

Chapter 1: Orientation

1.1 Introduction

Passed by the American Congress in 2002 in the wake of the Enron and WorldCom scandals, the Sarbanes-Oxley Act (SOX) requires companies whose stocks are traded publicly in the United States of America to vouch for accounting controls and disclose weaknesses to shareholders. Section 404 of the Act, which came into effect in November 2004, stipulates that such companies must have policies and controls in place to secure, document and process information dealing with their financial results and transactions.

1.2 The reasons for the Sarbanes-Oxley Act being brought into being

The well-publicised, fraudulent activities at Enron, Tyco, WorldCom and Global Crossing but to mention a few examples brought to the American public's attention the need for robust financial reporting which accurately reflected the state of a company's affairs. These firms all fell into financial difficulty as a result of fraudulent accounting practices and directors engaging in transactions clearly geared for their own interest and not the interest of the company. There was also widespread indignation and anger that the auditing firms involved in attesting to the validity of these firms financial results did not pick up the errors and/or fraudulent misstatements. The following headlines from newspapers, magazines and journals around the times of the mentioned scandals sum up the atmosphere in America the United States of America at the time:

- Financial Restatements Up Sharply. 2002. *New York Times*. 11 June
- Securities Suits Hit Record Total of 483 in 2001. 2002. *Wall Street Journal*. 10 June: C5
- If You Can't Believe the Auditors, Who Can You Believe?. *The Metro West Daily News*. 6 June.

In response to the public outcry the Senate Banking Committee undertook a series of 10 hearings over a six-week period. The lead panel included five former chairmen of the Securities and Exchange Commission (SEC), appointed by both Democratic and Republican presidents. The hearings heard evidence from numerous experts, former regulators, leading academics and representatives from consumer and industry groups. The hearings identified the following main problems (Lucas, 2004):

- Inadequate oversight of accountants
- Lack of auditor independence
- Weak corporate governance procedures
- Stock analysts' conflict of interests
- Inadequate disclosure provisions
- Grossly inadequate funding of the Securities and Exchange Commission (SEC)

At the time of Enron and similar financial crises, auditors did not only fulfil auditing service for clients, but also provided numerous lucrative services such as consulting. This created a situation whereby auditors were no longer truly independent, and by pointing out accounting or disclosure misstatements, it could place large-scale lucrative consulting contracts for the same auditing firm under threat, which could lead the auditor in question to think twice before pointing out such accounting or disclosure misstatements.

Furthermore, audit partners were not required to rotate amongst clients, creating a very close working relationship with the client, which again could impact on independence. For example, David Duncan, the lead Andersen partner, had a decade-long unbroken relationship with Enron.

Andersen performed the internal as well as external audits for Enron and also acted as a consultant in non-audit and tax matters. Andersen's three way relationship with Enron created the opportunity and possibility for many conflicts of interest. Enron paid Andersen \$5.7 million for advice on certain special purpose entities (SPE) transactions. The Enron board and its audit committee relied heavily on the advice provided by Andersen on these SPE transactions.

In the author's opinion, it was a serious error of judgement from both the Enron board as well as Andersen to obtain and provide these opinions, and Enron would have been much better served if it had obtained independent advice on these transactions. Andersen further pioneered at Enron a unique integrated audit system whereby Andersen operated almost like a branch of Enron with permanent offices in the Enron buildings. In the year before Enron's bankruptcy, Andersen earned \$25 million dollars for audit work and \$27 million for non-audit work at Enron. It also came to light later that some serious reservations voiced internally by other Andersen partners about the Enron SPE transactions were never disclosed to the Enron audit committee.

Regarding staff, there was a "revolving door" between Andersen and Enron. Significant numbers of Andersen personnel moved to Enron after performing external audit or consulting work for Enron. During the senate hearings, it was agreed that a cooling off period would be required before an employee of an audit firm can accept employment from a client.

For the above-mentioned reasons, it is apparent that a necessary distance did not exist between the auditor and the client. In his testimony before Congress, the then CEO of Andersen, Joseph Bernardino, admitted to an error of judgement in this regard. Had proper independence been in place, a strong argument could be made that the Enron collapse may not have happened.

Before the Sarbanes-Oxley Act, auditors and accountants were self-regulated. Politicians were particularly concerned and angry about the fact that the Federal Accounting Standards Board (FASB) was a private, rather than a publicly funded organisation. This created the appearance that there were no real consequences for accounting firms and management executives who don't abide to the rules. Nearly all the witnesses at the senate hearings held to discuss the way forward after the Enron debacle, agreed to the suggestion that a new independent oversight board was required in order to ensure that audit firms improve their role in assuring that financial statements are correct.

Before the Sarbanes-Oxley Act there was very limited regulation in order to prescribe what a company should do in order to ensure good corporate governance. Company boards generally just performed an internal self-analysis on the manner in which it was operating in order to have a view on governance in the company. In most cases, audit committees were insufficiently skilled and experienced to fulfil their role and not truly independent of company boards.

Similar to the concerns raised about auditors, it is highly improbable that investment banks would issue a “sell” recommendation on firms it was performing lucrative investment banking services for. In an interesting article, Harrison Hong states that not only were analysts rewarded when being very optimistic about shares, but that opportunities, as well as their assignments to cover prestigious companies, were heavily influenced by how optimistic they were about stocks that they were covering at the time. Hong further notes that accuracy is not really rewarded as much as wildly optimistic valuations even in cases where it subsequently turned out that the information presented at the time was fundamentally incorrect (Hong, 2003).

Prior to the Sarbanes-Oxley Act, companies were allowed to, as in cases such as Enron, not disclose information of critical importance to investors and other stakeholders by following the letter of the accounting rules rather than the spirit in which it was written. United States reporting is very rule-based, emphasizing the uniformity of the application of accounting principles across firms so that similar transactions should receive similar accounting treatments. This improves the user of financial statements ability to make comparative judgments about financial performance and position between companies. The down side of this is however that the lack of an accounting rule may in fact dictate the form of a transaction as a means to circumvent a certain rule. Many critics are calling for accountants to be more responsible for compliance with the spirit of accounting rules and less focused on helping their clients avoid the spirit of the rules while complying with the letter (Hotaling and Lippitt, 2003).

It was the opinion of Senator Sarbanes that the SEC was grossly under funded for a government organisation that had such an important task to fulfil. This remains a problem even up to the present day. To quote from an article by Fawn Johnson in The Wall Street Journal: "The SEC has always been a proud agency, but in recent years it has become outgunned and outmanned by Wall Street" (Johnson, no date).

Taking all the above into account as well as plummeting stock markets, approaching elections, and the summer recess of 2002, the bill was drafted with lightning speed and was approved on the 25th of July 2002 by 423 to 3 votes in the House and 99 to 0 votes in the Senate. On July 30th, 2002, President George W. Bush signed it into law, stating it included "the most far-reaching reforms of American business practices since the New Deal." (Sarbanes-Oxley Is Business Disaster; Passage of the Sarbanes-Oxley Corporate Reform Act Was Supposed to Stop Corporate Abuses, but Instead It Has Strangled Small Business and Slowed Job Growth, 2004).

The intent of the Act is to make managers and directors of corporations more accountable to shareholders and in doing so to increase investor confidence in the capital system. A number of major financial failures of large enterprises in which billions of dollars was lost served as the catalyst for the Sarbanes-Oxley Act.

1.2.1 Enron

Enron had its beginnings in 1985, when it started operations as an interstate pipeline company created from the merger of Houston Natural Gas and Omaha-based InterNorth. Kenneth Lay, the former Chief Executive officer of Houston Natural Gas, became CEO. A year later, he was named chairman. From the very start, his ambition for the company was that it would be involved in much more than merely piping gas.

In the 1980's, energy corporations lobbied the US Government to deregulate the energy markets in America. The main thrust of the argument by many American energy companies including Enron was that the extra competition in the marketplace would benefit both companies and consumers. In response to consistent pressure, the government began to lift controls on who could produce energy and how it was sold. New suppliers came to the market and competition increased. However, the price of energy became more volatile in the free market (Fogarty and Iwata, 2002).

As a consultant for McKinsey & Company, Jeff Skilling worked with Enron in 1987, helping the company create a forward market in natural gas. Skilling impressed Kenneth Lay in his capacity as a consultant, and was hired by Lay in 1990 as chairman and Chief Executive officer of Enron Finance Corp (Zellner, 2002). Skilling believed that Enron could profit from trading futures in gas contracts between suppliers and consumers – effectively betting against future movements in the price of gas-generated energy (Byrne, 2002).

Buyers and sellers use the futures market in order to provide stability in their input price, as well as attempt to obtain the commodity at a better price than it would if it had bought it on the open market. Enron offered gas futures, enabling customers to buy and sell tomorrow's gas at a fixed price today. In the deregulated energy world, it appeared to make sense to many suppliers and industry consumers who took up the offer.

In a few short years, Enron became a massive player in the US energy market, controlling at its height a quarter of all gas business. Buoyed by its success, the company went on to create markets in a myriad of energy-related products. Enron began to offer companies the chance to hedge against the risk of adverse price movements in a range of commodities including steel and coal. By the end of the decade it had expanded its trading arm to include hedging against external factors such as weather risk. By 1999, the company had moved into completely new fields, including Enron Online, the company's website for trading commodities. It soon became the largest business site in the

world (Hale, 2001). About 90 per cent of Enron's income eventually came from trades over Enron Online.

In 2000 Enron began with a plan to move into broadband internet networks and trade bandwidth capacity as the dot-com economy prospered. Enron's dynamic ideas, coupled with its stable old-economy energy background, appealed to investors and the share price soared. It was one of the first amongst energy companies to begin trading through the internet, offering a free service that attracted significant traffic and activity on its site.

But while Enron boasted about the value of products that it bought and sold online – a mind-boggling \$880bn (£618bn) in just two years – the company remained silent about whether these trading operations were actually making any money (Hale, 2001). At about this time, it is believed that Enron began to use sophisticated accounting techniques to keep its share price high, raise investment against its own assets and stock, and maintain the impression of a highly successful company. In order to satisfy rating agencies, Enron had to ensure that its debt to equity and other relevant ratios were within acceptable ranges. Chief Financial Officer Andrew Fastow continually lobbied ratings agencies to raise Enron's credit ratings apparently to no avail. There were however other methods to ensure that the ratios fell within acceptable limits (Thomas, 2002).

Fastow and Skilling focused on a strategy to outsource or in any other creative way remove assets from the companies' balance sheet. This tactic enables very good profitability ratios for companies, especially ones that focus on things like return on assets. Removing the assets also meant that in most cases liabilities were also removed (Hays, 2006).

Skilling wanted an "asset-light" company that could rapidly exploit deregulating markets for energy, water, broadband capacity and anything else that could be traded. So beginning in 1993, Fastow created hundreds of special purpose entities (SPE) designed to transfer Enron's debt to outside companies and get it off the books without giving up control of the assets that stood behind the debt.

Enron could also legally remove losses from its books if it passed these “assets” to an independent partnership. Equally, investment money flowing into Enron from new partnerships ended up on the books as profits, even though it was linked to specific ventures that were not yet up and running. The use of special entities and partnerships to transfer debt off the Enron books while still accounting for profits is depicted in Figure 1 below. One of these partnership deals was to distribute Blockbuster videos via broadband internet. The plan fell through, but Enron had already posted some \$111m venture capital cash as profit (Ackman, 2003).

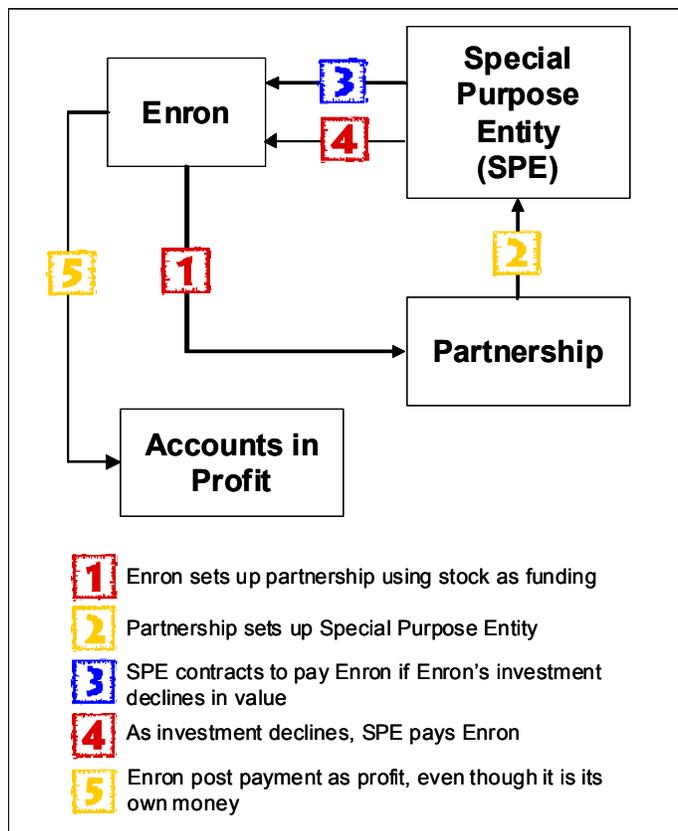


Figure 1: Schematic representation of Enron's use of partnerships and Special Purpose Entities

The company enjoyed spectacular growth with annual revenue hitting \$100 billion US in 2000, making it the seventh-largest company on the Fortune 500 and the sixth-largest energy company in the world. Income had risen by 40% in three years. By the summer, Enron's shares had hit an all-time high of more than \$90. In reality, real revenue would have been far lower had it not been for the SPE's established by Chief Financial Officer Andrew Fastow.

On 14 August 2001, seemingly from nowhere, Jeff Skilling resigned as Chief Executive, citing personal reasons. Kenneth Lay became Chief Executive once again. The development was a shock to investors who suddenly began to fear that all was not well in Houston. Investors sold millions of shares, knocking some \$4 off the price by the end of the week.

As the price dropped below \$40, Mr. Lay only stated the following: "We regret Jeff's decision to resign, as he has been a big part of our success for over 11 years, but we have the strongest and deepest talent we have ever had in the organization, our business is extremely strong, and our growth prospects have never been better" (Forest, 2001). In reality prospects were not good at all and probably had not been for some time – although perhaps the board was not fully aware of this. In May of that year, Enron executive Clifford Baxter left the company, apparently in uncontroversial circumstances. But there were rumours among executives that Baxter – who would shortly thereafter commit suicide – had clashed with Jeff Skilling over the appropriateness and sustainability of some of the special purpose entity transactions. When Skilling resigned, Sherron Watkins, who knew of Baxter's concerns, decided to act and warned Lay that Enron was on the verge of imploding (Vullaimy, 2002).

In October 2001, Enron reported a loss of \$618 million – its first quarterly loss in four years. Chief Financial Officer Andrew Fastow was replaced, and the US Securities and Exchange Commission launched an investigation into investment partnerships led by Fastow. That investigation would later show that a complex web of partnerships was designed to hide Enron's debt (Diesner and Carley, 2005). By late November, the company's stock was down to less than \$1. Investors had lost billions.

On 8 November 2001, the company took the highly unusual move of restating its profits for the past four years. It effectively admitted that it had inflated its profits by concealing debts in the complicated partnership arrangements. The following day in a desperate attempt Enron entered into negotiations to be taken over by its much smaller rival, Dynegy (Thomas, 2002).

No longer able to cope with its debt, Enron filed for bankruptcy protection in a New York court on 2nd December 2001 in the biggest case of bankruptcy in the United States up to that point (WorldCom's collapse would later steal that dubious honour). Roughly 5,600 Enron employees subsequently lost their jobs. In one year its share price had fallen from above \$80 to below \$1.

The next month, the US Justice Department opened its investigation of the company's dealings and Ken Lay quit as chairman and CEO. Hundreds of charges would eventually be laid and 19 former executives would either plead guilty or be convicted for their part in what would become known as one of the biggest frauds in American history. The shockwaves of a corporate crash are always keenly felt, but few failures have led to the kind of investigations Enron and its managers faced.

Congress hearings began in December 2002 as America and investors around the world demanded answers. Founder Ken Lay and former CEO Jeffrey Skilling were both convicted in May 2003. But Lay died two months later, escaping what would surely have been a lengthy jail sentence. Skilling on the other hand was sentenced to more than 24 years (24 years for Skilling in Enron Case, 2006). Andrew Fastow, Enron's former Chief Financial Officer, was given a relatively light sentence of six years after he cooperated with prosecutors (Johnson, 2006).

Looking back, it becomes obvious that the general public were not able to understand and oversee Enron's complex operations. The main reason Enron was able to announce one record profit after another was the lack of transparency caused by the opaque financial structure. Enron's CFO, Andrew Fastow, established many offshore partnerships with thousands of companies. These partnerships created liabilities of over USD1 billion, which were not shown in the group balance sheet. It was therefore possible to artificially raise accounting profits period by period and to profit from the euphoric attitude of the analysts. Douglas Carmichael, the Wollman Distinguished Professor of Accounting at Baruch College in New York City, told the Wall Street Journal in November of 2001 that most people would be hard pressed to understand the

effects of these disclosures on the financial statements, casting doubt on both the quality of the company's earnings as well as the business purpose of the transaction (Thomas, 2002).

Critics also targeted Arthur Andersen in respect of its large scale destruction of documents as well as its failure to force Enron to properly disclose the numerous special purpose entities on its books, in its function as independent auditor. At the time, Arthur Andersen LLP belonged to the "Big Five" of public accounting firms in the USA and had audited Enron for sixteen years. The energy group was Andersen's second largest client. As they had signed off on the Enron financial statements it was required that they should have informed the public about the numerous special purpose entities it had interests in either by forcing Enron to properly disclose them or qualifying their financial statements.

It has been speculated that Arthur Andersen acted the way it did because of the high revenues earned through Enron as a customer not only through audit but also through consulting work done for the firm. It has been suggested that Andersen partners believed that revenue from the Enron account could amount to \$100m, an amount that would clearly cloud anybody's judgement (Hirsch, 2002). This also amounted to roughly 27% of the fees from public clients for the Houston Office (Thomas, 2002) thus tying many people at Andersen Houston's office livelihoods to this account. It is well known that auditors are very likely to be dismissed if they issue a qualified audit opinion (Carrera, Gómez-Aguilar, Humphrey and Ruiz-Barbadillo, 2007).

Another viewpoint is that auditors at Arthur Andersen had an unconscious bias towards Enron. It has been proven in psychological research that our desires significantly influence our decisions even if we attempt to be logical and objective. Thus, because of the close relationship between Andersen and Enron it became very difficult for auditors to be entirely objective (Bazerman, Loewenstein and Moore, 2002).

Ambiguity in accounting rules also caused endless problems. Due to the fact that US accounting is rules based and it is physically impossible to write a rule for every circumstance which may arise in accounting, it is possible that if your knowledge of the accounting standards is extremely good, as Andrew Fastow's seemed to be, that you could probably convince auditors that the law as you apply it is not specifically stated to be incorrect and as such cannot be refuted by yourself (Mano, Mouritsen and Pace, 2006).

The gradual erosion of the importance and independence of the professional standards group (PSG) within Andersen over the past decade before its demise also played a significant role in Andersen's incorrect decisions. While in previous years the PSG had the final say about the application and interpretation of standards at clients, at Enron this group was frequently overruled and one partner was even removed from the engagement because of him being too critical of Enron's accounting practices (American Accounting Association, no date).

Finally, the fact that Enron and Arthur Andersen destroyed evidence enhanced the scandal of the bankruptcy. In June 2002, Arthur Andersen was convicted of obstruction of justice. Following this the firm had to surrender its licenses and its right to practice before the SEC.

1.2.2 WorldCom

WorldCom, very similar in some respects to Enron, also rose from very modest beginnings. "In 1983 in a coffee shop in Hattiesburg, Mississippi, a minute town in the "deep south" of America, Bernie Ebbers, Bill Fields, David Singleton and Murray Waldron founded LDDS or "Long Distance Discount Service", the name suggested by a waitress" (The Associated Press, 2002). The growth of the company was initially caused by the United States courts ordering the break-up of the AT&T's Bell system and the subsequent deregulation of the long distance market. This enabled companies such as LDDS to make a profit by buying excess capacity from carriers and then on selling same to customers at a slight mark-up. These companies had no operating cost and the only risk was that

they had to on sell the capacity at a price above what they had promised to pay. (Mead, 2008).

After two years of operations the shareholder asked Ebbers to take over as CEO – quite surprising as his experience at that point related to managing a high school basketball team and running a small chain of motels in Mississippi. However, Ebbers was very successful. His strategy mainly focused on cutting costs aggressively and it resulted in the company being in such good shape that it was publicly listed in 1989.

After listing, Ebbers aggressively launched his other key strategy which centred on buying up competitors, which would eventually turn WorldCom into the second biggest telecoms company in America. Ebbers accomplished this by always buying up the targeted companies using WorldCom shares. This became possible as the WorldCom stock price continued to rise. This strategy made him famous and a billionaire, and would ultimately lead to his and WorldCom's downfall.

Ebbers kept the WorldCom stock price rising by regularly doing mergers and acquisitions (over 60 communication companies were purchased in the 1990's) and in this he and Chief Financial Officer Scott O'Sullivan saw an opening to commit accounting fraud. When acquiring companies, Ebbers and O'Sullivan ensured that when these companies' assets were brought into the books of WorldCom that these assets were brought in at a value much lower than the asset value recorded in the books of the purchased entity. This enabled WorldCom to defer expenses as these assets were written off over a period in most cases much shorter than the 40 years WorldCom used in order to amortise its goodwill. This was used in particular in the purchase of the MCI business that had a very significant asset base and resulted in goodwill of several billion dollars being raised on the WorldCom balance sheet.

Another way in which WorldCom “massaged” its results was by writing off these assets or raising excessive provisions at the point where these assets were brought into the WorldCom books and the goodwill raised, resulting in excess charges against the WorldCom income statement in the period in which the company was acquired. This would then result in a significant up tick in the results in the period directly after the company was acquired, giving shareholders and the market the opinion that WorldCom had turned the business around or realised significant synergies while the improvement was mostly just due to accounting trickery (Kuhn and Sutton, 2006).

During the 1990’s, these strategies worked extremely well and took WorldCom to a peak of having revenues of \$40 billion a year and regularly posting growth of 20% a year in revenues. It was a favourite stock amongst analysts and investment banking firms and in particular Jack Grubman at Salomon Smith Barney. Grubman met Ebbers during the early 1990’s and became close friends with him. Grubman, through his relationship with Ebbers, obtained frequent inside information. Grubman in return gave the company’s stock an enthusiastic buy recommendation, fuelling the stock’s meteoric rise, making Ebbers a widely admired CEO and Grubman being recognised as one of the best and most powerful analysts around (Moberg and Romar, 2003).

Unfortunately for all the parties involved, reality had to set in at some stage. Unbeknownst to the outside world, WorldCom had not really managed to extract synergies from the countless acquisitions it performed and business in actual fact was almost chaotic (Mead, 2008). In 1998, the wheels started coming off with the pressure on the telecommunications market as a price war started developing between competitors due to the slowdown in the American economy and capacity far outstripping supply. WorldCom thought however that it had another merger up its sleeve and announced in 1999 a \$115 billion merger agreement with Sprint. In 2000 the death knell for WorldCom’s spectacular growth was sounded when US and European regulators decided to call off the deal (Mead, 2008).

At the same time, Bernie Ebbers had come under increasing pressure from banks to cover margin calls on his vast personal purchases which have been mainly financed with debt secured against his WorldCom stock holdings. As the stock price came under pressure in 2000 the banks became nervous and demanded that he started repaying some of the loans or put up additional other security (“JJ”, 2007). Because his personal assets were insufficient to cover these margin calls, his first option was to sell his personal WorldCom stock. The WorldCom board stopped him in his tracks because news that the CEO was offloading his stock would depress the stock price even more. The board eventually lent \$341 million to Bernie Ebbers at preferential rates in order to assist him in covering his margin calls. Granting the loan was an extremely bad business decision by the WorldCom board because the loan continued to ensure that Ebbers’ fortune and livelihood was tightly linked to the WorldCom stock price. This was probably one of the significant contributing factors which caused Ebbers to give the instructions he did in order to ensure that the WorldCom share price was not impacted.

In 2000 Scott O’Sullivan started making adjustments to the revenue and cost numbers of the business in order to ensure that analysts’ expectations were met. Numerous staff in the accounting department was aware of the adjustments, but due to a strong sense of loyalty to the company and fear of Ebbers and Sullivan they went along with it. Some took their concerns directly to Sullivan, but Sullivan told them that Ebbers was aware of their concerns, that they would not be held responsible and would not be asked to make such entries again (Pulliam, 2003).

On April 29, 2002, Bernie Ebbers resigned as WorldCom CEO amidst growing concern about the state of the company finances. This followed on the back of an announcement on the 11th of March 2002 that WorldCom would face an investigation from the Securities and Exchange Commission focusing on its accounting practices and loans to public officers such as Ebbers. At that stage the company’s share price had already lost more than 80% of its value since the beginning of 2002, most of it happening after an 11th April profit and revenue warning by the company which caused widespread downgrades in the

company's value by analysts and a debt ratings agencies (Ebbers out at WorldCom. 2002).

John Sidgmore was appointed the new CEO and immediately called for a total review and audit of the company's books in every division. Cynthia Cooper and her team starting picking up fraudulent entries during their routine audits, in particular entries that capitalised operating expenses. After much thought Cooper arranged a meeting with Scott O'Sullivan and David Myers, the WorldCom Financial controller. O'Sullivan stated during the meeting that he was aware of these problems, but requested that Cooper held off her investigation to the next quarter. Cooper however refused to stall and scheduled a meeting with Max Bobbitt, head of the audit committee. Bobbitt in turn asked Cooper to alert Farrell Malone, the KPMG partner responsible for the WorldCom audit.

After the facts were disclosed to him, he in turn discussed these matters with O'Sullivan who claimed that the entries were not incorrect. At an audit committee meeting, Malone stated that the entries are fundamentally incorrect and that there is no proper documentation to support them, although O'Sullivan maintained that they were correct and asked for more time to document the entries. The audit committee decided days later to fire O'Sullivan and publicly restated results from 2001 (Porretto, 2002).

The main problems which led to the fraudulent activity and subsequent bankruptcy of WorldCom are as follow (Rosenbush, 2005):

- Companies need to appoint ethical leaders with unquestionable integrity who will stick to the truth even when results are not what were expected.
- Any company with a culture in which the leaders of the company cannot be questioned at all, even in terms of matters which at the face of it seem blatantly wrong, are open to significant frauds.
- Industries which spend a lot of time lobbying government and are heavily exposed to government policy, make very risky investments.
- Companies and investors should be aware of the dangers of mergers and acquisitions, which are not an infallible policy in order to grow a company.

- Too close ties between the board and the executive management are not healthy for corporate governance. The WorldCom board was too closely tied to Bernard Ebbers, in particular to ask the difficult questions which could have uncovered the fraud much earlier.
- Lastly, it is not a good idea for the head of internal audit to report to the CFO as it makes it very difficult to disclose fraudulent activities, specifically when those activities have been perpetuated by the CFO himself, which in the case of significant frauds is frequently the case. Internal audit should much rather report to the CEO or preferably straight into the audit committee.

1.3 Objectives of this research

Numerous studies have examined the impact of Section 404 of SOX on the internal control provisions. However, most of these studies have focused on American and/or European companies. The author felt that an in depth qualitative study focusing on South African companies or South African based subsidiaries of global and multi-national companies who have to comply with SOX due to their holding companies being publicly listed in the United States of America, would contribute to the knowledge field around this matter. Such study would be of significant interest to South African companies currently trading or planning to trade their stock publicly in the United States of America, as well as those who believe that a voluntary adoption of SOX would be of benefit to their company.

This research report as a result focuses on the costs and benefits that five South African based companies or subsidiaries have experienced in implementing solutions to comply with Section 404 of SOX. The study also aims to compare these companies' experiences to mostly American companies in order to enable the author to come up with firm suggestions on how South African companies could curtail the costs of implementation and management while still extracting maximum value from the benefits thereof

1.4 Statement of the problem and sub-problems

The problem statement that the author aims to address is as follows:

To conduct an assessment of the costs that South African companies and subsidiaries have incurred, and what benefits have accrued to these companies as a result of it implementing the necessary systems and controls in order to be compliant with the requirements of SOX 404.

The sub-problems can thus be defined as follows:

- What costs had the South African companies incurred, and what costs do they still incur in implementing, maintaining and managing the necessary systems and controls in order to be compliant with the requirements of SOX 404?
- What benefits have accrued to these companies as a result of their SOX 404 compliance efforts?
- Do the benefits of being SOX 404 compliant outweigh the costs of compliance to the extent that it adds significant value to the companies in question?
- How do South African companies' costs and benefits relating to SOX 404 compliance compare to that of other organisations as can be deduced from existing literature and studies?
- What recommendations can be made to South African companies that could lead to the reductions of costs and/or the increase of benefits related to SOX 404 compliance?

1.5 Delimitation of the study

This study's focus is on South African companies and South African subsidiaries of overseas holding companies that have previously had or voluntarily adopted the requirements of the Sarbanes-Oxley Act. The focus group for the purposes of the study was the Senior Managers in these organisations responsible for governance, and feedback from this focus group was obtained via face to face interviews with these persons, which included questions being posed based on a pre-developed and approved questionnaire.

The scope of the study is specifically aimed at identifying the costs and benefits to the South African companies and subsidiaries in complying with the Sarbanes-Oxley Act, based on the insights of these Senior Managers.

The effect that compliance to the Act might have had on these companies' share price, and to what degree the organisations have managed to successfully apply the Act is specifically excluded from the scope of this study.

1.6 Importance of the study

The study should enable South African companies to identify opportunities in order to streamline its compliance efforts in order to reduce costs and maximizing benefits while still meeting the requirements of the Sarbanes-Oxley Act. The study will give other African and developing country organizations insight into the experiences of South African based entities regarding the associated costs and benefits to implement systems and controls to be compliant with the Sarbanes-Oxley Act, specifically if such organizations are considering a listing on the US stock exchange.

1.7 Outline of the research report

Chapter 2 of this research report consists of a detailed and extensive literature review to give an understanding and insight into the Sarbanes-Oxley Act itself, followed by a review on the cost and benefits of the Act to organizations as well as some of the best practices employed by organizations in this regards.

Chapter 3 details the research methodology applied for the purpose of this research while Chapter 4 details the research results.

Chapter 5 deals with the outcomes of the research, Chapter 6 with the conclusions, and Chapter 7 details the recommendations regarding the research topic. The report then finally concludes with the overall conclusion in Chapter 8 and the recommendations for future studies in Chapter 9.

Chapter 2: Literature Review

2.1 Theoretical base: Need for of accurate financial reporting

In an attempt to explain why the double entry system of accounting was one of the first examples of financial reporting in the world, Professor A. C. Littleton put forward seven key reasons which he felt were paramount in the reason for its existence (Alexander, 2002):

- **Private Property:** Around the time of the emergence of the double entry system, it was possible in Italy to pass ownership of assets from one person to another, and this created the need to record these transactions in some way.
- **Capital:** Persons were able to either invest or lend money to an organization, but they needed to know if their “investment” was save and/or what their future returns would be
- **Commerce:** The exchange of goods services for money became so prevalent that the need to record these transactions became imperative
- **Credit:** Credit was being extended from one person to another, creating the need for the person who lent the money to have insight into how that money was spent and the risk he was exposed to in that person not repaying his money
- **Writing:** It was now possible to record a transaction in writing rather than just attempting to remember it.
- **Money:** Money provided a “common denominator” in which the accounts of the day could be written up.
- **Arithmetic:** The knowledge of performing basic arithmetic calculations which made the recording transactions a reality

Modern reasons for “writing up the books” are not that dissimilar. In terms of the conceptual framework for financial reporting the following is stated by the International Accounting Standards Board: “The objective of general purpose financial reporting forms the foundation of the Conceptual Framework. Other aspects of the Conceptual Framework – a reporting entity concept, the qualitative characteristics of and the constraint on useful financial information, elements of financial statements, recognition, measurement, presentation and disclosure—flow logically from the objective. The

objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.” (International Accounting Standards Board, 2010).

Thus to put it in layman’s terms, the objective and the basis for financial reporting is to ensure that the information created by companies about their financial performance as of a certain date should be relevant and faithfully representation of the financial state of the company as at that date (International Accounting Standards Board, 2010). Of critical importance here is that a company’s assets or resources as well as liabilities or claims against it is accurately and faithfully portrayed as it stands on the relevant date the report is drafted for.

Of the many key moments in the history of accounting and financial reporting one of the most important was the creation of the Securities and Exchange Commission (SEC) in 1934. This commission was brought about because it was seen that the haphazard financial reporting practices of the time was directly responsible for the wild speculation on stocks, which directly or indirectly led to the stock market crash of in 1929 in the resulting depression in America (Van Rieper, 1994). The SEC was specifically set up in order to oversee financial accounting and reporting.

The widespread suffering and misery caused by the great depression caused a considerable interest in financial reporting by the American public. It was realised that if companies were not properly regulated and reports by management was not accurate, it could lead to large sections of society suffering because of that. In more recent history, the occurrences of corporate failure at large listed companies such as Enron and WorldCom has caused the world once again to sit up and take note of the effects of bad financial reporting on significant amounts of people, entire economies and the world at large (Sutton, 2009).

An even more recent example where inaccurate financial reporting also played a large role was the sub prime crisis in America in which loans which could never be paid in

reality, was still reported at a value far above that what could be recovered through the sale of the underlying assets.

All of the above points to the extreme importance that accurate financial reporting plays in the economies of countries and the world and why it is so important to ensure that it is properly performed and controlled.

2.2 The Sarbanes-Oxley Act

The SOX Act was not only a considerable change in law, but also a departure in the mode of regulation. The Federal regime that had existed until the Act was created consisted primarily of disclosure requirements rather than substantive corporate governance mandates, which were traditionally left to state corporate law. Many of the substantive corporate governance provisions in SOX are not in fact regulatory innovations devised by Congress to cope with deficiencies in the business environment in which Enron and WorldCom failed. Rather, they may more accurately be characterized as recycled ideas advocated for quite some time by corporate governance entrepreneurs.

In particular, the independent-director requirement and the prohibition of accounting firms' provisioning of consulting services to auditing clients had been advanced as necessary corporate law reforms long before Enron appeared on any politician's agenda. That is not of course unique or surprising, because congressional initiatives rarely are constructed from whole cloth. Rather, successful law reform in the US national arena typically involves the recombination of old elements that have been advanced in policy circles for a number of years prior to adoption (Romano, 2005). Unfortunately, the first thing that needs to be said is that when acts are promulgated with such speed it is generally not well thought through and can be onerous on business.

Generally, the SOX Act applies to US and non-US public companies that have registered securities (debt or equity) with the SEC under the Securities Exchange Act of 1934. The Act has the aim of enhancing audit committee effectiveness and responsibility, increasing their oversight over auditors, and in particular limiting the non-

audit services provided by the financial statement auditors. It places CFO's and CEO's under the spotlight by requiring that they certify that their companies' annual and quarterly reports are accurate and not misleading, and that they have evaluated their companies' internal control structure and found it to be effective. It also contains several punitive measures for those who don't comply. This is mainly in response to the main two wrongs that were identified from the WorldCom, Enron and other scandals:

- Firstly, that company executives are greatly incentivised to cheat by the nature of the stock options that they are offered as part of their remuneration.
- Secondly, that the internal control and audit procedure was deemed to be wholly inadequate in order to prevent these frauds.

We will look at the main sections of the Act, namely corporate responsibility, auditor independence and regulation, enhanced disclosure, management certifications, as well as other provisions and penalties.

2.2.1 Corporate Responsibility

Subchapter III of the Act deals with corporate responsibility. The section aims to ensure that senior executives take individual responsibility for the accuracy and completeness of corporate financial reports. To this end it requires that the CFO and CEO certify in writing that based on their knowledge the company's reports do not contain any material misstatements and that the financial information is fairly presented. They must also certify that they take individual responsibility for establishing and maintaining their company's internal controls, that they have designed such controls and that they have recently evaluated the effectiveness of internal controls.

It requires that audit committees be composed entirely by independent directors, i.e. persons who are not employed by the company in question and also do not accept any consulting or advisory fees, and that the audit committee must have the authority to hire independent counsel and other advisers. The chapter brings about the creation of a fund for investors aimed to benefit victims

of violations of the SEC code. Lastly, the chapter prohibits any officer or director to fraudulently influence, manipulate or mislead an auditor resulting in the financial statements being misstated. It also contains specific forfeitures of benefits and penalties for non-compliance.

2.2.2 Auditor Independence

Subchapters I and II deal mainly with provisions which are aiming to achieve and strengthen auditor independence.

Firstly in subchapter I, the public company accounting and oversight board is established as a non-profit foundation. The purpose of this board is to “oversee the auditing of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports for companies, the securities of which are sold to and held by and for public investors” (United States of America. Securities and Exchange Commission, 2002). This chapter also tasks this board with registering auditors, defining specific processes and procedures for compliance audits, inspecting and policing conduct and quality control and enforcing compliance with the specific mandates of SOX.

In layman’s terms, this board oversees all public accounting firms and such firms now have to submit extremely detailed information to the board. This information includes all audits performed, fees charged, statements of quality control policies in place, lists of employees and their qualifications and certifications, any information regarding criminal or civil actions affecting the firm, and any other information the board requests in the furtherance of its mandate. All this reporting, registration, and oversight is financed by both tax money and fee assessments on all monitored accounting firms. Accounting firms, subject to oversight, are required to be uniform in following whatever procedures the board adopts for their profession. Each regulated firm will also be physically inspected at least once per year if it serves over 100 clients, and

not less than every three years if it serves less than 100 clients (Formaini and Siems, 2005).

In subchapter II, standards are set for external auditor independence. In particular several types of non-audit services to public company clients are banned in order to limit conflicts of interest. This list includes internal audit outsourcing, financial-information-system design and implementation services, bookkeeping, actuarial, outsourcing and expert services (Petra and Loukatos, 2009). These scope-of-service restrictions go beyond existing SEC independence regulations. In addition, all other services, including tax services, are permissible only if pre-approved by the issuer's audit committee and all such pre-approvals must be disclosed in the issuer's periodic reports to the SEC.

There are also requirements set in place whereby the client company's audit committee pre-approves all auditing services, and that each public accounting firm shall report to the audit committee of the board of directors regarding critical accounting policies and alternative treatments, the consequences of using those treatments and the practices that the registered accounting firm prefers (Petra and Loukatos, 2009). The Act further requires auditors to report to the company's audit committee the procedures and communications carried out between auditor and management in a further effort to ensure auditor independence (Braddock, 2006). The auditor reports directly to the audit committee, not to management, reinforcing the position that the auditor's duties are to the shareholders, rather than management. The Act also requires audit work to be prepared in substantial detail to support the conclusions attained and should be kept for no less than seven years.

Each audit report is to be supported by a second partner. Movement of personnel between accounting firms and clients is also restricted (Petra and Loukatos, 2009). Lastly, audit partner rotations are also legislated whereby the lead audit partner and/or the concurring review partner must rotate off the engagement if he or she has performed audit services for the issuer in each of the five previous fiscal years.

2.2.3 Enhanced disclosure

Chapter IV mandates the following in order to enhance the quality and timeliness of financial reporting:

- All material off balance sheet transactions, arrangements, obligations and any other relationships with unconsolidated entities that might have a material impact on the company's financial statements must be disclosed (this would include special purpose entities).
- Additional rules surrounding the presentation of pro forma information to outside parties are also implemented.
- Management and auditors are required to annually assess their companies' internal controls and related disclosures.
- Section 404 of Sarbanes-Oxley commands management to include an "internal control report" in any annual report required by the Securities Exchange Act. The internal control report must contain an assessment of the effectiveness of the internal control structure and of the issuers' procedures for financial reporting (Braddock, 2006).
- It also prohibits public companies from making personal loans to executive officers and directors.
- Furthermore, it is required that all public companies disclose whether or not they have adopted a code of ethics for Senior Financial Officers and that at least one member of the audit committee is a "financial expert".
- Finally, it requires timely reporting of all material changes in the financial condition of the company, as well as instituting regular and systematic review of companies' reports by the SEC.

2.2.4 Management Certifications

As stated above, management (principal executive and financial officers) will be required to certify all periodic (quarterly and annually) reports filed with the SEC. Additionally certification requires that the principal executive disclose any deficiencies in the control procedures to the audit committee and the auditor, including any fraud, material or not, involving management or employees who have a role in the company's internal controls (Braddock, 2006).

The Committee of Sponsoring Organisations (COSO) has developed common criteria to evaluate and define internal control. Internal control is "a process, effected by the entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Reliability of financial reporting,
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations" (Committee of Sponsoring Organizations of the Treadway Commission, 1992).

The companies making use of SOX must use a registered control framework such as COSO described above, as a standard for management's assessment. (Bowling, Julien and Rieger, 2003).

2.2.5 Other provisions and penalties

Other provisions include protection for the independence of security analysts and enhanced disclosures regarding possible conflicts of interest. There is also an increase from the previous penalties for securities law violations. Of interest is that if the company is required to prepare a restatement due to misconduct with any securities law financial reporting requirement, the Chief Executive officer and chief financial officer may be required to repay to the company any bonuses received or profits realised from the sale of the company's stock for the twelve month period (Braddock, 2006). Subsequently the SEC may "seek

equitable relief that may be appropriate or necessary for the benefit of investors” (Petra and Loukatos, 2009).

2.3 Comments in literature about the Act

Numerous findings and opinions regarding the Act have been made and discussed by a wide range of authors in the literature on the matter. The following section will aim to highlight the positive and negative findings regarding the Act by such authors.

2.3.1 Positive findings and opinions

- **Audit committees:**

The need for audit committees to be made up of independent board members including at least one financial expert are a positive contribution of the Act, as in some of the companies it was clear that audit committees pre-Sarbanes-Oxley were ill equipped to deal with the complexities of ensuring that businesses were operating ethically, complying with accounting rules and having effective governance (Braddock, 2006).

Audit committees post Sarbanes-Oxley take their duties much more seriously. Before Sarbanes-Oxley many audit committee members felt that they were just “rubber stamping” the results without much say or input, and this has significantly changed because the role of the audit committee has been better defined in the Act (Braddock, 2006).

Since the advent of independent audit committees and the indications that the regulations of SOX will lead to a strong ethical tone at the top, it is envisaged that this will empower the rank and file members of organisations in deterring fraud (Booboo and Boodoo, 2007). In the WorldCom case, it was clear that many of the accountants felt extremely uncomfortable about what they were doing but did not feel as if there was a strong ethical person or committee that they could approach to disclose these facts.

- **Boards of Directors**

Some studies have shown that companies with an independent board of directors that is prepared to stand up to the company's executive directors, produce greater returns on shareholder equity and ensure that excessive executive compensation does not occur (Byrd, Cooperman and Wolfe, 2007).

The importance of governance is now better understood and there is an increased focus at publicly listed companies on governance, ethics and internal control. Now governance will be on the boards' agenda right next to market share and increasing revenue growth (Barrier, 2003). With the onerous requirements on companies' top executives they won't only know that it is crucial to focus on good corporate governance, they will also have a strong incentive to do so. It is believed that the Act intensified the fight against corruption and money laundering (Booboo and Boodoo, 2007).

- **Auditors Independence**

The measures made to strengthen auditors' independence and to ensure that they are not reporting to management but rather to the audit committee should definitely strengthen the auditors' ability to report on fraudulent activities. This should reinforce the fact that auditors should act in the interest of shareholders and creditors rather than management. (Braddock, 2006)

- **Quality of companies' internal controls and processes**

With the increased focus brought about by the Act it is clear that internal controls have to improve. "The fact that companies are having difficulty complying, after controls have been in federal law for 25 years, doesn't speak well for the quality of their controls," stated one high-ranking regulator. (Henry, Borrus, Lavelle, Brady, Arndt and Weber, 2005). A study by the Institute of Internal Auditors found that due to SOX corporations had

improved their internal controls and that financial statements are perceived to be more reliable (Coigne, 2008).

Some companies have begun using the by-products of section 404 compliance to improve training and orientation programs. Hub Group Inc. is using the documentation outlining internal controls as training manuals (Petra and Loukatos, 2009).

By making use of COSO, a business can not only evaluate its controls over financial reporting, but also use it to evaluate the controls that control operational effectiveness, efficiency and compliance with laws and regulations, and with that the obvious improvements that will bring (Bowling, Julien and Rieger, 2003).

Process improvements should result when reviewing the controls in an effort to always try and look for opportunities to centralise, decentralise, streamline or reengineer. In some cases this can improve efficiency, lower risk and reduce costs (Bowling, Julien and Rieger, 2003).

A good example of process improvements brought about as a result of reviewing controls is the management at Cisco who discovered ways to streamline and connect the ordering process with the customer service process after completing a review of the internal controls (Petra and Loukatos, 2009). It has also, per a Deloitte round table discussion, led to increased exploitation of companies existing enterprise resource planning systems as a means to enable the enforcement and management of these controls (Deloitte and Touche, 2005).

All companies that have to comply with SOX must have an accurate assessment of the effectiveness and efficiency of its internal control structure. This point was affirmed during a recent study by Protiviti in which nearly two-thirds of respondents indicated that they are making use of the documentation and review of financial reporting processes that Sarbanes-

Oxley requires to streamline and improve the efficiency and effectiveness of these controls. (Protiviti, 2010).

Significant improvements in revenue controls, improved controls over the closing process (specifically the year end closing process and recording of journal entries) as well as improvements in controls over accounting estimates have also been reported by many companies (Rittenberg and Miller, 2005).

A more thoughtful analysis of monitoring controls should occur with the realisation by companies that monitoring is an integral part of the control process; an aspect that has frequently been neglected by managers, sometimes with disastrous consequences. (Rittenberg and Miller, 2005). Lenin is attributed to have stated that "Trust is good but control is better"; a proverb most managers would be advised to pay serious attention to.

A better understanding of the risks associated with general computer system controls and the need to improve both control and audit procedures to gain assurance that risks associated with computer systems have been mitigated, is thought to result in an improvement in this very high risk area (Rittenberg and Miller, 2005).

There should in most cases be an improved documentation of controls, with the resulting benefits being that it is readily available for guidance and facilitation of the control review process (Rittenberg and Miller, 2005).

An improved definition of controls and the relationship between risks and controls in the organisation that results from following the process required by SOX, should improve risk management in companies (Rittenberg and Miller, 2005).

There should be an embedding of internal control ownership into the culture of the organisation which, together with the documenting of standardised procedures, supervisory review and approval, management actions and

decision, and the investigation and resolution of un-reconciled and/or outstanding items, will increase the effectiveness of risk management in companies (Rittenberg and Miller, 2005; Harrington, 2005).

An improvement in information technology controls will bring about improvements in information system security, segregation of duties, access controls, controls over program change management and processes for documenting policies, procedures and controls (Rittenberg and Miller, 2005). This is of exceptional importance as all of the transactions in companies are processed through the accounting system, and if that system is ineffective, fraud and/or misstatement on a significant scale can easily arise.

In a very recent study during June 2010 by Protiviti, 67% of respondents indicated that the benefits of Sarbanes-Oxley exceeded the costs mainly due to increased efficiency in compliance brought on by the increased focus that the Act required. The other main benefit listed is that the law has forced companies into an increased understanding of control design and control operating effectiveness. (Protiviti, 2010). In 2011, the study was performed again with similar results, with the only change being that the percentage increased from 67% to 70%.

- **Confidence and competence in financial reporting**

The implementation of the Act has led to added confidence in financial reporting. As per former congressman Michael G. Oxley, who co-sponsored the Act, the Dow Jones stock market had doubled in the period between 2002 when the law was enacted to late 2007 (Lenckus, 2007).

When important role players in the investment community were questioned about the effectiveness of Sarbanes-Oxley, there were numerous positive comments made about the new disclosure requirements from the SEC, particularly the reconciliations to “pro-forma” numbers. There was also a general feeling that the improved disclosure numbers meant that there was a decrease in adjustments for unusual charges and write-offs. Also, the fact

that expenses such as incentive stock options have to be disclosed are seen as being positive by this fraternity (Henry, 2007).

"SOX has led to greater uniformity and discipline in preparing financials and finding problems at an earlier stage," said corporate securities attorney Amy Goodman, a partner with Gibson, Dunn & Crutcher L.L.P. in Washington (Lenckus, 2007)

- **Other benefits**

Because of the stresses the law has placed on accounting personnel, and the fact that there is now also a greater search for independent directors, this will no doubt increase employment. Additionally, it will potentially enable women, who would only want to work half day, to return to the job market as firms would have to be more flexible due to the staffing shortages they experience. It is unsure if this realised as expected due to the current economic crisis which has reduced jobs especially in America significantly (Boodoo and Boodoo, 2007).

Improved management insight into things such as whether local strategies are superseding corporate ones can result from properly implementing Sarbanes-Oxley (Bowling, Julien and Rieger, 2003).

Looking at resource realignment could be of benefit to the company which should lower costs, eliminate redundancy and improve quality. (Bowling, Julien and Rieger, 2003).

Improvements in record retention and audit trail processes which should ease the investigation in cases when things do go wrong (Rittenberg and Miller, 2005).

Increased implementation of anti-fraud activities (Rittenberg and Miller, 2005).

Increased importance of the Internal Audit function as well as hopefully a change in reporting lines for the internal audit function directly into the CEO or Audit Committee (Barrier, 2003).

2.3.2 Negative findings and opinions:

- **Code of Ethics**

It is somewhat naive to think that forcing companies' Senior Financial Officers to adopt a code of ethics will stop them from committing fraud. Personnel who chose to be dishonest will not be deterred by a code of ethics. As a result it is argued that this will give investors a false sense of security. (Braddock, 2006).

Forcing companies to report any waivers to their code of ethics on a Form 8-K or on their websites will ensure that companies draft very relaxed ethical standards which will ultimately hurt shareholders. (Braddock, 2006).

The fact that there is an ethical code will not overcome a dysfunctional compensation plan, particularly one that rewards short term gains at the expense of the long term (Rittenberg and Miller, 2005).

- **The ability to stop unethical behaviour / fraud**

Some persons will succumb to the temptation of unethical behaviour or fraud regardless of the regulatory environment at the time. This is evidenced by corporate wrongdoings that have occurred under various regulatory schemes over the last one hundred years. The American Congress has reacted to these wrongdoings by promulgating new legislation, yet corporate fraud still exists. (Braddock, 2006). The recent sub-credit meltdown has also borne credence to this statement as Sarbanes-Oxley has done nothing to stop the crisis from occurring.

The SOX corporate governance mandates were not carefully considered by Congress. In particular, they were not evaluated in light of the empirical literature questioning their efficacy (Romano, 2005). In particular, there was empirical evidence available at the time of the drafting of the legislation showing that in particular independent audit committees and prohibition of non audit services and executive loans would not improve the accuracy of reports and reduce fraud (Romano, 2005). It is felt by many that the compliance effected through SOX would not have prevented the fraud perpetrated at Enron, as “management erred by intentionally misrepresenting the results using approved GAAP procedures” (Petra and Loukatos, 2009).

Attempting to prevent all fraud is impossible and very expensive. Money should not be spent on fraud prevention if it cannot be proven that every dollar spent has resulted in a reduction in fraud of one dollar. Some commentators believe that the costs of SOX exceed by an order of magnitude the fraud it prevents; believing that it will only stop a very small portion of frauds committed (Carney, 2005).

Securities fraud was already illegal and subject to severe penalties prior to the enactment of the Sarbanes-Oxley Act, thus it can be implied that this piece of legislation is aiming to achieve what was already proven to be impossible (Carney, 2005).

A study in 2007 found that 75% of executives would still go to extraordinary lengths to ensure that their earnings meet the quarterly forecasts, even if this means that they sacrifice corporate values in the process. Methods used include postponing important investments and maintenance or giving incentives to customers to buy before the end of the quarter. These practices, which are still very damaging to investors, have not been prevented at all by Sarbanes-Oxley (Henry, 2007).

- **Preventing a stock market crash**

The fact that Enron, WorldCom et al collapsed did not cause the stock market to decline in 2000. Fundamental factors in the marketplace were to blame and declines in the US were in many ways similar to those experienced at European companies. Thus, to say that Sarbanes-Oxley alone would have prevented the stock market decline in 2000 is very optimistic (Braddock, 2006). Again the author concurs with this comment by having a look at the recent world recession which has occurred despite the Sarbanes-Oxley Act being firmly entrenched in American companies.

By diversifying, investors would be able to absorb a catastrophic failure such as Enron. This would be much more beneficial to them rather than SOX as a means to mitigate exposure to market risk. SOX are impacting on the costs of companies, but the cost and the associated risk related to that cannot be diversified away by the investor (Coigne, 2008).

Legislating a one-size-fits-all solution is very rarely effective due to the widely divergent situations and problems from company to company.

- **Costs of compliance**

A decreasing return to American investors due to compliance costs and small cap and foreign companies deciding to de-list or not to list on the US stock exchange (Braddock, 2006).

Some believe that costs of the act exceed the benefits.

Many of those who stand to benefit most from expenditures on internal controls have a significant incentive to oversell Sarbanes-Oxley (Langevoort, 2005).

Audit fees have risen significantly with the advent of SOX.

The feeling from some quarters is that the majority of companies did have a very good control structure and Sarbanes-Oxley will only result in minor improvements which in no way justifies the costs.

- **Other**

“It is a top notch expensive piece of legislature enacted by persons who have little or no experience in the day to day running of business operations.” (Romano, 2005).

The law is complicated, costly and burdensome to accountants, firms and taxpayers (Formaini and Siems, 2005).

The law will result in increasing conservatism in board decisions at the detriment of shareholders – a by-product of SOX’s extraordinary penalties and concomitant additional bureaucracy (Formaini and Siems, 2005; Butler and Ribstein, 2006).

The law will make American companies uncompetitive against their European counterparts (Formaini and Siems, 2005).

Increasing unnecessary paperwork burdens and second-guessing of stable routines.

Due to the extensive punitive penalties that can be expected, not only when risks or controls are understated, but also and more crucially when inherent business or economic conditions drive a firms price down, there is a real fear amongst executives and auditors that can easily lead to an absolute overkill in terms of the work performed in order to attempt to ensure that they are not liable (Butler and Ribstein, 2006).

The outlaw of loans to insiders has the effect of punishing everyone for the bad behaviour of a few. It is inarguable that for instance the loans provided to Bernie Ebbers were not at all in the interest of WorldCom; however there can be an argument that some insider loans could have positive effects, particularly when it causes increased ownership of the company the employee works for's stock which should incentives the employee to act in the company's interest (Butler and Ribstein, 2006).

Because of the extensive provisions and penalties, this increases the incentive to cover up transactions which cannot definitively be categorised as bad for the firm and that would probably be of more value and of better risk reducing measure if disclosed (Butler and Ribstein, 2006).

Additional responsibilities on members of corporate boards are increasing board members' workloads and require increased compensation (Braddock, 2006).

Expending resources as part of the compliance effort that could have been utilised in a more productive and profitable manner (Braddock, 2006).

Many of those who stand to benefit most from expenditures on internal controls have a significant incentive to oversell Sarbanes-Oxley. Sarbanes-Oxley's risks and demands are trumped up by those who stand to benefit most from it leading to unnecessary expenditure in some companies (Langevoort, 2005).

- **Difficulty of legislating correct accounting treatments, especially if you operate in a rules-based society**

The law assumes that there is or can be a single, objectively determined accounting set of figures for each firm that is correct and therefore legal, while all others are incorrect and fraudulent. Accounting is not an exact science, and more than one interpretation of how things are done in a firm is absolutely possible. In fact, there is nothing wrong with that especially with

regards to once-off, complex transactions, as long as proper judgement and theory was taken into account when making decision. As a result of the very narrow application of the law, it will make it very difficult to attract and retain directors and executives because of the increased criminal liability they face regarding matters being judged after the fact to be in violation of SOX. Fines of up to \$5m and/or 20 years in prison per offence per person and \$25m per offence per company can be levied (Formaini and Siems, 2005).

- **Independent directors / audit committee members**

Independent directors will not be able to question practices at the firm properly due to the fact that as a consequence of them being independent, they don't know the goings on of the firm well enough to know what is being hidden or is wrong (Easterbrook, 2009).

The argument that independent directors will assure compliance on behalf of outside shareholders is fatally flawed due to the fact that independent directors are unlikely to have the time, incentive and information to ensure that they are as effective as would be hoped. There are also studies available that have shown that the number of independent directors do not correlate with an increase in profitability (Butler and Ribstein, 2006).

A study by Roberta Romano, a Yale university professor, found that out of sixteen studies attempting to relate audit committee independence to increased performance, the majority showed no correlation – one reported inconsistent results and three suffered from methodological flaws (Romano, 2005).

Because of independent directors' unfamiliarity with the business, their first point of call on most transactions will be to be very cautious and conservative, which will not in all cases be beneficial to the continued profitability of the firm (Butler and Ribstein, 2006).

By forcing independence of directors, rotation of auditors as well as auditors not being allowed to perform any other services at an audit, potentially significant and critical knowledge transfer can no longer occur (Butler and Ribstein, 2006).

- **Excessive power to auditors**

Auditors in some cases – and especially at the start-up or implementation phase of SOX – are forcing companies to disclose issues that are not relevant to financial reporting and second guessing management's judgement about how to document internal controls (Levisohn, 2005).

- **Onerous provisions of the Act**

The significant acceleration of the deadlines for all reporting to the SEC has created an even greater risk of mistakes being made as company personnel are being placed under significant pressure (Carney, 2005).

SOX has tied up a lot of resources as previously stated, with research indicating that increasingly more of legal council's time is being spent on compliance. Additionally, new positions such as Chief Compliance Officer are being created in companies, which of course bring in another layer of costs (Carney, 2005).

It can lead companies into a formulaic and checklist driven approach to their tasks (Scott, 2004).

The Act is causing a diversion of managerial talent from doing what it is supposed to do, i.e. add value to the company being managed to spending time on SOX. Also, due to the punitive provisions of the Act, fewer people are interested in leading a company and would rather spend their time in places such as private equity (Butler and Ribstein, 2006).

2.3.3 Best Practices

The following section highlights the best practices that the literature reviewed have identified.

- The aim should be to realize long term savings by automating controls in order to free up resources and time. A good benchmark that has been established is that preferably more than 50% of all controls should be automated. This can be done by establishing a multi-disciplinary team to identify automation areas and to develop recommended actions to increase the prevalence and reliance on IT based controls (Ernest and Young, 2005).
- Ensure that SOX is part of the day to day activities of a company, not just something that gets rolled out and actioned at the end of a month, quarter or year. This will have various benefits, the biggest being that risks get identified at inception, requiring less effort to be spent on remedial action (PwC, 2005).
- Continue to challenge the number of locations, processes, and controls with each review of the controls (Ernest and Young, 2005).
- Redefine where necessary all the relevant roles and responsibilities within the company in order to ensure appropriate accountability and delegation without abdication (PwC, 2005).
- Explore opportunities to increase reliance on entity level controls which will hopefully reduce the amount of transaction level testing in low risk locations (Ernest and Young, 2005). These controls set a framework and boundary within which transactional controls need to operate (Gerkes, van der Werf and van der Wijk, 2007).

- Ensure that internal audit doesn't get so caught up in SOX testing that it doesn't pay enough attention to its traditional very important focus area of monitoring governance in all spheres of the company, not only Sarbanes-Oxley compliance (Marks, 2011).
- Make use of internal audit to perform the testing of controls. This has many advantages such as introducing another independent review of the SOX controls. Because internal auditors work with controls every day they know exactly what to look for and won't easily mark off a control as operating effectively if it isn't. Also they could come up with value adding comments and suggestions; and lastly it should be more cost efficient for internal audit to test the controls (Marks, 2011).
- Make use of a risk based top down approach in order to reduce effort (Ernest and Young, 2005).
- Embed section 404 processes at the business unit level in order to increase efficiencies and reduce cost (Ernest and Young, 2005).
- Standardise IT processes and controls as far as possible over the organisation (Ernest and Young, 2005).
- Make use of third party IT applications in order to aid with risk identifications, controls and automating the SOX process (Ernest and Young, 2011).
- Consider outsourcing your testing to low cost third party operators (Ernest and Young, 2011).
- Validate the process list. Businesses should ensure that they only focus on those processes that impact on financial reporting. There are literally thousands of processes in a business, and while most of them are very important only some impact on financial reporting, management's authorisation of assets and safeguarding of assets. These are the processes that Sarbanes-Oxley requires a company to address. Also, at all times the

materiality threshold needs to be kept in mind, and there is no point in looking at a process if it is wholly immaterial. Specific processes that should be considered as they are normally problematic include capturing and recording accruals for the following (Douglas, 2010):

- a) Any process that generates non-operating income.
 - b) Any process that generates non-operating expense.
 - c) Asset acquisition, delivery and installation.
 - d) Capturing and recording the cost of internally developed assets.
 - e) Impairment of assets.
 - f) Disposal of assets.
 - g) Hiring and termination of employee's service.
 - h) Approval and payment of travel and entertainment.
 - i) Leave pay and other payroll related accrual
 - j) Bad debt allowance and sale and purchasing of investments.
- Make use of the appropriate guidance if your company is a small one. COSO has developed specific guidance for small companies in 2006 (Douglas, 2010).
 - Review the COSO published Guidance on Monitoring Internal Control Systems to ensure that a company makes use of indirect monitoring of controls as much as possible to limit direct testing to a minimum. The internal audit department of the company can also play an important role in this regard to reduce the burden of testing on other departments (Douglas, 2010).
 - Write procedures and make use of templates in order to ensure remediation of efficiencies is done and they are correctly rated at each period end (Douglas, 2010).
 - Where possible attempt with the help of your companies procurement department to ensure that all SAS70 costs (which relate to auditing of third party processes where they have an impact on your financial reporting) are borne by your vendors (Douglas, 2010).

- Ensuring that a risk-based approach is followed when grading each business process and the impact that has on testing can significantly reduce the Sarbanes-Oxley compliance burden (Douglas, 2010).

- Deciding on key controls that need to be tested can reduce the amount of controls that need to be tested. The following represents good guidance in deciding whether a control is a key control or not:
 - a) The control must be operating effectively, and its functionality must be verifiable by some form of evidence.
 - b) The control must either be sensitive enough to prevent or detect a specific risk or error or should ensure that other separate controls are working.
 - c) The control should be easy to test.
 - d) The control should ideally mitigate several risks.

COSO's Guidance on Monitoring Internal Control Systems provides two official criteria to consider when identifying key controls:

- a) Their failure could materially affect the objectives for which the evaluator is responsible, but might not be detected timely by other controls.
- b) Their operation might prevent other control failures, or detect such failures or detect such failures before they have an opportunity to become material to the organisation's objectives.

The list of key controls should be as concise as possible and should not represent a “washing list” of what companies want, need or require (Douglas, 2010).

- Effective engagement with auditors. The company should enter into discussions with its external auditors as early as possible to ensure that they rely on the workings of the company's internal audit SOX as much as possible. This will hopefully at least result in a reduction of the companies' external audit fee and the time the external auditors spend auditing the company (Douglas, 2010).

- Frequent training of personnel involved in the SOX process would also realise savings as these should enable these personnel to go about their tasks much more efficiently (Douglas, 2010).
- By making use of a benchmarking approach test strategy for automated controls in an ERP or IT environment, the company can reduce workload and at the same time have excellent reduction of compliance risk (De Bruijn, 2008).
- Management should make use of a risk based approach in deciding which evidence it will evaluate in order to ensure that controls are operating effectively. This should management to make use of the most efficient processes in order to obtain evidence about the operation of controls. (Securities and Exchange Commission, 2007).
- The control self-assessment and sub-certification processes can ensure continued awareness and adherence to controls and practices for companies. These processes also assist the CEO's and CFO's in having more information and comfort that everything is working as it should before they sign off (Deloitte and Touche, 2007).

Chapter 3: Research Methodology

3.1 Problem Statement

The problem statement that the author aims to address is as follows:

What costs have South African companies and subsidiaries incurred, and what benefits have accrued to these companies as a result of it implementing the necessary systems and controls in order to be compliant to the requirements of SOX 404?

The sub-problems can thus be defined as follows:

- What costs had the South African companies incurred and do they still incur to implement and maintain the necessary systems and controls in order to be compliant to the requirements of SOX 404?
- What benefits have accrued to these companies as a result of its SOX 404 compliance efforts?
- Do the benefits of being SOX 404 compliant outweigh the costs of compliance to the extent that it adds significant value to the companies in question?
- How do South African companies' costs and benefits relating to SOX 404 compliance compare to that of other organisations as stated in existing literature/studies?
- What recommendations can be made to South African companies that could lead to the reductions of costs and/or the increase of benefits related to SOX 404 compliance?

3.2 Research Methodology

The decision was taken to follow a qualitative rather than a quantitative research method. The reason for selecting a qualitative research approach is best motivated by looking at the differences between qualitative and quantitative research as described by Cassell and Symon (Cassel and Symon, 1994).

Quantitative research is mainly about phenomena that can be exactly counted, for example how many personnel believe that Sarbanes Oxley has been good for their companies. Interpretation (or in other words qualitative) research on the other hand attempts to interpret research, i.e. a respondents beliefs or views on a matter, for example whether Sarbanes Oxley has been of value to their organisation. To the author for the purposes of this particular research report, a qualitative research approach was of more value as he wanted a more in dept study of the subject.

Qualitative researchers have the propensity to be personally involved in their subject matter with quantitative authors normally having a more detached, impartial view of the matter being studied. The author of this research report cannot hide from the fact that he has been involved with Sarbanes Oxley in his own organisation for many years so it is impossible for him to be totally detached from the subject matter.

Qualitative research allows for it to be adapted according to the researchers needs, even in some cases half way through the study. Quantitative research follows a much more rigorous, planned, exact approach and doesn't normally veer from the path it has chosen once the research has been planned. The author wanted to have the flexibility of being able to adapt the research methodology and questions depending on the situation and the outcomes at every stage of the research. The author wanted to have the flexibility to ask additional clarifying questions if required during the interviews, something that would not have been possible with a quantitative study.

Qualitative research is more about “understanding” the problem at hand while quantitative is more about “predicting the outcome” of a research problem. The author’s main objective was to gain an in-depth understanding of how the implementation of the requirements of the Sarbanes-Oxley Act was experienced and the consequences thereof at South African companies, and thus a qualitative research method is more supportive of this aim.

Qualitative research offers a bigger contextual depth but can give rise to problems when attempts are made to generalise that what was found in the sample to large populations or other settings. The author was aware of this potential problem, but because of the need to gather significant detail on the subject matter, the author was prepared to make the trade off and focussed on ensuring that the risk with generalisations were taken account of when presenting the results.

Qualitative researchers can explain in significantly larger level of detail the exact responses of respondents. For instance, by making use of an interview in a qualitative approach, the author could also take into account other conversations held and facts revealed in between the questions being answered. Furthermore, matters such as the respondents’ body language, level of comfort with the subject matter, etc. could also be assessed and interpreted, which would not be possible in the case of a quantitative study.

The research methodology followed for this research report is a descriptive / exploratory method. The motivation for employing this method is three fold:

- As the author has been closely involved in the Sarbanes-Oxley process in his own company, formulating any hypothesis / proposition would have a significant amount of bias.
- As there is no theory underlying the study that needs to be tested, it is impracticable to make use of the hypothesis method.
- The study has the main purpose to gather information about a certain subject rather than prove / disprove theories.

The following propositions can however be made:

- Sarbanes-Oxley is an expensive and time-consuming exercise for companies in general, and for South Africa companies in particular.
- There are benefits for a company that accrues due to Sarbanes Oxley implementation and these benefits will be listed.
- It is unlikely that the benefits of Sarbanes-Oxley outweigh its costs.
- Sarbanes-Oxley has probably cost South African Companies more to implement than similar companies overseas.
- There are still things that can be done in order to streamline the Sarbanes-Oxley process in South African Companies.

3.3 Sampling Method

The focus for the interviews was Senior Managers in South African organisations responsible for implementing and sustaining the Sarbanes-Oxley effort in their organisations. The author was fortunate enough to make contact with an Associate Director in PwC who was thinking about performing a similar study on behalf of PwC. An agreement was reached whereby the author would conduct the interviews jointly with the PwC Associate Director. All interviews were held with PwC clients as a result of the contacts that PwC have with these companies through their client-auditor relationship. As a result the sample could be viewed as a convenience sample, but the author is of the conviction that the results of the research nonetheless provide valuable insights into the workings of Sarbanes-Oxley within the South African context.

The original aim was to arrange interviews with ten companies as this would have represented a significant portion of the estimated 50 companies in South Africa that apply the Sarbanes-Oxley Act. It was however with the time frame of this study only possible to get committed interviews arranged with five companies, which represents approximately 10% of the entire estimated population.

The author took responsibility for the drafting of the minutes, the analysis of the information gathered and developing conclusions there from. The PwC Associate Director had no influence on the views and conclusions reached in this research report.

When introducing ourselves to the sampled managers, the only information that was shared was the purpose of the study, that all information gathered would be kept confidential and that the information would be used for a MBL Research Report as well as the publication of a PwC Survey. The interviews were held in a relaxed environment in either the specific managers' office or a conference room at the managers' offices. In all cases except for one, this was the first time that the interviewers and interviewee met each other.

3.4 Design of the research

For the purposes of the research it was important to assess the costs and efforts involved for the sample companies in meeting the Sarbanes-Oxley requirements. Because compliance to the Sarbanes-Oxley Act is a legal requirement, there would be significant value in any action that would result in a reduction of the effort and/or cost involved to be compliant or the extraction of additional value and benefits by implementing best practices. The research further aimed to identify such best practices and their impact.

In order to fulfil the objectives of the research, the author chose to make use of a personal interview with Senior Managers in the sample companies that are accountable for governance and compliance to the Sarbanes-Oxley Act in particular. A qualitative research methodology was selected rather than employing a quantitative method, as the answers to questions asked to address the problem statements for this research are not easily stated in a manner in which they can be statistically measured and analysed.

The use of a personal interview in addition brought about the following advantages:

- By conducting a personal interview, it was possible to ensure that the information being collected was from a reputable source. It made it much easier to ascertain if the selected respondent had a good command of the subject matter and could provide worthwhile views and opinions.

- It was possible to ensure that questions were answered in enough detail to ask for immediate clarification of an answer when needed, which contributed significantly to accurate analysis and conclusions being reached.
- The respondents were motivated to provide as accurate and detailed information as possible, as they were informed before the interview commenced that the results of the survey would be communicated back to them in sufficient detail as to enable them to benchmark themselves with their peers and increase their own effectiveness and efficiencies regarding SOX.

The knowledge base and understanding of the respondents interviewed were of a high quality and as a result almost all of the questions could be answered. The only area in which most of the respondents struggled was with the specifics of costs associated with or as a direct result of the Sarbanes-Oxley efforts.

3.5 Target Population

The target population was Senior Managers in South African based companies who had direct responsibility for Sarbanes-Oxley compliance in their companies.

3.6 Sampling frame

The sampling frame was Senior Managers in South African based companies who had direct responsibility for Sarbanes-Oxley compliance and who could be contacted for an interview through PwC South Africa due to the relationships that had been formed with them through their association with each other.

3.7 Data collection method

Structured personal interviews were held with the respondents. This method of research was also used by numerous other researchers in the same field with good results. This data collection method allowed the author the following:

- The author could ensure that the respondent completely understood the questions being asked and would thus be in a position to give the most accurate response.

- The personal structured interview allowed the author to ask clarifying questions for responses where it could have more than one interpretation, which improved the accuracy of the data collected.
- The personal structured interview allowed for all questions to be answered, whereas in the author's opinion a very low response rate would have resulted if the questionnaires used as the basis for the interview were sent out to the respondents and they were asked to complete it in their own time.
- Additional information could be gathered due to the fact that some of the questions and requests to clarify answers could lead to general discussions around more than just the information relating directly to the question.
- The ability of the individuals to answer questions and provide insights into the subject matter would quickly be determined, as due to the researchers own knowledge of the subject matter as well as that of the PwC Associate Director, they would easily pick up if the person being interviewed had little or inadequate knowledge about the subject matter.

3.7 Measuring instrument

The author acknowledges that there could be a slight bias towards the subject matter from the respondents interviewed due to the fact that they are all directly and significantly involved with SOX compliance in their respective companies, and as such, would in some cases advocate its usefulness. However, in the author's opinion this possible bias will not significantly impact on the results of this research. The respondents have demonstrated that they are the very people that have well thought through and value-adding comments and opinions around the subject matter as a result of their position and responsibilities towards SOX compliance in their companies, and as such their responses will be indicative of the true current state of affairs with regards to SOX in a South African context.

The questions for the structured interview have been designed to be as simple and unambiguous as possible. In the author's opinion, most respondents would interpret all the questions in the same way, and by making use of a personal interview it could be picked up quite easily if a respondent did not understand or misinterpreted the meaning of a particular question. The author also took great care in ensuring that all the questions were asked and answered in the same sequence without deviating from the questionnaire other than for the purpose of asking clarifying questions, and this increased the reliability of the instrument used.

In developing the questionnaire, careful thought has gone into all the questions in order to ensure that the questions being asked tie back exactly to the problems and sub problems that are being investigated. The author developed a questionnaire based on a questionnaire used in another master thesis study by Peter Krimmer. This questionnaire was reviewed by a senior SOX coordinator and a Senior Manager in the SOX Centre of Excellence in the company in which the author is employed. This company is a large South African based multinational petrochemicals and fuels manufacturing company with a secondary listing on the NYSE. This questionnaire was then scrutinized by the PwC Associate Director who had previously developed a questionnaire of her own, and it was found that on many points the two questionnaires agreed on key points. The two questionnaires were then combined and the best of both were retained. The questionnaire formed the basis for the structured interview and all interviews lasted between one and one and half hours. The questionnaire consists of 11 sections and 50 questions, some questions asking for figures, others questions with yes or no answers, and others asking for opinions about issues. The detailed questionnaire has been captured as Annexure I to this report.

The first section of the questionnaire deals with demographics and ensures that sufficient information is gathered to draw accurate conclusions in relation to who in the sample answered the questionnaire; and whether this would impact the answers being given. The questions related to the position of the respondent in the company and additional information about the company the respondent works for in order to be able to make a proper assessment of the size of the Sarbanes-Oxley effort.

The second section of the questionnaire relates to how the implementation of SOX has been experienced in the individual's company. Questions specifically relate to the roles that management, consultants and external auditors have played in the implementation process.

The third section addresses to the costs of Sarbanes-Oxley. Questions relate to man hours and costs spent on SOX, impact of costs for external advisors, impact on the audit fee, and lastly expectations relating to Sarbanes-Oxley costs going forward.

The fourth section relates to the involvement of internal audit in the implementation and day to day SOX activities, as well as how the focus has changed or not after the implementation of SOX at the respondents company.

The fifth section of the questionnaire deals with the risk management process that has been implemented at the respondents company.

The sixth section relates to the methodology used in ensuring that the requirements of the Sarbanes-Oxley Act are met.

The seventh section looks at the software, if any, implemented in order to assist in meeting the requirements of the Sarbanes-Oxley Act, and the effectiveness thereof.

The eighth section asks questions about the overall control environment of the respondents company, in particular whether SOX has brought about an improvement and increased effectiveness, the role of automated controls and what deficiencies were identified through the use of the SAP process.

The ninth section of the questionnaire relates to the use of spreadsheets within the organisation, an area that has been identified as a significant risk in most companies due to the errors that can be easily be made if spreadsheets are not properly controlled.

The tenth section addresses the continuing efforts of the respondent's company with regards to SOX compliance, and in particular, if the company would continue with its SOX efforts if these were no longer mandatory.

The eleventh and final section aims to identify the benefits and best practices that can be extracted from Sarbanes-Oxley compliance. The questions in this section inquire about the relationship between cost and benefits for the respondents company, main benefits and drawbacks of Sarbanes-Oxley, and possible best practices that can be employed in order to increase Sarbanes-Oxley compliance.

The author himself has been directly involved in SOX since its implementation in the company in which he is employed and has also formed some very strong opinions about the subject matter while researching and reviewing the literature on the subject matter. As a result, the author made extra effort to ensure that no leading questions were asked. The answers provided and captured as well were scrutinized afterwards to ensure that it captured the facts as provided by the respondents and that it was not marred by any bias from the author or the PwC Associate Director.

In the author's opinion, the five companies which the respondents were interviewed, compare very closely to other companies in South Africa in terms of Sarbanes-Oxley compliance, as most of these companies that are dual listed on the South African and New York Stock exchange are also large, successful companies with a good reputation regarding corporate governance, similar to the sample interviewed. Thus, in the author's opinion conclusions reached from the questionnaire can be extended to these companies. The author believes that one should be careful to argue that the conclusions drawn here could be extended directly to other companies operating in Africa or other developing companies. The differences between the South African based companies interviewed in this study and companies from other African or developing countries would most likely be too significant due to differences in the economic and political landscapes in which these companies operate in comparison. However, such companies most likely might extract more value from this study than from most of the other studies in this regard that have mainly been done in an American or European context, which is even further apart in terms of the economic and political landscapes in which they operate.

Chapter 4: Research Results

4.1 Section 1: Demographics of respondents

The respondents interviewed all occupied middle to top management positions in their respective companies and in all cases were ultimately responsible for the SOX compliance effort in the companies they represent. The sample included one Chief Financial Officer, one Head of Internal Audit and three Senior Managers. All respondents had many years work experience ranging between 14 to 20 years, and also extensive SOX experience with most being involved or having exposure to SOX for a period of at least 7 years. The respondents' academic qualifications included 3 chartered accountants (CA (SA)), one certified internal auditor and one certified information systems auditor. The quality and experience and close contact of the respondents to the Sarbanes-Oxley process in their companies make it acceptable to draw conclusions on the state of Sarbanes-Oxley implementation in their companies based on the information they provided during their interviews.

Below table provides more detailed demographic information relating to the companies that the respondents represent.

Demographic Information	Company 1	Company 2	Company 3	Company 4	Company 5
Turnover	R142,436m	US\$10,924m	US\$5,400m	CAD148,3m	US\$28,311m
Total Assets	R177,972m	US\$33,322m	US\$10,300m	CAD1,092m	US\$28,311m
Employees	33,708	20,000+	62,064	Not answered	70,000
Industry Type	Oil, Gas & Petrochemical	Mining	Mining	Mining	FMCG
Year end	30 June	31 December	31 December	31 December	31 March
Key business locations	4 out of 34 outside South Africa	No key business locations in South Africa	Numerous locations outside South Africa	Yes	Numerous locations worldwide
SOX Classification	FPI	Foreign subsidiary of SEC Registrant	FPI	Foreign subsidiary of SEC Registrant	Voluntary adoption
First year of reporting	30 June 2007		31 December 2006	30 December 2010	31 March 2005

Table 1: Demographic details of companies which respondents represented

4.2 Section 2: Implementation Resources

All companies except one had extensive involvement from management and consultants with regards to risk assessment, scope identification, design and documentation of processes and controls, as well as design effectiveness assessments and walkthroughs. Three of the five companies also extensively made use of consultants throughout the entire implementation process, from risk assessment straight through to developing the process to management of and reporting on the SOX process. In two of the five companies the external auditors were extensively involved the entire process with the other three involving them within one or two specific areas. In most cases parties involved in the process of implementation were so intensely and extensively involved, and in very few instances were such parties only involved for mere sign-off purposes.

It is clear from the respondents' answers that companies had to make use of significant outside resources in order to implement Sarbanes-Oxley. This also alludes to the fact that in almost all cases, implementation of SOX was a very expensive exercise both from an internal and external resource perspective, and specifically in relation to the internal resources the resulting effect being that it diverted their attention away from other matters. It is further interesting to note that when it came to the critical areas of risk identification, -assessment and -scoping, as well as the identification, design and documentation of processes and controls to mitigate those risks, all companies relied heavily on outside consultants to either complete this role or play a leading role in getting it done. As most of these companies are very large, well-established concerns which have been around for a number of years, it is concerning that these skills, it seem, did not exist in the companies and that these processes were not in place before the advent of Sarbanes-Oxley "forced" it unto these companies. These are processes which should be formally in place in every large listed company to ensure that the company is governed properly and risks are adequately addressed. It was a revelation to the author that companies had to have the advent of Sarbanes-Oxley in order to ensure that these critical processes were formally followed and documented.

4.3 Section 3: Implementation costs

Respondents to the questionnaire were not able to answer the questions in this section in the manner requested by stating Rand and cent amounts. This is to the fact that in all cases accurate records of the costs of implementing and maintaining the SOX is not and has not ever been tracked by the companies in question. The feedback that the respondents could give was that in all cases, the initial implementation was quite expensive and exceeded their initial budgets and assumptions on how much it would cost. Secondly, costs have significantly reduced since the first year, again in all cases mainly due to the discovery during the first review that a reduced number of controls will address the risks effectively. The companies also became smarter and more efficient in completing the documentation and addressing the risks after the first year of implementation.

Most companies except for one had reached a mature state regarding SOX as it has been implemented in these companies for more than three years, and they thus do not foresee big reductions in the costs going forward. Companies were however still looking at ways to reduce their controls or automate them even further, and the implementation of shared ERP platforms were seen to be the biggest opportunity that could be exploited in this area.

4.4 Section 4: Internal Audit involvement

This is the section of the questionnaire in which the greatest disparities and differences between the respondents companies were identified. The two ends of the scale were between the one company in which the Internal Audit function has extensive involvement from implementation (i.e. risk identification, control design, etc.), reporting, quality assurance and the continuous management of the SOX compliance process on a daily basis in the company, compared to another respondent in which the Internal Audit function has nothing more than an incidental impact on the SOX process.

In two of the respondent companies, this made sense as the Internal Audit departments had only recently gained critical mass in these companies and thus did not have the expertise to contribute fully to the process. One company, however, has a very large, well-staffed Internal Audit department, but they are seen as having a pure governance role with no or little focus on SOX. If however, a process is selected to be tested by the Internal Audit department and there are SOX controls in that process, Internal Audit will test and report on those controls as part of their reporting. In line with what was found during the literature studies, most companies interviewed reported that their Internal Audit departments had increased in size and importance and that because of SOX, governance played a much bigger role than before. In the literature study, there was a strong preference noted in the market that Internal Audit should have a role to play in ensuring Sarbanes-Oxley compliance, and at least provide overall assurance on the effectiveness of the organization's documentation and testing of internal controls and Section 302 certification.

Some experts argue strongly that the Internal Audit department must be involved in testing the Sarbanes-Oxley controls due to perceived cost efficiencies, independence and possible value adding suggestions. Also, in the interviews, it became clear that in the companies where Internal Audit departments performed the testing, it does work very well. The companies also believe that it is very efficient, and another means whereby management can ensure that these controls are being tested due to the independence of the Internal Audit function. In none of the companies interviewed was the focus of Internal Audit departments changed to completely focus on financial reporting controls, even though that was expressed as a concern by some of the commentators in the literature.

4.5 Section 5: Risk Management Process

All companies except one reported a significant improvement in the risk management process as a result of implementing an Internal Control over Financial Reporting Framework in order to comply with the requirements of the Sarbanes-Oxley Act. As a minimum, SOX has increased the focus in this area, with most companies reporting an increased effectiveness in this process due to a more rigorous or methodical approach being implemented and annual workshops to assess risks and controls.

In the case of one company, the CFO expressed the opinion that before SOX he had real difficulty in bringing across the importance of a risk management processes to the employees in his company. He stated that the SOX process assisted greatly in ensuring that the critical non-negotiable controls were implemented, and secondly assisted the CFO in ensuring that the necessary discipline was brought into the process as it was well known after SOX that there would be serious consequences if controls were not performing as required. Unfortunately, in most cases the internal controls over financial reporting are not managed as part of the overall risks managed by the Enterprise Risk Management function and seem to remain in most cases the exclusive domain and responsibility of the companies' respective financial departments. This despite the fact that the literature review has highlighted that a best practise in large companies in other part of the world is that SOX is managed as part of the overall risks by the Enterprise Risk Management function.

4.6 Section 6: Methodology

All respondents interviewed stated that their companies followed a top-down risk based approach as recommended by the Guidance to Management issued by the Securities and Exchange Commission (SEC) effective June 2007. All companies also made use of the Committee of Sponsoring Organisations (COSO) framework as a framework to document their controls in order to ensure SOX compliance. However, most respondents noted that they in some cases went beyond the guidance prescribed, as the advent of SOX was seen as an opportunity to not only meet the requirements of the Act, but also to improve on most financial controls in the business.

Most respondents agreed that they had gone beyond the minimum requirements of the Act in order to ensure better governance in their organisations. It is also seen as an advantage to ensure that one is more conservative than the auditors, as this should provide additional comfort that the auditors will not pick up anything at period end which could constitute a significant deficiency or material weakness.

All companies interviewed indicated that they update their risk assessments at least annually, in order to determine their scope for their internal control over financial reporting framework, stating that there is a fixed date in the yearly calendar to do so. However, if any personnel in the organisation become aware of any change which can lead to a risk, it has been stressed that these changes need to be related to the department responsible for SOX in each company so that the impact of these changes on SOX can be assessed and the necessary controls implemented before the change is implemented. In comparing this to what is recommended worldwide, it is good to note that this is very much in line with world best practices in this regard.

The existence and use of entity controls differed significantly between the five entities interviewed. One of the companies interviewed made full use of entity level controls in order to assess financial reporting risks and the adequacy of their controls in order to assess those risks. That same company relied on entity level controls as far as possible in order to eliminate the number of key controls at process level as suggested by the Guidance to Management issued by the SEC. This is very much in line with world best practice.

Another company makes use of entity level controls in assessing their financial reporting risks in addition to the adequacy of their controls in order to assess those risks. However, due to the level of maturity of the control environment inside the company as well as the level of manual controls in operation, the company cannot rely on direct entity level controls to the extent it would like as a means to reduce the amount of controls that need to be assessed and tested at period end. Another company assessed that their control environment is in such a period of infancy that it cannot rely on entity level controls at all and all its efforts should be directed to ensure that the key controls at process level are working well before moving on to entity level controls.

What was a bit surprising to the author was the fact that two companies, despite the fact that they had very mature control environments and numerous entity level controls, did not make use of these controls at all in assessing their financial reporting risks and controls. This is even more surprising as it was to their own detriment since this resulted in a significantly higher number of controls being tested. They did not use

these entity level controls at all in order to eliminate the need for the testing of key controls at process level as suggested in the Guidance to Management issued by the SEC. In both cases, the respondents indicated that although entity level controls existed in their organisations, they did not at all feel comfortable that by testing these controls the need for testing key controls at process level was diminished or could be ignored despite the guidance issued. This is a definite area of improvement for these companies if something could be done in order to ensure that greater reliance could be placed on the entity level controls, as this would result in a significant reduction in the amount of controls that would need to be tested.

Four out of the five companies surveyed indicated that they did not follow a risk based approach at all in determining the nature of the evidence needed to substantiate the effectiveness of the controls. Only one company allowed a reduction of evidence required if the risk associated with the control was perceived as being low. Similar to the feedback received on questions relating to the utilization of entity level controls, this also seems to be due to the fact that management in these companies don't want to get caught out by the auditors. They would rather do more than what is required in order to ensure compliance at period end. South African companies should realise that this conservative approach is resulting in an increased effort and resources being tied up in SOX compliance compared to their American counterparts.

With regards to testing cycles, a significant disparity between companies was also noted. Again there were extremes with one company testing controls monthly and another two testing controls once a year. The other two companies chose to complete testing on a quarterly basis. It is difficult to express an opinion about what number of testing cycles are a best practice and it is definitely advantageous to reduce the amount of testing cycles from a cost and resource perspective. However, if a company only tests once at year-end then finds out that that a key control has failed, this could immediately lead to a significant deficiency and the company would have no time to remediate this control. One would thus have to assume that the management of the particular companies have taken this risk into account in arriving at what they believe to be an optimal mix risk versus benefit when determining the amount of testing cycles per year.

All five companies surveyed had put in place a centralised SOX function which is in line with what American companies have done in order to drive down costs by ensuring standardisation across companies' divisions and/or structures.

In all cases except one the companies have implemented a control owners self-assessment whereby the control owners, once a quarter, or in some cases monthly, certify that the controls for which he/she is responsible have been performed for the period under review and documented properly as to enable auditing thereof by an internal or external party. The one company which decided not to implement this has only recently implemented SOX, and as such, felt that its personnel and control environment had not yet reached the level of maturity required in order to perform control self-assessments. As noted and discussed above there is a wide disparity in the usage of the Internal Audit department to perform operating effectiveness testing.

The one company that has not implemented the control owners self-assessment is also the only one who has made use of consultants in order to perform the operating effectiveness testing on his behalf. This has mainly been done due to capacity constraints within the company in question in addition to having a very small internal audit and SOX department at present which is not resourced to a level which could enable them to assist with the testing. In only one instance is control operating effectiveness testing also performed by the Enterprise Risk Management function, and one of the respondents head office Risk Management function also reviews all test documentation to ensure compliance. None of the companies interviewed made use of cross departmental testing of operating effectiveness, and from the literature review this form of testing is generally not widely used internationally.

Taking the result of the research into account, the author is of the opinion that the best manner in which to perform operating effectiveness testing is to do control self-assessment on a monthly basis in order to ensure that the controls remain in the front of management's minds and no lapses in operating control occur. In addition, the Internal Audit function then test these control self-assessments on a random, surprise basis ensuring that adequate coverage is obtained over the financial year period so that signoff is possible. Because of the unscheduled and independent nature of the

Internal Audit testing this would ensure that tests are performed and also documented to a very high standard so that no problems occur when the audit takes place.

With regards to the testing of automated controls, all of the companies which participated in the survey felt that they could implement more automated controls into their environments. One company felt that they had a reasonable amount of automated controls which they could subject to testing. In this company's case, it did not make use of a benchmarking approach (also commonly known as a base lining) in order to test these automated controls. The reason for this was because these controls were outsourced to outside parties and as such the company did not trust their change controls intrinsically and thus wanted to have a more "hands on" approach to testing these controls. From the literature review however it is clear that benchmarking is the preferred method of testing both in terms of the results obtained as well as the reduction in effort required to reach an appropriate conclusion.

Three of the five companies interviewed made use of the cascading approach in assigning responsibility for the sign-off of the effectiveness of the control environment. In terms of the literature review this is the preferred method of assigning responsibility. It ensures that the person who is responsible for ensuring that the control is operating effectively over the period is also the same person who needs to sign off on a regular basis that this specific control is operating effectively. It ensures proper ownership and allows executives higher up in the organisational hierarchy the comfort to sign off based on the fact that others have taken responsibility for their specific portion of the control matrix. Lastly, it is also cost effective in that it is easier for a person to sign off on something he knows intimately and is involved with on a day to day basis. The one company that has not implemented the cascading approach is still in its infancy regarding Sarbanes-Oxley implementation, and plans to do so at a later stage once a higher level of maturity has been reached.

One of the two companies which stated that they do not make use of a cascading approach do in fact make use of an approach where everybody signs off portions of the controls that are assigned to them. Yet, nobody signs off that their subordinates have done their work or that all the controls that relate to their subordinates have been successfully and correctly completed. Internal Audit in this instance reports on behalf of

the entire organisation stating that controls are operating effectively for the period under review. In the author's opinion, this places too much reliance and strain on the Internal Audit department and middle management should also be tasked to ensure that the SOX controls in the organisation under there are of responsibility are operating effectively for the period under review.

4.7 Section 7: Software

All companies interviewed except for the one which has only in the past two years commenced with SOX implementation has implemented software solutions to assist with the management of its SOX process. As identified in the literature study, this is another main area in which companies can reduce the burden of Sarbanes-Oxley compliance. In terms of software packages used, the companies utilised among others BWISE, SAP GRC, Oracle GRC and Livelink, an open text product.

All companies were highly complementary of their software packages purchased, although none of the packages met all of their needs off the shelf and thus needed to be modified in order to meet their precise requirements. In terms of the storing the relevant documentation and evidence, three companies made use of an intelligent systems such as SAP GRC, BWISE and Oracle GRC with built in workflow, notifications and detailed reports. All three companies however admitted that the functionality was not yet working exactly as they had envisaged. One company made use of Microsoft Word and Excel documents maintained centrally by the company's SOX function. The fifth company made use of a combination of Microsoft Word and Excel documents with data capturing functionality in a central repository with reporting capability functionality but no workflow.

In terms of the retention of testing evidence, two companies made use of scanned and electronic documents centrally saved, another two had scanned and electronic documents saved in a central repository, with one company preferring to make use of paper-based files. It makes sense for companies to strive towards having electronic copies saved in a central repository and it seems almost frightening that a company in this day and age still relies on paper based files in order to retain evidence of their testing.

All companies indicated that they were very satisfied with their current software solution and if given the chance would probably select the same solution again. One respondent did however state that he might consider SAP GRC the next time around. The only complaints that were raised by some of the companies were that the reporting out of their software solutions did not meet their full requirements at the present time.

4.8 Section 8: Control Environment

All companies interviewed saw a significant improvement in their control environment due to the implementation of Sarbanes-Oxley. The main reasons can be summarised as follows:

- Rightly or wrongly, SOX can very effectively be used as a “big stick” in order to ensure compliance to good governance due to the fact the penalties for non-compliance are very harsh for the company, senior executives and the personnel involved.
- Due to the seriousness of non-compliance, many companies have written SOX compliance into their employees performance contracts, giving an added incentive to employees to “toe the line” in this respect.
- Sarbanes-Oxley has resulted in some areas which would have previously been stated as being immaterial and left out of the governance net to be included due to a more formalised and rigorous approach of doing risk assessments.
- Commitment from top management in setting the “tone at the top” regarding the importance of governance resulted in the embedding of internal control ownership in the organisation.
- It is interesting to note that benefits such as making use of the COSO reference framework, a better understanding of the risks associated with general computer controls, and also an improved definition of controls and the relationship between risks and controls highlighted by the literature reviewed were not mentioned by the respondents. In the authors opinion the respondents merely forgot to mention these facts as he is sure that they have gained similar benefits from his own experience.

With regards to a reduction in controls tested, all companies excluding the one company who was only in its second year of Sarbanes-Oxley testing indicated a significant decline in the number of controls tested. The reductions mentioned ranged between 20% to 64%, with most companies reporting reductions in the upper end of the scale. These are significant improvements and show that the South African companies have matured significantly since implementation.

Reasons for the reduction in controls were stated as follows:

- Better understanding of risks of material misstatement, mentioned by three companies
- Better use of entity level- and/or monitoring controls at entity and process level, mentioned by one company
- Optimisation and standardisation of controls, mentioned by 2 companies
- Better use of automated controls to limit manual controls. Only one company reported limited use of this opportunity
- One company has, due to cost pressures, decided to streamline business processes which has brought down the number of controls - but this is not a direct consequence of SOX.

The findings from a recent study from Protiviti (Protiviti, 2011) were compared with the results above and the following was noted:

- Companies in the US also listed a risk-based approach, using entity level and monitoring controls and the optimisation and standardisation of controls as key strategies used in order to reduce the burden of compliance.
- It was interesting to note that in comparison the companies in the Protiviti survey had also not yet made better use of automated controls but were planning to do so in coming years.
- The only strategy mentioned that were not picked up in the South African interviews were the establishment of process owner accountability.

With regards to automated controls, it was noted that South African companies, in line with the experience of their American counterparts, were making very limited use of automated controls at present, with only two companies reporting that they did have some limited automated controls. The big hindrance in employing more automated controls are the fragmented state of their ERP systems, with the ERP systems technically separated from each other and hosted on servers and locations, as well as in some cases numerous different typed of ERP systems being used. With regards to automated controls, it is evident that the level of maturity up to the required standard and many manual controls still exist as a result.

Every company surveyed reported that the implementation of SOX has resulted in an improvement in process knowledge and awareness of governance within their organisation. In the respondents' views, this was due to SOX "forcing" companies to perform a walkthrough test of each of its controls on an annual basis. Also as stated earlier, SOX highlighted the importance of controls and the impact of their failure on the organisation, thus ensuring that employees spent much more time understanding processes in the company and how it could be controlled. This also sensitised employees to bring any changes that could affect the SOX control environment to the immediate attention of the accountable entities. Lastly, SOX forced companies to document their controls and processes which further assisted in increasing knowledge and awareness.

As mentioned previously the companies confirmed that SOX implementation has resulted in a significant improvement in control owners taking ownership for their controls. Companies have implemented additional measures to ensure that controls remain a big focus area and these include:

- Including SOX compliance in employees KPA's and bonuses
- Holding regular road shows to increase awareness
- The impact of having regular control self-assessments
- Key top managers such as the CEO stating the importance of controls and setting the tone at the top.

All companies except one also stated that there has been a significant improvement in the efficiency and effectiveness of their processes and controls by eliminating unnecessary or duplicated controls.

Companies further stated that more reliance could now be placed on the numbers being generated by the systems within their companies. However, none of the companies believed that because of SOX there was now necessarily better data available for decision making and strategic planning. It should be noted that this was never one of the key objectives of SOX.

Only two companies stated that they had significantly standardised processes and controls because of Sarbanes-Oxley. Another company stated that this had been done but was done as a business imperative and not because of SOX. The remain two companies stated that it was something they would like to focus on in the future, but once again, because of the maturity of their control environment and the fragmented state of their business at present, this was not possible. This is of course a major benefit of SOX and as such at least all the companies were aware that it was something that they should focus on.

With regards to Information Technology General Controls (ITGC) and the implementation of automated solutions to manage access and segregation of duties within the respondents key financial applications, again only two companies reported a significant improvement due to the implementation of the SOX process, with one other stating that there has been a significant improvement but again due to it being a business imperative rather than being driven by SOX. The other two companies could not make any significant headway in this regard, due to the now familiar reasons of the relative “immaturity” of their control and information technology departments, and the fact that their information technology was highly fragmented with systems being hosted on various servers and in numerous geographic locations, as well as many varying systems being used in order to compute their numbers for them. All the respondents except one mentioned their information technology systems as a section of their relative businesses which could be optimised greatly and with a significantly positive impact on the companies bottom line as well as governance.

Unfortunately, in most cases, it seems that IT systems in the South African context were set up somewhat haphazardly, and systems were merely added without much or any consideration being given to standardisation at all. This result in significant expenses with regards to the resources, as well large monetary expenses for the companies who wish to sort out the mess. One of the companies indicated that estimations are that it would cost 1 billion South African Rand in order to consolidate all its ERP systems into one and it would take between two and three years to complete.

It is also concerning to note that only two companies were able to implement an automated solution to manage their access and segregation of duties within their key financial applications. It would not be overstating the importance by saying that it is of absolute critical importance that companies ensure that these controls are properly in place, and that no control failures occur. A failure in this section of the controls of a company would certainly place a company's entire control structure at risk and could easily result in a material weakness being disclosed at year end.

Three of the five companies interviewed had components of their Information Technology General Controls that were considered in scope for SOX outsourced to third party service providers, however none of the companies surveyed made use of International Standard on Assurance Engagements 3402 in order to provide them with comfort that the controls over their applications being outsourced is operating effectively. This is despite the fact that this standard and its predecessor is widely used by external auditors of organisations to understand and gain assurance that proper controls relevant to companies internal control over financial reporting are in place at entities to whom these controls have been outsourced (Grant Thornton,2011). All respondents stated that rather than relying on the standard, they preferred to visit the entity and perform audit tests which are designed in exactly the same fashion as if the outsourced activities had been performed in-house. All respondents felt that this was a better and more cost effective approach rather than making use of the audit standard.

With relation to the specific themes that could be identified in the ITGC deficiencies that were recognized at the companies, there was a 100% alignment between the respondents that access control security and the segregation of duties were the most problematic and most likely to give rise to a problem. This again makes the finding above, that only two of the companies surveyed have implemented an automated solution in order to manage the risks, even more surprising.

The area that was ranked as second most likely to give rise to a deficiency was change management, i.e. the procedures employed to ensure that all changes to a company's IT system is properly tested and approved before being implemented. The last matter noted which is least likely to give rise to a deficiency in the opinion of the respondents, is controls over the IT departments operations, with these generally not giving rise to significant problems.

When the question was asked what were the typical control deficiencies or issues that your company had to remediate as a result of the organisation implementing SOX, the following themes emerged:

- Lack of formalised process descriptions and documented controls, noted by three companies.
- Lack of formalised evidence to support operating effectiveness conclusions, noted by two companies.
- Accounting issues related to the application of GAAP/ IFRS, in particular in relation to once-off unusual transactions, noted by two companies.
- The financial close-out process, including journals posted at this period in order to correct the accounts with problems most frequently occurring when non routine or complex transactions occur within a specific period end, noted by two companies.
- Information Technology issues, noted by two companies.

In one company's set of circumstances, control design in any of the areas above was not seen to be a problem. However, there were frequently deficiencies picked up due to high staff turnover, inadequately skilled personnel and poor discipline amongst staff. This frequently led to controls not being exercised in the time period as stipulated, which leads to deficiencies. In some cases, it was also felt that the time frames which

were communicated by head office were unrealistic. However, any attempts to change these controls to more reasonable time frames were rejected by the central SOX office of this company.

In another company's situation, most deficiencies relate to the product to cash process mainly because it is a very high volume, low to medium value process in which any of a number of small things can go wrong. However, 99% of the time it was with immaterial consequences for the company involved and as such not a major area of concern. So, although errors are picked up in this area, they are generally so immaterial that the company is happy with the design and manner in which the controls are operating at present.

Only one of the companies surveyed stated that it had identified significant deficiencies. In relation to this company, the following main themes have been identified as contributing to significant deficiencies:

- Incorrect application of IFRS in some transactions processed by the entity, specifically in the area of once off, non-routine transactions such as BEE deals.
- There has frequently been an ineffective review process as the level and precision of review applied by managers have not been up to the required standard.
- Lastly, some problems related to inadequately skilled personnel.

In the author's opinion, it should be of concern for the other companies to not have picked up significant deficiencies. In the author's opinion, all companies will have significant deficiencies appearing infrequently. It would be irregular to not see any significant deficiencies reported in companies that have such significant operations such as the ones that have been interviewed.

It is difficult to comprehend how the one company which has only recently decided to implement SOX, did not pick up any significant deficiencies in its first year of implementation. In the author's opinion, this would point to a situation where personnel are simply too scared to report that a control has failed and are thus covering up the mistakes rather than disclosing it and then taking the necessary steps in order to

remediate it. This could point to a serious cultural issue in the organisations and should be investigated.

4.9 Section 9: The utilisation of spreadsheets for key processes

All companies interviewed, except one, indicated that they had made use of a large number of spreadsheets in their key processes. One company indicated that there was only one spreadsheet in the entire organisation which related to its key processes. This seems to be a best practice as most companies in the USA reported that the significant use of spreadsheets in key processes were one of their major concerns and focus areas when starting to implement SOX.

Of the four companies who stated that they had made use of a high number of spreadsheets, three had as a result of SOX implemented a system whereby they now had proper control and visibility over the spreadsheets and could ensure that the spreadsheets are properly controlled via:

- Adherence to spreadsheet policy that would address certain key concepts that needed to be adhered to when making use of spreadsheets such as change control, access control, backups etc.
- Implementation and regular updates to a spreadsheet register
- Making use of a software solution to validate the accuracy of the spreadsheet being used by looking at common errors such as formulas referring to empty cells, inconsistent copying of formulas, text entered into cells used for calculations etc.

Again, a key area of concern is that the one company has not implemented any standardised process to control this very important area. Only one of the companies surveyed had managed to reduce their spreadsheets significantly since implementing Sarbanes-Oxley.

4.10 Section 10: Continuing with SOX efforts

All companies would continue with their SOX compliance efforts even if their company or holding company would de-list from the NYSE. Comments made in this regard were that SOX had provided a great impetus and framework in order to implement and maintain controls in the organisation with less duplications and increased efficiencies, thus resulting in a better control environment. It has also ensured that all the companies' heads of departments are much more committed than before to the control process. One company however stated that even though SOX does add value, if it weren't compulsory the respondent was of the view that he would like to apply SOX with a little less rigour as enforced at present by the SEC.

None of the companies surveyed had de-listed from the NYSE, thus this question was not answered.

4.11 Section 11: General

All respondents replied positively to the question of whether the benefits outweigh the costs of implementing SOX in their respective companies. In fact, all answers were not only yes, but yes in the strongest possible manner. Comments in this regard were as follows:

- Yes – Sarbanes-Oxley has ensured that the company has an increased focus on governance. It is imperative for such a large company to be control-conscious about something that was probably not entirely the case before Sarbanes-Oxley.
- Definitively the benefits outweigh the costs, the biggest reason being that it is highly unlikely that such a good control environment would have been implemented in such a short period of time if it was not for SOX.
- Yes definitively – Sarbanes-Oxley has provided increased assurance for the board of directors and audit committee. It has also significantly increased ownership and accountability for key controls by management.
- Definitively as indicated before, SOX has cut out duplications, increased efficiencies and resulted in a better control environment
- Heads of departments are so much more committed to the control process.
- Yes, it has increased accountability and control over processes.

The respondents were asked for their opinion on what could be done within their companies and industry to increase the effectiveness of SOX compliance. They responded as follows:

- Stabilise the control framework and drive standardisation, as different interpretations of the rules by different people is problematic at present.
- Work has only started and much more can be done in terms of the documentation of controls, implementation and making use of entity level controls, as well as enhanced ITGC controls.
- Personnel can be made even more aware by increased efforts to ensure continuous awareness amongst staff about SOX and controls and the importance thereof. Further embedding of SOX into all processes is also needed.
- In my company, SOX consolidation, increased standardisation and the continued implementation of the centralisation of functions. For the industry, including my company, more focus on automated controls.
- Sometimes personnel still display disrespect for controls, and in my organisation this is a serious problem. Also, in some cases personnel still don't see SOX as part of their daily activities, resulting in changes in controls not being made even though the activities have changed. Maturity of personnel still remains an issue.

In all cases except one, the respondents indicated that they would recommend SOX to their peers as a valuable instrument to implement in their respective companies even though it is not compulsory if you are not listed on the NYSE, due to the increased focus on controls and the manner in which it assists in establishing a robust control environment. Some however, indicated that they would not have implemented SOX with the same rigour as enforced by the SEC if it was a voluntary adoption.

The one company, who stated that they would not recommend SOX to their peers, stated that the only reason is due to the fact that such a negative stigma is attached to SOX, with all the reporting in the press focusing on the opinions of those that believe that it is a complete waste of money. They would thus rather recommend that other companies implement an integrated control framework over financial reporting that would bring most of the advantages of SOX with it without any of the negative perceptions that surround it at present.

One company interviewed stated that even though it was an early adopter, it did not disclose this fact in its annual financial statements. This alludes to the view held by this company that it does not believe that implementing SOX would have a significant positive influence on its share price. This was somewhat surprising as one of the main aims of the Sarbanes-Oxley Act to increase investor confidence in companies with the resulting increase in those companies' share prices.

Chapter 5: Outcomes

The author feels that the overall outcome of the study was positive, with most of the objectives being met, despite the fact that the sample was smaller than originally planned. Even though contact were made with respondent companies through PwC, it was still very difficult to find time available in the diaries of the relevant people and to set up and confirm the dates and times. It is unfortunate, but the only conclusion that can be drawn is that clients did not see the benefit of partaking in such study, and as a result they were not motivated to set aside some time in their busy schedules to partake in the study.

The five companies selected provided a reasonable spread, with one company being only two years into SOX implementation and the others being between four and six our years into the process. It became clear during the study that one of the other four companies who are 4 to 6 years into implementation still had significant problems in its control environment and its governance culture structure, and that procedures were still reasonably immature. This is probably due to the fact that its SOX location is based in an Eastern African rural area which, according to the respondent, was so isolated that it posed significant challenges to attract and retain suitably qualified staff to work in there. The company frequently found that personnel would after their first stint working at the mining operations of the company not give even 24 hours' notice and simply not return to work after their first vacation period.

Four of the companies interviewed are resources companies, with one company competing in the FMCG area. Due to this, the companies employ large numbers of staff, with numbers ranging between 20 000 and 70 000 staff members. It would thus have a devastating impact socially if any of these companies were to go out of business, and thus it was encouraging to see that most of these companies took SOX compliance and governance in general very seriously indeed.

Three companies had SOX locations internationally as well as in South Africa, one only had a location in South Africa and another only had a location outside of South Africa. The spread of company classification was also excellent with two FPI's, two foreign subsidiaries and one voluntary adopter. In fact, the author was very fortunate to obtain an interview with one voluntary adopter, as these make up a very small percentage of the total population. As also noted in the research results section, although the sample was small, the quality of the respondents was very high and the structured personal interviews lend it to obtaining detailed in depth data with regards to almost all the questions asked. This provided sufficient information to draw conclusions.

Chapter 6: Conclusions

The following section identifies and discusses the conclusions reached by the author from the research conducted.

6.1 Effort and resources

Sarbanes-Oxley involved a significant effort to implement both, in terms of internal resources of companies being tied up in the process, as well as costs spent on outside consultants needed to exist. In the research results, it was noted that Sarbanes-Oxley was very expensive to implement. Although exact figures could not be given, the respondents indicated that it was a very long complicated and expensive process. This is aligned with what was predicted by the critics of the Act such as Formaini, Siems and Braddock.

Formaini and Siems stated that the law is complicated, costly and burdensome to accountants, firms and taxpayers (Formaini and Siems, 2005). Braddock was most concerned that there would be a significant opportunity cost to companies due to substantial time and resources being spent on Sarbanes-Oxley rather than focusing on core business activities. He was also adamant that these resources could have been utilised in a more productive and profitable manner which could add much more additional value to the company than Sarbanes-Oxley activities (Braddock, 2006).

6.2 External consultants

Companies could not manage the implementation process on their own and were heavily reliant on external consultants to implement Sarbanes-Oxley effectively. All companies interviewed stated that they made use of consultants in their implementation efforts. The one conclusion that can be drawn from this is that it was very onerous to implement SOX, and the other is that in some cases companies' internal knowledge and practices around governance were not up to standard and needed significant help in order to get their practices up to speed.

6.3 Internal governance prior to SOX

Most companies' internal governance processes were not up to the standard required before the advent of Sarbanes-Oxley. As noted previously, significant effort was spent by the companies in getting Sarbanes-Oxley implemented. This, together with the fact that most of the respondents mentioned that Sarbanes-Oxley had given rise to a considerable increase in the quality of controls as well as adherence, points to the reality that governance processes were not what they should have been in these companies, especially since they are publicly listed and employing tens of thousands of people. The failure of governance at organizations was one of the main reasons for the birth of this legislation, and even in a South African context does the propensity to leave governance by the wayside unless it is enforced seem to hold true.

This finding aligns with the thoughts of US regulators who felt that because companies still are having difficulty complying after controls have been in federal law for 25 years; it does not speak well for the quality of companies' controls (Henry, Borrus, Lavelle, Brady, Arndt and Weber, 2005). An Institute of Internal Auditors study also found that due to SOX, corporations had improved their internal controls (Coigne, 2008).

6.4 Role of Internal Audit departments

In direct contradiction with what was revealed during the literature study, and more specifically during a review of the impact of SOX on American companies by Protiviti, it was noted that in most South African companies Internal Audit departments did not significantly change their role inside companies due to the advent of SOX. Most Internal Audit departments carried on with their duties as normal, with only one company reporting that they were now also responsible for SOX testing. Most companies however report that Sarbanes-Oxley did have the effect of ensuring that Internal Audit had more resources to do their tasks and also had grown in importance since SOX was implemented. In the author's opinion, this is an area where South African companies could be more aligned to world best practices and that the Internal Audit function should play a much larger role in Sarbanes-Oxley efforts.

6.5 Impact on risk management

In line with the findings by Rittenberg and Miller that an improved definition of controls and the relationship between risks and controls in the organisation as a result of SOX should improve risk management in companies (Rittenberg and Miller, 2005), South African companies reported a significant improvement in the risk management processes in their companies as a direct result of SOX. In the author's opinion, this is most likely as a direct result of the penalties in the Act that can such as the directors and specifically CFO and CEO to go to jail if found that they had not complied with the provisions of the Act. Thus, most companies have implemented a much more rigorous and methodical approach to risk management, and at the very least, they have implemented workshops annually to assess their risks and ensure that there are adequate controls to control those risks.

6.6 Top down risk approach

It is reassuring to note that all respondents stated that their companies make use of a top down risk approach as recommended by the SEC and various subject experts in the literature review. Douglas, in particular, felt that this was one of the key principles that needed to be followed in order to reduce the burden of Sarbanes-Oxley compliance (Douglas, 2010).

6.7 Over-compliance

Most South African companies went beyond what was strictly required by the Act in order to ensure compliance. It is a key concern from some commentators in the literature that due to the fear of non-compliance and the associated extensive penalties of the Act, that this could easily lead to an absolute overkill in terms of time and resources in an attempt to ensure compliance (Butler and Ribstein, 2006). The same commentators also lamented the fact that the Act would most probably cause a diversion of management time and talent away from their primary tasks, which are to ensure that there is increasing value add for shareholders.

In light of the comments made by the respondents, one would have to concur that it is in fact a reality in these South African companies that in terms of compliance to the Act, they go above and beyond the legislative requirement. Whether or not the respondents believe that this in fact cause a significant diversion of manage time and talent was difficult to gauge, because in the opinion of the author the respondents have a significant bias to the subject matter as the Act effectively gives credence to their position in their respective companies.

6.8 Change control

South African companies have made an effort to ensure that any changes to the businesses that could have an effect on controls and risks are appropriately escalated. All respondents stated that significant efforts have been made through activities such as “appropriate tone at the top”, road shows and frequent communication to ensure that all staff is aware that any changes in activities should be related to appropriate personnel. This would enable the control environment of the company to be assessed regularly and with each instance of such change that could possibly create risk. As per the view of a PwC study, all companies should ensure that SOX is part of the day to day activities of the company. This should result in risks being identified at inception and thus reduce the probability of the risks being missed or action taken too late (PwC, 2005). It is thus heartening to see that the companies interviewed are following this world class practice.

6.9 Status of internal control environments

Despite the implementation of Sarbanes-Oxley, many South African companies internal control environments are still not up to world class standards. Throughout the study, it became apparent through the answers to various questions that the respondents felt that compliance in their companies still had some way to go before it could be classified as being world class. This has many undesirable effects, with the most important one being that it means that despite all the work done there is still an unacceptably high percentage on non-compliance that could occur.

Secondly, it means that many of the best practices such as entity level controls are not utilised or implemented. In the opinion of the author, this is something South African companies should make urgent work of. It is worrying to note despite many years of Sarbanes-Oxley implementation in most cases, most companies are still struggling to reach this milestone.

South African companies are however not alone in this regard, as per a recent study by Protivity in the US, it was noted that nine years after the Act had been promulgated in the United States, companies surveyed felt that they were still learning and increasing the efficiency and effectiveness of control environments (Protivity, 2011).

6.10 Number of testing cycles

There was significant disparity with regards to the amount of testing cycles performed, with one company testing controls on a monthly basis and another two testing it on a yearly basis. The amount of testing cycles should be based on management's assessment of the risk involved when testing is done less frequently versus effort and impact on resources with more frequent testing cycles. It is difficult for the author to argue for or against the approach chosen by any one company, as the specific risk factors that each company are facing may differ significantly between.

The author is however of the opinion that testing only once a year, as in the case of two respondents, probably exposes the company to more risk than could be sufficiently balanced by the benefits in reduced time and effort spend. One company mentioned that they managed to drive down effort and cost considerably by reducing the amount of testing cycles, and the feedback from the respondents do demonstrate that management do think about the most optimal number of testing cycles from both a risk and cost perspective.

6.11 Centralised SOX functions

In line with American best practice, all South African companies have a centralised SOX function which drives standardisation.

6.12 Control owner self-assessment

Most South African companies have implemented control owner self-assessment in order to increase accountability and to keep controls in the forefront of staff's minds.

6.13 Cascading approach

Some South African companies don't make use of the cascading (also known as sub-certification process) approach when assigning responsibility to managers. The majority of overseas companies make use of the cascading approach in assigning responsibility to managers. This has been identified in the literature review as a best practice due to the fact that it prompts managers and others responsible for controls to continue to execute them effectively, and can be a main driver of accountability (Deloitte and Touche, 2007). Also, the Protivity SOX survey of United States companies, listed establishing owner accountability as being one of the key practices driving increased Sarbanes-Oxley efficiency.

However, two out of the five South African companies do not make use of this approach and rather assign all their responsibilities to the Internal Audit or SOX departments. In the author's opinion, the cascading approach is definitively the best approach to follow for the reasons mentioned above and should be followed by all companies. One of the two companies did however state that it was on its agenda for implementation at a later stage.

6.14 Use of software

Most South African companies do make use of a software package in order to reduce the burden of SOX compliance. The software packages used by the companies in

order to aid with their SOX process do not meet all their reporting requirements currently, but work is underway to change that.

6.15 Improvements in control environment

All companies interviewed saw a significant improvement in their control environment and attributed this in the most part due to Sarbanes-Oxley implementation. As stated in the research results section, the main reasons for this was as follow:

- Making use of Sarbanes-Oxley as a “big stick” in order to ensure that managers as well as ordinary personnel always have controls and governance at the front of their minds.
- The guidance in terms of the Act has resulted in a much more formal and rigorous approach to risk assessments and control allocation being followed.
- Commitment from top management in setting the right “tone at the top” in the companies that were interviewed, something that is also prescribed by the Act.
- Making use of the COSO framework.
- A better understanding of the risks associated with general computer controls.
- Improved definition of controls.
- Improved understanding of the relationship between risks and the controls that are supposed to reduce those risks to an acceptable level.

These comments are substantially in line with what has been reported in American studies, specifically the Protivity surveys of 2010 and 2011.

6.16 Reduction in number of controls

All South African companies reported a significant reduction in the number of controls (between 20% to 64%) in line with what was experienced internationally. The most important reason for this was listed as being in a position to better understand the risks of material misstatement after being exposed to the Sarbanes-Oxley implementation.

6.17 Business process knowledge

All South African companies have increased their process knowledge and awareness as a result of SOX implementation.

6.18 Annual “walk through” tests

Annual “walk through” tests of controls are a world best practice in terms of ensuring better process knowledge and awareness and are practiced at all South African companies.

6.19 Unnecessary and/or duplicated controls

As a result of Sarbanes-Oxley, companies eliminated many unnecessary and/or duplicated controls resulting in increased efficiency and effectiveness of their processes.

6.20 Ownership of controls

Sarbanes-Oxley has resulted in many control owners in the companies’ surveyed taking more ownership for their controls.

6.21 Trust in numbers reported

Sarbanes-Oxley has realised its chief objective, in that South African companies believe that greater trust can be placed in the numbers reported. However, the respondents feel that SOX has not resulted in new and/or more relevant information being presented to top management which could have enabled better decision making.

6.22 Standardised processes and controls

Some South African companies have not yet significantly standardised their processes and controls because of SOX, although it is well known to all the companies that this is a key benefit of SOX.

6.23 Contributors to control deficiency

Second only to automated controls, change management is the matter that most managers believe is most likely to give rise to a control deficiency or failure in its Information Technology operations, while controls over IT operations were mentioned to be less likely to give rise to problems by the respondents.

6.24 Typical problems remediated towards SOX compliance

Five issues were identified as being the most typical problems that South African companies had to remediate as part of their efforts to be SOX compliant:

- Lack of formalised process descriptions and documented controls
- Lack of formalised evidence to support operating effectiveness conclusions
- Accounting issues related to the application of GAAP/ IFRS, in particular in relation to once-off unusual transactions
- The financial close-out process, including journals posted at this period in order to correct the accounts with problems, most frequently occurring when non-routine or complex transactions occur within a specific period end
- Information technology issues

6.25 Elimination of significant deficiencies

South African companies have for the most part eliminated significant deficiencies in their controls. Only one in five companies surveyed had picked up significant deficiencies in their controls since starting with the Sarbanes-Oxley effort.

6.26 Use of spreadsheets

The advent of SOX has not really aided in the reduction of the use of spreadsheets. Only one of the companies surveyed reported that they had managed to reduce the number of spreadsheets used to supply critical information to their accounting system. Three of the five companies surveyed at least made use of a system which aided them in ensuring that the numbers being generated by spreadsheets were controlled and could be relied upon. In the author's opinion, the wide spread use of spreadsheet to generate critical accounting information should be limited as far as possible, or as minimum systems should then be deployed to bring more surety in terms of accuracy and control over spreadsheets.

6.27 Additional value add

Sarbanes-Oxley has added more value to companies other than only the aspect of being legally compliant. All five of the companies interviewed indicated that they would continue with the SOX effort even if they were no longer forced by law to comply therewith. This is one of the critical questions that the author wanted to have answered when starting with this research. The author was initially surprised at this particular outcome of the research, but again one need to take into account the possible bias in the respondents' answers. The respondents' livelihoods in most cases depend on SOX and the work surrounding it, and SOX have given prominence to their importance and the resources that they have been afforded in their organisations. The author is thus of the opinion that even though the answer to the question was a resounding yes, another study in which the CEO's and boards of companies are questioned about the impact and value of SOX is needed before a definitive answer can be given as to whether SOX compliance has had more value to companies other than mere legal compliances.

Nonetheless, the reasons given for the resounding support for the Sarbanes-Oxley Act beyond legal compliance do ring true from the perspective of the author, and include that:

- SOX had provided a great impetus and framework which were used in the companies surveyed to great effect to implement and maintain controls and to sharpen up the governance processes.
- SOX has through the increased investigation it has prompted into the relative companies' internal control environments, cut duplications and increased efficiencies.
- It has resulted in heads of departments being much more committed to good governance and control practices.

Some companies did however state that they would like to lose some of the rigour imposed by the Act at present if they were to continue with Sarbanes-Oxley in their companies without it having to be a legal requirement.

6.28 Benefits versus Costs

When asked whether the benefits of Sarbanes-Oxley outweighed the costs, the answers were in all cases a resounding yes. Comments made in this regard were interesting to note:

- Sarbanes-Oxley had made the companies much more focused on controls and governance than before.
- Sarbanes-Oxley enabled the companies to implement a good control environment in a short period of time, something that would likely not have been possible without it.
- Sarbanes-Oxley has resulted in increased assurance for the board of directors as well as the audit committee, and it has significantly increased ownership and accountability for controls.
- Sarbanes-Oxley has reduced duplication, increased efficiencies and resulted in a better control environment.
- It has greatly increased accountability and control over processes.

These comments dovetail with what was stated in the literature review under positive comments about the Act in particular:

- An Institute of Internal Auditors study found that due to SOX, corporations had improved their internal controls and that financial statements are perceived to be more reliable (Coigne, 2008).
- There should be an embedding of internal control ownership into the culture of the organisation and, that as well as the documenting of standardised procedures, supervisory review and approval, management actions and decision and the investigation and resolution of un-reconciled and/or outstanding items, will increase the effectiveness of risk management in companies (Rittenberg and Miller, 2005 and Harrington, 2005).

These comments are in line with those aired by American counterparts, with 70% of respondents to the Protivity survey stated that they experienced that the benefits of Sarbanes-Oxley outweighed the costs of compliance. This response rate dropped to 39% for the companies who just completed SOX implementation for the first time, a figure that is still very significant.

6.29 Means to increase effectiveness of SOX compliance

South African companies agree that the main themes for increasing the effectiveness of SOX compliance were standardisation and centralisation of functions, utilising entity level controls, enhancement of ITGC controls, more automated controls and increased awareness and vigilance regarding controls. When these are compared to the results of the Protivity survey which focused on American companies which need to comply with Sarbanes-Oxley, it became apparent that the American and South African companies agree on the benefits of increasing automated controls and consolidation of information technology processes, platforms and systems (Protivity, 2011).

Which was not revealed during the study was making use of continuous monitoring tools or techniques and data mining and analytics (Protivity, 2011).

Chapter 7: Recommendations

From the research conducted and the conclusions reached, the following are recommendations by the author for consideration by South African companies who have implemented SOX.

7.1 Use of Internal Audit

South African companies should consider making more use of their Internal Audit functions to drive compliance with Sarbanes-Oxley. The author agrees with the comments of Norman Marks, Vice President: Governance, Risk and Compliance at SAP, who stated that companies should make use of Internal Audit to perform the testing of controls (Marks, 2011). This has many advantages, the most important being that it should result in cost efficiencies, the possibility of increased value add due to their proficiency in the internal control environment, and – most importantly to the author -their independence which would ensure that any controls or evidence that don't meet the requirements are immediately picked up. Companies should then ensure that the Internal Audit department is adequately to ensure that they can fulfil this function

7.2 Involving the Risk Management function

The internal controls over financial reporting should be managed as part of the overall risks managed for the company by the Risk Management function. Due to the significant penalties involved as well as the reputational damage and effect on the companies' share price etc., it is the opinion of the author that the financial reporting risks and controls must form part of the overall risks managed by the Risk Management function in the business. Unfortunately, all the companies surveyed reported that this is not the case and SOX is left out of the overall risk management process and seen to be part and under control of the Financial function. In the author's opinion it is too important to leave it to the Financial department alone to manage and an integrated risk management approach may well serve companies well in managing risks in a much more proficient manner.

7.3 Use of COSO

“By making use of COSO, a business can not only evaluate its controls over financial reporting, but also use it to evaluate the controls that control operational effectiveness and efficiency and compliance with laws and regulations, with the obvious improvements that will bring.” (Bowling, Julien and Rieger, 2003).

The above view from Bowling, Julien and Rieger has been backed up in no small part by the sample companies' responses in their interviews. Most of the interviewed companies recommended SOX as good tool to evaluate control. But they all recommended that at the very least companies should make use of a framework such as COSO in order to effectively manage the risks in any organisation due to the structure, efficiency as well as cost efficiencies it brings in terms of ensuring that financial reporting risks are effectively managed.

7.4 Use of entity level controls

South African companies should make more use of entity level controls in order to reduce transactional level testing. One of the key best practices identified in the literature review is the use of entity level controls. The author concurs with the views of Ernest and Young as well as Gerkes et. al. that entity level controls can significantly reduce the amount of transactional testing, and that it provides a framework and “infrastructure” within which operational and transactional controls operate.

As such, the author feels that it is imperative to implement and make use of entity level controls as far as possible. Most respondents however stated that either their environment had not yet reached a ‘level of maturity’ in which reliance could be placed on entity level controls only and that management did not trust that just reviewing the entity level controls reduced the risk of an error occurring to an acceptable level. South African companies should place this close to the top of the list of priorities for governance they want to achieve in the near future.

7.5 Risk based approach towards evidence

South African companies do not allow for a risk based approach in the evaluation of evidence presented, and this could be considered in order to increase effectiveness. A risk based approach toward evidence was mentioned in the recent Protivity Sarbanes-Oxley survey amongst American companies to be one of the top seven strategies that companies are currently employing in order to increase the effectiveness of their Sarbanes-Oxley processes.

In terms of best practices identified in the literature review, the Securities and Exchange Commission in 2007 identified making use of a risk based approach in order to decide which evidence should be reviewed to ensure that the controls are operating effectively as intended. So, for instance in the case of a controls which has a low level of risk and is very unlikely to fail, management could rely on something such as a management self-assessment, while for a critical risky control, more direct evidence would be required. From the interviews it was clear that most South African companies did not follow this practice, which is something they could consider in order to reduce the costs and time of compliance in future.

7.6 Use of automated controls

South African companies can implement more automated controls in order to drive down risk and reduce work and cost. South African companies are well aware of the benefits of automated controls and have spent some time and effort to increase the prevalence of these controls in their business. However all of them agree that they are far removed at present from a world class percentage of their controls being automated.

In the literature study, a best practice identified was that companies should strive towards having 50% of their controls being automated controls (Ernest and Young, 2005). All companies surveyed for the purposes of research report have indicated that they are not close to this number. This is however a worldwide problem with a recent study from Protivity indicating that American companies rated increase in automated controls as one of their top five priorities for the year ahead (Protivity, 2011).

7.7 Base lining approach to testing automated controls

Companies should make use of a base lining approach when testing automated controls. From the research it was noted that South African companies don't make use of a base lining approach when testing automated controls, preferring to have a more hands-on approach. The respondents indicated that they felt that the requirements of base lining when testing to be onerous and were reluctant to trust the results. However, the author believes that this is an area which should be revisited by companies, as the literature indicated that by making use of a benchmarking approach test strategy, the company could reduce their workload significantly and at the same time reduce their risks to an acceptable level (De Bruijn, 2008).

7.8 Document management for SOX

South African companies can improve the manner in which they manage their SOX documentation and testing evidence. Two companies surveyed did not make use of a workflow enabled solution for storing their SOX documentation, and one company was still storing its testing information manually using paper-based files and folders. Employing appropriate electronic document management solutions for the SOX environment is really an easy way to reduce the burden of SOX compliance, as the software solutions available are off-the-shelf and the companies that do make use of them were very complimentary regarding their performance and ease of use.

7.9 The role of Information technology

Information technology and the use thereof in order for business to gain a competitive advantage, shows significant room for improvement in the South African market. Almost all the respondents mentioned that their IT systems were highly fragmented, operating off several different platforms while also making use of numerous software solutions to operate various processes in their business. Some companies even have two systems to complete exactly the same task although it is for different businesses frequently in different geographical locations in the companies being surveyed. This causes great difficulty for these companies in attempting to have a sound control environment, especially with regards to Information Technology General Controls.

Companies are not able to replicate the same standard set of controls at each location due to the fact that the environments differ so significantly and the fragmented state of IT in the companies. It is also a significant high risk area for problems occurring, and a failure in this area could probably result in a significant misstatement of amounts, which is an area of grave concern for all respondents interviewed. This must most probably be the area most companies want to improve in first.

7.10 Solution to manage segregation of duties and system access

All companies should implement a solution to manage their segregation of duties and access to its systems. To the author it is mind boggling to think that such an important task is still enabled by making use of manual controls. Firstly, it is much more efficient to have automated controls in this regard and secondly, this is a very high risk area for all companies. If people can incorrectly gain access to certain areas in your information technology systems, there is almost no limitation to the amount of havoc that could be caused.

7.11 Use of ISAE 3402 Report

South African companies should consider making use of International Standard on Assurance Engagements (ISAE) 3402 report in order to provide comfort that controls over their applications that have been outsourced, are operating effectively. As stated in the literature review, Grant Thornton and many other experts believe that this is the standard and best way for companies to obtain the above assurance that controls are operating effectively.

7.12 Reducing the use of spreadsheets

Companies should put more effort into reducing the number of spreadsheets used to calculate critical information used in the companies' accounting systems. In this area, the South African companies are not alone, in that 72% of respondents to a recent survey conducted by Protiviti amongst United States Sarbanes-Oxley filers stated that they rely on spreadsheets to perform critical accounting actions (Protiviti, 2011). What should inspire South African companies to reduce their number of critical spreadsheets

is that in the same study it was mentioned that spreadsheets are the one process within the companies surveyed that was most likely to have a negative impact on their Sarbanes-Oxley compliance process. The reasons for this are well known but worthwhile stating again. Spreadsheets are often designed and developed without taking into account the important aspects of ensuring adequate controls and processes that can reduce the risk of a spreadsheet calculating an incorrect result to an acceptable level. All of this should make it an imperative for organisations to ensure that the number of spreadsheets used is reduced.

Chapter 8: Overall Conclusion

It is difficult to draw a conclusion on the costs, as it was very difficult to obtain any detailed information in this regard from the companies interviewed. Respondents did however state that it was very expensive to implement, but that costs reduced significantly since then, with the general opinion being that after a few years it was no longer such a substantial amount in terms of the companies' overall governance and reporting expenses.

With regards to benefits, as noted above, these were increased focus on controls and better buy in and accountability from staff in the organisations surveyed, and lastly the fact that CEO's and company boards now had an increased assurance that the figures being presented before them was correct.

Sarbanes-Oxley compliance has been good to the companies in South Africa that have implemented it. All of the respondents mentioned that they were of the opinion that the benefits far outweighed the costs and that they would recommend to their peers that they implement a similar process in their companies.

With regards to benchmarking the costs and benefits to overseas companies, in terms of costs, unfortunately no comparison could be made. But in terms of benefits, these are in most respects in line with what was picked up in American companies.

Overall South African companies can feel proud that their implementations have for the most part been in line with international best practices.

Chapter 9: Recommendations for a future study

The author recommends that a future study similar to this one should aim as far as possible to address a larger sample. However, it is still the author's opinion that a structured personal interview is the best means in which to collect the in depth information required to answer the problem statement as for this particular research best. As such, it might be difficult to increase the sample size.

It is the view of the author that rather than increasing the sample size by acquiring feedback from more South African companies, that it might be more beneficial to, in addition to the Senior Managers responsible for SOX compliance, interview the CEO's or Managing Directors of the same companies. They would have, in the opinion of the author, a much more balanced view with regards to the benefits that Sarbanes-Oxley compliance has brought to their company, and whether it justifies the costs involved.