Finding Your Cost-of-Compliance Sweet Spot

IT TAKES A FRAMEWORK THAT ANALYZES THE STRENGTHS AND WEAKNESSES OF YOUR COMPANY'S CONTROLS TO DETERMINE WHERE TO SPEND THE DOLLARS.

BY JOHN SCHNEIDER

"How confident are we that our firm is in compliance?" This question strikes fear and loathing in the minds of today's financial executives to the point of keeping them up at night. But more than that, compliance has become a dollar investment preoccupation.

Put simply, compliance program costs have increased exponentially over the past decade. The reasons for this vary: Some blame it on the costs of increased staff, legal review, and assistance from consultants, while others point to the need to integrate expensive IT software for surveillance and reporting. It has been estimated that firms in the securities industry will spend more than $28 billion on compliance programs and program enhancements in 2007—compared to $23 billion in 2004. Compliance with the Sarbanes-Oxley Act (SOX) alone in 2006 reached approximately $6 billion. Are such levels of spending even necessary?

Executives in charge of compliance program spending tend to err on the side of caution and overspend in an attempt to bulletproof their organizations. But a look at the results of regulatory examinations shows that there's no insurance policy available to stave off negative regulatory findings. In some cases, it's advisable to accept a little risk rather than to overinvest. Knowing where that sweet spot is requires companies to have an established framework that analyzes the strengths and weaknesses of their controls to determine where to spend compliance dollars. In today's heightened regulatory environment, many companies haven't yet developed the appropriate analytical tools and framework to find that sweet spot, so they continue their struggle.

Here I'll discuss both the hard and soft costs of compliance; the business and corporate political drivers of compliance program inefficiencies; the benefits of a deliberate, risk-adjusted compliance program; and how some companies are finding their sweet spots.

HARD AND SOFT COSTS

To understand where to conserve on compliance program investments, it's useful to consider typical expense allocations. By far, the largest cost drivers are staff related: recruitment, salary, variable compensation, benefits, and other overhead such as providing personal business equipment and office space. These expenses account for 93.9% of the total dollars spent on compliance programs. The remaining costs are allocated to capital expenditures: IT software and hardware (3.3% of costs) followed by out-of-pocket expenses including IT supplies, vendors, and accounting, legal, and audit services (2.8%). Within this mix, audit fees comprise part of the expense structure and continue to rise—especially when additional staff is required to manage the audit.

Overspending on compliance programs creates another kind of risk—wasted resources that otherwise would have been devoted to the company's strategic position and growth. These incalculable soft opportunity costs can cause large-scale distraction in four major areas.

1. Reallocating and Stretching Limited Resources

As organizations continue to focus on leveraging existing resources, it's important to evaluate the current governance functions or control groups (Finance, Internal Audit, and Risk Management) to determine the right mix of individuals possessing the appropriate subject matter expertise required to implement change. One often overlooked tenet of success in stretching limited resources is determining what resources (training, process change, and technology) are required to retool existing resources to take on additional responsibilities efficiently.

For example, new regulations, such as SOX and the Investment Company Act Rule 38a-1, require the implementation of ongoing monitoring programs. Although these initiatives require audit skills, they also require legal, regulatory, and financial technical skills. Ensuring that the dedicated compliance staff is appropriately skilled for their new responsibilities is an essential factor to consider when stretching limited resources.

2. Limiting R&D Due to Increased Costs for Outside Counsel

As there's an increased need to rely on external experts, such as outside counsel, the costs rise exponentially for many firms. These expenses should be considered up front during the development and implementation phase. If firms haven't planned appropriately for an individual or individuals to retain the knowledge from advisors, a one-time cost may turn into a recurring expense.

3. Overworking Employees Who Can't Focus on Compliance

Balancing workloads for employees is always difficult for managers, but it becomes more challenging when employees *must* wear more than one hat. Smaller organizations often employ the multitasking model, with varying levels of efficiency, while in larger organizations employees are critically overworked due to the volume of work required in a larger compliance infrastructure. As a result, job responsibilities are more difficult to measure,

and those responsibilities with respect to compliance become deemphasized.

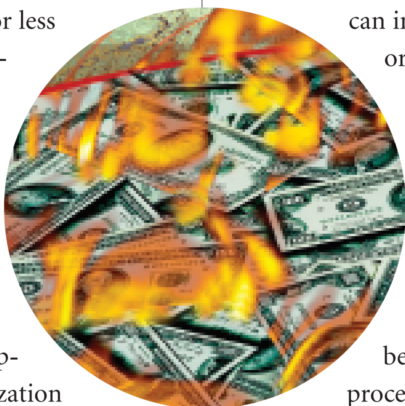
4. Spending Equal Time on Compliance-related Activities and Creating New Business/Relationships

Executives should consider the process for building a comprehensive governance function in much the same way as building any other capability within the company. The trade-off may be to sacrifice short-term business relationship building in lieu of developing an effective compliance program. CEOs are already spending 20% to 25% of their time on compliance-related activities vs. 5% only five years ago. They have embraced the importance of compliance, which is evidenced by the significant increase in the time allocation dedicated to compliance-related matters.

OTHER PROBLEMS AND CONSEQUENCES

In addition to losing focus on the corporate mission and distracting key decision makers from their main roles, other problems and consequences arise from the view that regulatory compliance is too overwhelming—a view that could be mitigated if executives had a better sense of how to balance and manage the challenges.

These preoccupations, combined with the fact that many companies are merging with others that have different compliance cultures, tend to create confusion and lack of direction. Compliance programs often take on differing structures within a merged organization and aren't always implemented in the same manner. On a pragmatic level, knowing whom to contact if a potential issue or question arises often becomes a significant challenge. Differing business models require more or less compliance oversight depending on product complexity, distribution, and regulatory oversight. In addition, the merged entity may have inherent inefficiencies and in many cases should redefine the compliance program, its roles, and its responsibilities. If the business models aren't aligned, overspending of compliance dollars will result. Therefore, developing a model that's tailored to each organization is critical.



Beyond merged entities, there has been an interesting trend of reticence when deciding to take companies public—based in part on the perceived complications and unnecessary capital expenditures surrounding compliance programs, business and IT infrastructure, and required overhead. Firms opt to stay private to avoid having to comply with the regulations governing public companies. This development is holding down new public offerings, and, as a result, domestic securities markets are losing business to non-U.S. markets. Consider that in 2005, the NYSE and NASDAQ combined had only 20 new listings from foreign firms vs. 129 foreign firms in the London market. Industry analysts have pointed to the negative influence that the U.S. regulators have on the critical decisions such firms are facing in the decision to take a company public.

One of the most profound impacts on compliance program expenditures has been the sharp rise in earnings restatements in the U.S. In 2006 approximately 1,876 companies went through a restatement—an increase of 17% from 2005—and significantly exceeding the 452 pre-SOX restatements filed in 2001. While not all of these restatements were SOX related, this large jump suggests that compliance demands are creating even more challenges for accounting and finance departments.

ON THE BRIGHTER SIDE

Tight, comprehensive compliance regulations have many benefits. They are helping restore investor confidence, which was needed after recent stock market declines, accounting scandals, and securities laws violations. A restoration of investor confidence has helped companies and the economy as a whole.

When companies eventually get a handle on compliance requirements, they can benefit from business operations improvements, such as standardized processes. An example of how the new regulatory requirements can influence standardization is that many organizations have implemented new product-development policies, procedures, and governance requirements. Organizations with established processes to ensure all stakeholders have an opportunity to review new products before they're launched are finding governance oversight is now being built into the processes and that processes are, more than ever, being reviewed more carefully to ensure that operations and finance can standardize processes to mitigate risk appropriately. A retroactive review of existing products and services has created more opportunities for standardization.

Another benefit of standardizing processes is that it establishes opportunities to strengthen the internal con-

trol environment as well. This can be attributed in large part to streamlining processes and aligning operational and governance capabilities to the products and services.

A positive aspect of standardizing processes and strengthening internal controls is companies are forced to evaluate their standard operating procedures. Ensuring that processes are repeatable and provide the visibility to guarantee that they have the capacity to prevent, detect, and remediate compliance breaches is a windfall from the recent regulatory changes.

Other benefits come from getting a handle on compliance regulations:

- Compliance officers have a view of the control activities within several key business processes because of the supervision and monitoring aspects many compliance programs provide.
- Compliance programs mitigate potential legal liabilities because most regulatory responsibilities are captured within the contracts that are formed between companies and clients, companies and service providers, etc.
- A more secure information environment results.

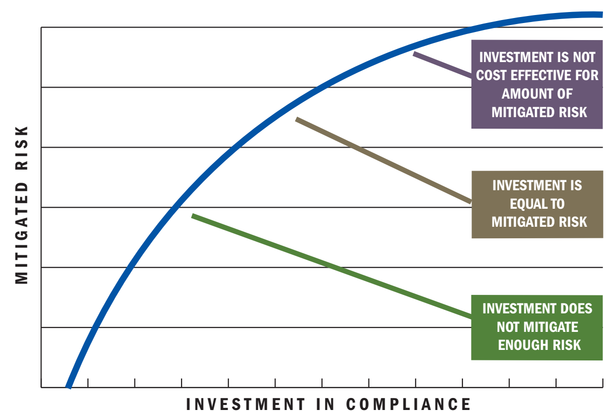
FINDING THE SWEET SPOT

To set the stage for finding the sweet spot, consider a quote from Warren Buffett: "Berkshire can afford to lose money, even lots of money; it can't afford to lose reputation, even a shred of reputation….There is plenty of money to be made in the center court. There is no need to play around the edges."

An important first step is to acknowledge that the cost of compliance is an ingredient of a broader effort for a governance and risk management infrastructure to protect the company's reputation. Each industry is slightly different and, therefore, comes with a unique set of economic decisions that will factor into determining how much is enough. As with all business activities, measuring the risk vs. reward is fundamental to assess the appropriate business model. Distilling this thought process into a diagram helps to visualize where to align and/or allocate resources in a more efficient manner. See Figure 1.

The "Efficient Frontier" is less quantitative than it is qualitative, so analyzing the key business drivers is a good starting point. This analysis will assist in the inventory process of the client types, distribution channels, services, and/or products that are being provided. Why is this important? By knowing a company's business lines and client service providers, a risk assessment can be made more efficiently. This risk assessment will be directly

Figure 1: Measuring Risk vs. Reward



related to the proper location of a business's compliance expenditure sweet spot. Here are six other business attributes to review:

1. What is the size of the organization? What is the scope of the assets under management? Millions? Billions? Does the compliance program apply to a self-contained organization, or is it employed in many different parts of an organization where scale, leverage, and other economic efficiencies exist?

2. What is the level of complexity? Issues to address include the number of offerings, distribution, private labeling, whether the company is a service provider, etc.

3. In what jurisdictions does an organization operate? In what countries are products and services being sold? Also, what regulatory oversight exists?

4. How much of the compliance program can be automated? Is there a commitment to invest in compliance-related technologies?

5. What other sources of testing and monitoring can be leveraged for compliance purposes (i.e., SOX Audit Testing, Internal Audit, SAS 70 (Statement on Auditing Standards No. 70, "Service Organizations") audits, etc.)?

6. What part of the compliance program can be outsourced?

Integrating compliance and governance into the fabric of an organization can be a differentiator that can add value to attract resources, sell product, create or enhance reputation, and attract new clients, among other positive outcomes. Consider recognizable brands, such as McDonald's, Citibank, and UPS, and the value associated with them. Creating these brands required a significant amount of effort and resources, but protecting the brands and their reputations requires just as much investment and diligence. Leadership is a difficult quality to measure

and define, but most people will say that they "know it when they see it." Leaders with the insight to envision, create, and implement solid compliance programs add value to their brands. A good compliance program needs to be a proactive venture and a dedicated, respected part of an organization. If financial executives can accomplish this, they will find that creating compliance program efficiency is a much easier task.

The complexities associated with delivering products and services in a cost-effective manner—while simultaneously managing the risk associated with noncompliance—can be a daunting task. To relieve some risk and reduce cost, an important first step is to ensure that all disciplines communicate in a similar manner. The next step is to evaluate the following questions that need affirmative answers:

- Has the company established a vision for compliance and its role within the organization?
- How does the company coordinate its compliance efforts?
- Are the roles and responsibilities understood clearly?
- Are the compliance efforts aligned with the organization's size, scale, complexity, etc.?

NO ONE SIZE FITS ALL

Compliance requirements have evolved over time. As a result, many companies have addressed the design and implementation of solutions in a series of one-off initiatives. In a perfect world, the landscape for regulation would be stable, and guidance for what is required would be clear. Because this isn't the case, it's critical that organizations evaluate their present-state capabilities to determine if the cost of compliance is appropriate.

For many of them, looking between the lines at the division of responsibilities can result in efficiency gains and reduced costs. For example, the control environment mitigates the risk of inaccuracies and/or legal, regulatory, financial, and operational risk. If each control group performs a review of the control environment only from the point of view of the expertise they bring to the table, without communicating with one another, duplication arguably will occur.

Finding the sweet spot for investing in compliance programs and governance infrastructure certainly isn't an end-goal—it's a meaningful and necessary part of the fabric of how a company does business. Compliance and governance are the primary ingredients for a recipe to protect and enhance a company's reputation in the business community and the marketplace.

COST ESTIMATES IN THE SECURITIES INDUSTRY

In addition to understanding your business, providing a set of economic data that will put into perspective the compliance spend for a given industry will contribute to good decision making. This type of benchmarking is another ingredient to consider in the efforts to find your company's sweet spot.

Cost ($) – securities industry
2004 – $23.2B (estimate)
2005 – $25.5B (estimate)
2006 – $27.3B (estimate)
$6B to SOX
2007 – $28B (estimate)

Firms in the securities industry spent 13.1% (2005 estimate) of net revenue (gross revenue – interest expense) on compliance.

Large firms – 14.9%
Midsize firms – 17.5%
Small firms – 8.6%

A May 16, 2007, Financial Executives International (FEI) survey states that the total average cost for Section 404 compliance was $2.9 million during 2006 as opposed to the Securities & Exchange Commission's (SEC) original estimate of $91,000.

Knowing exactly how much to invest in these key areas is specific to each company and should be considered in the strategic plan. Given today's heightened regulatory environment, the importance of investing in compliance and governance has clearly become more of a priority. This investment decision, however, should be evaluated together with all other business decisions with a priority weighting correlated with the risk mitigation and reputational benefits. The investment decision is about actively assessing a company's business lines, knowing the company's governance and risk areas, and investing human and capital resources in the most critical areas. ■

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