



Sarbanes Oxley:
Who, What & Why Not to Panic

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Who's Involved in SOX

- The History:
- Executives & Auditors Failed the Public in 2001
- Enron – publicly traded oil company
 - went bankrupt and caused millions in losses for employees & shareholders
 - Executives failed to report off-balance sheet investments
- Arthur Andersen
 - Enron's Audit: failed to catch &/or ignored Enron's problems

Who's Involved in SOX

- Problems w/ Client/Auditor Relationships
 - Significant % of income from consulting jobs
 - Auditors assist clients in writing financial statements...giving clients the opportunity to blame their auditors for an misstatements
 - Audit partners served on Board of Directors for their client, limiting objectivity
- Bankruptcies: WorldCom, Enron, Tyco

Who's Involved in SOX

- Senator Sarbanes & Congressman Oxley
- Took action to develop the Sarbanes-Oxley Act to prevent further incidents and protect stockholders
- Formed the PCAOB (Public Company Accounting and Oversight Board)
 - consisting of 2 CPA's and 3 non-CPA's
 - monitor public companies' financial reporting & auditing activities
- All publicly traded companies were forced to comply by various deadlines, primarily 12/31/04

SOX: What's in the Details?

- Most Notable Sections of the Sarbanes Oxley Act:
- Section 302
 - For each Quarterly Report (10Q, 10K), Officers (CEO, CFO) must report any significant deficiencies, fraud, and significant changes within the company for public review
- Section 404
 - In Annual Report, company must report on Internal Controls
 - Management states responsibility for establishing and maintaining Internal Controls
 - Contains an assessment of the effectiveness Internal Controls
 - An outside auditor performs attestation of management's assessment of Internal Controls

SOX: What's in the Details?

■ Compliance

- As of 9/15/04, every public company must comply during their next year end reporting process
- Costs vary, ranging from \$1 - \$10 million dollars
- 2 Levels of Reporting: Entity Level & Activity Level
- Entity Level - "Tone at the Top"
 - dozens of interviews at all levels to determine consistency
- Activity Level – Documenting Internal Controls
 - Management must maintain documents for each financial process that affects the financial statements
 - Includes: narrative, flow chart, risk matrix & test plan
 - Companies have hundreds of activity level processes

12/31/04: Why Not to Panic!

- Challenges of the Sarbanes Oxley Act
 - Materiality
 - Remediation
 - Timing of Changes & Improvements
 - Financial Statement Preparations

12/31/04: Why Not to Panic!

- Materiality: tough to determine & even tougher to handle
 - Materiality is calculated differently by each audit firm
 - Materiality determines what accounts are tested & skipped
 - One common method = 2.5% of Net Income
 - A public company w/ a mediocre year generates \$1,000,000 profit, which calculates a materiality level of \$25,000
 - Even with \$1 billion in revenues, a \$1 million profit is not abnormal
 - Some public companies may have to audit *every single account*, down to the uniform closet!
- The biggest challenge: materiality is determined as of year end...but testing has to be substantially completed prior to year end

12/31/04: Why Not to Panic!

■ Remediation

- If any material deficiency is detected in a process, management must remediate
- Remediation must take place 6 months prior to year end, to ensure proper time for testing
- Since many Sarbanes projects are just getting underway, if a deficiency is found its already too late to fix and the company will receive a negative audit letter

12/31/04: Why Not to Panic!

- Timing of Changes & Improvements
 - Any material changes to financial processes must be completed in suitable time prior (up to 6 months) to year end
 - This includes common corporate changes and improvements, such as software upgrades, mergers & acquisitions, and organizational restructuring
 - Corporations will now be forced to complete these changes based on Sarbanes Oxley testing, *NOT* based on best practices or beneficial timing

12/31/04: Why Not to Panic!

- Financial Statement Preparation
 - Audit firms can no longer help companies write their financial statement, they can only audit them after they've already been finalized by the company
 - Corporations must take responsibility for something they were never responsible for in prior years
 - Companies must hire/secure additional resources for bringing all financial reporting in house
 - Changes the auditor/client relationship forever

Wrap Up

- News is starting to break, and will intensify in early 2005, when reports are issued.
 - Current estimates = 60%+ companies failing!
 - There's a possible "con"
 - Due to the number of companies failing to adhere, investors will no longer see negative audit letters as a sign of wrong-doing or cause for suspicion
 - As shareholders, it is important not to panic when the negative audit letters start to arrive
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Questions?

