

Risk Management

SOX internal controls are not just for public companies anymore

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The indictment of several Texas Southern University officials for using \$1.9 million in public funds for personal expenses provides a valuable lesson that many public companies have already learned: Internal controls can result in more effective management, not to mention fewer negative headlines and the erosion of reputation.

While many in the public sector initially complained about the increased scrutiny of Sarbanes-Oxley legislation, more progressive organizations have found an internal review process to proactively identify key control issues and to be effective in creating processes to not only monitor financial activity but to operate more effectively.

A recent research study by **Lord & Benoit LLC** indicates that stock prices of companies in compliance with SOX internal controls rules grew by 27.7 percent from March 31, 2004, until March 31, 2006 -- significantly higher than Russell 3000 index companies, which grew 17.7 percent during the same period.

On the other hand, companies reporting internal control weaknesses in both the survey years experienced a 5.7 percent drop in share price during the same period.

Private companies at risk

Privately held companies often find it necessary to modify their internal controls because, over time, they usually experience sales growth without corresponding controls growth.

What may have once been a successful small business with tight controls may have grown into a company in which exponentially more employees control financial or IT areas, which can increase the risk of fraud or inefficiency. In one instance, a large international company assumed all relevant account reconciliations were being performed timely and accurately by their overseer personnel. However, upon an internal audit, it was found no reconciliations were being performed and as a result the company received a material weakness.

The lack of internal controls in middle market companies can often be attributed to a lack of higher-level staff professionals with internal controls experience. And sometimes an event such as a merger can highlight the lack of these controls, resulting in a squelched deal, since public companies' SOX compliance can come under scrutiny from acquisitions and in some cases, suppliers.

Nonprofits and internal controls

Increasingly, nonprofits and not-for-profit organizations are also conducting internal controls reviews. The University of Texas, for example, adopted a three-year plan in 2002 for establishing an audit committee and policies, defining financial reporting duties and certification, conducting its first external financial audit, and documenting internal controls.

According to a report on the Texas A&M University Web site, their reviews process includes financial, compliance, operational, management information systems and system development, and implementation reviews. When properly executed, these complete reviews are quite effective.

While Texas' two largest university systems have been proactive on internal controls, other nonprofits -- education and others -- are under more pressure by outside boards, banks and donors to ensure that financial controls are protecting financial integrity and the entity's reputation.

The TSU indictments, while tragic, can at least serve as a reminder of the benefits to internal controls for any organization -- public, private or governmental:

- To ensure the confidence of the organizations' constituencies (boards, employees, patients, donors, students).
- To assure there are checks and balances wherever there's opportunity for mistakes or miscommunications.
- To mitigate information technology risk to protect confidential records.
- To help monitor assets of geographically dispersed organizations.
- To reduce inefficiencies and bad practices

And, of course, to aid in the detection of fraud or the possibility of fraud.

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