How Sarbanes-Oxley Has Impacted the Compensation of Audit Professionals

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These are the best of times for auditors. Jobs are plentiful, salaries are rising and assignments are more challenging. One expert refers to these times as a renaissance for the profession. What's behind these trends? Answer: Past corporate financial scandals involving auditors and new legislation to prevent them, the Sarbanes-Oxley Act of 2002 (SOX).

Impact of Sarbanes-Oxley

As a result of financial fraud at major U.S. companies, and the complicity of their auditors, the most important corporate legislation in the last 70 years, SOX is law (Donaldson 2003). It sent shock waves through public accounting firms and corporations, where the most pervasive and costliest effects have been on a firm's financial controls and internal audit department, its early warning system for fraud and error (Deloitte and Touche 2005(1)) (Gullapalli 2005(2)). One expert believes the past two years have been the most difficult for any profession in U.S. history (Harrington 2005).

A summary of the changes required by SOX (Donaldson 2003) (Sarbanes-Oxley 2005) (AICPA 2004 and 2005(1)) follows.

- Requirement for internal control systems
- Attestations and disclosures of internal control problems by CEO and CFO
- External audits of internal control systems
- Governmental audits of public accounting firms.

Requirement for Internal Control Systems

Under SOX, management must establish, document and test internal control systems for financial reporting — work done by company and/or contract internal auditors. Internal controls are policies, procedures, practices and organizational structure designed to provide assurance that business objectives (for example, operational effectiveness, reliability of financial reporting and statutory compliance) will be achieved and undesirable events will be prevented. For some firms, SOX and the New York Stock Exchange require internal auditing.

Attestations and Disclosures of Internal Control Programs by CEO and CFO

CEOs and CFOs must attest to effectiveness of their internal controls in annual reports and disclose "material weaknesses" quarterly. In the post-Enron era, the concern is negative reports will damage a company's reputation and lower its stock value, and officials who knowingly sign false reports are subject to felonies, with up to 20-year prison sentences.

External Audits of Internal Control Systems

Public accounting firms are required to examine and independently attest to the design and operating effectiveness of their client's internal control systems for preventing error and fraud.

Governmental Audits of Public Accounting Firms

Under SOX, a new organization, the Public Company Accounting Oversight Board (PCAOB), under the Securities and Exchange Commission (SEC), was created. PCAOB registers and inspects, for the first time, the quality of the work of public accounting firms — yearly, if it has more than 100 clients (otherwise every three years). One part of the registration process impacting the demand for auditors is a check to see if a proper ratio of clients to accountants exists (McDonough 2004).

In summary, SOX created a need for auditors at:

- Companies — to establish, test and audit internal control systems.
- Public accounting firms — to audit and attest to the effectiveness of these systems.
- PCAOB — to inspect the work of the public accountants.

Demand for qualified auditors has outstripped supply and salaries have risen sharply (Bennett 2005) (Schroeder and Reichardt 2005) (Oxner and Oxner 2004). This paper explores the effects these changes are having on the duties, supply and demand and salaries of auditors.

Changes in Duties and Responsibilities

When a change of this magnitude occurs, compensation analysts are well-served to audit the existing organizational structure and positions to ensure that this structure and these positions will support the new tasks, and employees are properly classified and compensated as follows.

- Reporting Relationship. While not required by law, some firms have aligned the internal audit function under the audit committee of the board of directors to provide greater independence and stature (Deloitte and Touche 2005(1)). For internal audit reports within finance, auditors may audit areas under the position to which they report. Others use a dual reporting relationship — to the audit committee for audit matters and to a finance executive for administrative matters (IIA 2003) (Katz 2002). When positions report to higher levels, technical and staff review of work output decrease, adding to a position's responsibility, a key consideration for upgrading. Also, when reporting to the board of directors, upgrading may be necessary to attract an executive who has the skills to interact effectively with board members, who can be former company presidents and CEOs.
- Impact. Some position-evaluation systems measure a position's importance based on its impact on the

company's results. Internal audit positions pick up points here given the impact that negative financial disclosures can have on a company's reputation and stock value (PWC 2005) (Calabro 2004). According to a 2005 survey of 576 finance professionals conducted by *Business Finance*, "business and financial reporting, analysis and forecasting" have surpassed "creating shareholder value" as the most important determinant of CFO compensation based in part on SOX compliance (Krell 2005). Changes in importance are signaled when a reporting relationship is changed to a higher organizational level, for example, from CFO to the audit committee (Calabro 2004). Some positions will lose importance with a change in reporting relationship. When external auditors report directly to the audit committee, the position that they formerly reported to, such as CFO, loses a significant responsibility and impact.

- New or Upgraded Skills. Establishing internal control system may be a new duty for internal auditors who were primarily tasked with inspecting compliance with company operating standards (Harrington 2004) (McDonough 2005). When developing new systems, auditors need different skills to analyze processes, collaborate with management, write control procedures and prepare and present training programs (IIA 2004) (Deloitte 2005(2)). Some auditors may find financial systems are more complex and require a higher level of competence (McConnell and Banks 2003). To gain a better understanding of professional auditor skills and knowledge, analysts should become acquainted with professional internal auditing standards and their certification, Certified Internal Auditor (CIA), provided by the Institute of Internal Auditors (IIA). Internal audit charters also are available (Protiviti 2004). State-licensed Certified Public Accountants (CPAs), who typically work for external auditing firms, may also be assigned to the internal audit department. CPAs specialize in the audit and certification of financial statements and fall under the American Institute for Certified Public Accountants (AICPA) (Applegate 2004(1)).
- Changes in Areas Audited. Some internal audit activities may have been focused on company operations, perhaps in the auditor's field, such as manufacturing or customer service (Applegate 2004(1)). Accounting systems may be completely foreign to some auditors and as a result have been outsourced (Koller 2003) (Serafini et al. 2003). Internal audit positions have greater scope if tasked to audit new areas — corporate governance, enterprise risk management and fraud — as suggested by the IIA (Warga 2005). The detection of fraud and malfeasance has resulted in a new specialty, forensic accounting, with its own certification, Certified Forensic Accountant (CFA).
- Paradoxical Impact of Information Technology (IT). IT is an integral part of most company's business processes, so auditors must ensure that systems are protected from unauthorized changes and comply with audit standards (Robert Half 2005(1)) (Protiviti 2004). IT systems are so pervasive that an audit of internal controls encompasses an audit of IT (CFO 2005). Following the enactment of SOX, the IIA issued Global Technology Audit Guides and commissioned Deloitte & Touche to develop IT audit training seminars (2005(3)). IT technologies have increased audit difficulty, and a survey of chief audit-executives indicates that it is the most common technical reason given for outsourcing audits (Cangemi and Singleton 2003) (Serafini et al. 2003).

Auditor positions are enriched if tasked to assist in the design of IT controls, since this design requires an increased understanding of IT programs and systems (Tongren 1999) (Chan 2004). Computer software also assists auditors in conducting audits. Analysts must determine if this adds weight to a position or represents the computerization of work

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that affects all fields (Applegate 2004(2)) (Buckley and Forelle 2005). Auditors specializing in IT systems may obtain the Certified Information Systems Auditor (CISA) certification.

In general, these changes have increased the importance, difficulty and scope of internal audit positions and contributed to higher salary levels.

Supply and Demand

The sudden need for accountants has resulted in a shortage of qualified internal auditors, and for accounting graduates to train as auditors to replace experienced accountants moving into auditing positions. As SOX implementation is completed in 2007, demand will slow. (Solomon 2005).

Supply of New Graduates

The AICPA indicates college accounting enrollment has increased by 19 percent from 2000 to 2004 and by 1.5 percent from 2003 to 2004 (AICPA 2005b)

Employee Turnover

Institute of Internal Auditor surveys indicate:

- 55 percent of staff will depart in four years (Oxner and Kusel 2002).
- 45 percent believe internal auditing is a rotational assignment for gaining a broad knowledge of the firm (Oxner and Oxner 2004).

The turnover rate at public accounting firms was 12 percent in 2004, an increase of 2 percentage points from 2003 (AICPA 2005(2)).

Client Turnover in Public Accounting Firms

SOX has caused a sharp increase in client turnover for public accounting firms, resulting in auditor "churn" (Goff 2005). More than 1,609 (about 10 percent) public companies changed auditors in 2004. The four largest firms gained 164 clients while losing 564. Second-tier firms lost 116 and gained 233, while all other firms gained 1,146 audits while losing 929 (Glass, Lewis & Co. 2005).

SOX contributes to turnover in these ways:

- Facing higher auditing cost, clients have decided to leave a larger firm for a smaller one, seeking lower rates (Goff 2005) (Glass, Lewis & Co. 2005).
- Large accounting firms have dropped small clients that produce lower revenues and profits (Glass, Lewis & Co. 2005).
- Large firms have dropped small clients due to the greater potential for reporting material weaknesses in internal controls to the SEC that reflects negatively on the firm (Scott 2005) (Glass, Lewis & Co. 2005).

Demand for New Graduates

According to the National Association of Colleges and Employers (NACE), more employers (51 percent) are recruiting accounting majors than any other major in 2005 (NACE 2004).

A Graduate Management Admission Council (GMAC) survey of 1,691 recruiters, representing 1,019 companies, reports a decline of 22 percent in 2005 from 30 percent in 2004 in MBAs hired for accounting roles (GMAC 2005).

In 2004, accounting hires increased by 17 percent from 2003. Estimates of hiring at CPA firms through 2009 were optimistic (AICPA 2005(2)).

Staff Shortages

A 2004 Institute of Internal Auditors Job Market Survey showed that only 48 percent of members believed their staff size was sufficient for its workload.

In 2004, PricewaterhouseCoopers LLP., (PWC) surveyed 441 companies concerning SOX's effects on staff resources, with these results:

- More than 40 percent increased internal audit staffing; 38 percent expected increases to continue in 2005.
- Most were *not* using outside resources for SOX compliance — 28 percent report using some outside resources, and only 2.5 percent fully outsourced it.
- Forty-one percent dedicated more than 40 percent of their internal resources to SOX support work (PWC 2004).

Competition from Other Employers

Corporations have strong competition when recruiting accountants:

- Twenty-nine percent of graduates with a bachelor's degree work in public accounting, while 21 work in business and industry. For master's degrees, the percents are 53 percent and 15 percent, respectively (AICPA 2005(2)).
- A growing number are joining federal agencies, such as the FBI and CIA, in addition to the IRS (Harrington 2005). The CIA has a special need for forensic accountants who can, for example, track international cash flows in money-laundering operations (O'Sullivan 2005).
- Although not covered by SOX, private companies and nonprofit organizations are being influenced by it, possibly exacerbating the auditor shortage (AICPA 2005(3)) (Hymowitz 2005).

Competition within the Company

Internal auditors are prized within some companies outside of the internal audit department, where SOX has increased the importance of having effective internal controls (Oxner and Oxner 2004) (Van Wijk 2005).

Impact of Technology

According to AMR Research's survey of more than 300 business and IT leaders, SOX budgets are shifting from headcount to technology, so that SOX compliance can become repeatable, sustainable and cost-effective. Headcount expenditures are expected to fall by 8 percent in 2006, while technology will grow by 13 percent to $1.9 billion. Approximately 76 percent of firms have an operational SOX system in place, eliminating manual compliance work and the need to add staff (AMR 2005).

Salary Trends for College Graduates

According to NACE's 2005 survey of 250 employers, the average salary offer to undergraduate accounting majors rose 4.6 percent to $42,940 during 2004, compared to 3.3 percent and 2.1 percent for in-demand computer science and chemical engineering majors (NACE 2005). Since 1999, salary offers to accounting majors have risen 23.9 percent, compared with 13.5 percent and 14.3 percent for computer science and chemical engineering majors.

Starting Salaries — Robert Half International Inc.

Robert Half International Inc. publishes annual starting salary guides for accounting and finance professionals, based on thousands of job searches, salary negotiations and placements. The Bureau of Labor Statistics and professional organizations cite these reports.

In 2004, Robert Half noted the first salary impact of

SOX. While starting salaries for all accounting and finance professionals were expected to increase 2.4 percent in 2005, internal audit professionals in corporate accounting (from entry level to director in small to large companies) were expecting an 11.9 percent increase. Internal auditors with one to three years of experience at midsized companies ($25 million to $250 million in annual sales) were expecting the largest increase of any position in 2005 — 16.8 percent to $46,125.

Starting salaries at public accounting firms were expected to rise by 9.7 percent. Entry level professionals at large firms were expecting the largest increase — 13.4 percent to $44,375 (Robert Half 2004).

Starting salaries for all accounting and finance professionals were expected to increase by 3.1 percent in 2006. Internal audit professionals again were expecting the largest salary growth — 5.9 percent. IT auditors were expected to see the largest rise of any position — 11.2 percent to $80,625. Salary increases for public accounting professionals were 5.3 percent, with senior auditors at medium-sized firms having the largest increase — 8.8 percent to $60,000 (Robert Half 2005).

Incumbent Salary Trends — Institute of Management Accountant Surveys

The Institute of Management Accountants (IMA) member survey reports the rank of the internal audit functional area within the accounting and finance field.

From 2001 to 2004, the internal audit rose from the seventh to the third most highly compensated function. In 2001, the average base salary was $77,273. That base salary is 28.1 percent below the highest-paid function (general management) at $98,954. (Reichardt and Schroeder 2002).

In 2004, the average salary was $102,385, which is 2.5 percent below the highest-paid function (finance) at $104,962. In three years, the average salary of auditing professionals increased 32.5 percent, compared with 14.3 percent, for 12 other functions,

Starting salaries at public accounting firms were expected to rise by 9.7 percent.

and 25.9 percent for public accountants (Schroeder and Reichardt 2005). According to Mercer's compensation planning surveys covering a wide range of U.S. employees, pay increases have increased by 14.8 percent during the same period (Mercer 2004). When compared to six other similar positions (staff and senior accountant, financial and system analyst and programmer), auditor moved to the highest paid, by salary, in 2004 ($76,835), from third in 2001 ($60,954).

Incumbent Salary Trends — Institute of Internal Auditors Surveys

The Institute of Internal Auditors (IIA) 2004 survey of 1,100 members, representing all sectors and industries, showed base salaries increased 6 percent from 2003 (Oxner and Oxner 2004). Figure 1 provides detail on each position.

FIGURE 1 **2004 Internal Audit Position Salaries (Oxner and Oxner 2004)**

- Chief Audit Executive/ Partner — $122,061 (4.1 percent)
- Director — $93,179 (7.3 percent)
- Manager — $75,122 (4.2 percent)
- Supervisor — $66,314 (6.1 percent)
- Senior — $57,959 (6 percent)
- Staff — $47,887 (5.7 percent)
- Entry level — $40,824 (8.3 percent)

Performance Factors

The additional responsibilities and impact of SOX have probably influenced the salaries through above-average merit increases, to recognize the tremendous amount of work required by SOX. The *Controller's Report*, a trade publication of the Institute of Management & Administration, indicated that SOX initiated a 24-month period of extreme career demands for controllers, often resulting in an extra 20 or more hours of work a week. This tends to confirm PWC's report that most companies deal with SOX without outside help.

The demands of SOX may also be reflected in junior auditor salaries at large public accounting firms, where small bonuses are received for extensive overtime work (Gullapalli 2005(2)).

Satisfaction with Salary

The 2004 IIA Job Market Survey indicates that about 60 percent of internal audit professionals believed their salary was fair.

Conclusion

Internal auditors have moved to center stage in the corporate world in the past three years, thanks to mandated changes in corporate auditing practices. The unprecedented efforts and demand for audit professionals to improve financial controls and reporting in a short period of time have resulted in a shortage of qualified auditors and a sharp rise in salaries. These trends are predicted to level off somewhat as firms finish installing internal control and labor-saving systems. But good evidence indicates that, while returning to its foundations of internal control, the profession will expand its horizons to continue its relevance and growth. In light of these major changes in duties and salary trends, compensation analysts should review their internal audit organizations, positions and salary levels for internal equity and external competitiveness.

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