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Small Firm Angles For Big Impact On The Audit Future At Small Public Companies

John Malone was bored. As a partner running a small general practice in Houston, he was earning about \$120,000 a year doing work that didn't excite him. His days were spent on small audits, tax returns – the typical work of a general practitioner at a tiny firm, and he no longer felt inspired or passionate about it.

Although he was in his 40s, Malone enrolled in the South Texas College of Law, searching for a spark to ignite career passion again. While there, in the early days of the new millennium, he noticed that “things were really starting to open up for small public companies.” He'd found the spark he was looking for.

Malone, along with his partner and friend, Sterling Bailey, began carving a niche specialty focused on small public companies and a new way of practicing public accounting. “We wanted a place where employees could have fun, be rewarded, have meaningful career opportunities and do meaningful work without preconceived notions. So many firms have preconceived notions of what an accounting firm should be and how it should operate, and in many cases, they are full of themselves. We didn't want that kind of firm.”

Like the little engine that could, Malone & Bailey is quietly picking up steam. FY05 net revenue was \$3.3 million – a growth rate of 94% over the previous year. M&B is on target to net \$6.5 million for FY06 and should hit \$10 million in FY07. Malone predicts the firm will see net revenue of \$30 million in six to eight years, with 80% to 90% of it coming from small public audit clients. M&B had 92 SEC clients at the end of 2005, a gain of 17 over the previous year.

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**Small Firm Seizes
Opportunity Left
By Void In Market**

“We want to be ahead of BDO Seidman and Grant Thornton in terms of number of public audit clients. We want to be large enough to say we audit more public companies than anybody in the nation, and we do it better than anybody for small companies,” Malone tells *IPA*. “This is a chance for me – and the firm – to make a difference in the profession, to add value, and to have real impact.”

M&B has no desire to tread into Fortune 500 territory. The overwhelming majority of its clients have less than \$25 million in sales, although one tops \$1 billion. “We beat out a nine-figure New York firm for [the engagement of] the \$1 billion client. The client asked us twice to bid on it. We weren’t going to, but they loved our niche and our expertise,” he tells *IPA*.

Malone believes small public companies are underserved, and his firm is eager to fill the void. “Many non-national firms are scared at the thought of the government putting them out of a job with the wave of a pencil, so many of them don’t audit public companies anymore. We offer small public companies three things they want and need: expertise, fast service, and reasonable fees, because the cost of a public company audit has risen dramatically,” he says.

**Lower Leverage,
Electronic Audits
Are Part Of Recipe**

The firm’s expertise and target market make audits of small public companies less risky than many perceive, Malone adds. “Small public companies don’t have a lot of risk, because they don’t have earnings. Investors are hoping that these companies will become the next Intel or Microsoft, and investors don’t look at their financial statements because they expect these companies to show a loss. But people still want to start public companies, because it’s easier to get money on the stock market than from a bank. The American dream used to be to own your own business. Now it’s to own your own public company.”

Two ways that M&B is bringing expertise, timeliness and reasonable fees to small public companies are through a different leverage model and electronic auditing.

M&B (www.malone-bailey.com) has seven partners and 29 total staff, or 4.1 employees per partner – a significantly lower leverage ratio than the

average of 7.4 for all non-national firms participating in *IPA's* 2005 Annual Analysis of Firms. "Small public companies require a disproportionate share of partner time," Malone points out. "A 200-hour audit for a public company may require 50 partner hours, but you don't need as many people. You really need only one staff person, an intermediate person and a partner. It's a different animal. Partners who work on these audits are more involved and have a better understanding of the clients' complex issues. The result is fewer mistakes and significantly less risk."

The PCAOB visited M&B in December 2004, and inspectors "had no objections" to the firm's electronic auditing practices, Malone says. "I haven't met half our clients, because we audit electronically. In a small company, there's one accountant, a CEO and maybe some inventory. It's all about what the documents say and how money changed hands, and that's electronic. Electronic auditing gives us a major part of our competitive edge. We don't have to travel. We're more efficient than our competitors, and we can do an audit better and at a lower cost than our competitors can." M&B has clients in 14 states and four countries besides the U.S., including 10 in Canada.

Malone supports the purpose of the PCAOB – "raising the quality of the audit" – but the board is flawed in design, he says. "Many of the requirements of SOX don't necessarily make sense for a small public company audit, such as some of the certification requirements" he says. "Fraud can't be addressed by an audit at the small public company level. It's manipulation of stock price" that leaves small public companies most vulnerable to improprieties, he says.

"I support the purpose of the PCAOB, but the way they're doing it is scaring people. It's a very authoritarian approach, and you can't effectively raise audit quality with a sledgehammer. There should be more consensus-building. The people who work for the PCAOB and the SEC are trained almost exclusively by people who come from large firms or companies, but auditing a small company is a specialty that isn't recognized as a specialty. Big businesses are run by professional managers whose goal is to avoid risk. Small companies are run by entrepreneurs. Each is after different goals and

results. So as auditors of public companies, it's much more important to look at the thoroughness of transactions and less important to focus on controls and procedures.”

Malone believes that his firm is making a difference, and as it grows, so will its impact. “In the end, I want to be able to say that I made a positive difference, that I helped solve a major problem in our profession, that I had a major impact on the credibility of auditing and accounting at small public companies. I want to bring big firm expertise to the small company environment.” ■