

No shelter from the storm

While the UK may have escaped the typhoon weather that has engulfed the US in recent weeks, another major storm is making its way across the Atlantic. For UK companies with US listings, there will be no shelter when Sarbanes-Oxley strikes home. Liz Salecka reports.

Executive summary

- Section 404 of SOX places stringent requirements on the internal controls used for financial reporting. UK companies with a US listing must be compliant for financial year-ends as of July 2005.
- In the US, the cost of s404 compliance has soared well beyond expectations. Although the average cost per company was estimated at US\$1.93m in January, it is now US\$3.14m.
- There is no escape for treasurers of UK companies with a US listing. They must play a key role in ensuring the effectiveness of internal controls, and be prepared to take the blame should things go wrong.
- To ensure compliance, treasurers must start early, focus on key controls and collate adequate evidence over a sufficient period of time.
- Testing of internal controls is one of the biggest hurdles, accounting for about 40% of a s404 project – and it is not going to go away in the future either. An independent audit of controls must also be conducted annually.
- New IT systems that provide s404 compliance may be the answer to treasurers' prayers. Although the technology is still in its infancy, solutions that allow greater transparency of processes are being developed.

UK companies with US listings must brace themselves for one of the toughest challenges of their 'corporate governance' lives. As of next year, they must comply with the stringent requirements of section 404 of Sarbanes-Oxley (SOX) which places major requirements on the internal controls in place for financial reporting (see SOX and s404 – the background).

It is a huge task that could call for tens of thousands of additional working hours – not only in the planning and documentation of internal controls, but also in rigorous testing to ensure the controls' effectiveness.

On top of this come the crippling costs of using external consultants and advisors, implementing new systems, and, of course, hiring auditors to provide the advice and attestations required.

ARE UK COMPANIES READY? Of the 120 or so UK companies affected, many already have s404 projects up and running and are now documenting their internal controls. But others have clearly underestimated the full implications of s404.

A recent survey of mainly UK treasuries by Ernst & Young (see *Delicate operations*, page 13) found that 21% of UK companies are still in the planning stage, while not one has yet completed all the work required.

"Some companies are now realising that compliance with s404 is much bigger than they originally thought," says a spokesman for one leading accounting firm. "Some started work on it as soon as they saw it coming – but others waited until the last minute. There is a lot of catching up to be done."

THE US EXPERIENCE. The potentially massive impact of compliance with s404, and the huge costs it brings, are best understood by looking at the US experience.

Despite being much further down the line in their internal controls compliance – 64% are at the testing stage according to a recent survey of 200 US companies – many are still having to meet spiralling costs which are well beyond their original expectations.

Indeed, a recent survey of 224 US public companies, with revenues of about US\$2.5bn, by Financial Executives International (FEI), revealed that the average total cost of s404 compliance per company is now US\$3.14m – up 62% on the US\$1.93m cost per company estimated in January 2004.

The average US company faces an internal control audit fee of US\$823,200 – more than 50% of total annual statement fees. Moreover, equally steep costs have also been swallowed in relation to external IT consulting, new software and other vendor charges. The FEI survey revealed an overall cost of US\$1m in new systems per company, and further expenditure is still anticipated.

Aside from physical costs – although this area also has its price tag – the extra man hours that US companies have put in to document and test their internal controls is also phenomenal. The recent FEI survey revealed that s404 has called for an extra 25,667 hours of work in US companies, 27.4% of total internal hours. In terms of additional external man hours, meanwhile, the average is 5,067 hours.

NO ESCAPE FROM YOUR RESPONSIBILITIES. For treasurers of UK companies listed in the US, there is no escape. With responsibility for their companies' balance sheets, and the control environment of their treasury operations, it is up to them to set their own templates for s404 compliance – and get it right!

And they must be prepared to assume full liability should their internal controls not be up to scratch. Corporate management are not going to risk facing any of the sharp penalties associated with non-compliance and are making sure that everyone takes, not only their share of the responsibility – but possibly, the blame too should things go wrong.

"Although treasurers are not legally responsible for compliance with SOX, this responsibility is being trickled down inside organisations," says a consultant with one leading accountancy firm.

And the treasury director of a leading European company adds:

"Although it is the chief executive and CFO that bear criminal liability for non-compliance with SOX, we face a civil liability.

"They are making sure that every individual in the chain signs off his/her own report, saying he/she has complied. They can then sue us if we are in breach."

GETTING READY FOR S404. So what does the corporate treasurer of a company with a US listing need to do to make sure he is up to speed and ready for s404. The advice is straightforward:

- Start early;
- focus on your key internal controls; and
- collect enough evidence over sufficient time for effectiveness evaluation.

A treasurer must be actively involved in the entire s404 compliance process from day one – project planning – through to documentation of internal controls, effectiveness testing, remediation and reporting to management.

Determining the extent of documentation needed is crucial. While on the wider company scale, this involves assessing the scale of revenues and which locations should be covered, on an individual location basis this boils down to identifying how many processes should be documented and which controls within each process to include. This in itself is dictated by the significance of a process and the underlying risk.

"On having done his/her analysis, the treasurer must identify about 100 controls that he/she sees as key in order to mitigate the risk of financial reporting going wrong," advises one leading consultant, pointing out that every element of the treasury process will not always call for such detailed treatment. But he warns: "When it comes to this stage, it is a trap to think that you have good documentation. You cannot be complacent – it won't be good enough for SOX."

TESTING TAKES TIME. The testing of internal controls and collation of evidence from them – a process accounting for an estimated 40% of most s404 projects – represents another major hurdle. Indeed, while many UK treasurers already recognise testing as a difficult process, others are almost fearful of having to 'retest' on an annual basis.

Crucial to the testing process is determining which documented controls are tested, the nature and quantity of evidence collated, and the length of time over which evidence is collected.

"You have to ensure that you are doing enough, and collecting the right evidence," warns one consultant. "Also, you have to make sure that your evidencing takes place over a sufficient financial period – it should be collated over a six month period at least."

Engaging the services of an independent auditor at an early stage who can advise on the collection of evidence and any corrective actions required can be a major plus.

This concept has been taken even further by one treasurer who has

SOX and s404 – the background

The SOX Act (2002) aims to tackle the financial disclosure, corporate governance and auditing problems at the heart of financial corporate scandals such as Enron and WorldCom.

Aimed at all companies with a US listing, regardless of their country of origin, one of the Act's key requirements is for the self-certification of company accounts. It obliges directors to personally certify the accuracy of all financial statements and disclosures.

Miscertification can lead to imprisonment – with sentences of up to 20 years and unlimited fines.

For corporates today, one of the toughest challenges is meeting the requirements of s404 on internal controls. This calls on companies to evaluate the effectiveness of the controls they use when compiling financial information for reporting purposes, and to certify this in their annual reports. Internal controls will also have to be audited by independent auditors about three months prior to companies' year-ends.

The US Securities and Exchange Commission requires most US companies to be compliant with s404 for financial year-ends on or after November 2004. Others – smaller companies, foreign private issuers and companies with registered debt – must be compliant for fiscal year-ends as of 15 July 2005. The latter date applies to all UK companies with a US listing.

arranged for spot independent audits of his department which will be conducted without any warning. "This is self-enforcing – it is a really good way to test our controls," he says.

WHAT DOES THE FUTURE HOLD? Requirements governing the testing of internal controls are not going to disappear. Whilst the planning and documentation phases of s404 may become more straightforward in the years ahead – with the main obligation on treasurers being to keep internal controls documentation up-to-date – they will still be legally required to fully test the effectiveness of their internal controls annually. Indeed, testing will remain a complete repeat process for all concerned year in and year out, as will independent auditing of the controls. This means that the intensity of both the work required and associated costs will stay at current levels.

To ensure s404 compliance into the future, companies are being strongly advised to start monitoring their internal controls on an ongoing basis as of now. They must also put in sustainable structure and processes to deal with s404 compliance, instead of continuing to rely on the services of third parties.

IT systems that help treasurers to monitor and test their controls for s404 compliance could provide the best route forward. Although s404 technology is still in its infancy, new systems are being developed to provide a complete structured audit trail of treasury transactions, ensure segregation of duties and allow greater transparency of automated treasury processes.

"Some companies – albeit a minority – will want to get away with the systems they already have as it is always very expensive to improve your IT infrastructure," says one consultant. "Others have decided to be early and buy now. But most are likely to invest next year when more solutions dealing with s404 compliance become widely available."

In next month's issue of The Treasurer, we will be taking a closer look at the technologies being developed to help companies comply with s404, as well as other sections of SOX.

Why SOX won't work

While they may disagree over its impact on their workloads and time, the extent of the system overhauls required and how it will affect their operations, treasurers are united on one thing – SOX won't work.

Its introduction is understandable, the penalties imposed on senior management justified, and improved standards of corporate governance can be anticipated. But whether it succeeds in its original goal of preventing further Enron/WorldCom type scandals is another matter altogether... "When a small number of very senior executives decide to criminally alter the apparent financial situation of their company, no amount of internal controls are likely to prevent it," says Karl Fenlon, Group Treasurer at Hanson.

And the treasury director of another leading European company adds: "We will always see corporate scandals of the scale of Enron and Parmalat – people will always be dishonest."

For companies raising capital in the US markets – yes, the threat of going to jail will help to enforce SOX.

"But good companies don't get rewarded for being good companies. In order to resolve this problem, you need to put dishonest people in jail."

SOX is also identified as possibly serving as counter-productive to the quest for openness and correct, verified information in financial reporting. "There is now a big reluctance by us to do any more than what is required by SOX," says one treasurer. "It is likely that we will be far less open in terms of the amount of information that we put out into the public domain because of the risk of criminal action."