



### **Sarbanes-Oxley: Opportunity Knocks?**

The financial press is full of copy on the subject of financial reporting. Important changes are upon us now or just on the horizon. Among the most talked about are, The Proceeds of Crimes Act 2002 (Money Laundering provisions), the increase in the audit threshold for smaller companies and the adoption of International Accounting Standards. Not to mention the spate of financial scandals and high-profile business leaders losing their jobs. Now add Sarbanes-Oxley to the list!

The Sarbanes-Oxley Act 2002 is a far-reaching and controversial piece of US corporate governance and financial reporting legislation. It was enacted in response to the damaging scandals at Enron, World-Com and others. Why far reaching? Because the often threatened regulation of the auditing profession has finally come about – in the form of an Act of Congress with teeth! Although this is US legislation (and only applies to quoted companies), the ramifications for UK industry and its auditors should not be under-estimated. Even now there are many Finance Directors and Controllers across the UK who are working hard to meet the Act's timescales because their businesses are US-owned.

The workload revolves around a company's system of internal accounting and reporting controls. Sarbanes-Oxley demands that it be documented and monitored. Moreover, it demands that the system be comprehensive and that any weaknesses be reported to management and actions implemented to remedy. Sound familiar? This is the same methodology as the quality management systems we have got used to.

The detailed and time-consuming (and costly) work to be done in order to comply with Sarbanes-Oxley is contained largely in Section 404. In order for any assessment of internal controls to be carried out and for any system of monitoring to be effective, the controls must be well documented. The extent of the additional documentation required can come as a shock to many businesses which believe they are already well controlled. The new rule is, 'if a control isn't documented, then it's a weakness'.

Only controls relating to financial reporting are required to be certified; other operational controls fall outside of the Act. Therefore management is required to decide which controls are 'in' and which are 'out'. For example, controls over overtime and other wage payments would usually be 'in'. Controls over equipment effectiveness scores would usually be 'out'.

I want to make the case for the business benefits of embracing the spirit of Sarbanes-Oxley, for all UK companies, something I believe is being overlooked in the rush to 'tick-the-boxes'. Improving internal control could, if designed into the project from the outset, improve various aspects of the overall management of a company, particularly:



- a) reduced risk of errors and non-disclosures
- b) improved reporting timescales (e.g. month-end)
- c) greater ownership of performance amongst management
- d) reduced risk of theft or fraud
- e) focus on non value-added processes
- f) improved communication
- g) less mystification surrounding the numbers

As with quality management system standards in the late 80's and 90's, Sarbanes-Oxley could well be a turning-point. Post Sarbanes-Oxley, major companies will I believe, want to encourage their suppliers to comply with the same rigorous standards of internal control and may make it a condition of doing business. This drive will come from US companies (e.g. Ford, GM) and the rest may have to follow suit.

The difference between Quality Management System certification and Sarbanes-Oxley is that ISO9002 and other standards can be achieved at the company-level whereas Sarbanes-Oxley certification only applies at the level of the security-issuer. However, I believe that something similar may emerge once the benefits of Sarbanes-Oxley are fully appreciated.

The essence of Sarbanes-Oxley is that management are held responsible for published financial reports. The CEO and CFO must attest to the proper operation of a comprehensive system of internal controls that ensures their accuracy. They must attest to the fullness of disclosures made in connection with the reports. These claims are then tested by independent auditors. The penalties within the Act for wrongful certifications are potentially severe.

This is very different to just having the accounts audited to a 'true and fair view' standard. This is also very different culturally, from the reality most of us have experienced in our careers! What we have in UK industry today are, I submit, chief executives who delegate all financial responsibilities to their finance directors and who are vague about 'internal controls'. The remit of the Finance Director is to ensure that there are no surprises and accounting reserves are used 'creatively' to ensure this is so. Major culture changes will be required to encourage work units to report bad news!

Post Sarbanes-Oxley, this type of approach will become more difficult to manage and will incur the displeasure of auditors and audit committees. How will businesses therefore manage the increased risk of 'surprises'? By better planning for a start. The budgeting cycles of many large corporations are really very poor; one listed US corporation I know of has not yet finalised its 2004 budget!



So, should companies implement the Sarbanes-Oxley standards for reporting? This is a choice for management. No company can afford to mislead auditors and regulatory authorities. In the US, far-sighted private companies are already implementing some and in many cases, most of the provisions of the Act. Every company of sufficient size and complexity would benefit from more effective governance; the governance process can only be enhanced by efforts to strengthen the control environment and accountability.

The current business environment should drive all businesses to take another look at their governance, risk assessment and financial reporting processes to ensure they are effective.

### **Detail of Sarbanes-Oxley Act 2002**

The Act concerns itself with the following:

- 1) Corporate Governance
- 2) Financial Reporting
- 3) Internal Controls
- 4) Executive Conduct

### **Public Company Accounting Oversight Board**

Sections 101 to 109 deal with the creation and powers of the Public Company Accounting Oversight Board to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

### **Independence of Auditors**

Sections 201 to 209 deal with the independence of auditors and the provision of audit and non-audit services.

### **Corporate Responsibility**

Sections 301 to 308 deal with Corporate Responsibility. In particular, Section 302 is headed 'Corporate Responsibility for Financial Reports' and addresses the requirement for the principal executive and financial officers to certify that all material facts have been disclosed and that internal controls are effective in relation to financial reports filed with the U.S. Securities and Exchange Commission (SEC). This section became effective on August 29, 2002.



### **Enhanced Corporate Disclosures**

Sections 401 to 409 deals with Enhanced Corporate Disclosures. In particular, Section 404 'Management Assessment of Internal Controls' requires management to assess the effectiveness of the system of internal controls and this assessment must be attested to by an independent auditor. This statement is required annually and this part of the act is effective for accounting periods on or after 15 June 2004 for certain 'accelerated filers', or 15 April 2005 for all other quoted companies.

### **Other sections**

Other sections deal with such topics as Analysts Conflicts of Interest, Tax , Penalties under the Act and others. In particular, Section 906 provides for penalties of up to \$5 million or 20 years imprisonment or both, for principal executives who wilfully sign a 'clean' Section 302 report when they knew that the requirements of the Act have not been met.

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