005, the London Stock Exchange surveyed 80 international companies that conducted an IPO in its markets. The survey revealed that, of those companies that had considered listing on a U.S. exchange, 90 percent felt the demands of SOX made listing in London more attractive. In addition to London's AIM market (the Exchange's global market for growing companies), Toronto's TSX Venture Exchange has become an increasingly attractive market for emerging international companies.

SOX is also making U.S. capital markets less attractive to non-U.S. companies. "When you speak to executives outside of the U.S. there is a real fear," said one individual. "They think the U.S. went way overboard. You had a few bad apples and you create this huge regulatory hurdle for everyone else." The attractiveness of offshore trading for domestic and foreign firms cannot be ignored—the percentage of international listings on AIM nearly doubled in 2004 and 2005 as shown in the graph to the right.

International Stock Listings on London's AIM Market as Percentage of Total Llistings



Source: AIM Market Statistics

Trickle-Down to Private Companies

"Private company managers who think that SOX is simply a bump in the road should think again." [President, Investment Bank]

Although SOX only applies to public companies, and others registered with the SEC for various reasons, private companies are feeling the effects as well. While this is making firms more aware of the importance of strong, independent boards and good corporate governance, it is also making acquisition work much more demanding and costly.

According to the head of M&A at one major Boston law firm who was interviewed for this report, overall deals take longer and it is more likely that the buyer will bring in outside experts. SOX is slowing down transactions, and the greater the time involved to do a deal, the more likely things will break down.

Any company considering an IPO needs to start thinking about SOX immediately. And those looking to be acquired need to recognize that potential buyers may not want to assume the added risks of non-compliance or bear the upfront cost of bringing the targeted firm up to speed. This could affect the purchase price or even drive the buyer away.

SOX is also limiting the options for private firms being acquired. Mirus Capital Advisors, a Burlington, Mass. investment banking firm, recently polled a select group of senior attorneys at top Boston-area law firms, as well as senior deal makers at two leading private equity firms, to ask about the most significant consequences they had seen of discovering SOX non-compliance during an acquisition process. The key conclusion: owners and managers at private middle-market businesses need to become savvy about SOX, and quickly — even if they have no intention of going public and even if a sale isn't in the immediate future. Non-compliance not only reduces the credibility of management, but can also have an adverse effect on the terms of a deal.

"The biggest unintended consequence is that it is discouraging capital formation by smaller firms, taking a whole engine of growth out of the economy." [COO, Small Telecom Firm]

Changed Relationships with Auditors

Without question, the post-SOX environment has created challenges for how clients and auditors interact and has affected the collaborative work style that previously existed. Many feel audit teams have adopted an overly risk-averse position to protect themselves from liability rather than trying to help their clients develop workable solutions. In addition, uncertainties about providing advice that might compromise an auditor's independent status is further straining relationships. This has become particularly burdensome for small firms, adding unnecessary time and costs to getting important issues resolved. "SOX has put fear into auditors and created a 'you do it and I'll police you' attitude," said one small business executive. "You should be able to get advice from auditors—they have more expertise by definition."

In addition, large accounting firms are experiencing such high customer demand that some are unable to take on smaller clients. This trend will likely reshape the accounting industry landscape in the long-term, as more companies turn to regional and local accounting firms for support.

RECOMMENDATIONS TOWARDS A FAIRER CLIMB

Helping Smaller Companies Reach the Peak

Smaller public companies have a challenging climb as they strive to establish their operations, raise capital, and create a competitive edge. While it is essential that they exhibit good corporate governance along the way, they should not be treated as if they were large, complex businesses requiring a complicated framework to assess internal controls. The very nature of smaller companies suggests a more streamlined approach, and one that is flexible enough to easily accommodate changes that occur throughout the year in product offerings, delivery mechanisms, and geographies served.

Because SOX needs to be implemented in an efficient and cost-effective way at all affected companies if its measures are to endure, steps must be taken to reduce its onerous burdens on smaller firms.

To achieve this goal, the Chamber will work with public officials and business organizations to advance the following five recommendations.

1. Establish small company criteria: The SEC should clearly define what constitutes a smaller public company by using market capitalization and revenue breakpoints that are well understood.

2. Revise compliance requirements for small companies: The SEC should address today's overly burdensome compliance procedures by exempting smaller public companies from certain aspects of Section 404.

3. Provide guidance to small companies: The SEC should provide additional guidance to smaller public companies by outlining approaches and best practices for conducting a cost-effective self audit of internal controls.

4. Improve audit efficiencies: The SEC and Public Company Accounting Oversight Board (PCAOB) should work for the widespread adoption of top-down, risk-based audits of internal controls by the accounting industry.

5. Streamline accounting industry standards: The SEC should work formally with the Financial Accounting Standards Board (FASB) and the PCAOB to develop streamlined accounting standards and reduce complexities faced by smaller companies, while providing benefits to all.

ESTABLISH SMALL COMPANY CRITERIA

Recommendation of the Greater Boston Chamber:

The SEC should define smaller public companies as those below $750 million in market cap, with less than $750 million in annual revenues as of their last fiscal year. These breakpoints should be adjusted for inflation each year.

Rationale:

This reform will affect firms facing disproportionate cost burdens, and will recognize certain efficiencies in the implementation process moving forward.

The Chamber believes that these market cap and revenue breakpoints capture the large portion of firms that face disproportionate costs of complying with Section 404. While some firms above these breakpoints may also face higher than average compliance costs, the Chamber believes these will be reduced somewhat given efficiencies in the implementation process moving forward with management and auditor experiences, and SEC and PCAOB guidelines.[8]

The Advisory Committee on Smaller Public Companies has suggested a definition where market cap is in the lower six percent of all U.S. public companies (below approximately $700 million to $750 million) and last fiscal year revenues no greater than $250 million. As outlined in the following table (see table on page 18) presented by the Committee,[9] the Chamber's recommended definition would add approximately 538 companies to the category of smaller public company.

[8] "Any firm looking for Well-Known Seasoned Issuers (WKSI) status would be required to comply in full with Section 404 to receive benefits."

[9] "Preliminary Report of the Internal Controls Subcommittee the Advisory Committee on Smaller Public Companies," December 2005; "Background Statistics: Market Capitalization & Revenue of Public Companies," August 2, 2005.

Recommendation 1 continued

Market Capitalization Interval ($MM)

Revenue Interval ($MM)	0-125	125-250	250-500	500-750	750+	Total
$0-125MM	5,252	534	343	75	74	**6,278**
125-250	152	94	178	97	119	**640**
250-500	79	76	118	102	248	**623**
500-750	24	33	53	53	197	**360**
750-$1 B	8	18	29	27	149	**231**
$1B+	16	12	43	64	1,161	**1,296**
Total	**5,531**	**767**	**764**	**418**	**1,948**	**9,428**

Source: "Background Statistics: Market Capitalization & Revenue of Public Companies," SEC, August 2, 2005.

Advisory Committee Recommended Small Company Definition

Additional Companies affected by Chamber Small Company Definition

Chamber Recommended

REVISE COMPLIANCE REQUIREMENTS FOR SMALL COMPANIES

Recommendation of the Greater Boston Chamber:

The SEC should exempt "microcap" companies from Section 404, subject to achieving certain corporate governance guidelines, as recommended by the Advisory Committee.

- Microcap companies should be defined as companies below $125 million in market cap and $125 million in revenue.

The SEC should eliminate external auditor attestation for smaller firms if they have complied with all other SOX and SEC requirements, as recommended by the Advisory Committee.

- It should also require an external audit of the design and implementation of internal controls every three years.

Rationale:

Smaller firms require a less complex approach.

The Advisory Committee clearly articulated the differences between large and small companies in their preliminary report presented in December of 2005. The Chamber supports the Committee's main recommendations to exempt microcap companies from Section 404 and to eliminate the external auditor attestation for smaller firms. Both groups would be subject to all other SOX corporate governance requirements.

The Chamber believes that there should be an external audit of the design and implementation of internal controls,[10] to be completed every three years. This will help guide smaller firms as they put in place an appropriate internal control framework.

[10] An audit of the design and implemementation was outlined as a possible option by the Advisory Committee.

PROVIDE GUIDANCE TO SMALL COMPANIES

Recommendation of the Greater Boston Chamber:

The SEC should provide the following guidance to smaller public companies:

- Specifics on how to conduct a top-down, risk-based audit.
- Ongoing support for questions and sharing of best practices.
- Clarification of the role of the Committee of Sponsoring Organizations (COSO).

Rationale:

Additional support and guidance is needed given the unique and dynamic situations faced by smaller firms, and their more limited resources.

Additional details, along with examples of best practices, are required for management of smaller companies to better understand how to conduct an effective assessment of internal controls that is both risk-based and cost-effective. The Chamber recommends that the SEC provide additional support on this front and act as a central point for sharing ideas and best practices. In addition, the SEC should clarify the role of COSO in providing guidance to smaller companies to help them understand how they should be responding to COSO's recent report for smaller companies.[11]

[11] "Guidance for Smaller Public Companies Reporting on Internal Control Over Financial Reporting," COSO 2005.

IMPROVE AUDIT EFFICIENCIES

Recommendation of the Greater Boston Chamber:

The SEC and PCAOB should work for the widespread adoption of top-down, risk-based audits of internal controls by the accounting industry. The PCAOB should also solicit regular feedback from small companies on the effectiveness of such accounting industry guidelines.

Rationale:

Ensure the intent of the legislation is being followed to enhance implementation efficiencies.

The Chamber recommends that the SEC and PCAOB closely monitor auditing firms to ensure that a top-down, risk-based approach to internal controls is being adopted that reflects the unique circumstances of smaller firms. If the recommendation to exempt smaller firms from the external auditor attestation is accepted as outlined above, this would only apply to the audit of the design and implementation of internal controls.

The SEC and PCAOB should also continue to encourage auditors to use professional judgment in identifying more flexible approaches applicable for smaller firms. Ongoing PCAOB site inspections at larger firms should be used to offer regular feedback to the auditing community along with concrete suggestions on how things can be further enhanced.

While the SEC and the PCAOB have encouraged better dialogue between companies and their external auditors, and the sharing of information about new accounting pronouncements and related matters, this also requires continued reinforcement for some auditors to feel comfortable that they will not be compromising their independence by providing advice.

5 STREAMLINE ACCOUNTING INDUSTRY STANDARDS

Recommendation of the Greater Boston Chamber:

The SEC should work with the FASB and the PCAOB to establish new accounting standards that are less prescriptive and more principles-based.

Rationale:

Today's standards are too complex and can be especially burdensome for some smaller firms. Adjustments would benefit firms of all sizes.

The Chamber recognizes that the issue of accounting standards is a complicated one that has the attention of FASB, the SEC, and others. The Chamber recommends that these organizations, along with the PCAOB, formally establish an agenda for pursuing this approach.

A key concern is that U.S. accounting standards have become too "rules-based." They include extensive details, exceptions, and contingencies, and rely heavily on percentage tests ("bright-lines") instead of professional judgment. Both small and large firms alike would benefit from a new set of standards that introduced a simpler approach based on an improved and consistently applied conceptual framework. A 2003 study by the Office of the Chief Accountant and the Office of Economic Analysis of the SEC on the adoption by the U. S. financial reporting system of a principles-based accounting system[12] concluded that such an approach should ultimately result in more meaningful and informative financial reporting to investors, and would hold management and auditors responsible for ensuring that financial reporting complies with the objectives of the standards.

[12] "Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System," SEC, 2003.

SUMMARY

A Fairer Climb

The Chamber supports the purpose and intent of the SOX legislation and believes it has enhanced corporate governance in firms throughout the region. But the costs associated with Section 404 are significantly outweighing the benefits for smaller firms. The Chamber urges the adoption of the recommendations outlined in this report to address SOX's unintended consequences and ensure a fairer climb for the smaller companies that are essential to economic growth.

ACKNOWLEDGEMENTS

The Chamber would like to thank the executives interviewed for this report for their valuable time, insight, and guidance.

The Chamber would also like to acknowledge the outstanding contributions of Ms. Susan Windham-Bannister, managing vice president of Abt Associates Inc., and Ms. Lyn Zurbrigg, managing partner of The KELYN Group LLC, in helping to prepare this document.

About the Greater Boston Chamber of Commerce

The Greater Boston Chamber is a broad-based association representing 1,700 businesses of all sizes from virtually every industry and profession in our region. At the crossroads of business and government, Chamber members work together to ensure the long-term advancement of Greater Boston as one of the world's great metropolitan regions.

About Abt Associates Inc.

One of the largest for-profit government and business research and consulting firms in the world, Abt Associates applies rigorous research and consulting techniques to a wide range of issues in social and economic policy, international development, and business research and consulting. With headquarters in Cambridge, Mass., the firm's staff of more than 1,000 employee-owners includes national and international experts who are recognized for their knowledge, innovative research techniques, and insightful analyses and recommendations.

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Tim Sweeney
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Marketing Communications
Manager

Mirage Design
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