



# The **CORPORATE COMPLIANCE** & **REGULATORY** *Newsletter*™

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## **SOX Changes the Ink from Red to Black**

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In the last year and a half, public companies have been entrenched in their compliance or plan to comply with the Sarbanes-Oxley Act of 2002 (SOX). Regardless of the size, industry or profitability of the company, this task is proving to be much more consuming than originally thought. The first surveys of direct costs associated with compliance indicate a flow of red ink in the billions. The indirect cost may, by all accounts, be just as large. Do these staggering costs have any benefit other than compliance and therefore survival?

SOX has been characterized by many as a hastily prepared, poorly written piece of legislation. Most agree some reform was necessary after the revelation of the alleged and acknowledged misconduct by and systematic failures of several corporations and their advisers. However, the sweeping, all-inclusive nature of the most significant change in securities regulation in 50 years is all but overwhelming to many public companies. While SOX was intended to restore faith in the capital markets and is supported by many, it is not without its criticisms.

Much of this criticism centers on the blanket application of the law to every public company no matter the size. This one-size-fits-all approach is potentially damaging to the financial well-being of the small and micro cap company. The burden of compliance on the organization as well as the actual out-of-pocket costs imposed on these companies may be disproportionate to the benefits derived.

### **COSTS AND BENEFITS**

The costs and benefits are quite different depending on market capitalization (Market capitalization can be defined as: large cap — capitalization greater than \$2.0 billion; mid cap — capitalization from \$1.0 billion to \$2.0 billion; small cap — capitalization from \$200 million to \$1.0 billion; micro cap — capitalization under \$200 million).

- **Large cap & Mid Cap Companies:** While these companies will see the largest increase in the cost of being public in dollar terms, they are able to absorb the additional costs better than smaller companies.
- **Small Cap and Micro Cap Companies:** The increase in cost will fall disproportionately on small cap and micro cap companies, which may not be able to absorb the costs. This could result in small companies either going out of business or executing a going private transaction, which requires still another cost/benefit analysis.

### **Costs Associated with the Audit**

Prior to the implementation of the new SOX independence rules, auditors were deriving significant revenues from many of their audit clients by providing many services now prohibited. This had the effect of significant competition among the audit firms to acquire the audit client, which acted as the entrée to providing these additional services. It also resulted in the audit firms greatly reducing the price of the audit in order to gain the entrée for the firm's other services.

According to Financial Executives International, fee increases are expected to differ based on the size of the company (See, [www.fe.org/news/404\\_survey.cfm](http://www.fe.org/news/404_survey.cfm)). For the largest companies in the survey, the companies estimate that they will have an average increase in audit fees of \$1.5 million, or 35.0%, while companies that are between \$500 million and \$1.0 billion estimate an increase in audit fees of \$272,000, or 39.0%. Although statistics for micro cap companies were not specifically compiled, it is expected that their audit fee increase in percentage terms will likely be higher than the small cap companies.

### **Costs Associated with the Board of Directors**

The provisions of SOX have shaken the foundation of corporate governance for public companies and will likely have an impact on larger private businesses as well.

Foley & Lardner, LLP conducted a survey regarding the estimated costs of staying public in the post-SOX era (Foley & Lardner, LLP, "The Increased Financial and Non-Financial Cost of Staying Public," 2003 National Directors Institute). The survey specifically addressed the issue of director compensation, and found that director's compensation increased from 2001 to 2002 as a result of SOX. Director fees increased 7.0% and 11.0% for small cap and mid cap companies, respectively. Foley & Lardner also reference a study done by Executive Compensation Consultants (ECC), which provides estimates that director compensation is likely to increase 20.0% to 50.0% due to increased scrutiny.

Directors and officers (D&O) insurance will be harder to find and for certain smaller companies it may be impossible to find. This may increase the potential cost to attract board members.

### **Costs Directly Associated with Sarbanes-Oxley Compliance**

A new service area has been created by SOX. Under section 404 of Sarbanes-Oxley, management is responsible for among other things establishing and maintaining internal controls and evaluating the effectiveness of the company's internal controls. These processes will require significant expense either for outside consultants or loss of productivity for those employees that are responsible for these activities internally. The cost lies primarily in the scrutiny that will result due to SOX's implementation.

### **Costs Associated with the Utilization of Outside Consultants**

Arthur Andersen's demise has increased the opportunity for other accounting firms to receive revenue as third party consultants for SOX 404 compliance. The irony of this outsourcing is that the largest players, the big four and other national and large regional accounting firms, will realize hundreds of millions of dollars of revenue from increased audit and consulting fees. These fees stem from a law that was largely a reaction to the Andersen-Enron scandal.

Financial consulting work, which auditors previously provided, will now be performed by outside consultants, primarily different audit firms. The start-up cost associated with engaging consultants who have never worked for the company before will be high because the consultant will have to do the initial research in order to perform the required services. The recurring costs are likely to decrease over time as a result of the learning curve. Consultants who work closely with a company over a period of years will gain a deeper understanding of their clients and be able to perform their services with increased efficiency.

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### **Costs Associated with Training, Human Resource Development, and Culture**

Deloitte and Touche addresses the cultural costs and their relative importance with this statement, "An approach to Sarbanes-Oxley that neglects the organizational culture — a key element of the overall 'control environment' — is one with little likelihood of success." (Deloitte & Touche, "Deloitte's Point of View: Sarbanes-Oxley Compliance — A Bridge to Excellence," p. 5, 2004).

The cost associated with training, development of human resources, and this cultural tone will vary depending on the organization, but is still a consideration the company must make when determining how it will meet its goals regarding compliance.

It is clear that even minimum compliance will be costly and may ensure survival but focusing on minimum compliance means that a company is less likely to realize any of the potential benefits available from a more diligent effort. When companies embrace these regulations as a value added exercise they can potentially realize benefits in excess of the costs.

### **Benefits of Improved Training, HR Development, and Culture**

The benefits associated with the improved culture are difficult to quantify. It is expected that these benefits will provide a fairly rapid return on their compliance dollar and will continue into the future. Clearly, companies that are largely in compliance to begin with will not receive much benefit; however, they will incur little cost. This attitude can only come from a positive "tone at the top" that sends a message and creates a culture that is conducive to adding value rather than mere compliance. Out of the new culture and new training, one immediate benefit is the creation of a positive attitude that will facilitate adjustment to the new systems without disgruntlement. The positive tone set by management, if successful, will likely result in the employees buying in and committing to the new culture, and the ensuing changes will potentially reduce the need for outside consultants.

Complete documentation of business systems allows for efficient cross-

training, which will reduce downtime and future training cost for new employees and create a better trained workforce. Implementing new systems and documentation of the existing systems will lead to employees that are better trained, more efficient, and more satisfied in their workplace. Employees who understand their job or are provided guidelines in how to perform that job, and are given the appropriate tools to accomplish their tasks are happier. This environment will naturally lead to lower employee turnover, which for many companies is a major expense.

### **Benefits of Improved Corporate Governance**

SOX and the stock exchange rule changes have all but eliminated the "good-old-boy network." There is unlikely to be drive-by audit committee meetings. Appointment to a Board will be taken as serious as any assignment a business professional has ever undertaken. A post-SOX Board is likely to be well structured, well trained, diligent, and cognizant of the accountability and scrutiny it will be subjected to. As Martha Stewart would say, "This is a good thing."

Boards of this caliber will provide better direction, better decision-making, restoration of investor confidence, and renewed faith in the capital markets. Moreover, good corporate governance translates into higher shareholder value. As illustrated by Institutional Shareholders Services' (ISS) survey, companies with better corporate governance are more likely to perform better than companies with worse corporate governance. ISS focuses on the following four areas when examining a company's corporate governance:

- Board composition;
- Board compensation;
- Takeover defense; and
- The audit.

Of these four areas, ISS places the most emphasis on Board composition and compensation. ISS focuses on many measures of company performance; however, for the purposes of this discussion, we have focused on the 5-year stock price returns, share price volatility, and return on equity.

Companies with the best corporate governance have 5-year returns that

are 7.91% above the industry adjusted average while companies with the worst corporate governance are 3.95% below the industry-adjusted average. Those with the best corporate governance have a share price volatility that is 5.63% below the industry-adjusted average while firms with the worst corporate governance are 6.20% above the industry-adjusted average. Firms with the best corporate governance have a return on equity that is 18.98% above the industry-adjusted average while companies with the worst corporate governance are 4.86% below the industry-adjusted average. Although deviations are to be expected from the study, the ISS findings are probably indicative of reality.

Corporate governance as an indication of financial performance and company well-being has been in the forefront of the news with the recent no-confidence vote for Michael Eisner as Disney chairman. In bowing down to the shareholder vote, the Board instead voted George Mitchell as chairman, even though he received the second highest no-confidence vote.

Disney is known for not having good governance. ISS notes that although Disney has "improved its governance in recent months ... reform, like the company's improved financial condition, has come in fits and starts." (Institutional Shareholder Services, "ISS Reiterates its Position on the Upcoming Annual Election at the Walt Disney Company," Feb. 11, 2004). In determining whether Disney's corporate governance has any financial impact, we have com-

pared its 10-year average return with IBM and General Electric, which are known for their good corporate governance. These companies both have a 10-year average return of over 20.0%, while Disney has a 10-year average return of 7.0%. Although other factors have an impact on stock returns, corporate governance is certain to have an impact on the performance of a company's stock.

Our ideal post-SOX company has the highest ISS rating for corporate governance, a well-trained workforce, well-documented business systems, and a culture that is focused on the ethical conduct of their business. Over the long run, this will most likely result in lower audit fees, less reliance on outside consultants, and lower system maintenance cost. The return on investment, in regards to compliance, will ultimately depend on the company.

#### CONCLUSION

The impact of SOX and other regulations that resulted from the Andersen-Enron scandals will have disproportionate impacts depending on the size of the company. Large cap companies most likely already have some of the required systems in place and will have the least adjustment to make. Although they will face the highest costs in absolute dollars, it is a smaller percentage of revenue and profits than smaller companies, and they are better able to absorb these costs. However, due to the efficiencies that are already in place for larger companies, the benefits they will realize are likely to be less than the smaller companies that survive the reforms.

Small and micro cap companies will face a heavier burden for compliance than their larger counterparts. Small and micro cap companies most likely do not have these systems in place, and will have the largest adjustment to make in order to comply. Smaller companies will face high initial compliance costs due to the nature of the changes they are likely to require. However, small companies stand to benefit the most from realized efficiencies and improved business systems.

Small cap companies stand to gain the most benefit relative to the costs they incur due to their ability to absorb the additional costs. Micro cap companies, however, face a unique situation. Micro cap companies are less able to absorb the initial costs, and are likely to avoid compliance altogether either by going private, or worse, going under due to the daunting task they face in meeting the regulations. How will companies end up after the dust settles? Management and the Board of Directors will determine whether a company embraces the changes and makes the best out of a tough situation, or resists the changes and face the consequences of denial.



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