

Sarbanes-Oxley Implementation Challenges Companies

Implementation of the Sarbanes-Oxley Act of 2002 – otherwise known as SOX or Sarbanes – poses significant compliance challenges for companies in the U.S.

President George W. Bush Signed the Sarbanes-Oxley Act of 2002 into law on July 30, 2002. It requires (in simple terms), that:

- The CEO and CFO of publicly-traded firms sign a statement that their internal control system over financial reporting is adequate and will catch, before the external auditors do, any accounting problem that would materially impact the financial statements.
- The company's independent auditors, in addition to the usual financial audit, must also sign off on the company's internal controls over financial reporting. Qualified opinions are not permitted.

Publicly traded companies with a market capitalization of greater than \$750 million must file these statements as of December 31, 2004. Those publicly traded companies with market capitalization of less than \$750 million will have until June 30, 2005 to make the same filings. The absence of either controls statement could have significant consequences for the company's stock price and its listing on the stock exchange.

Sarbanes-Oxley is a reaction to the reported excesses of TYCO, ENRON, Adelphia, (etc.) and alleged corporate malfeasance. SOX is intended to provide, among other things, more transparent financial reporting by making senior executives personally accountable for their companies' controls and financials. This accountability will presumably give the stockholders more confidence in their investments in publicly traded companies.

Sarbanes-Oxley cannot guarantee that companies will not engage in fraudulent, collusive activity. SOX will encourage most large companies to tighten their internal controls. Compliance with Sarbanes-Oxley is an opportunity for business to identify substandard financial processes and procedures, determine what changes within the company will affect the financial statements and how, and take a hard look, on an ongoing basis, at all business changes (software purchases/development, personnel moves, outsourcing, etc.) and how those business changes could affect the financial results of the company.

The Challenges

The regulatory framework being produced by the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) requires auditors and company staff to accommodate changes in their compliance activities while pressing to meet statutory deadlines. The SEC (<http://www.sec.gov/spotlight/sarbanes-oxley.htm>) continues rulemaking to clarify what it expects from the certifications. The new PCAOB (<http://www.pcaobus.org/>), a private sector non-profit corporation created by SOX to oversee company auditors, produces guidance for public accounting firms.

Trained auditors are in short supply for both businesses and regulatory agencies. Because many accounting firms are already busy doing work on the company's quarterly and annual financial statement reviews, they have had to add staff to pick up the new SOX work. One recruiter was trying to find 30 new auditors just for SOX work for a single public accounting firm in just one city. This draw on experienced auditors for the public firms, combined with other general consulting firms trying to get SOX work and the companies trying to hire internal auditors (50-60% of companies are using their internal audit staff for SOX work, per an Ernst & Young survey), has created a surge in demand for experienced auditors and upward pressure on auditors' fees.

Sarbanes-Oxley compliance is a process of in-depth, detail-level review, understanding and documentation of a company's financial processes. The review includes everything that feeds the financials – premium, claims, investments, underwriting, reserves, payables, cash, etc. The

company must then document all of its internal financial controls around financial reporting. Once that is done, both the company and the external auditors, must determine if those controls are, in fact, adequate to protect the financial statements from mistakes, oversights, poor estimates, and fraud. These are called Design tests.

Companies must have adequate financial controls in place. If the decision is that the controls do not adequately protect the company, it must change or supplement the controls. Adequate control mechanisms may involve additional sign-offs, emails, supplemental documentation or additional staff. For example, if a department is too small for adequate separation of duties, a firm might be required to add staffing. The small shop/no segregation of duties for controls is often rampant in smaller divisions of even the largest companies.

Sarbanes-Oxley is also about Information Systems (IS). IS controls tend to be “pervasive” – that is, if a breakdown happens, it has the ability to affect every facet of financial reporting. IS units often do not document controls as part of project design so safeguards may go missing in the heat of the production battle. So the effort to document processes and controls, while beneficial, can be monumental. For SOX, if you haven’t documented a control activity, it doesn’t count!

Once documented to the satisfaction of the internal and external auditors, the processes and controls must be tested for effectiveness. Both the internal and external auditors will sample, observe and test that the controls are actually working. For example:

- Account reconciliations must be performed on a timely basis.
- A manager must review the reconciliations.
- Someone must determine that an actuary’s estimates are reasonable.
- Financial or administrative software controls must transfer all data on time and accurately between systems and into the financial reports.
- Programmers must be restricted from access to production files.
- Financial spreadsheets must have adequate controls to make sure there are no erroneous formulas.

Once again, if it cannot be proved that someone has been performing or reviewing a particular activity, it doesn’t count for SOX!

Terminology is another challenge. PCAOB guidance for auditors’ judgments about the adequacy of internal control systems can be murky. For example, there are “deficiencies”, and then there are “significant deficiencies” which must be reported to the company’s audit committee. A deficiency is “significant” “if by itself or in combination with other control deficiencies, it could result in more than a remote likelihood of a misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be prevented or detected.”

The internal auditors and the external auditors must each decide what is “significant.” The external auditors are still trying to determine what kind of standards will result in each kind of valuation. It will be very challenging for the internal auditors to classify any deficiencies they find ahead of the external auditors while using separate criteria.

Very little education on SOX has been provided to employees. Compliance activities in many companies often started before all the regulations and guidance came out. Consequently, the staff in the business units often perceive all this documentation and testing as just an added burden above and beyond their normal work, for which they are already arriving early and staying late. So until senior management can get behind the SOX analysts, it is often like pulling teeth to get the necessary documentation. SOX is a “sea change” in internal control documentation, and it often takes continued reinforcement from the SOX analysts and senior management to impress on all those impacted that these new requirements are not going away.

Sarbanes-Oxley will require a continuing compliance effort by companies. Many of the operating units have taken the approach that they will do whatever is necessary to get the documentation

created or forwarded and the testing behind them so they can go on with their lives. However, a key facet of SOX is that it requires companies to continue, after December 31, 2004, on a quarterly basis, analyzing controls and any changes to those controls (such as software implementations, personnel changes, procedural changes, etc.), and reporting any significant weaknesses to the SEC. This is already creating a whole new level of compliance overhead staff just to track, document, test and report all new control changes.

Non-publicly traded insurance companies may not “dodge the SOX bullet” for very much longer. The National Association of Insurance Commissioners (NAIC) is drafting model regulations to require all insurers to comply, in some fashion, with the internal control requirements of SOX. Extending Sarbanes-Oxley to all insurers would be much like the NAIC’s approach to the GLB (Gramm-Leach-Bliley Act) regulations.

Submitted by Nick Mallouf
MRC Consulting Group, Inc.
www.mrcgroup.ws
nmallouf@mrcgroup.ws
817-261-7674