The Compliance Chasm

RevenueRecognition.com

Revenue Management Resources for Today's Financial Executive

FINANCIAL EXECUTIVE BENCHMARKING SURVEY

Sarbanes-Oxley Edition

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EXECUTIVE SUMMARY

RevenueRecognition.com in association with International Data Corporation (IDC) recently surveyed 220 business leaders about the cost and effectiveness of Sarbanes-Oxley compliance activities. The survey was conducted by email and all responses were on an anonymous basis. More than 75% of respondents are CFOs, Controllers, senior finance executives, and compliance leaders. Approximately half are from companies with more than $200 million in revenue, 20% are from companies with more than $1 billion.

Key Findings:

- A Sarbanes-Oxley "compliance chasm" must be crossed before costs are offset by effectiveness
- Public companies with more than $1 billion in revenue incurred an average of $3.7 million in labor costs. The top 10% averaged $9.4 million — the highest was more than $20 million.
- The cost of external auditing services increased 52% for public companies, but mid-sized companies with $200 million to $1 billion in revenue reported an 81% average increase.
- The relative cost and effectiveness ratings of specific Sarbanes-Oxley 404 and 302 compliance tasks were approximately even with two exceptions:
    - The cost of documenting internal controls was rated significantly higher than the effectiveness of doing so; and
    - The effectiveness of remediation of weaknesses found was rated significantly higher than the costs involved.
- Revenue accounting far outweighed other factors as the financial process that presents the most risk of restating financial results.
- 83% of respondents from public companies indicated that they plan to deploy or evaluate solutions for one or more revenue management processes in 2005.

SARBOX COMPLIANCE COSTS

Complying with Sarbox is a major undertaking at many companies, and this survey examines the first full year of compliance initiatives which have been dominated by Sarbox 404 activities.

As shown in Figure 1, the personnel requirements for Sarbox compliance activities increased in direct proportion to the size of organization based upon revenue. For public enterprises with more than $1 billion in revenue, the average amount of labor spent on compliance was approximately twelve person-years. Outside consulting services from Big 4 and non-Big 4 audit firms contributed three of those person-years. Companies in the $200 million to $1 billion revenue range averaged six and a half person-years of effort with a year and a half of outside consulting.

In dollar terms, we applied average market costs to the hours spent on compliance activities. The resulting average labor costs for public companies by size category are shown in Table 1. Companies with more than $1 billion in revenue averaged $3.7 million in total estimated labor cost. However, for some companies labor costs were much more significant. The average among the top 10% was $9.4 million; the highest was more than $20 million.

Figure 1
Labor Cost of Sarbox Compliance at Public Companies:
Average Person-Years (n=95)

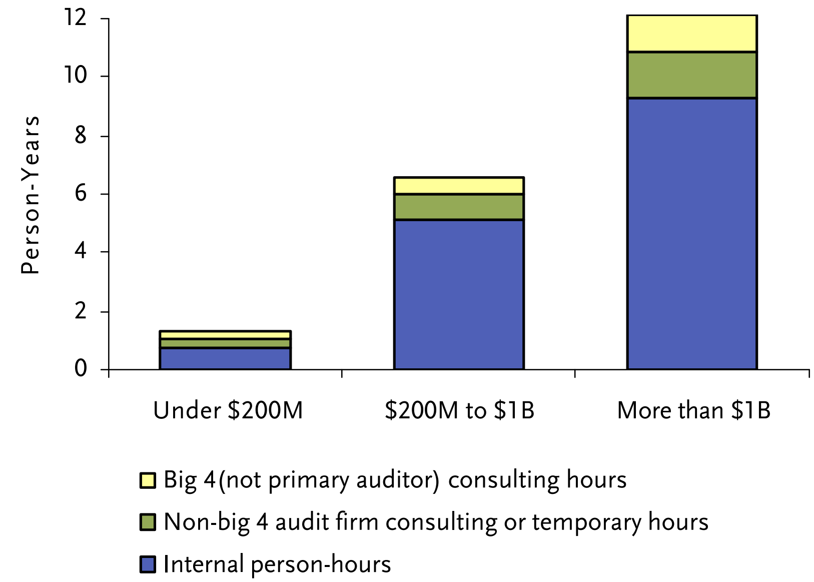


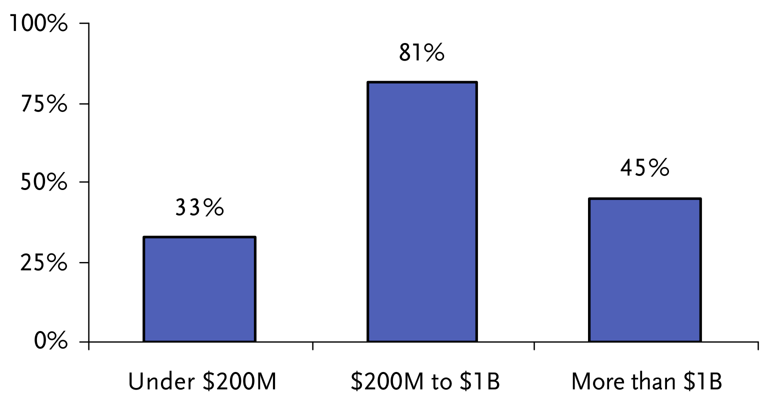
Table 1
Labor Cost of Sarbox Compliance at Public Companies:
Average Dollar Cost by Revenue (n=95)

	Average Cost in Millions
More than $1 billion	$3.7
$200 million to $1 billion	$1.6
Less than $200 million	$0.5

COSTS CONTINUED

While labor costs were distributed in proportion to revenue across size categories, increases in external audit fees were significantly out of balance, as illustrated in Figure 2. The overall average increase in external auditor fees for public companies was 52%. But public companies in the middle revenue bracket got walloped with an 81% average increase. If the distribution was as balanced as overall labor costs, the mid-size segment should have only experienced a 39% average increase.

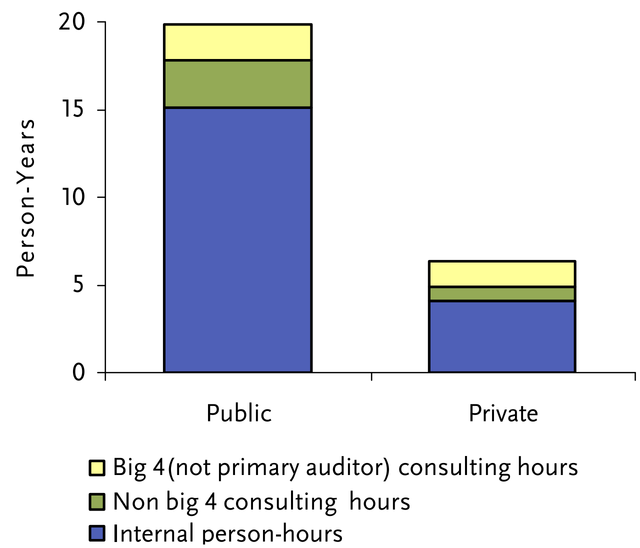
Figure 2
Cost of Sarbanes-Oxley Compliance for Public Companies:
Average Percent Increase in External Audit Fees (n=95)



As depicted in Figure 3, Sarbox clearly has had an impact on private enterprises who incurred, on average 32% of the labor costs of public companies. Private companies needed to make changes in their financial practices because the impact of Sarbox trickles down to them in the form of heightened standards for raising capital, going public, and M&A. As a result, many private companies must now operate as if they were public and bear the associated burden for compliance.

Interestingly, the largest public and private enterprises reported virtual parity on the cost of Big 4 consulting hours. Some of the explanation for this may be that mergers and acquisitions activity that is frequently a growth driver for the very largest enterprises subjects them to similar level of scrutiny and therefore, similar needs for Big 4 auditing services.

Figure 3
Labor Cost of Sarbanes-Oxley Compliance:
Person-Years, Public vs. Private (n=95)



COSTS AND EFFECTIVENESS

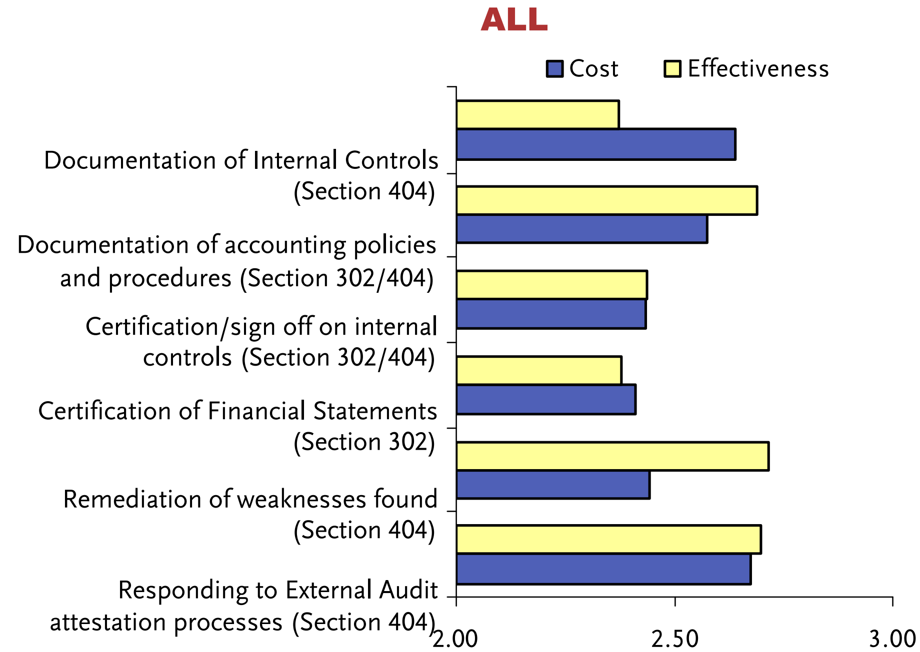
We asked respondents to rate the cost of six major Sarbanes-Oxley compliance tasks, as well the effectiveness of those tasks for improving risk management, using a four-point scale with 1 being least costly and 4 being most costly. The results are shown in Figure 4.

The overall average was 2.5 for both the cost and the effectiveness. The range of average scores was also essentially identical from 2.4 to 2.7. However there were two activities in which significant discrepancies occurred:

> 1) The cost of documenting internal controls was rated significantly higher than the effectiveness of doing so;
> and
> 2) The effectiveness of the remediation of weaknesses was rated significantly higher than the costs involved.

A clear sign that public companies are seeing value in Sarbox is that they gave the highest effectiveness ratings to remediation of weaknesses found (2.8) and responding to external audit attestation processes (2.7), two key mandates of Section 404 that have caused a great deal of debate and expense. Overall, public companies ranked costs at 2.57 and effectiveness at 2.51—close enough to call it even.

Figure 4
Please rate the cost of compliance and the effectiveness of improving risk management for the following Sarbanes-Oxley activities. (n=220)



THE COMPLIANCE CHASM

While the overall cost and effectiveness ratings are equivalent, there is a distinct chasm between public companies whose average effectiveness ratings equaled or outweighed cost ratings, and those for whom average cost ratings outweighed effectiveness. We compared average cost and effectiveness ratings for each respondent using a scale on which zero means the ratings were equal; a negative result means costs outweighed effectiveness, and a positive result means effectiveness outweighed costs.

Figure 5
The Compliance Chasm
Sarbox Cost-Effectiveness Index
for Public Companies (n=79)

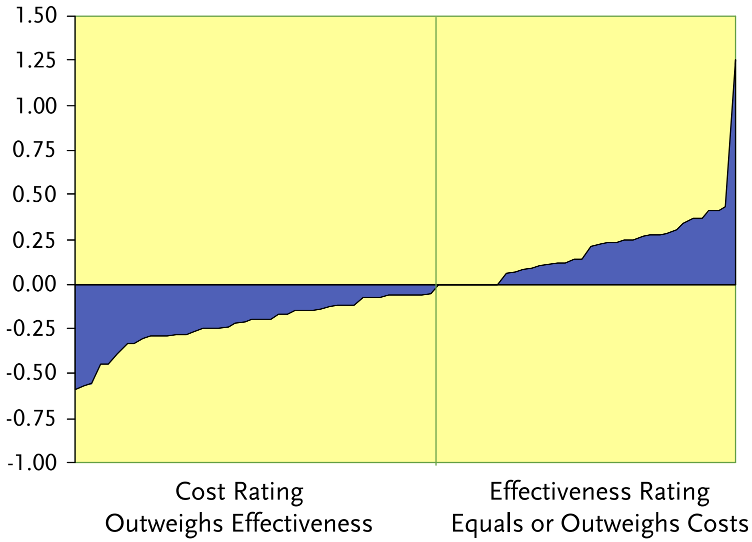


Figure 5 presents the cost-effectiveness indexes for 79 public companies. There are 43 companies to the left of the green line and 36 companies to the right. (Sixteen respondents did not provide enough data for this analysis.)

There are some key differences between these two groups. The group that did cross the compliance chasm required only 83% of the person-years and achieved more satisfactory results than the other group. This seems to indicate that they had a smaller gap between existing practices and those required by Sarbox. Their staffs were more focused on external auditing activities, a much smaller portion of the overall labor cost.

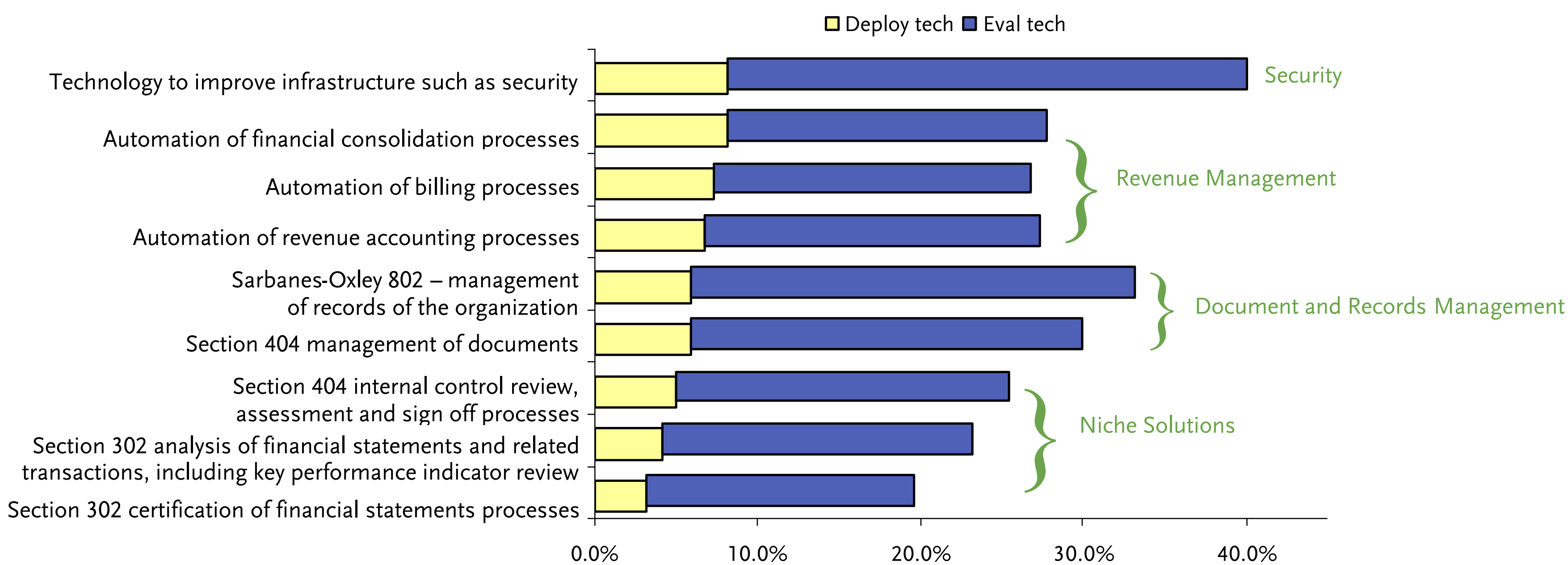
But there is more to the story. Surprisingly, those who crossed the chasm are actually less likely to keep their existing processes and technology in 2005. The key factor being that they are much more likely to deploy new technology for key compliance activities in 2005.

COMPLIANCE PROCESSES AND TECHNOLOGY

Sarbox requires constant vigilance over financial reporting processes that can extend throughout an enterprise. As a result it is no surprise to see that technology is playing a vital role in the compliance effort. Figure 6 ranks a number of technologies related to security, document management, and financial management in order of which are most likely to be deployed in 2005. Security tops the list both in terms of plans to deploy in 2005, and in terms of how many companies indicated that they are evaluating technology options with the intent to buy.

The next three technologies being deployed in 2005 are for automating financial consolidation, billing and revenue accounting processes. All three of these processes have direct impact on revenue, which is one of the areas under the most scrutiny. In fact, 83% of respondents from public companies indicated that they plan to deploy or evaluate at least one of these revenue management solutions in 2005. The next tier is document and records management solutions. The last three are niche solutions designed to support the analysis and approval of internal controls, financial transactions, and financial statement certification.

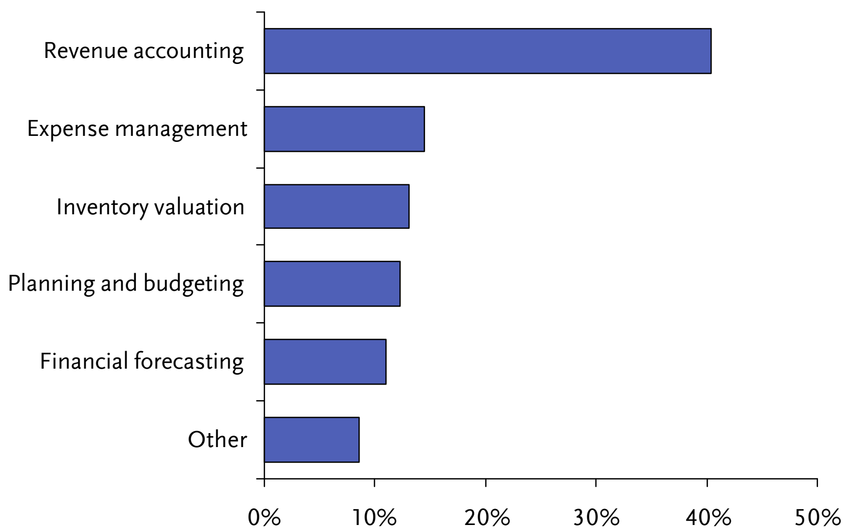
Figure 6
Plans for improving Sarbanes-Oxley processes using technology
at public and private companies in 2005. (n=220)



COMPLIANCE PROCESSES AND TECHNOLOGY (CONTINUED)

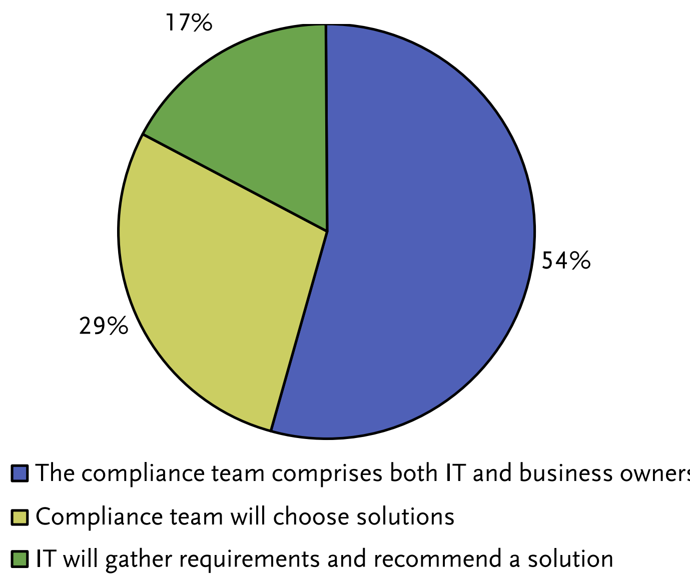
Further evidence of the critical nature of revenue management processes is found in Figure 7. Revenue accounting is rated by a wide margin as presenting the most risk of restating financial results—approximately 40% of respondents selected it, while none of the other processes received more than 15%. Of course revenue accounting has the most direct implications for Sarbox compliance and historically it is the primary reason for most financial restatements of public companies.

Figure 7
Which financial process presents the most risk of restating financial results within your organization? (n=220)



When deploying technology for compliance purposes, the majority of respondents assemble cross-functional teams that include both IT and business owners, as shown in Figure 8. This is a very well established and effective approach for the deployment of any type of technology solution, so it is no small surprise to see that at 29% of companies the compliance team alone is responsible for choosing solutions.

Figure 8
If considering technology to support Sarbanes-Oxley, what role does IT play? (n=220)

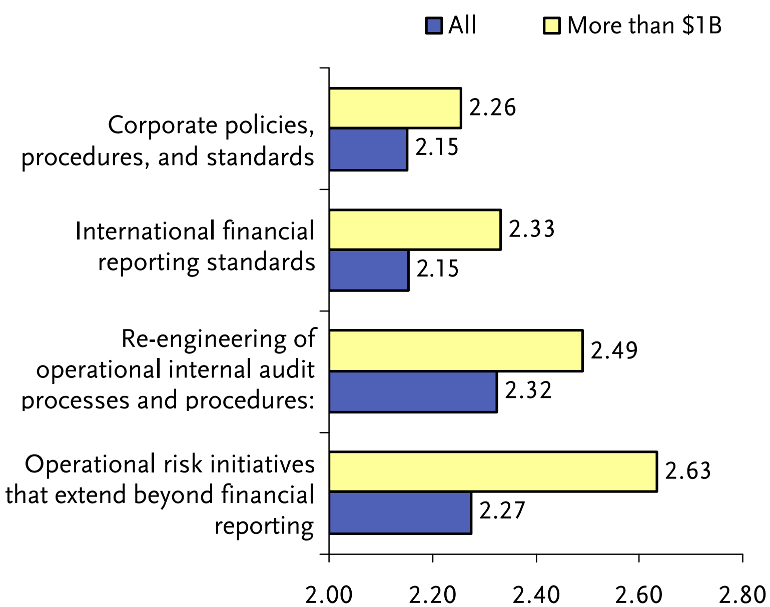


OTHER ISSUES

In general, few companies rated other issues such as reviewing corporate policies, international reporting, internal audit processes, or operational risk initiatives as being important to address within the scope of their Sarbox efforts. On a four point scale the overall average was only 2.2 (1=low, 2=medium, 3=high, 4=very high). However, companies with more than $1 billion in revenue ranked all of these issues much higher in importance, with operational risk initiatives being most important, as shown in Figure 9.

Figure 9

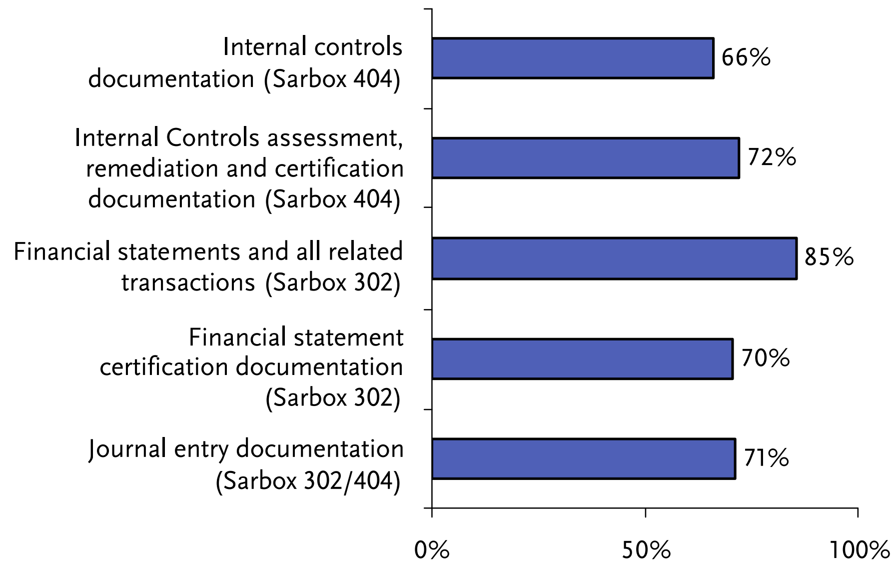
Please rate the importance of other issues that are being addressed within the scope of your Sarbanes-Oxley initiatives. (All: n=220, More than $1B: n=45)



Sarbox section 802 mandates that key corporate records be archived for seven years. However there is some discussion about what constitutes a key financial record. Most companies are taking a conservative approach and planning to retain many of the documents listed in Figure 10.

Figure 10

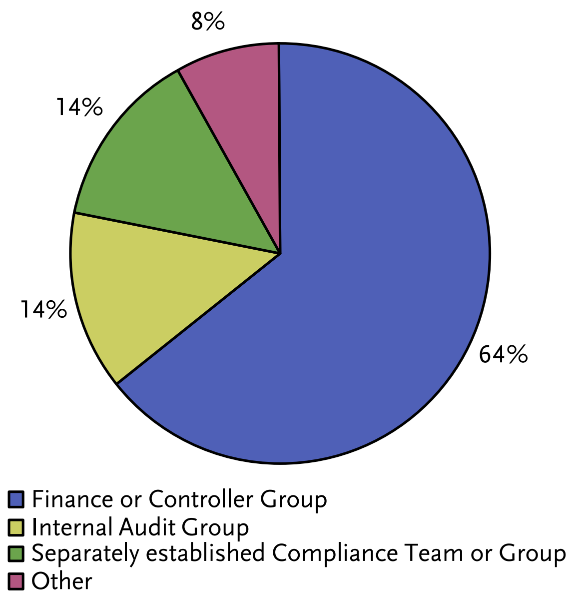
Which of the following do you consider records that must be managed under the 7-year retention requirement of Sarbanes-Oxley? (n=220, multiple responses accepted.)



THE ORGANIZATIONAL RESPONSE

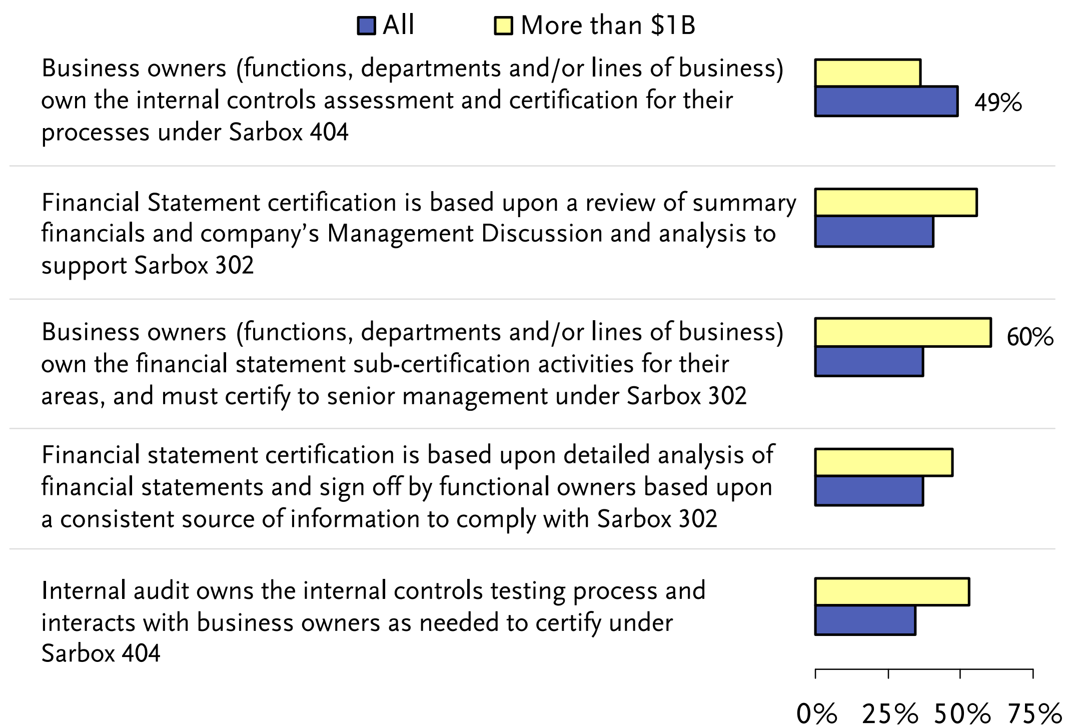
Sarbox is sweeping in scope and application. Complying with the mandates of sections 404 and 302 in particular necessitated an enterprise response directed from the highest levels. As illustrated in Figure 11, most companies placed primary ownership for their Sarbox initiatives within the finance or controller group. Companies with more than $1 billion in revenue were more likely to establish a dedicated compliance team (24%) or used their internal audit resources to lead the effort (16%).

Figure 11
Where does primary ownership for Sarbanes-Oxley initiatives reside in your organization? (n=220)



As shown in Figure 12, about half of all respondents indicated that certification is based on a review of summary financial statements. But companies with more than $1 billion in revenue are much more detailed and decentralized, 60% said business owners are responsible for financial statement sub-certification and must certify to senior management under Sarbox 302.

Figure 12
Are Sarbanes-Oxley processes performed centrally or are they decentralized? (n=220, multiple responses allowed)



COMPLIANCE AND PERFORMANCE

There is a great debate about whether all the costs of complying with Sarbox will result in payback for Corporate America above and beyond restoring faith in capital markets. Respondents were asked to rate their level of confidence that changes required by Sarbox will lead to improved business performance for publicly traded companies in the US. Using a four-point scale (1= very low, 2= low, 3 = high, and 4 = very high) the average was only 2.4 very close to the mid point of the scale. Despite this result, only 12% of respondents selected "Sarbox will have no impact."

Figure 13

What level of confidence do you have that changes required by Sarbanes-Oxley will lead to improved business performance for publicly traded companies in the US? (n=79)

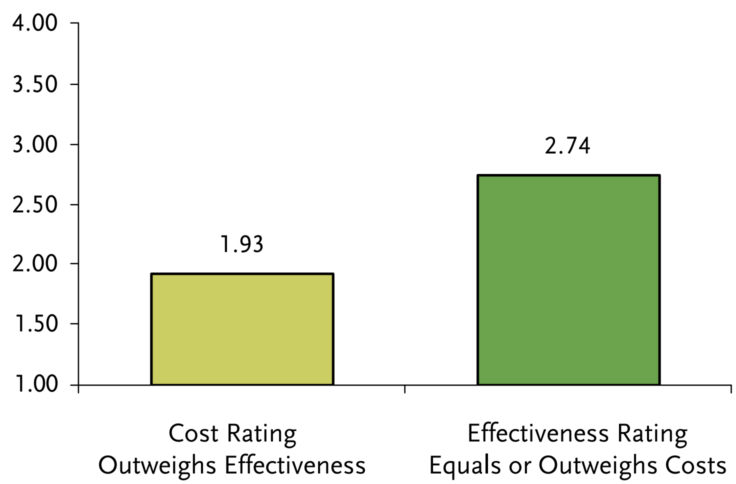


Figure 13 compares the results for public companies that crossed the compliance chasm and those that did not. The first group not only rated their costs lower and effectiveness higher, they are also most confident about the potential for performance improvements resulting from Sarbox compliance activities.

> "2004 was a baseline year for organizations to understand and execute on Sarbox section 404. Companies will now shift into sustainability mode, looking to optimize Sarbox processes through the use of technology and with an eye towards broader performance and risk management goals."
>
> **– Kathleen Wilhide, Compliance Research Director, IDC**

SUMMARY

Certainly compliance has been an expensive endeavor. But in general, respondents seemed to think the cost and effectiveness of Sarbox mandates were fairly equal. Over the long term, as the costs of achieving initial compliance recede, the new world of corporate governance may actually provide some payback for Corporate America. As technology is brought in to automate key compliance processes, particularly those related to revenue, the overall long-term costs should continue to decrease while risks of restatements and penalties are mitigated. Nevertheless, there appears to be a chasm between companies that have embraced the changes required by Sarbox and those that have not.

DEMOGRAPHICS

Figure 14
What is your title? (n=220)

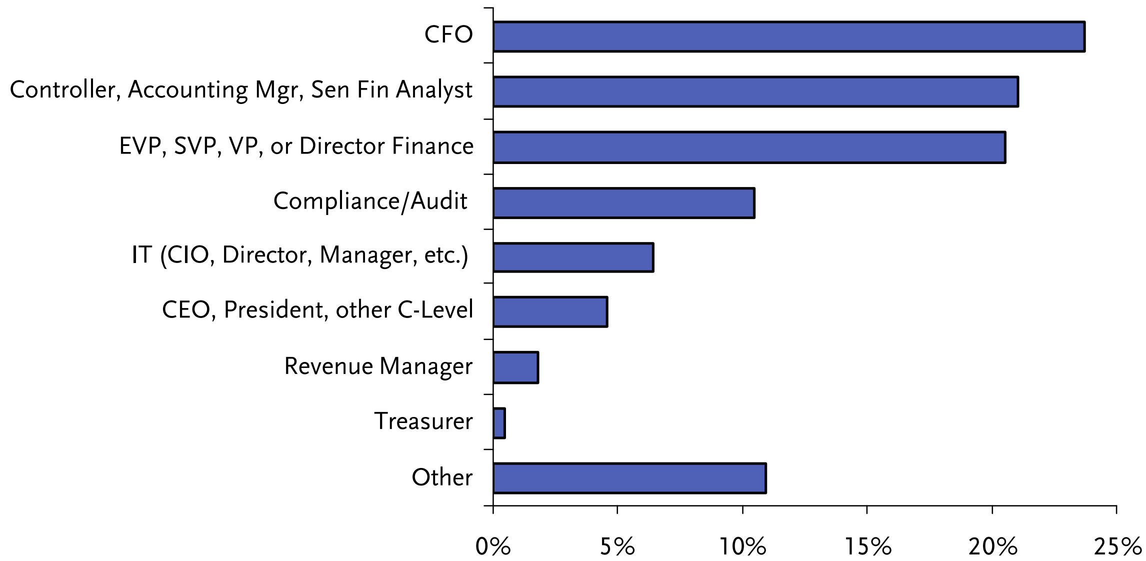


Figure 16
What is your annual revenue? (n=220)

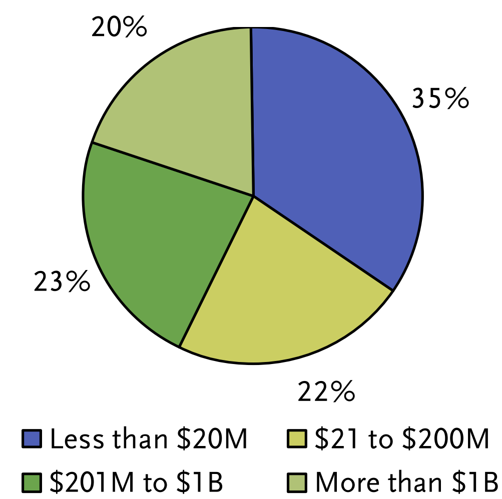


Figure 15
What is the ownership structure of your company? (n=220)

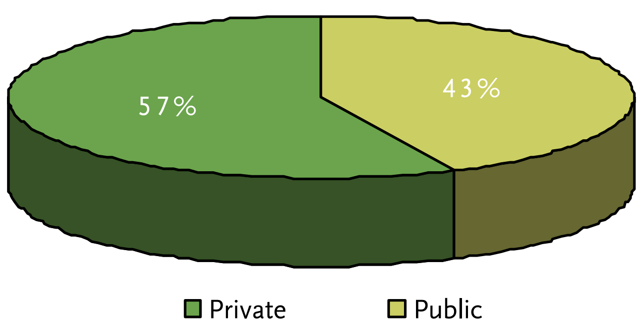
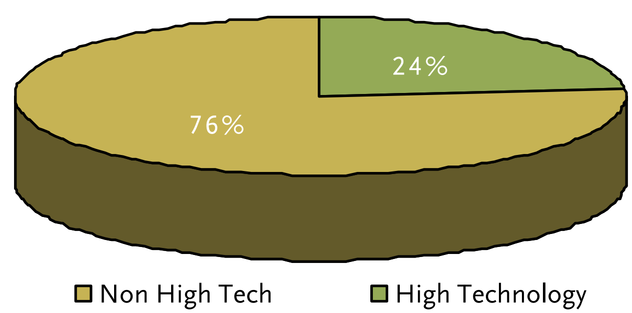


Figure 17
What is your company's main industry? (n=220)



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