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TRACKING THE NUMBERS

Outside Audit

Checks on Internal Controls Pay Off

Study Shows Share Prices Can Climb If a Company Uncovers, Fixes Problems

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Critics of a law that requires public companies to prove they have adequate systems in place to prevent accounting mistakes and fraud argue that the cost of complying with the rule is too onerous.

But a study to be released this week suggests that shareholders benefit when companies perform checks on their internal controls: Those companies whose houses are in order enjoy market-beating gains in their share price. Conversely, the stocks of companies with weak internal controls underperform the market.

Further, the process of checking on internal controls -- even if the checks turn up problems -- can lead companies' shares to outperform if the companies act on the problems, according to the study by research firm Lord & Benoit LLC.

"It's like a pro athlete coming off an injury," says Robert Benoit, the firm's founder. "One might expect higher compensation after proving through an in-depth physical that he is free from that suspected injury."

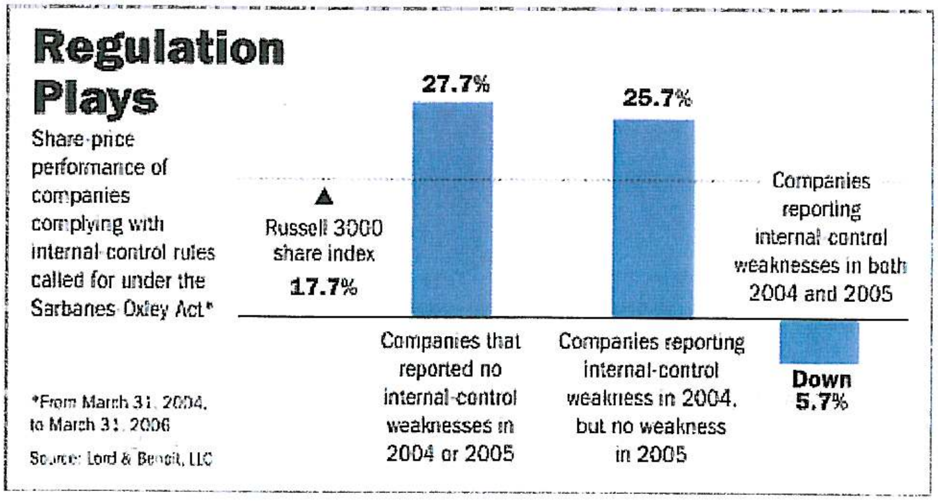
The study surveyed the share-price performance over two years of 2,481 companies that have had to follow the internal-controls rules contained in the Sarbanes-Oxley corporate-governance law of 2002. The study's release comes as the Securities and Exchange Commission and the accounting industry's regulator are weighing whether to tweak the internal-controls rules.

The SEC and the Public Company Accounting Oversight Board are holding a discussion on the rules on Wednesday. An SEC small-business advisory group has recommended that regulators scrap the internal-control rules for companies whose market value is less than $128 million. The advisory group also recommended that companies with a market value of up to $787 million shouldn't be required to have an auditor sign off on their internal controls, as the rules now require, although management should still have to attest to the quality of their controls.

The rules on internal controls were part of a larger effort to improve corporate governance in the wake of scandals such as at energy company Enron Corp. But they have become a point of contention among small companies, investors and auditors. Small companies, along with the SEC advisory committee, argue that the requirements are cumbersome and add burdensome costs. Investors counter that the rules are especially needed at small companies, which are susceptible to accounting problems.

While the battle lines remain drawn, there is growing acceptance that some changes might be needed, even if it doesn't mean exempting companies from them. In June, the Institute of Management Accountants plans to release a study by Parveen P. Gupta, a professor of accounting at Lehigh University, showing that corporate executives want more guidance on how to follow the rules so they make more sense for their businesses. The institute, an association for management accounting and finance professionals, is opposed to exempting companies from internal-control rules, but says regulators need to tailor the requirements so that companies are focusing on controls that are applicable to them, which could help cut the cost of compliance.

The Lord & Benoit report, done in conjunction with online research firm Auditanalytics.com, didn't assess the performance of the smallest companies the SEC advisory panel is looking to exempt. That's because companies with a market value of less than $75 million don't have to comply with the requirements until next year.



But among larger companies that already are reporting on their internal controls, the study found that those reporting no problems in either 2004 or 2005 showed an average share-price gain of 27.7% between March 31, 2004, and March 31, 2006. That compared with a 17.7% gain for the Russell 3000 share index, a very broad market measure, during this same period.

Companies that reported internal-control deficiencies in both 2004 and 2005 saw an average share-price decline of 5.7%.

Markets, it seems, love a repentant sinner and rewarded companies that reported problems with their internal controls in 2004, but shaped up in 2005: The 264 companies that fell into this category saw an average share price gain of just 0.6% in the first year of the study, when problems came to light. Once the problems were fixed, they saw an average share-price gain of about 25%. The end result was that, over the two-year survey period, these companies saw an average share-price rise of 25.7%, just slightly below those that didn't have any problems and well above the broad market.

"The value of the increase in the internal controls more than offsets the outlay" required to comply with the contested rules, Mr. Benoit contends.