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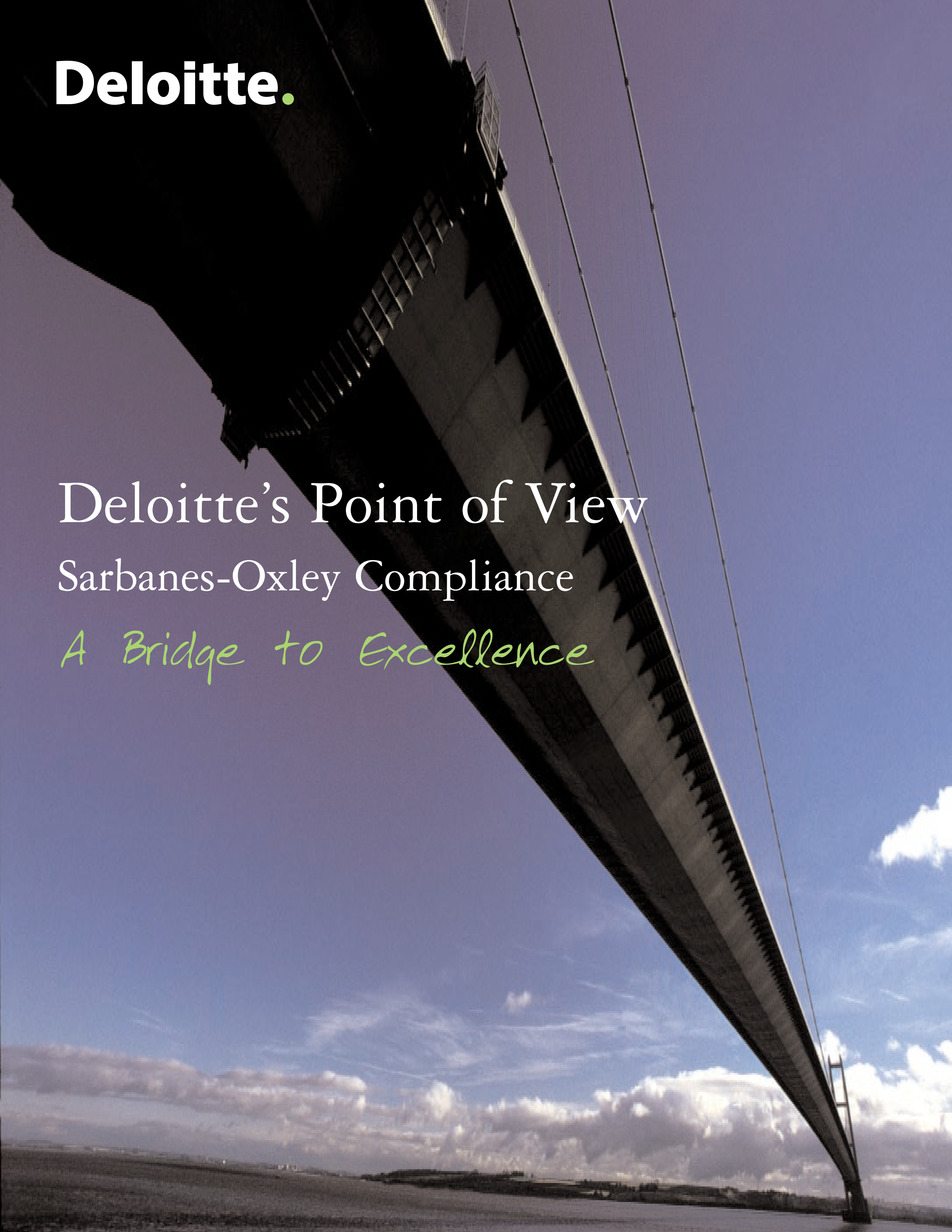


Deloitte's Point of View

Sarbanes-Oxley Compliance

A Bridge to Excellence

The Sarbanes-Oxley Paradox

Dealing with the mandates of the Sarbanes-Oxley Act[1], even under a "relaxed" implementation schedule, has proven something of a scramble for public companies. Many have found that the sheer volume of work has necessitated a process that favors speed over deliberation.

This haste is an unfortunate side effect of the strong medicine prescribed by Congress to improve corporate governance and restore investor confidence. And in this rush to action, something important has been left behind: context and perspective.

Fortunately, while we at Deloitte haven't enjoyed the luxury of rumination, we have reaped the benefit of experience. In the course of assisting with hundreds of section 404 readiness and other Sarbanes-Oxley-related projects, our Deloitte professionals have learned numerous lessons and gained valuable insights. Here's the most important:

Compliance is not the endgame.

Don't misunderstand. Compliance is critical. Simply stated, you have no choice. But a much greater reward can be earned by companies savvy and ambitious enough to seek it.

How is this possible? By using Sarbanes-Oxley as a bridge to better business performance.

The mindset of your management and board is the critical factor. Companies that focus on complying only with the *letter* of the law — doing just enough to get by — may find themselves in a quagmire of bloated controls, burgeoning expenses, and enduring headaches.

But corporate leaders who embrace the *spirit* of the law — strong ethics, good governance, reliable reporting — will get a re-energized company, reassured investors, and maybe even reduced costs.

Compliance: Not Enough

William Donaldson, SEC Chairman, remarked at the National Press Club on July 30, 2003:

"Simply complying with the rules is not enough. [Companies] should, as I have said before, make this approach part of their ... DNA. For companies that take this approach, most of the major concerns about compliance disappear. Moreover, if companies view the new laws as opportunities — opportunities to improve internal controls, improve the performance of the board, and improve their public reporting — they will ultimately be better run, more transparent, and therefore more attractive to investors."

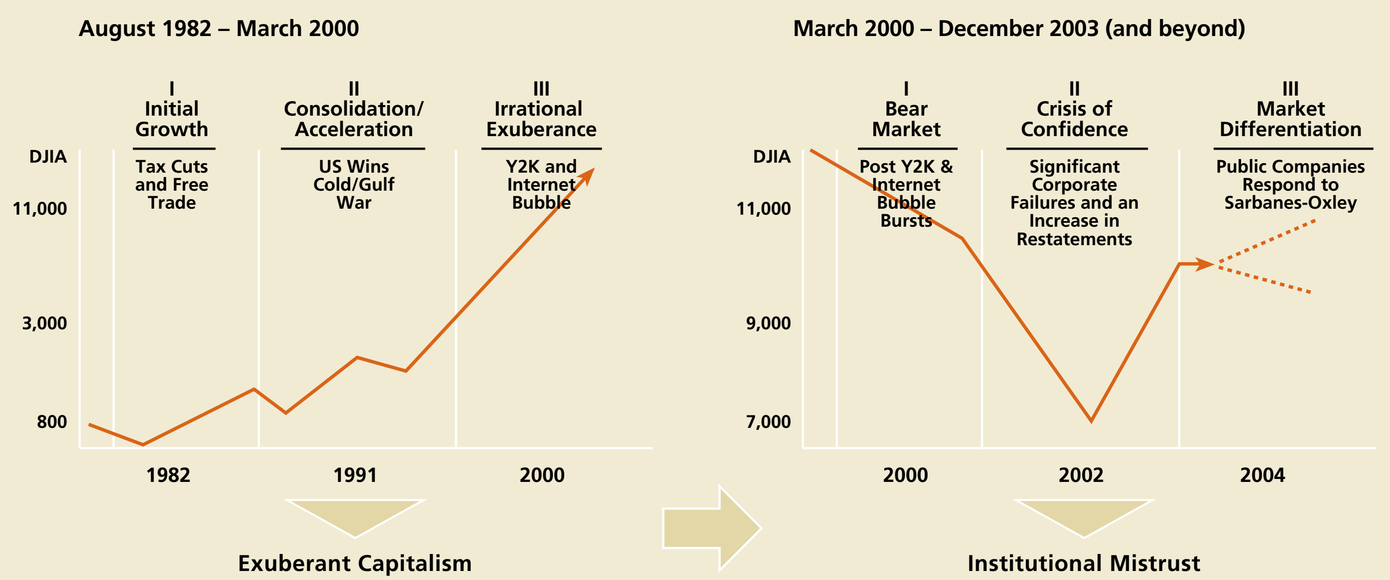
That's right — *reduced* costs. Not to say that your readiness and compliance work won't be expensive, because it will. But at the same time, if you leverage your Sarbanes-Oxley compliance efforts to include a hard look at business processes and systems, you will almost certainly find complexities that, if eliminated, can cut costs, sometimes dramatically.

Call it the Sarbanes-Oxley paradox: Wholeheartedly embracing the law can be less expensive than grudgingly accepting it.

Of course, in either case, compliance can be attained. But visionary companies will consider compliance just one step on the bridge to excellence.

1 For purposes of this document, the term **"Sarbanes-Oxley"** refers to the Sarbanes-Oxley Act of 2002 in its entirety, including all sections of the law enacted by Congress, all associated rules promulgated by the Securities and Exchange Commission, and all related standards issued by the Public Company Accounting Oversight Board. The term **"section 404"** refers specifically to the "management assessment of internal controls" section of Sarbanes-Oxley and all the rules and standards that fall under that section.

Market events have damaged investor confidence and public trust



Source: Deloitte Research

Confidence Shaken/Regulators Stirred

While the business world has always had its share of scandals, the cusp of the 21st century may be regarded by historians as particularly noteworthy for its abundance of transgressions. As the chart above illustrates, the capital markets have been buffeted by an "imperfect storm" of events. Contributing to the gale have been the following:

- dot-com bust
- excessive CEO pay
- insider trading
- accounting scandals
- financial restatements
- executive malfeasance
- fraud
- corporate failures
- mutual fund crisis

This unfortunate confluence of events severely damaged investor confidence in the quality of historical and predictive information put forth by public companies. And as confidence plummeted, so too did the market capitalization of many of the embroiled corporations.

The inevitable outcome of this crisis was legislative and regulatory action. Congress had little recourse but to act boldly, and did exactly that when it passed the Sarbanes-Oxley Act of 2002, heralded as the most sweeping piece of business legislation enacted in a half-century.

Since the passage of the law and its associated rules and standards, many improvements in corporate governance have taken hold: boards are increasingly independent; audit committees are acting with newfound skepticism and autonomy; CEOs are assuming greater responsibility for financial reporting.

This is not to suggest, however, that the days of failure and fraud have been permanently relegated to the past. Indeed, despite substantial progress, new business scandals still arise frequently. (And it should be noted that no amount of legislation and rule-making will dissuade a corrupt executive bent on fraud.)

Nonetheless, one might reasonably expect that the new emphasis placed on corporate governance and internal control will mitigate the conditions that contributed to the crisis.

Fortune Out of Misfortune

One doesn't have to be a linguist to find fortune at the root of misfortune. Nor does it make one a cynic to note that, in light of the intense media coverage and regulatory scrutiny, early adopters of strong corporate governance measures stand to reap significant benefits.

This theory is borne out in numerous surveys. For example, recent research conducted by McKinsey & Co. found that:

- Fifty-seven percent of institutional investors said that good corporate governance determined whether they increased or decreased their holdings in a company.
- Investors are willing to pay a premium for good governance — up to 41 percent, depending on their country of origin.
- By moving from worst to best in corporate governance, companies can expect a 10-12 percent gain in their market valuation. While this may not be significant on a per share basis, it translates to an increase of over $1 billion for a company with a $10 billion market capitalization.

Interlocking Goals

Deloitte's Sarbanes-Oxley-related work at hundreds of companies has uniquely positioned us to hear from boards, audit committees, CEOs, and C-suite executives. Based on reports from the field, the goals expressed by these business leaders often include these three:

1. Fully comply with all the rules and standards promulgated under the Sarbanes-Oxley Act of 2002.
2. Restore shareholder trust.
3. Increase overall shareholder value.

Some executives view these goals as unrelated or even mutually exclusive. Yet we contend that they are inextricably linked, and we maintain that the most effective approach to compliance with Sarbanes-Oxley will tackle all three goals simultaneously.

To reach these goals, we offer a vision and a strategy that addresses the following:

Attain Full Compliance with All the Rules and Standards Promulgated Under Sarbanes-Oxley

As cited above, while we consider compliance to be a milestone rather than a destination, it is irrefutably the most critical step of the journey.

Design and Implement an Infrastructure to Sustain Compliance Efforts

Unlike year 2000 remediation projects, compliance with the mandates of Sarbanes-Oxley is not something you can do once and check off your list. The systems and procedures that you put into place must be diligently maintained for the lifespan of your company.

Identify and Implement Changes to Improve Performance

Deloitte contends that mere compliance is an opportunity missed. Documenting, testing, and remediating controls will require substantial work. An incremental increase in effort, coupled with the right attitude and expectations, will allow you to identify and reduce complexities, including inefficiencies, redundancies, and inconsistencies — and, ultimately, lower costs.

We also consider certain other activities critical to a successful outcome:

Link Control Activities at the Operational Level with the Governance Activities at the Board Level

In many companies, there is a disconnect between the governing boards that hold ultimate responsibility for effective internal control, and those employees who must carry out the control activities. Effective readiness and compliance programs should close that gap.

Consequences of Sarbanes-Oxley

Just as with any other business issue, Sarbanes-Oxley has raised a number of intriguing questions and concerns. Below are a few factors that should be considered.

Strategic Imperative	Consequence	Business Issue
Public Ownership	Compliance with Sarbanes-Oxley has a substantial price tag for public companies.	Will the cost of compliance affect my share price? For smaller companies, does it make sense to be public? Does the additional cost of capital that Sarbanes-Oxley represents still make it worth tapping into the public equity or debt markets?
Outsourcing and Alliances	Sarbanes-Oxley requirements for internal control and oversight extend beyond internal operations.	Companies should reconsider their strategies on outsourcing, strategic alliances, suppliers, and go-to-market business partners.
Shared Services	Sarbanes-Oxley has contributed to a renewed interest in shared services. Effective controls can be more efficient and sustainable in a shared service environment.	Companies should assess their current and future use of shared services.

Address the "Cultural Needs" of the Organization

An approach to Sarbanes-Oxley that neglects the organizational culture — a key element of the overall "control environment" — is one with little likelihood of success. Among the critical components are a strong "tone at the top" and a culture that emphasizes ethics and responsibility. Whether you are working to establish the right culture, or maintain one that works well, the importance cannot be overstated.

Address the Technological Impacts and Implications

Technology can be part of the problem — but it must also be part of the solution in establishing and maintaining an effective compliance program. Information technology plays at least four roles: the application controls in existing financial information systems; overall controls on IT business processes; new functionality or systems to meet new requirements; and changes to simplify, standardize, and improve integration.

Consider Other Consequences of the Act

See sidebar on previous page.

The benefits of this integrated approach should be many:

- Compliance with the regulatory and legislative requirements of the Sarbanes-Oxley Act
- Establishment of an exemplary risk management and governance structure recognized by independent rating services and rewarded by the capital markets
- Organizational, process, and technology improvements resulting in greater accuracy, transparency, reliability, and timeliness of financial information
- Cost-effective utilization of existing systems and processes, when feasible
- A culture built on integrity that seeks to "do the right thing"
- The elimination of redundant business processes and IT systems

Sustain: It's Not "Once and Done"

Compliance with Sarbanes-Oxley section 404 is not a "once-and-done" effort. Because the testing, monitoring, and certification requirements recur on a quarterly and annual basis, companies must sustain compliance in perpetuity.

In order to achieve sustainable compliance, companies should build an efficient and effective compliance infrastructure that enables repeatable, reliable actions. We consider the following to be essential elements of sustained compliance:

People

When it comes to implementing a system of internal control, no factor is more critical than people. The success or failure of the program rests with those who are charged with implementing it. The following steps should be considered:

- Conduct a cultural assessment to determine the state of employee and management awareness, understanding, and commitment.
- Evaluate the overall organizational structure and determine how decisions are made within it.
- Based on the results of this evaluation, establish new or altered roles and responsibilities for compliance activities.
- Set high standards and hold people accountable for meeting them.
- Institute incentives, such as new systems of measuring progress and recognizing individuals responsible for control assessments.
- Establish training initiatives, including new curriculum and standards for compliance.
- Facilitate a varied and open system of communication horizontally and vertically throughout the organization.
- Create knowledge management procedures to ensure that institutional knowledge is documented rather than residing solely "in the head" of a few employees.

- Integrate risk identification, control evaluation, and monitoring activities into the day-to-day activities of individuals responsible for internal control. (Note, however, that performance capacities must be taken into account. That is, if control responsibilities are simply piled onto existing job responsibilities, the control activity may not be efficient and the evaluation activity may be impaired.)

Process

A well-organized business is built upon standardized processes, such as those for approving accounts payable or for handling customer inquiries. A sustainable compliance infrastructure is similarly dependent, and most companies will need to create new or revise existing business processes in order to reach their compliance goals.

In addressing section 404 requirements, new processes should be established and maintained to perform ongoing compliance assessment, monitoring, and remediation. Many other processes should be created or strengthened, including:

- Processes for employees to report potential control weakness and for determining appropriate action to take
- Processes for handling disclosure-related issues
- Processes for assessing the compliance impacts and implications of significant business changes (for example, mergers, acquisitions, new outsourcing relationships, changes in organizational structure)
- Processes for identifying and qualifying employees assigned responsibility for internal control assessments
- Processes for addressing other mandates of Sarbanes-Oxley, such as whistleblower requirements

Technology

Sustained compliance may require new technology applications as well as enhancements to existing applications. Initial section 404 projects could conceivably be accomplished with straightforward workflow tools and databases for internal control documentation. However, sustained compliance — especially for larger and more-complex organizations — will likely require the use of more powerful and versatile internal control applications that can be integrated with other corporate systems.

Other sections of Sarbanes-Oxley can present technological challenges to the achievement of sustainable compliance, including the whistleblower provisions of section 301, and the disclosure of material changes in the financial condition or operations as required in section 409.

Interdependencies within the Sustainable Compliance Infrastructure

The people, process, and technology components cited above are all connected and interdependent. As such, decisions should be made in consideration of the entire Sarbanes-Oxley compliance framework and not in piecemeal fashion. Companies should steer clear of the narrow view that one compliance action leads only to a given result, when in fact one action may lead to many results, some unintended.

Reduce Complexity

Once your company has embraced the spirit of Sarbanes-Oxley in general and section 404 in particular, you should work to reduce complexity, inefficiencies, redundancies, and inconsistencies. Doing so will yield myriad benefits of improved information quality, reduced risk, enhanced organizational efficiency and effectiveness, and possibly reduced costs.

At a fundamental level, reducing business complexity involves rationalizing, standardizing, and simplifying organizational structures, business processes, and information technology.

Symptoms of Complexity

Unnecessary complexity increases the likelihood of ineffective controls and creates business inefficiencies. These complexities add real, bottom-line costs as well as increase the risks of errors in financial information. By reducing complexity, companies can reduce risk, increase efficiency, increase shareholder trust, and potentially reduce costs.

Symptoms of business complexity include fragmented data sources and inconsistent data definitions, redundant processes across business units for even basic business activities (such as paying invoices, receiving customer payments, or processing payroll), manual and error-prone processes, and non-standardized and non-integrated technologies.

Sources of Complexity

Corporate growth and organizational strategies can have the unintended consequence of increasing business complexity. For example, a strategy of growth through acquisition can result in non-integrated business units running multiple, disparate financial systems.

Another example may be found in the trend toward decentralized organizational structures. This strategy can lead to inconsistent business processes and technology standards. Errors can arise as information is moved within and across corporate boundaries; duplicate data entry and poorly controlled manual manipulation of data can result.

Also, outsourcing, partnerships, and shared services arrangements raise additional concerns of control responsibility and accountability as interactions with customers, suppliers, strategic partners, and outsourcers become increasingly complex.

Consequences of Complexity

Complexities within organizations can detract from the quality of financial information in a variety of ways. For example:

- Complexity in the communication structure can impair the ability of employees to provide management with timely information.
- Complexity may hinder the ability to provide investors with the information they need to make their investment decisions.
- Unnecessary complexity in business operations may interfere with compliance with laws and rules.
- Unnecessary complexity can undermine business performance (measured by earnings), which in turn affects shareholder value.

Necessary Complexity

While reducing complexity is a laudable goal, we recognize that certain complexities are critical to achieving business objectives and cannot or should not be removed or reduced. Thus, a cost/benefit analysis must take place. Certainly, wherever the costs and risks associated with business complexity exceed the business benefits, opportunities for performance improvement abound.

Unnecessary Complexity Defined

Cost of Complexity + Risk of Complexity > Benefits of Complexity

Increase Quality

One might reasonably argue that the Sarbanes-Oxley Act was born out of a need for quality: quality in corporate governance, in internal control, in financial reporting, and in disclosure. A renewed emphasis on quality can help companies meet the mandates of Sarbanes-Oxley, restore investor confidence, and improve shareholder value.

The Attributes of Information Quality

An organization's information quality is influenced by four key attributes: transparency, timeliness, accuracy, and reliability.

Transparency means that information provided to investors contains an unimpeded view into the business, improving their understanding of how and where the company generates value. Information should be simplified and standardized to ensure that it is easily understood.

Timeliness requires that information be provided at or near a real-time rate to investors. Investors should never feel "starved" for information. Manual processes should be eliminated where feasible, as they often delay the delivery of timely information to investors. However, the pressure to deliver timely information should never compromise the integrity of the data presented. It is more important to "get it right" than to "get it fast."

Accuracy means that information provided to investors represents a true picture of performance. Causes of inaccuracy include the need for numerous handoffs of information within and across corporate boundaries, duplicate entries of data, and manual manipulations of data.

Reliability refers to the completeness of the information provided. For example, data may be technically accurate, but if it is provided out of context or without supporting information, it may not yield a reliable picture of the company's true financial position.

Guiding Principles

Just as most companies create mission statements to provide a unifying and galvanizing message, so too should companies adopt guiding principles for their Sarbanes-Oxley compliance program. Sample guiding principles can include:

- Leadership, commitment, and effort will be required if our company is to become an industry leader in corporate governance.
- Our internal control program will be adopted and endorsed by the board, audit committee, CEO, and other C-suite executives.
- Compliance with Sarbanes-Oxley will be the result of effective and efficient business processes, enabled by properly designed and implemented technology, executed by competent people.
- We will be recognized by all our stakeholders for the accuracy, timeliness, reliability, and transparency of our financial information.
- We will embrace change as a necessary component of improving the organization.
- Sustainability is critical. We are in this for the long haul.
- Strong governance requires a financial commitment.
- Open communication is critical. Our employees will be listened to.

Take Action: Beyond Compliance

The first crossroad your company faces demands an important decision: Should you aim for basic compliance with Sarbanes-Oxley — the letter of the law — or move beyond compliance to the spirit of the law?

Deloitte contends that this choice is somewhat illusory, as the latter option so clearly represents the superior course. The benefits to be gained from a spirit-of-the-law approach — enhanced operations; reduction of unnecessary complexity; improved standing with stakeholders; restoration of strong corporate culture and integrity of financial statements; and the possibility of long-term cost reductions — are simply too substantial to be ignored.

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