Beyond Compliance: The

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Many companies complying with the Sarbanes-Oxley Act (SOX) focus primarily on effective internal controls and reliable financial reporting. Addressing only these aspects, however, leaves most of the value on the table. By putting the spotlight on the broader definition of internal control, which includes effectiveness and efficiency of operations, evidence suggests that companies can make compliance with SOX, particularly Section 404, more of a value proposition. Our research examines the additional value that public and nonpublic entities have extracted from compliance with SOX and SOX-related procedures.

Unintended but Beneficial Consequences for Public Companies

In 2002, Congress passed SOX to address declining confidence in the marketplace following multiple high-profile accounting scandals. Because SOX Section 404 significantly increased the depth and breadth of internal control evidence that auditors must evaluate, the Act quickly became one of the most costly accounting-related laws in history. The popular press and research studies have described the tremendous costs of SOX compliance for public companies. The high costs, coupled with a lack of clear implementation guidance, caused widespread resistance among publicly traded companies and quickly made the legislation unpopular.

Despite the negative reaction to SOX compliance costs, anecdotal evidence suggests that once they experienced benefits beyond mere compliance, companies adjusted to the new standards and regulations imposed upon them. Since 2004, when the first companies began complying with SOX, the focus has been on documenting, testing, and remediating internal controls. For the most part, public companies rushed to determine what controls to test, how much to test, what to document, and what would satisfy their auditors for remediation purposes.

Some articles, however, suggest that other companies have been able to look beyond compliance and frame SOX compliance as an ongoing, value-added process. Doing so has enabled them to unlock valuable informa-

Value of SOX

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tion and allowed for quicker, more insightful decision making. Pursuing SOX-related benefits has helped some companies achieve strategic goals and analyze performance more effectively and efficiently. Companies that view SOX as more than required legislation or an annual repetitive exercise have used it as a stepping stone to achieve comprehensive improvements in performance by standardizing and upgrading processes. While hard evidence is lacking, additional benefits may include the elimination of duplicative processes, greater individual responsibility and employee empowerment, a reduction in inconsistent data, less "paper shuffling," and increased transparency of reported information.

Nonpublic Companies Jump Onboard

While SOX compliance is required for public companies, many nonpublic companies and government entities have voluntarily implemented comparable procedures (see "Flirting with SOX 404: Are Private Companies Interested in a Relationship?" in the September 2007 *Strategic Finance*). For instance, the federal government has mandated risk management and internal control standards similar to SOX that could affect state governments through new federal grant program regulations.

At least two states have already begun to enact SOX-type standards. In 2007, North Carolina passed legislation 143D-2, the State Governmental Accountability and Internal Control Act, to ensure a strong and effective internal control system within state government and to clearly indicate responsibilities related to internal controls. As such, the EAGLE program (Enhancing Accountability in Government through Leadership and Education) reflects the depth, breadth, and guidelines found in SOX 404 and its related audit guidance. According to Ben McLawhorn, risk mitigation services manager of the North Carolina Office of the State Controller, "The EAGLE program resulted from the actions taken by the North Carolina general assembly and utilizes a top-down, risk-based methodology to assess internal controls across state government."

Likewise, in 2006, the Commonwealth of Virginia's Department of Accounts issued Comptroller's Directive

No. 1-07, Agency Risk Management and Internal Control Standards (ARMICS), as part of the SOX "trickle-down effect." According to a memo from the comptroller, "Each year agency heads certify to my office, and to the Auditor of Public Accounts, that you have established, maintained and evaluated your agencies' internal control framework. These new standards establish the basis against which your annual certifications will be measured." In addition to government, industry groups such as the National Association of Insurance Commissioners (NAIC) and experts in healthcare have also discussed whether and how private companies should adopt SOX. These findings show that while SOX adoption isn't mandated for nonpublic entities, some have taken the initiative and applied SOX-based concepts and recommendations.

Since prior articles have focused on recognizing and evaluating improvements in internal control related to SOX compliance, we know little about if and how SOX adds value beyond internal control enhancements. Institutional Shareholder Services (ISS) conducted one study that revealed more than 60% of 153 managers and directors believed that SOX has had a positive impact on their companies (see "The Value Proposition: There's More to Sarbanes-Oxley Compliance than Meets the Eye" in the September 2005 *Journal of Accountancy*), but the study didn't document or analyze any specific benefits. We examine the benefits both public and nonpublic organizations have experienced by improving internal controls, specifically those related to improving the financial reporting and external/internal audit processes, automating manual controls, reducing nonvalue-added work, eliminating human resource costs, and improving overall operations.

Description of Survey Respondents

To obtain data for our study, the Institute of Management Accountants (IMA®) sent e-mails to its members with accounting-related job titles. Of the 2,284 e-mails received and opened, 330 members began the survey, and 273 finished it. Our sample consisted of 45% (124) from public firms and 55% (149) from nonpublic (i.e., private, nonprofit, and governmental) entities. The sample represents a wide range of industries (see Table 1), with the largest percentage (36%) from manufacturing, as well as information from both large and small organizations (see Table 2). Respondents held various accounting-related job titles, with accounting manager (26%) and controller (23%) comprising the largest groups.

Nonpublic Companies Report Greater Benefits

For the most recent fiscal year-end, we examined nine measures of value-added SOX 404 outcomes for public companies and, for nonpublic organizations, improve-

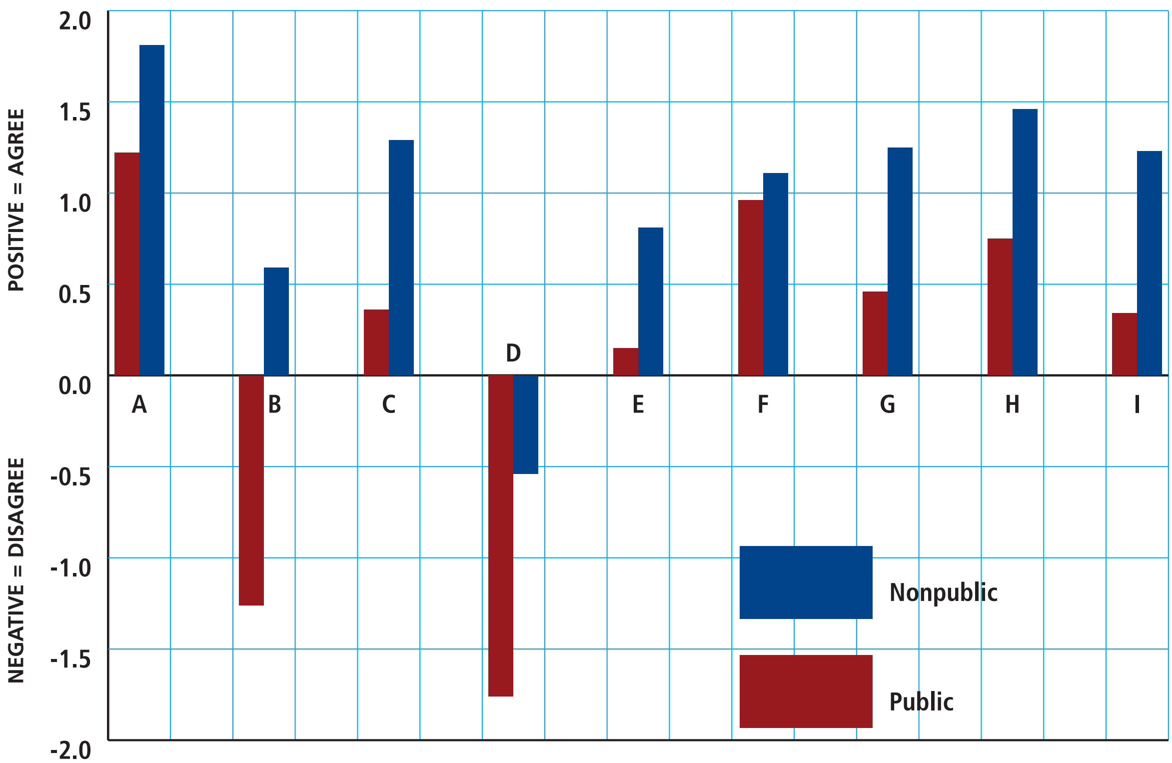
Table 1: Respondents' Industries

	NONPUBLIC	PUBLIC	TOTAL	PERCENTAGE OF TOTAL
Manufacturing	43	55	98	36%
Retail/wholesale/distribution	9	5	14	5
High-tech	5	10	15	5
Government/nonprofit	19	1	20	8
Telecom/transportation/utilities	9	9	18	7
Healthcare	11	2	13	5
Financial services/insurance	10	9	19	7
Construction/mining/agriculture	10	5	15	5
Other services	14	8	22	8
Other	19	20	39	14
Total	149	124	273	100%

Table 2: Number of Employees in Respondents' Organizations

	NONPUBLIC	PUBLIC	TOTAL	PERCENTAGE OF TOTAL
Under 100 employees	51	5	56	21%
101-250	20	5	25	9
251-500	26	7	33	12
501-1,000	13	5	18	6
1,001-2,500	11	8	19	7
2,501-5,000	16	13	29	11
5,001-10,000	5	16	21	8
>10,000	6	65	71	26
Total	148	124	272	100%

Figure 1: **Value-Added Outcomes**



SOX (or Internal Control Improvements) helped my company:

A Improve financial accounting processes
B Reduce nonvalue-added work
C Improve operations overall
D Eliminate human resource costs
E Automate manual controls
F Make internal audit processes more effective
G Make internal audit processes more efficient
H Make external audit processes more effective
I Make external audit processes more efficient

ments attributed to improved internal controls (IC). Figure 1 shows the results. On the X-axis lie the nine specific benefits linked to value added from internal controls. Public company respondents completed the following statement using items A through I in Figure 1: "SOX 404 helped my company ________." They responded on a scale of –4 to +4, where –4 = strongly disagree, –2 = disagree, 0 = neutral, 2 = agree, and 4 = strongly agree. Nonpublic companies responded to the question, "Effective internal controls over financial reporting have helped my company ________" on the same scale. Table 3 includes means for each benefit, categorized by company type. For every item (A to I), the average response was between –2 and +2, effectively reducing our scale to a five-point scale. Thus, on average, we didn't observe extreme responses from IMA members.

Value-Added Attributed to SOX

For most areas under examination, both public and nonpublic organizations experienced improvements as a byproduct of SOX Section 404 activities or, for nonpublic companies, improving internal controls. Neither public nor nonpublic entities, however, credited these activities with reducing human resource costs. Research has suggested that SOX 404 compliance has improved processes, broadened employees' job responsibilities, eliminated duplicate activities, and automated manual controls. These changes should all lead to workforce reductions, but it's likely that heightened internal control concerns have led to increased human resource levels post-SOX. (Note that this data was collected prior to fall 2008, i.e., before the current recession. Thus, wide-scale layoffs weren't occurring at the time.)

Table 3: Effect of SOX (Internal Controls Improvements) on Public and Nonpublic Companies, Means* and Differences

OUTCOMES FOR: SOX/IC HELPED MY COMPANY…	PUBLIC COMPANY	NONPUBLIC COMPANY	STATISTICALLY SIGNIFICANT AT .05 LEVEL
Make internal audit processes more efficient	.46	1.25	Yes
Reduce nonvalue-added work	–1.26	.59	Yes
Improve operations overall	.36	1.29	Yes
Eliminate human resource costs no longer necessary	–1.76	–.54	Yes
Make external audit processes more efficient	.34	1.23	Yes
Improve financial accounting processes, including financial close activities	1.22	1.81	No
Make external audit processes more effective	.75	1.46	No

*Measured on a scale from –4 to +4 where –4 = strongly disagree, –2 = disagree, 0 = neutral, 2 = agree, and 4 = strongly agree.

Upon further analysis, we find differences in *the extent* to which SOX helped public vs. nonpublic companies improve internal controls (Table 3). In certain areas, nonpublic entities reported *significantly higher* benefits than public companies did, but, in other areas, there were no significant differences. Overall, both public and nonpublic entities saw improvements in financial accounting business processes. To a lesser extent, both types of organizations also reported improvements in the automation of manual controls.

Significant differences occur between public and nonpublic entities for three nonaudit areas. The greatest difference is in the reduction of nonvalue-added work. While nonpublic entities credited improvements in IC for reducing nonvalue-added work, public companies didn't. It appears that, to some extent, public companies viewed SOX 404 compliance as a burden, increasing nonvalue-added work. Nonpublic organizations saw IC improvement as an opportunity, and, by seeking to strengthen their internal control policies, they found more chances to streamline processes. IMA members from nonpublic entities also reported greater improvement in overall operations (e.g., manufacturing, sales, HR), and the difference is large. One explanation for this could be that since nonpublic entities aren't required to be in technical compliance with SOX, they can focus on controls that are most beneficial to them, thus ignoring less cost-effective controls.

Table 4: Prior Effectiveness of Internal Controls

PRIOR EFFECTIVENESS OF IC	NONPUBLIC	PUBLIC	TOTAL
Noneffective	6	0	6
Minimally effective	11	6	17
Moderately effective	16	10	26
Very effective	36	36	72
Extremely effective	5	12	17
Total	74	64	138*
Mean	5.7**	6.9**	6.2

*Total is less than 247 because of nonresponses.

**Means are significantly different at .05 level.

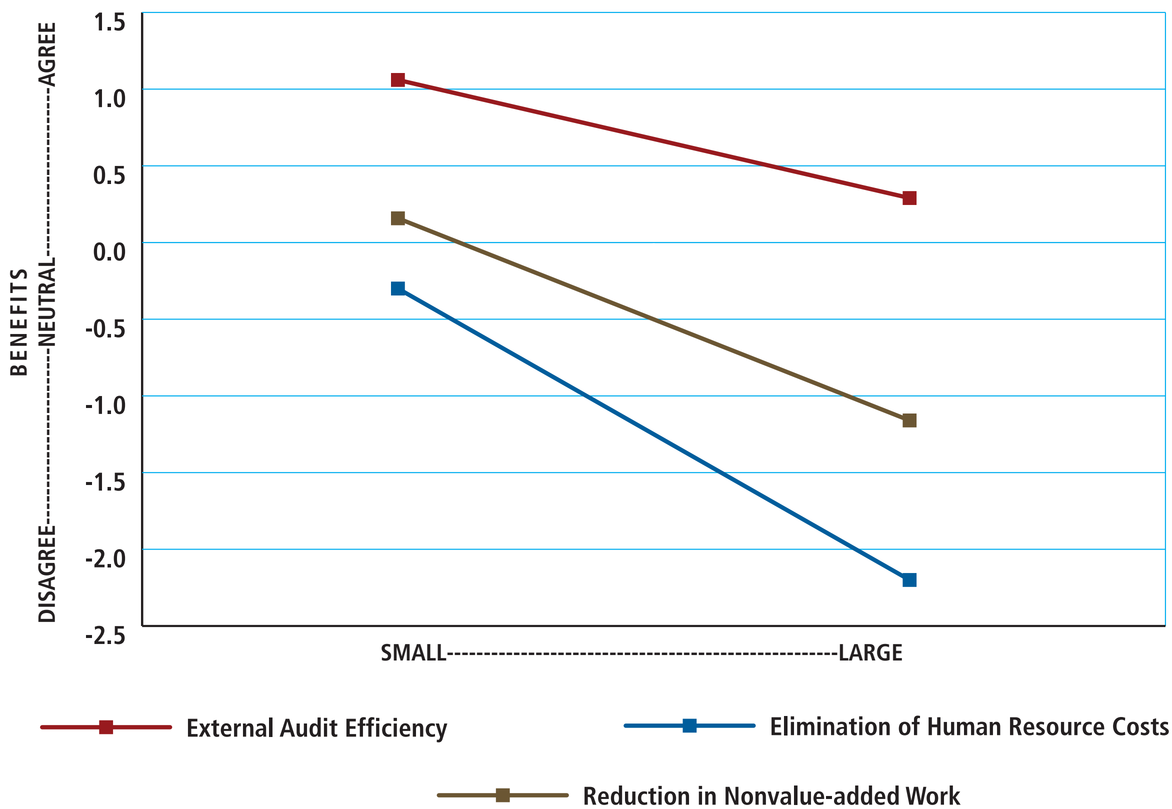
Smaller Companies Report Greater Benefits

In addition to collecting data on whether an entity is public or nonpublic, we benchmarked the prior effectiveness of internal controls before the SOX mandate or, for nonpublic entities, prior to 2002 (see Table 4). IMA members responded to the question "Assess your company's effectiveness of internal controls prior to 2002" on a scale of 1 to 9, where 1 = noneffective, 5 = moderately effective, and 9 = extremely effective.

Table 4 reveals that, on average, both public and nonpublic entities felt they had moderately effective internal controls prior to SOX. Public companies, however, rated the prior effectiveness of their controls significantly higher than did nonpublic companies (6.9 vs. 5.7). This measure may help explain why nonpublic entities attributed greater benefits to tightening of internal controls after SOX. Nonpublic organizations had greater room for improvement, and, in turn, it appears they voluntarily improved controls in areas where the return on investment would be highest.

As previously noted, we measured firm size in terms

Figure 2: Relationship of Internal Audit Staff Size to SOX (IC) Benefits



of number of employees (see Table 2). Combining data from public and private entities, we found interesting results when we explored SOX benefits as they relate to firm size. As Figure 2 shows, small firms reported greater benefits from SOX implementation in eliminating human resource costs. Smaller firms also reported greater reductions in nonvalue-added work and improvements in external audit efficiency compared to large firms. Again, a consistent finding is that organizations with room to grow (smaller firms) and need for improvement experienced the greatest benefits from SOX-related activities.

The Value Proposition

While public companies must comply with SOX, the reforms of the law have begun to affect the way private entities address internal control and corporate governance issues. Private companies have found that they have something to gain by embracing the spirit, if not the letter, of SOX. It appears that nonpublic entities are taking advantage of their internal control initiatives to improve their organizations by reducing nonvalue-added work and improving operations. Neither public nor nonpublic entities found that SOX translated to a reduction in human resource costs. Both types of organizations reported that internal audit and financial reporting processes were more efficient because of SOX-related activities. After implementing SOX 404-like improvements, nonpublic entities had greater external audit efficiencies. Overall, the results from our survey show an upbeat view of improvements in internal controls—*that value is more than just compliance.* **SF**

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