

**Xayce**



Point of View

# Sarbanes-Oxley Section 404

“Finance transformation opportunity  
or expensive audit”



# Sarbanes-Oxley Section 404



## “Finance transformation opportunity or expensive audit?”

### Key Sections of Sarbanes-Oxley Act 2002

Section 302 CEO and CFO must certify/report quarterly and annually that:

- Filed reports are accurate and fairly represent results
- Internal controls exist, are maintained and evaluated for effectiveness
- Deficiencies &/or changes in controls are reported

Section 404 Management must assess Internal Financial Controls Annually:

- Define internal control structure
- Document key internal controls and procedures
- Determine they are operating effectively
- Gain attestation from external auditors

### Key Timetable

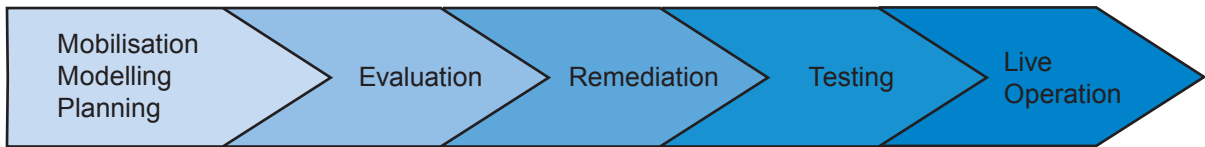
For UK based companies: Compliance is required for fiscal years ending on or after April 15, 2005. Controls need to be in place at the start of the first qualifying financial year.

### Overview

For such a far-reaching and important piece of legislation the Sarbanes-Oxley Act is remarkably light on practical guidance to its implementation. The bulk of the work in achieving compliance with the act is driven by Section 404 which looks at the internal controls. However Section 404 of SOX simply states that a requirement exists that “Annual reports filed with the SEC shall state the responsibility of management for establishing and maintaining adequate internal control structure and procedures for financial reporting”, and “contain an assessment of the effectiveness of such controls”.

Given the aggressive timelines and the lack of fully complete practical examples in implementation organisations are working from first principles in devising their SOX strategy and approach.

Our own practical experience and research highlights that there are widely varying approaches to implementation with correspondingly wide results in terms of costs and outputs. Most projects share a common series of activities. However significant differences arise in the strategy and approach that are adopted. This latest ‘Point of View’ from Xayce provides you with a basic framework for implementing Sarbanes Oxley, but more importantly, gives you practical guidance on the key decisions organisations face around how to approach their implementation, and a set of key tips on the practical execution of the project. It is our considered view that while many of the changes that SOX requires may initially be met with tactical solutions due to the pressure of time, the appropriate strategy for organisations is to view this as a finance transformation opportunity rather than an expensive audit. This should not be a quick fix transformation exercise but a well planned and structural programme designed to deliver a sustained long term relationship. For those organisations that do not fall under the jurisdiction of Sarbanes-Oxley, the UK Companies Act 2004 is currently passing through Parliament. This is likely to include similar requirements for those organisations that are quoted on UK markets but not in the US.



## A Framework for Implementation

In essence all SOX projects can be broken down into five phases.

- **Mobilisation, Modelling, and Planning**

From a practical perspective it is an essential first point to build a model which links the chart of accounts to the organisational units, processes and systems that generate that number. A level of materiality will need to be established. This materiality level will provide a basis for the development of a work plan. The plan will need to cover all areas but particular attention and priority will need to be given to those areas that are agreed to be highly material and/or have a significant degree of risk associated with them. These will clearly include areas where numbers are subject to significant interpretation, manipulation, and/or margin of error.

- **Evaluation**

Utilising these plans a process of evaluation takes place which evaluates the risks and controls associated with each material number.

- **Remediation**

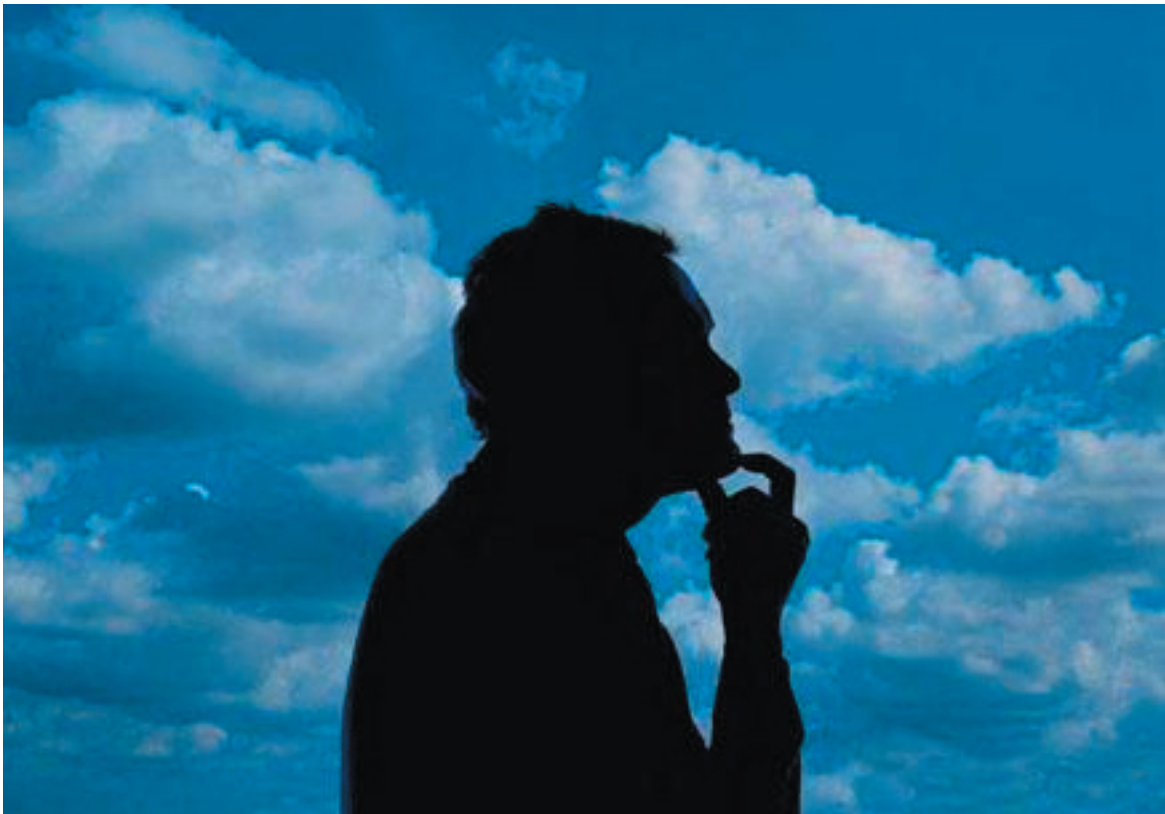
This phase is all about taking corrective action to deal with the control and risk issues identified. Remediation steps can range from new systems implementation through to the introduction of manual steps. Adopting the right strategy on remediation is discussed later in this document.

- **Testing**

A thorough test is required to ensure that the remediated systems and processes operate as they have been designed and that full sign off is obtained from responsible managers.

- **Live Operation**

Moving into Live Operation an approach is required to ensure long term compliance.





### Key Decisions

- **Is this is a compliance exercise or a change opportunity?**
- **Should we remediate tactically or strategically?**
- **How do I balance longer term cost and risks with short term investments?**

### Key Decisions

In the context of the above framework there are a number of strategic decisions to be made.

**“Is this is a compliance exercise or a change opportunity?”**

Much of the work that will be done in the evaluation phase is not dissimilar to that which would be conducted in the analysis phase of a change programme. Does the organisation therefore gear the project as a key change enabler around its financial control environment or does it adopt a more limited approach. Gearing the project as a change enabler will mean a more prolonged investment of time and effort in analysis and design as well as stakeholder management. Our view is that where you know change is overdue this is an excellent opportunity to use SOX as a platform to drive it through. Where you are very confident in the quality of your processes and systems a more ‘minimalist’ approach is appropriate.

**“Should we remediate tactically or strategically?”**

Regardless of whether the project is a compliance exercise or a change opportunity the results of the evaluation phase may indicate that major changes are needed over time to build a more robust financial control environment. Given the time pressures for initial compliance it is unlikely however that any organisation is in a position to make all the changes it might need in a strategic and considered fashion. At the same time tactical fixes merely store up future costs and increase the risk profile. In our view organisations should take a balanced view. Too strategic an approach risks undue delay in compliance, too tactical increases likelihood of uncontrolled events arising and increase longterm costs.

**“How do I balance longer term cost and risks with short term investments?”**

Section 404 is not about a one off exercise it is about ongoing compliance, which requires a full annual declaration of compliance and quarterly statements on any material changes to the control environment. Ongoing compliance has two associated costs – first the actual ongoing cost of activities required to ensure adequate compliance and to check those activities and second the potential cost of a control failure.

In relation to ongoing costs the more robust the environment that exists around financial control the less ongoing effort and cost will be required to gain assurance. Where controls and solutions are weak or tactical then the degree of effort to gain assurance will be significant.

With regard to a control failure the weaker the environment the higher probability of a control issue arising that will have a loss associated directly with it, but will also need to be declared with a corresponding impact on the market perception of the organisation.

As well as the investment in the financial control environment itself there is also the investment required to track the performance of the environment.

We believe that organisations should aim to move to an optimised environment over the early years of SOX compliance and ensure that they have controls and systems in place to cost effectively and efficiently monitor the performance of that environment. This will ensure the cost of compliance is minimised over time and that the risks of a control failure are appropriately reduced.

## Key Principles

There are some simple principles that underpin the right approach.

“This is a Business-wide not purely a Financial Project”

SOX is not purely a finance function exercise. While finance may ultimately be responsible for the generation of the financial results responsibility for the underlying organisations, processes, systems, and business practices that generate the raw data from which they are derived stretches across the organisation. SOX Project Managers need to engage the senior team in establishing this understanding. Recent problems at Shell highlight the financial issues that non-financial people can create for the accuracy of financial statements.

“This is a project not an audit”

It is vital to remember that this is a project not an audit. While many organisations are using audit practices to provide overall assurance it is not audit skills per se that are required.

You need people experienced in business analysis for the Evaluation phase and people experienced in project management and implementation through the Remediation and Testing. You need strong leadership and change management skills to keep the business engaged and fully participating in this process.

## Key Principles

- This is a Business-wide not purely a Financial Project
- This is a project not an audit
- Have a clear methodology and detailed methods
- Leverage what you know already
- Get aligned with other initiatives
- Be consistent in the levels of detail
- Use appropriate software
- Think about ongoing maintenance

“Leverage what you know already”

Most organisations have vast amounts of information already documented about their processes and systems. Most organisations know via their own knowledge, from external and internal audit reports where control and risk issues reside. While it is important from a completeness and integrity perspective not to over rely on previously gathered information you should leverage what you already know.

“Get aligned with other initiatives”

Many organisations are conducting work which has a significant overlap with SOX. For example systems improvements such as implementation of financial systems, new MI tools, other regulatory initiatives such as Basel 2 implementation. Utilising these initiatives can be a major way of saving time and costs.

“Have a clear methodology and detailed methods”

It is self evident that a strong methodology is important. However it is equally important that detailed standards and procedures exist at the lower level if the integrity of the process is to be relied upon and people are to investigate, record, and report in a similar way.

“Be consistent in the levels of detail”

Larger organisations will involve a considerable number of people in the process of gathering and recording information across departments. Establishing the right level of detail that processes and systems are to be analysed at will ensure proper and appropriate consistency across all of the work performed. This will minimise the risk of under analysis and the cost of over-analysis.





#### “Use appropriate software”

There are a number of ways in which software can streamline the process of both implementation and ongoing management and maintenance. Get a proper document and process modelling repository. A proper repository will ensure documentation is reusable and that a common set of standards are used. Remember that your auditors will be reviewing your work in detail. Make it as easy as possible for them. Utilise new functionality in your finance systems. Most vendors have brought out enhanced data capture and reporting facilities to improve compliance. It's worth checking what your system can offer. Look at exception management software. Going forward compliance will be easier where exceptions, for example around transaction size are rapidly highlighted to management. A number of exception based management tools are providing this kind of support.

#### “Think about ongoing maintenance”

SOX is not a one off exercise. Material changes to the control environment need to be reported quarterly and a positive annual statement on controls is also required. Clearly the time restrictions around compliance mean that most organisations will make some tactical choices in the first year around the solutions that they might have in place. Over time they may invest in more strategic alternatives. What should not be tactical is the approach, methods, and principles adopted to S404 compliance. Auditors are likely to err on the side of caution in conducting their reviews, therefore it is likely that time 'saved' now will only be 'lost' when rework is required later. Similarly it is important to ensure that annual reviews of the control environment can build easily on this initial exercise.

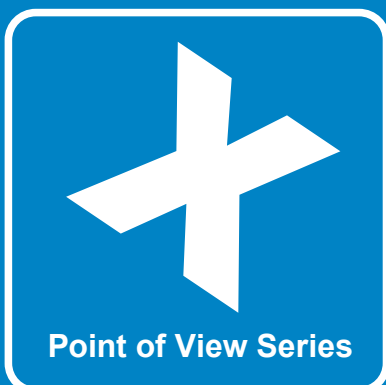


## **Point of View Series**

**This white paper is one of a regular series of Points of View on compliance and other leadership topics. Xayce ([www.xayce.com](http://www.xayce.com)) is a business and technology consultancy that specialises in helping its clients transform their back office operations.**

**The views and opinions expressed in this article are meant to stimulate thought and discussion. As each business has unique requirements and objectives, these ideas should not be viewed as professional advice with respect to your business.**

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