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THE PATH TO ONGOING COMPLIANCE

THE ORIGINS OF THE SARBANES-OXLEY ACT

A handful of companies have become household names mostly because of their demonstration of corporate greed, fraud, and accounting improprieties. The activities of these few organizations are not representative of the majority of companies in the United States, yet the result of their abuses has left a significant mark on public corporations. Considered the most significant legislation to impact the accounting profession since the Securities Acts of 1933 and 1934, the Sarbanes-Oxley Act of 2002 (the "Act") comprises 11 titles that outline complex compliance requirements affecting a public company's entire organization, including the relationship with its external auditor.

The Act was signed into law to improve the accuracy and transparency of financial reporting and corporate disclosures, as well as to reinforce the importance of corporate ethical standards. In turn, it has placed significant responsibility on issuers to design, implement, and maintain effective systems of internal controls to ensure adequate financial reporting to the Securities and Exchange Commission (SEC) and investors. In addition, the Act imposes significant criminal penalties and fines upon corporate executives who do not comply. Ultimately, the requirements of the Act seek to enhance the quality, accuracy, and timeliness of financial data to allow shareholders to make informed decisions regarding their investments.

GENERATING VALUE FROM COMPLIANCE

The resultant changes from the Sarbanes-Oxley Act, specifically SEC requirements and regulations, have forced businesses to reevaluate their organizational structures and systems of internal control and to create and/or modify the roles of individuals involved in the financial reporting process. Executive management is now explicitly responsible for establishing and maintaining a system of internal control over financial reporting and conducting an annual assessment of the same. The CEO and CFO must certify the accuracy of financial reports filed with the SEC under the risk of criminal penalties and fines. Other members of the executive management team are responsible for the new requirements relating to codes of ethics, record retention, insider trading, whistleblower policies, as well as other legal and human resource issues. While the Act does not specifically mention any requirements of managers and supporting staff, these individuals generally have been directly responsible for most of the additional work that is required for initial and subsequent ongoing compliance, and they must adhere to the same ethical standards of executive management.

Companies have experienced significant increases in costs and time necessary to achieve and maintain compliance with the provisions of the Act and the related regulatory changes. Unequivocally, the most significant cost increases have been related to the external auditor attestation of internal control over financial reporting and the internal and external cost of complying with the provisions of Section 404 of the Act. The cost of compliance has varied mainly based on the size of the company, the number of operations, and the complexity of the business, but nonetheless remains significant for most organizations.

Initial implementation of the Act's provisions for internal controls over financial reporting (Section 404) and executive financial statement certification (Section 302) has undoubtedly been time consuming and costly. The daunting requirements and evolving landscape in year one forced most organizations to initially take a short-term minimum requirement approach to compliance and forego process improvement and technology implementation opportunities. Today, those same companies are seeking to reduce the cost of ongoing compliance while realizing greater benefits. In moving beyond initial compliance, organizations should view the mandated changes as an opportunity to revitalize business practices, drive improved performance, and boost investor confidence in an effort to generate a return on their investments in initial and ongoing compliance.

Prior to passage of the Act, CFOs and chief auditors often sought to focus on value-added activities such as top-line initiatives, strategic acquisitions, and operational improvements. In today's compliance environment where internal controls, which were previously regarded as secondary considerations, are front and center, the challenge is to identify ways to help Finance remain a valued partner to the business in an environment of increased governance. The following activities can help Finance continue to deliver value to stakeholders while ensuring continued compliance:

Finance Checklist: Compliance Activities that Deliver Value

- ☐ **Identify the enterprise strategy and communicate it throughout the Finance organization.**

  Control remediation and process improvement should meet short-term goals and deliver long-term value. An organization's financial objectives are typically a combination of liquidity and working capital optimization, profitability, and growth. The strategic goals of senior management should be understood by Finance and incorporated into everyday activities. Consider the risk implications of the enterprise strategy and counsel management accordingly.

- ☐ **Develop a finance strategy to support the enterprise strategy.**

  Reevaluate existing key metrics to address crucial Sarbanes-Oxley processes. Identify internal and external stakeholders and the information they need to make insightful decisions. Define, develop, and deploy measurements to satisfy information objectives such as key performance indicators and balanced scorecards. Benchmark against industry leaders and key competitors to establish a performance baseline. Then set goals and define a plan to achieve them.

- ☐ **Generate a capacity to provide analytical and consultative services.**

  Remove non-value-added processes that were identified during Section 404 documentation. Develop an analytical and consulting capacity within the finance function. This competency is critical to transformation. Measure your own processes. Simplify and streamline transaction and reporting procedures through shared services, outsourcing, and accelerated close methodologies.

- ☐ **Leverage technology to deliver and distribute results.**

  Avoid manual workarounds and reduce the cost of ongoing compliance through use of technology. Use automation as a key enabler to transformation. Leverage the capabilities of existing ERP system(s) and integrate wherever practical. Eliminate spreadsheets as a focal point of the reporting process by implementing consolidation and reporting packages. Consider Business Intelligence and Web-based distribution (XBRL) applications to improve the timeliness and accessibility of critical information.

MOVING BEYOND INITIAL COMPLIANCE

Sarbanes-Oxley accelerated filers spent countless hours and resources on initial compliance and in preparation for the filing of their first Section 404 certification. As the focus shifts to ongoing monitoring and maintenance, organizations must avoid complacency and recognize that compliance is not a one time event. There is a significant risk of noncompliance beyond year one if an organization does not have a long-term strategy and comprehensive compliance plan implemented that will support the required quarterly and annual certifications.

Compliance planning for subsequent years necessitates a reassessment of requirements and an approach definition that differs from the first-year compliance readiness plan. A more sustainable and practical program that is based on new and/or clarified guidelines must be developed and implemented. The plan may involve the implementation of new technology and a modified focus on process and policy that will support a more efficient and cost-effective approach to ongoing compliance.

An efficient and effective infrastructure that enables repeatable, reliable activities such as documentation reviews and updates, testing, and remediation is key to ongoing compliance. Because the Act requires the linking of Section 404 monitoring efforts to quarterly reporting under Section 302, companies must have the capability to conduct quarterly evaluations and to report any changes in internal controls over financial reporting that either have or could have a material effect on the financial statements. Companies must develop the ability to keep their assessment of internal controls over financial reporting current throughout the year. An organization cannot wait until the end of the fiscal year to evaluate changes in internal control for their annual assessments.

To maintain a strong control environment and derive the maximum value from an ongoing compliance program, the answers to the following questions should be continuously evaluated:

- Are you satisfied that there are no critical gaps and overlaps in the ownership of your financial reporting processes and in the underlying internal controls?

- Are you utilizing Section 404 documentation to identify opportunities to build in quality, reduce costs, and gain efficiencies, while reducing financial risk?

- Do you have an appropriate structure and detailed plan for ensuring continued compliance with Sections 302 and 404?

Good governance, as evidenced by an effective system of internal control, and adding value to the business do not have to be conflicting objectives. Many forward-thinking organizations have recognized the compatibility of the two goals and have incorporated both perspectives into their planning and compliance programs (see Figure 1.1).

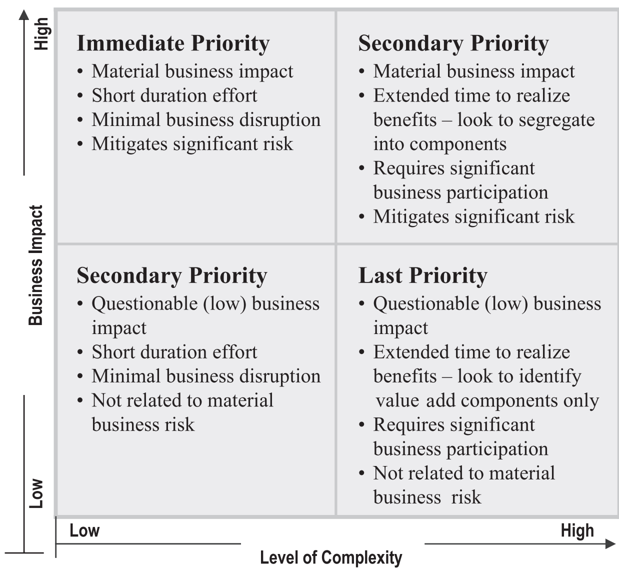

Exhibit 1.1 Prioritization based on business impact and level of complexity

Best practice considerations for ongoing compliance plans include:

- □ Modify compliance approach (based on the SEC Releases 5/05, 5/06, 12/06) to adopt a more risk-based topdown approach
- □ Develop a formal, detailed ongoing compliance plan
- □ Define the compliance organization structure and roles/ responsibilities
- □ Communicate the ongoing compliance plan to the external auditor
- □ Communicate the ongoing compliance plan to employees
- □ Develop a practical, comprehensive integrated testing plan
- □ Reduce testing through key control review/rationalization, based on risk assessment, control automation, and eliminate redundant controls
- □ Implement a compliance management tool
- □ Implement a control monitoring tool
- □ Develop an ERM strategy and plan
- □ Identify and implement business process improvement opportunities

Reevaluating the Compliance Program

One of the intended results of the Act was a heightened process owner awareness of financial controls and risks, as well as increased responsibility and accountability for those controls and risks. In year one, compliance documentation and testing was often managed and/or performed by external resources, which prevented process owners from fully embracing ownership of the control environment. To encourage greater internal resource involvement, the ongoing compliance plan should be designed to drive greater awareness through continued education/training as well as documentation and testing approval. Specifically, each organization should reevaluate its compliance program from four perspectives: ongoing compliance, remediation prioritization, process improvement, and operational structure and efficiency.

Ongoing Compliance Considerations

The following checklist summarizes the key principles that should be considered when planning and developing an ongoing compliance strategy:

Ongoing Compliance Strategy Checklist

- ☐ **Communicate a positive "tone at the top."**

  The "tone at the top" significantly influences behavior throughout the organization, so certifying officers and senior executives should continually reinforce executive support and commitment to reliable financial reporting and continuous improvement and strengthening of the internal control structure and environment. The executive management tone will drive the success of ongoing compliance efforts. If management projects compliance is a burden, it will be perceived as a burden by employees, and much of the value will be lost. Compliance objectives may still be met; however, control breakdowns may occur more frequently, and the opportunity to recognize value from process improvements will most likely be forfeited.

- ☐ **Develop a supportive organizational structure.**

  Adequate organizational support is critical to successful compliance in year two and beyond. An organizational structure that supports ongoing compliance should be defined and established, and the role of internal audit (where applicable) should be specifically outlined. Organizations should consider integrating the annual audit test plan with Sections 302 and 404 certification testing.

- **Reinforce the roles and responsibilities of process owners.**

  The importance of the process owners' roles in the success of ongoing compliance cannot be overstated. Businesses can hire teams of external auditors and consultants to design, implement, and test systems of internal control, but they cannot ensure that those systems will be properly used and internal controls will be followed once they exit. Because process owners are accountable for the existence and effectiveness of internal controls, their roles and responsibilities in the ongoing compliance process should be clearly defined. Only then can accountability and control ownership be truly reinforced. An effective self-assessment process can assist in facilitating this reinforcement and help ensure that any control breakdowns are detected early and corrected.

- **Invest in compliance education and training.**

  Continuous compliance education and training is vital to the success of an ongoing compliance program. Employees need to receive sufficient training on overall company compliance requirements and be educated about their individual roles in the compliance process in order to perform their jobs well and support the organization in meeting the requirements of the Act on an ongoing basis.

- **Implement a continuous monitoring and maintenance process.**

  Because Sections 302, 404, and 409 each require ongoing compliance, every organization should design and implement a detailed continuous monitoring and maintenance process. This will help ensure that any identified remediation is completed in a timely manner. Organizations can take advantage of numerous software applications that have built-in monitoring capabilities and/or implement internal control self-assessments. Any tools that are used to facilitate the process will be dependent upon the knowledge base and commitment of employees in the organization.

- **Eliminate redundant closing and financial reporting activities.**

  Organizations should review their current closing and financial reporting procedures and compare them against Section 302 and Section 404 certification requirements. A consolidated checklist/schedule can then be developed to enable the most efficient process and eliminate redundant activities.

- **Implement a process change procedure.**

  Section 302 requires disclosure of any changes that materially affect internal control over financial reporting. A formal process change recognition and update procedure will help ensure timely quarterly disclosure, an efficient annual certification process, and continued confidence in the internal control environment supporting financial reporting.

- **Implement process improvement.**

  During the initial compliance effort, a vast amount of process and control information was obtained and documented. Organizations can utilize this knowledge to foster positive change and potentially realize a return on the compliance investsment. Value can be recognized through process improvement, control remediation, and expansion beyond compliance through the development or enhancement of enterprise risk management and corporate governance programs.

REMEDIATION PRIORITIZATION

Prioritizing compliance and remediation efforts is crucial to the certification of financial reports, the annual management assessment of internal control over financial reporting, and the related external auditor attestation engagement. Remediation efforts should be designed to improve the efficiency and productivity of operating processes as well as to strengthen internal controls. Each internal control remediation plan should address not only how the corrective action improves the overall control environment, but also how it streamlines transaction process flow.

The timing of remediation efforts should also be considered. Companies should determine to what extent remediation could be conducted in conjunction with compliance activity. It is a best practice to plan for parallel documentation, control gap identification, gap remediation, and testing for both initial and ongoing compliance, because parallel execution can have a dramatic impact on the cost and the timeline of compliance efforts.

The first step in effectively coordinating various remediation requirements is to categorize them by type of improvement. Category examples include the following:

Checklist: Control improvements

- ☐ Mitigate missing or deficient controls
- ☐ Eliminate unnecessary or redundant controls
- ☐ Minimize process risks
- ☐ Eliminate policy and/or authorization deficiencies
- ☐ Establish control process metrics
- ☐ Eliminate manual controls (automate)

Checklist: Sarbanes-Oxley compliance and financial reporting improvements

- ☐ Establish Sarbanes-Oxley reporting package
- ☐ Establish standardization across financial processes and financial reporting (internal and external)

Checklist: Productivity improvements

- ☐ Eliminate non-value-added tasks/activities
- ☐ Automate manual activities/processes
- ☐ Establish universal data and/or process standards
- ☐ Update/revise policies
- ☐ Align business activities and efforts with perceived value

Improvement opportunities should then be prioritized based on business impact and complexity (see Figure 1.1). *High-impact improvements* address material business issues that can be accomplished in a short duration with minimal business disruption. They mitigate significant business risk and typically yield results quickly. Implementation should not extend beyond 90 days. *Medium-impact improvements* also focus on material business issues; however, they require an extended period of time and strong participation from the business. Implementation will typically take between three to six months.

Prioritizing remediation activities based on process improvement opportunities will not only reduce the organization's latency in reporting and disclosures, but also advance Finance's position as a valued business partner.

Process Improvement

Documentation efforts required for Section 404 compliance have prompted many companies to take the first step in business process improvements (e.g., documentation of current processes, and identification of redundancies and inefficiencies). As control remediation continues, companies are well positioned to incorporate additional process improvements into their compliance infrastructures.

Operational Structure and Efficiency

An increased pressure to do things faster, better, and more cost effectively has prompted companies to pursue various strategies to improve operational effectiveness. What functions should be performed within the business units? Who should select, purchase, and operate the supporting technologies? When should business units be free to choose operating standards, and when should Corporate mandate consistency? These questions are answered differently based on a company's operating style, industry, and market focus.

Because there are benefits to centralization and decentralization, companies should closely examine both approaches before making any operational changes (see Figure 1.2).

Benefits of Centralization/Standardization

- Less redundancy in operations
- Leverage of management time and attention
- Economies of scale
- Easier implementation of best-practice approaches
- More defined career paths for professionals in support functions
- Reduced maintenance costs and effort
- More efficient utilization of IT resources (e.g., technical infrastructure, application support and licensing, and modifications)

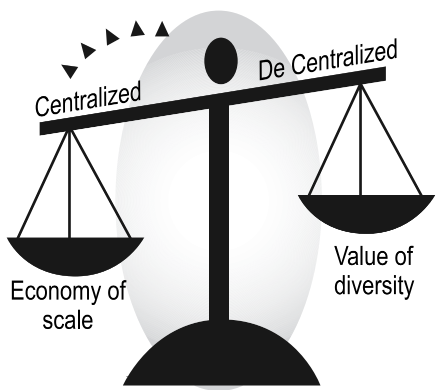

EXHIBIT 1.2 CENTRALIZATION VS. DE-CENTRALIZATION

Benefits of Decentralization/Customization

- Processes and systems can be tailored to each business unit's unique needs.
- Local systems can be more responsive to changes in business conditions.
- Local operations can help foster a culture of ownership.
- Local operations that are integrated through a monthly feed of summarized financial information to Corporate can be more easily incorporated or divested.

While there are benefits to decentralization, compliance requirements driven by the Act will likely increase the focus on economies of scale and therefore require greater centralization. The expense and time required to annually review process documentation and retest will increase with each separate department engaged in auditable activity. This will be particularly true where operations are not only separate, but also vary in terms of systems, formats, and process design.

Centralization is not an easy change. Companies are often reluctant to move away from their decentralized structures (even if they know they are ineffective) because the social, technical, and financial costs of change can be high. Nonetheless, more organizations are finding that the additional cost of complying with the Act warrants the decision to centralize or even employ a shared services model.

Public companies spent significantly more than they had previously estimated to comply with Section 404. Informal estimates indicate annual ongoing costs for monitoring and compliance currently amount to as much as 50 to 70 percent of the initial compliance costs. Organizations should conduct operational and budget reviews to prevent future costs from skyrocketing. Companies that have maintained critical financial functions at the divisional level should reconsider centralizing those functions in order to take advantage of greater economies of scale.

Leading companies have shifted Sarbanes-Oxley efforts from "project" to "process," moving toward a more sustainable infrastructure that will support ongoing financial management operations. Immediately addressing the four critical areas of *ongoing compliance, remediation prioritization, process improvements,* and *operational structures and efficiency* will help organizations leverage the knowledge obtained through compliance activities and capitalize on the opportunity to improve business processes, while maintaining a solid control environment. This approach will enable Finance to add value while ensuring good corporate governance.