

Don't take your eyes off the ball!

SOX Section 404 Extension

Companies that are in compliance with Sarbanes-Oxley are finding that good corporate governance makes good business sense. Companies being able to show quality corporate governance have been able to attract share premiums averaging 15% in Europe whilst those with weak or poor governance can have their market capitalization penalized by more than 20%. Quality of governance also has a direct impact on share returns where the difference between the good and the bad can be more than 20% when compared to average stock returns. Sarbanes Oxley has become the an opportunity to review management and governance practices and even companies not being required to certify for Sarbanes Oxley compliance have started to review their business practices and process structures.

On March 2 last year, the SEC extended the deadline to July 15, 2006, for non-accelerated filers and foreign private issuers to include in their annual reports a report by management on the company's internal control over financial reporting and an accompanying auditor's report. This is a one-year extension from the previously established July 15, 2005 deadline. Generally speaking, "non-accelerated filers" are US public companies with market capitalization of \$75m or less, and "foreign private issuers" are business entities incorporated or organized outside the United States with more than half of their ownership, management, assets, and/or administration outside the United States.

This extension should not be viewed as a sign that the SEC is caving in to pressure groups' claims that the cost of Sarbanes-Oxley is too much for the local economics to bear or that it's generally bad for business. It is simply the recognition that non-accelerated and foreign filers are finding the whole process more of a burden. Conversely, small and medium-sized companies must not sigh with relief just because of the extension.

They are still to be encouraged to complete the work that they've started so they can begin to reap the benefits of their investment. They must not "relax" for a period of time, knowing that they have this additional time. In our experience, most will need it in order to meet 404 attestation standards.

At Consuit, we suggest to our clients that they keep abreast of announcements and guidance from the SEC and in particular, the upcoming SEC roundtable meeting which is scheduled to be held in the third quarter of 2005. We encourage them then to incorporate any issues arising from these announcements into their Sarbanes-Oxley work.

For European companies, the task of ensuring compliance with Sarbanes-Oxley is made that much more time consuming and frustrating because of the additional challenges they face having to prepare their consolidated financial statements under International Financial Reporting Standards ("IFRS"). It has been estimated that these requirements will affect more than 7,000 companies within the EU alone.

The SEC has stated that, "While we fully support conversion to IFRS, we are mindful that this change will require significant resources, people, and time. The new standards are fundamental changes that will change how affected foreign companies use and report financial information. We understand that the successful conversion to IFRS is currently the primary focus of these foreign companies."

The additional time allowance will enable foreign companies having to prepare for, and initially comply with, two different sets of significant new financial reporting requirements within a similar time period. The extension will also grant smaller issuers that are subject to the Exchange Act reporting time to consider the

new guidance in the COSO Framework (The Committee of Sponsoring Organizations of the Treadway Commission). The three new components of the COSO framework are objective setting, event identification, and risk response

The extension should make implementation of the internal control reporting requirements more effective for non-accelerated filers and all foreign private issuers. As a consequence, this will give support to investors and aid the development of confidence as to the reliability of the disclosure made by these companies about their internal control over financial reporting.

However, companies must not rest on their laurels on the progress made thus far. Sitting back and taking a break from Sarbanes-Oxley could create a greater risk for these companies as their Section 404 compliance projects may inevitably start to lose momentum, not to mention the resources allocated to them as normal business activity resumes in the interim period. This was evidenced in the US when a number of companies took three or four months off after their initial extension was granted, and then found it extremely difficult to pick their projects up again and focus on the objective following this period of inactivity. As a result they're now fighting to meet the revised deadlines.

In order to be able to implement a purposeful Sarbanes-Oxley project, companies should be spending this additional time to review their current status and ensuring they have a solid foundation in place from which to move forward, because without it, they will be unfocused and unmotivated.

Consuit has identified the following three areas as being essential in order for good 404 project management and have proved to be effective in order to achieve compliance.

- 1. Culture**
- 2. Methodology**
- 3. Communication**

1. Culture

Culture, in this context, can be defined as "effective communication between personnel within an organization with a means to achieving a common goal".

The culture within an organization needs to change to one that understands the importance of Sarbanes-Oxley compliance, not only to the company, but also to the effect that non-compliance could have on the employees themselves. Without this culture change the company could be left in an exposed position, such that the attitudes and mindsets of people will not be focused enough.

2. Methodology

Many companies seem to realize they have a deadline in which they must have documented, tested and remediated their key-control activities affecting their financial processes. What they fail to realize is that Sarbanes-Oxley requires a very structured approach to managing such a project and without understanding exactly what it is that is required, not to mention, what it is that they require from the project, then a never ending circle of confusion will be set upon them.

Organizations very often confuse different levels of information within their documentation, simply because they adopt an accountancy based approach.

A suggested approach in documenting business processes and one that is easily manageable as well as being relevant to the whole organization could be:

- ✚ In preparing documentation based on the above methodology, it is clear that there are several levels of detail in which one can "drill-down" for more specific process style information, as is needed, and therefore avoids a "one page" approach which is all too common.
- ✚ In simple terms, this methodology permits the right information to get to the right people in order for them to do the right job and avoids having to gauge what level to pitch at,

3. Communication

Many companies are very organized in setting up a Project Management Office ("PMO") and having dedicated personnel managing specific areas of their global operations, which allows for a positive start to the project. What seems to be the failing point however is that communication often seems to be held at either a PMO level or a sub-group level, and as a result the chain of communication is broken very early on in the project.

Even the simplest of matters like the format of documents and the level of content will inevitably vary from business unit to business unit. The PMO must drive the project and ensure that everyone is reading from the same piece of paper, that the deliverables are clearly defined and, where external parties are being used, that the chain of communication is even more concrete.

In summary, the message that must be communicated is not to sit back and lose the momentum, but to step back and take a closer view on what it is that is being achieved, where the company currently is and what needs to be invested in the project, in terms of resources and time in order to comply with the requirements of 404.

This extension provides companies the prospect of getting the project completed correctly first time around,

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Consuit Management Consultants is a leading specialist consultancy in the areas of corporate governance, business processes and operational restructuring. Consuit provides their clients with specialist advice and second opinions on corporate and financial compliance areas such as Sarbanes Oxley whilst being completely independent of the auditing network. Leveraging company and client skills, Consuit is also providing strategy and post-compliance services such as structured testing, second opinions restructuring and strategy reviews.

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