



A day dawns, quite like other days; in it, a single hour comes, quite like other hours; but in that day and in that hour the chance of a lifetime faces us. - Maltbie Babcock

Okay, let's cut to the chase – you've probably read or heard about the Sarbanes-Oxley Act (SOX). In this issue of **TSI Info Source**, we are going to net out, in non-CPA speak, what SOX is and why you should learn more about it. Don't mistakenly think that SOX only has an impact if you are the CFO of a large public company. Au contraire dear friend– SOX has big time implications in many non-financial areas of public companies and will also affect private companies as well. Please read on, educate yourself and apply what you learn.

We hope this information is of value to you and others in your organization. Further, we appreciate you keeping TSI in mind for any of your forthcoming business and technology initiatives. We consistently demonstrate to our clients that we make a significant difference on your projects with our results orientation, expertise and work pace. There is a good chance that we have done a project similar to the one you are embarking upon – please call 312-492-6400 x202 to talk about your specific needs and how we might help you.

Any feedback for us? Please send us an e-mail at tsiinfosource@transforming.com.

- The Editors

The Sarbanes-Oxley Act for Dummies (and those who don't want to be left behind)!

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Picture this...you're at dinner with a few neighbors whom you haven't seen for a while. One of them says, "Hey, what do you think of Sarbanes-Oxley?" How do you respond? Choose the answer that best reflects what you would say:

- A. "That's a nice merlot and I'd recommend it with the filet"
- B. "You really ought to see a doctor about that"
- C. "He's been putting cork in his bat for years"
- D. "That is the most overpriced prep school on the east coast"
- E. "I think it will have more broad sweeping implications that virtually any other financial legislation of our time".

Well if you answered A, you are definitely a candidate to liven up our next TSI social outing, but as you guessed, E is the answer the judges were looking for. Thanks to companies like Enron, Global Crossing, WorldCom, Andersen (formerly Arthur Andersen, LLP), Tyco and too many others to name, taking as much creativity to financial reporting, as say, J.K. Rowling does to Harry Potter, the Sarbanes-Oxley Act was born. As a result, many of us can probably name more CFO's and accounting firm partners than we could just a few years ago. And our guess is that some of these folks know more about handcuffs and depositions than they did a few years back.

This article describes what SOX is, what approaches different companies are taking to address these requirements, and what implications SOX has to those outside of Finance and in the private sector.

... **SOX for Dummies** - *continued from page 1*

What is the Sarbanes-Oxley Act (SOX)?

On July 30, 2002, President Bush signed the **Sarbanes-Oxley Act** of 2002 into law. The Act is intended to address corporate accountability issues by improving the quality of corporate reporting, reforming the oversight of accounting practices, and restoring investor confidence in the marketplace. Many say that SOX is the most comprehensive and sweeping financially-oriented legislation enacted in the past 25 years. The sections of SOX are detailed below, but at 10,000 feet, SOX addresses issues around financial control and reporting, corporate governance, use of auditors detailing both the specific role auditors can play and potential conflicts of interest.

Corporate Responsibility for Accurate Financial Reports

SOX requires that the chief executive officer (CEO) and chief financial officer (CFO) of each public company certify that in each annual or quarterly report the report fully complies with the SEC's reporting requirements, and that the information contained in such report fairly represents the financial condition and results of operations of the public company. The teeth of this requirement come in the form of the associated penalties for non-compliance. The certifying CEO and CFO will face a penalty for any false certification of any financial information in an amount of \$1,000,000 and/or up to 10 years imprisonment if it was a "knowing" violation, and an amount of \$5,000,000 and/or up to 20 years imprisonment if it was a "willful" violation.

There are other penalties some of which are just coming out and may not be official yet, but there is an interesting penalty when a public company finds an error and is required to restate its financial performance. In this case, there is detail being discussed that a CFO must surrender a performance bonus that was earned during the period that is restated.

The “Guts” of SOX

SOX contains 11 Sections (called Titles). Each of these defines the standards, responsibilities and penalties associated with non-compliance. The Sections/Titles are:

- ▶ Title 1 – Public Company Accounting Oversight Board
- ▶ Title 2 – Auditor Independence
- ▶ Title 3 – Corporate Responsibility
- ▶ Title 4 – Enhanced Financial Disclosure
- ▶ Title 5 – Analyst Conflict of Interest
- ▶ Title 6 – Commission Resources and Authority
- ▶ Title 7 – Studies and Reports
- ▶ Title 8 – Corporate and Criminal Fraud Accountability
- ▶ Title 9 – White Collar Crime Penalty Enhancements
- ▶ Title 10 – Corporate Tax Returns
- ▶ Title 11 – Corporate Fraud and Accountability

While the scope of SOX can be a bit overwhelming, the most problematic areas are somewhat finite. According to Debra Hopkins, Director NIU CPA Review major areas of concern are “revenue recognition, any

estimated or subjective areas (warranties, guarantees, inventory obsolesce, bad debt, and market value computations, to name a few) are the financial areas to pay particular attention to. Now it is time to reanalyze how these are calculated and base these on sound fundamental principles.”

If you are a CFO/CEO or auditor of a public company, you probably know these titles intimately or you will learn these soon. Many of the requirements within these titles define the financial controls, documentation and governing policies that should be in place. Other requirements define boundaries (in terms of services) that an auditor can play and how long a CPA firm can be an auditor. At the end of the day, how strictly you comply with these requirements is a function of several factors including:

- ▶ How much change you can implement before the compliance deadline
- ▶ How much funding you have to implement the controls
- ▶ What resources are available
- ▶ What amount of risk are you willing to assume.

As of mid-May, 2003, public companies with a September year-end were among the most frantic since the amount of time they had to comply with SOX was the shortest. As a result, many companies were doing everything they can to meet the financial reporting and control issues without having the capacity to look “upstream” and consider other environmental and systemic conditions that cause their controls to be ineffective. Fortunately for them, as of May 27, 2003, the SEC delayed this deadline for an additional nine months. With this small amount of breathing room, many forward-thinking organizations are now using SOX as a lever to address some of the root causes of the poor control factors that may be present within their organization.

When you think about many organizations, both public and private, they have some or all of these characteristics:

- ▶ Acquired one or several organizations in the past 5 years
- ▶ Overseas subsidiaries or business units overseas
- ▶ Multiple systems that may or may not seamlessly and accurately provide consolidated financial statements
- ▶ Non-standard closing periods across the enterprise
- ▶ Different interpretations and local practices of some accounting and financial policies (e.g., revenue recognition, estimation of financial metrics)
- ▶ Decentralized accounting/financial functions
- ▶ Non-conforming employees that may be slow to adhere to financial and other policies and practices (e.g., time and expense reporting timeframes) which affect financial accuracy and compliance (note: SOX requires relevant e-mails are part of an audit’s work papers).

Of the many important sections of SOX is Section 404. Section 404 requires management to file an internal control report with its annual report. The internal control report must articulate management’s responsibilities to establish and maintain adequate internal controls over financial reporting, and management’s conclusion on the effectiveness of these internal controls at year-end. As you can imagine, if some of the “upstream” factors mentioned above are not addressed and, when necessary standardized (and “proceduralized”), the amount of effort to perform “downstream” checking, apply controls and input adjusting journal entries becomes enormous.

"We believe that to effectively cope with Sarbanes-Oxley, firms should enable the following:

- ▶ **Business Performance Management (BPM) metrics, reporting, and planning:** These provide visibility into key strategic metrics and align organizational performance management. This includes operational statements linked to dynamic business plans that can highlight anomalies and provide workflow to ensure awareness and action.
- ▶ **Financial reporting and consolidation from BPM solutions:** These are tools to consolidate multiple ERP solutions and provide capability for eliminating entries for inter-unit activity as well as provide capability for booking minority interests (e.g. joint ventures).
- ▶ **Continuous exploratory reporting on accounting details with BI tools:** These are tools that extend beyond BPM to report from ERP and data warehouses/data marts for transaction-level accounting details."

*John Van Decker
Meta Group
Sarbanes-Oxley:
The Impact on Financial Reporting
March 2003*

Impact on the Non-Financial/Private Sector folks

If you don't work in a Finance Department or if you are in the private sector and have tuned SOX out thinking that it really doesn't apply to you, you may want to think again. Debra Hopkins warns, "The audit standard setting process is in transition. The PCAOB (Public Company Accounting Oversight Board is a private, non-profit corporation) as designated by the Sarbanes Oxley Act, plans to promulgate auditing standards for public entities. How will this affect private companies? Will the current auditing standards be split into two groups? Will the Auditing Standards Board continue to issue auditing standards for private entities while the SEC, PCAOB sets the standards for public entities? If after the dust settles, only one auditing standard setter remains, it will be the PCAOB. As a result, private companies will need to implement many of these same standards that public companies are now implementing."

Many organizations are also implementing tighter sign-offs internally to share the responsibility that SOX is placing on the CEO and CFO's. This is NOT to say that other individuals are accountable in the way a CEO or CFO is, but some organizations are requiring all department heads, CIO's (if IT is structured as an independent organization or subsidiary), and heads of subsidiaries or business units to sign off on their own financials prior to the CEO and CFO signing off on the entire corporation. So unless you have absolutely no outside funding or line of credit, there is a strong probability that your organization will be required to implement at least some of these same financial reporting and control changes.

To other non-financial professionals, you are probably getting the notion that this will impact you too. As it was mentioned above, any estimation that is performed may be required to change (or at least get documented to capture the underlying assumptions). However, should your organization use SOX as an

opportunity to change, it will be in the examination/improvement of the following that will be the most time-consuming:

- ▶ Business Processes – documentation, improvement and potential standardization of processes. Now documentation of processes and systems using the required COSO framework (COSO is the Committee of Sponsoring Organizations of the Treadway Commission, a private-sector group that works to improve the quality of financial reporting through business ethics, effective internal controls and corporate governance) is not a trivial project. Like ISO's requirement to document work processes and prove that the documentation supports the work that is truly done, SOX documentation will also require the same level of documentation/compliance. Invariably, once a process is documented, you will discover that there is inefficiency and ideas about how to improve it. Determining the best way to improve the process to make it work better, faster and cheaper is now the challenge.
- ▶ Underlying Policies – Financial policies, especially in subjective or estimated areas will need reexamining. In addition, when analyzing the processes, one will be forced to reexamine a number of other policies including:
 - When should specific operational and financial work be performed?
 - Why is work performed by a certain group/person?
 - What rules should govern why work is performed in a certain way?
 - What compensation plans, bonuses and penalties should be in place to entice everyone in the organization to work towards SOX-Operational and Financial Reporting Excellence?
- ▶ Technology – Some think that SOX can be remedied by slapping on a financial reporting tool like Hyperion or Crystal Reports. Good financial reporting tools will help, but if the tools are reporting off of "dirty data", disconnected systems or systems that are not used in a disciplined manner, the reporting tools will be of little value. SOX will cause all organizations who have information spread out over multiple systems or have a random factor of information integrity, to address this in a more permanent way – like tightly integrating systems, replacing numerous systems with one or fewer systems and implementing better checks and balances along with tighter security and practicing better information integrity techniques.

Arghh – Not those letters again - ROI

It is becoming more evident that those organizations that are seeking to do more than just barely comply are using SOX as a lever to drive efficient and standardized processes. During the acquisition/consolidation and technology change period that occurred over the past 5 years or so, it is very common for organizations even in the \$100-200M range to have international subsidiaries operating on different financial systems with different financial closing periods. Now, many of those organizations are seeking to get something in return for this six or seven figure "investment" in SOX-triggered control and financial reporting change. Since these new standards make it mandatory for companies to improve record and document management, accelerate financial reporting through automation, and strengthen governance policies, many organizations are looking at some of the following options:

- a. Acquire tool and/or templates from one of the Big 4 and attempt to do it yourself



- b. Have one of the Big 4 to do it
- c. Get a mid-sized company along with other resources to help.

Each of these options has its own set of pros and cons. However, whichever way you turn, one common practice is to create a team comprised of internal and external resources that is a blend of SOX, legal, audit, financial reporting, governance, process and technology expertise. Due to the aggressive timeframes and demands from a subject matter expertise perspective, it is all but impossible to find all of the necessary expertise within one company and consulting firm.

The Bottom Line according to TSI

Sound internal controls cannot exist where business practices and policies are poor, or where oversight of operations is not at its best level. Therefore, if you improve your business processes and performance monitoring so that you can detect earlier any problems in financial performance, you are less likely to be surprised at period end. Better processes lead to better controls and fewer surprises. That is the value proposition of using SOX as a catalyst to improve processes, integration of system and integrity of information.

You can look at SOX in one of two ways – a regulatory cost forced on you or an opportunistic investment. If the former is your nature, you will have a tendency to spend the bare minimum to meet SOX requirements and hope to escape without a negative and costly IRS audit. You will not receive a return from your investment in SOX if you choose this path. If you are viewing SOX as an opportunity to fix broken or maybe less than perfect financial and other processes, better integrate technologies and even standardize disparate policies and practices, while the investment will be higher in terms of time required to complete this, your chances for a positive ROI is significantly higher also. Just keep in mind – SOX is not the type of legislation that you should treat in a “business as usual” manner.

TSI has effectively positioned itself to work with SOX and legal experts and proactively address “upstream” operational, technology and organizational problems that cause significant downstream financial reporting and control problems. TSI has the expertise to understand financial and operational control issues and address the root cause of these issues. TSI consultants are operational and technology change experts and will help ensure that the improvement initiatives are completed in a quality manner, quickly and in a way that transfers knowledge from our consultants to the internal client personnel working alongside with us. If you are interested in speaking about how we can help, please call TSI at 312.492-6400 ext. 202 or e-mail marketing@transforming.com.

Press Release

May 28, 2003

SEC Delays for Many the Implementation of Sarbanes-Oxley Section 404

Final rulings on Sarbanes-Oxley Sections 404, 302, and 906 discussed during May 27 Web cast.

The U.S. Securities and Exchange Commission (SEC) has delayed for many companies the effective dates of Section 404 of the Sarbanes-Oxley Act of 2002, which requires management of covered firms to report on internal controls over financial reporting.

In his opening comments during an SEC Web cast on May 27, N. Sean Harrison, special counsel of the SEC's Division of Corporate Finance, stated that companies, other than foreign private issuers, meeting the definition of an "accelerated filer" in Exchange Act Rule 12b-2 will be required to comply with Section 404 for fiscal years ending on or after June 15, 2004. Accelerated filers are, in general, U.S. companies that have equity market capitalization of more than \$75 million and that have filed an annual report with the SEC.

All other issuers, Harrison said on the Web cast — including small business issuers and foreign private issuers — will be required to comply with Section 404 for their fiscal years ending on or after April 15, 2005.

In the draft SEC proposal, the Section 404 compliance dates were Sept. 30, 2003, and Dec 31, 2003, depending upon the filer's fiscal year.

The purpose of the SEC's Web cast on May 27 was to make a final determination on proposed rules outlined in Sections 404, 302, and 906 of the Sarbanes-Oxley Act. Those interested in reviewing the proceedings can access the archived presentation by visiting the SEC Web site, www.sec.gov, and then clicking "News & Public Statements" and "Web casts." A related press release can be found at www.sec.gov/news/press/2003-66.htm

Specifically, Section 404 would require a public company — other than a registered investment company — to include in its annual report a certification from management that the company has established internal controls for its financial reporting process. Each covered public company also would be required under Section 404 to publish a similar financial reporting controls certification from the registered public accounting firm that audited its financial statements. Sections 302 and 906 require that the annual or quarterly report certification be signed by the CEO or principal officer of the company certifying that the information given in the company's financial statements is accurate to the best of his or her knowledge.

Web Sites to Check Out



- TSI Newsletter Archives – <http://www.transforming.com/archives.html> - check this page out for copies of past articles and other information.
- NIU College of Business CPA Review – the #1 CPA Review in the country – www.cob.niu.edu/cparev/
- Sarbanes-Oxley Act – having trouble sleeping? Want to read all 130 or so pages of SOX – go here - http://financialservices.house.gov/media/pdf/H3763CR_HSE.PDF

About TSI

TSI - Transforming Solutions Inc. - www.transforming.com helps organizations dramatically improve their organization by collaboratively and cost-effectively analyzing and improving how people, processes and technology are used within the organization.

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