

Sarbanes-Oxley: The Impact on the Smaller Accounting Firm Industry (As published in the September 2006 issue of *Accounting Today*)

By Brad Beckstead

Lost in the hotly debated issues surrounding the landmark Sarbanes-Oxley Act of 2002 are the unforeseen consequences impacting the accounting industry itself. Foremost among these is the creation of an inhibited marketplace that primarily benefits the Big Four accounting firms at the expense of their smaller, regional, and often more flexible counterparts.

Largely because of Sarbanes-Oxley, the Big Four now collectively audit 80 percent of all U.S. public companies. Under Sarbanes-Oxley, the Public Company Accounting Oversight Board (PCAOB) was established and set out to define and enforce a set of rules covering standards for all auditors of public companies. These standards are wholly inappropriate for smaller, entrepreneurial public companies and the small auditors that can most affordably and efficiently serve them. The PCAOB's standards practically wrote the Big Four into the rules, establishing what the U.S. Government Accountability Office has labeled an oligopoly.

In the climate of fear fueled by Sarbanes-Oxley, this oligopoly now has enormous power to demand additional auditing tests and countless hours of documentation under the guise of increased vigilance on corporate internal controls. These activities have naturally led to higher auditing and compliance costs, which now disproportionately punish small companies. Smaller audit firms now live in fear that their audit procedures and documentation do not exhaust every plausible or possible scenario that can arise from complex business transactions. This has resulted in a PCAOB-fueled environment of armchair quarterbacking and 20/20 hindsight as part of the requisite inspection process that can, and most likely will, have regulatory and professional ramifications.

Congress never intended to do this, but it has.

The remaining percentage of public companies the Big Four does not audit either cannot afford their fees or are deemed by the Big Four as too risky. On the surface, this might look like an opportunity for smaller audit firms, but the dizzying rules put in place by the PCAOB make them far less attractive. In short, the PCAOB's one-size-fits-all rules are inappropriate, even meaningless, for smaller companies and are too costly for smaller audit firms to implement, thereby creating a natural "barrier to entry" for small companies to access much-needed capital.

As a result, small public companies often cannot obtain the requisite services on an economic scale because the Big Four aren't interested and smaller firms cannot realistically meet the audit testing and documentation standards established and enforced by the PCAOB. Regulators tend to view small public companies that are not audited by the standard-bearing Big Four as suspect, and institutional investors therefore view them as too risky, causing capital investment and innovation to be stifled nationally. Further, a diverse and talented pool of hundreds of thousands of financial experts who are not employed by the Big Four are effectively shut out of the auditing market.

While sound internal controls are important, flexibility and choice of auditors are also important. Genuine competition is essential to the proper functioning of any market.

What is the solution? A good initial step would be to implement several key recommendations recently issued by the U.S. Securities and Exchange Commission's Advisory Committee on Smaller Public Companies.

- First, establish a new system of scaled regulation with exemptive relief from the internal controls requirements of the Sarbanes-Oxley Act for companies based on their size.
- Second, develop a safe-harbor protocol that would protect well-intentioned issuers and auditors from regulatory or legal action when the process is appropriately followed.
- Third, acknowledge the *inherent limitations* associated with audits of small public companies by amending the PCAOB audit standards to adopt and enforce the AICPA's audit standard of "Due Professional Care" which requires the auditor to "...obtain *reasonable* assurance that the financial statements are free of material misstatement, whether caused by errors or fraud." The AICPA standard further states that "...Because audits incorporate many tests of samples of transactions, there is a risk that material errors or fraud, if they exist, will not be detected. Therefore, the auditor is not an insurer and his or her report does not constitute a guarantee."
- Fourth, amend the PCAOB audit standards to acknowledge that audits of small public companies are not to be conducted by the auditor without regard to all costs and all time constraints in order to achieve total precision and absolute accuracy, thereby furthering acknowledgement of the inherent limitations associated with the audit process.
- Fifth, exempt smaller audit firms from the PCAOB inspection process and return them to the AICPA Peer Review process, thereby easing the regulatory burdens and scrutiny smaller audit firms face every three years.
- Finally, implement a *de minimis* provision in the application of the SEC's auditor independence rules. As small public companies generally cannot afford the added costs of retaining qualified financial experts, smaller audit firms should have the ability to advise clients so long as the advice is not construed to be management decision-making authority.

To ensure that government officials and policymakers recognize the consequences of the Sarbanes-Oxley Act, I have joined with others to mount a constitutional challenge to the PCAOB's authority based on its violation of the appointments clause. Our goal is to return free market principles to the auditing community. Barriers to entry can and should be lowered, and competition encouraged. Ultimately, entrepreneurs, innovators, investors and the United States economy will be the winners.

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