BUILDING A STRONG CORPORATE PHYSIQUE

Why Sarbanes-Oxley is good for business

BY PHILLIP G. STRAND

Parents and nutritionists agree spinach is good for you. A plateful packs a healthy dose of vitamins A, C, and E. Plus it's loaded with antioxidants believed to guard against cancer, cataracts, and other ills.

So why can't you grab a quick side of spinach at your local fast food joint? Maybe it's because the instant gratification of a cheeseburger, jumbo fries, and a thick, chocolate shake makes the greens a tough sell indeed.

Many public companies should be looking at the new Sarbanes-Oxley (SOX) financial disclosure requirements the same way most of us should view spinach—it's just plain good for you. Granted, SOX is creating a lot of extra work for CFOs, finance departments, and IT departments. But it's work that can provide long-term benefits for the enterprises that take the right approach.

Passed by Congress in 2002 in the wake of corporate fraud scandals that swept through the country, the Sarbanes-Oxley Act requires companies to file paperwork with the Securities & Exchange Commission (SEC) faster, create a more transparent means of collecting and posting financial data, maintain volumes of data, and test their procedures for posting accurate, timely information. The goal is to put an end to the kind of market confidence-shattering financial meltdowns that occurred at Enron and WorldCom.

The potential consequences of posting inaccurate statements are steep: prison sentences and multimillion-dollar fines for the company's chief officers. It's no surprise, then, that nine of 10 CFOs in a recent national survey by *CFO* magazine said that their jobs are harder than they were five years ago. In addition, more than half said they're working longer. The bean-counter label has been replaced by one that is equally derisive—corporate cop. And corporate financial professionals have been trying to shed that image for years as they've moved toward becoming strategic business partners.

As if going to jail weren't enough of a deterrent, company misrepresentations—even inadvertent ones—have a punishing effect on stock prices. "For every dollar that a firm overstates its earnings or inflates an asset value, we've seen it take a hit of two dollars in market penalties," says Dr. Jonathan Karpoff, the University of Washington's Norman J. Metcalf Professor of Finance. Consistent reporting across all parts of the enterprise has never been more important.

PATCHED-TOGETHER SOLUTIONS—A LONG-TERM FIX?

Since electronic record keeping is fundamental to adhering to Sarbanes-Oxley, consultants and software providers are trying to ease the CFO's pain by rolling out "solutions" that, in many cases, are nothing more than souped-up spreadsheets. It's easy to see why they are scrambling.

Results of an AMR Research survey indicate that 85% of companies predict that Sarbanes-Oxley will require changes in IT and application infrastructure that support the business, potentially reaching into the bowels of the company. Nearly 77% of companies will spend more on IT, business process change, corporate governance, and/or consulting this year as a direct result of SOX compliance. Just how much they should budget is directly proportional to each firm's risk and exposure, not necessarily its size. While most companies reported they would spend an average of 0.03% of total revenue on SOX-related activities in the next 12 months, conglomerates with widely different and independent business units have budgeted for up to 0.1% to 0.2% of total revenue. For a $5 billion company, that equates to $5 million to $10 million in incremental spending.

It's enough to make Corporate America wonder if Sen. Paul Sarbanes (D.-Md.) and Rep. Michael Oxley (R.-Ohio) were really pushing through an IT Full-Employment Act.

With some customization, spreadsheets do offer the quickest way to comply with one section of Sarbanes-Oxley. Known by its number, Section 404, it requires companies to define their internal controls and procedures, including tests to ensure that objectives are being met.

But spreadsheets have their limits. Executives that I've talked with worry that the files will grow far too cumbersome to manage easily.

VIEWING COMPLIANCE AS A WAKE-UP CALL

Instead, knowing that they'll need to spend money to change IT and application infrastructures, some companies are choosing to use the new regulations as an opportunity to better manage their records and improve data flow by incorporating analytics, forecasting, and modeling into the mix. Rather than being a burden, Sarbanes-Oxley can give companies the impetus they need to incorporate financial intelligence throughout the enterprise—and become more competitive in the process.

Quaker Chemical decided even before Sarbanes-Oxley that it needed to bring an enterprise-wide financial intelligence approach to the formerly spreadsheet-dependent finance operation. As far as CIO Irving Tyler is concerned, the new regulations are pretty straightforward if your company has consolidated financial information into a "single version of the truth" for planning, budgeting, reporting, and analysis. Financial intelligence frees Quaker managers to feel empowered rather than frightened. "The visibility is there, so there's less opportunity for mistakes, either intentional or otherwise, to crop up and cause integrity problems," Tyler says. "Transparency doesn't keep a company from operating aggressively—it just keeps it from operating aggressively through fraud."

Rather than Sarbanes-Oxley, it was significant growth over a three-year period—some 20-25 operations including acquisitions and business expansion—that motivated Progress Rail CFO David Klementz to create a unified and transparent data view. At first, he just wanted reports that didn't contradict each other. But driving for transparency accelerated data gathering and resulted in other benefits as well. "It's shifted the organization's thinking from being transaction based to providing business analysis and being forward looking. This put us in a better position to react to market conditions," he noted.

Progress Rail and Quaker Chemical sought transparency for strategic reasons. Pharmaceutical companies have needed transparency in their clinical trials operations for regulatory reasons. Pharmaceutical companies submit reams of clinical trial data to the U.S. Food and Drug Administration (FDA). Electronic file keeping is critical to getting a new medicine from the first clinical trial through to approval quickly, so critical that the FDA actually certifies software providers who meet their standards. While the SEC and the stock exchanges aren't certifying providers yet, it makes sense to consider software products from companies that have met the FDA's challenging requirements.

REAL-TIME VS. COBBLED SOLUTIONS

It also makes sense to consider the next four issues in choosing a consultant or vendor:

◆ Can your top officers quickly determine how well compliance efforts are being met? There's a lot of nittygritty to Sarbanes-Oxley. Can the CFO call up one screen and find a score on how well access to journal entries has been double-checked as well as a compliance matrix showing individual divisions? Or will the executive be wading through volumes of spreadsheets to get the answer? A dashboard that instantly and cohesively presents information frees busy executives to get on with their work.

◆ Can your solution provider integrate the Sarbanes-Oxley requirements with USA PATRIOT Act and Basel II regulations? Financial institutions need to follow these regulations, and there's some overlap with Sarbanes-Oxley. Basel II is an international banking agreement intended to improve the safety and soundness of the financial system by aligning capital adequacy assessment more closely with the underlying risks that affect banks. Under the accord, in order to earn the right to keep a minimum amount of operating capital, financial institutions need to store three years of data and model risks using that data. The USA PATRIOT Act requires institutions to aggressively pursue money launderers, a practice made simpler by software that can flag suspicious account activities and account holders.

◆ Can your software maintain digital signatures online? One of the seemingly mundane aspects of SOX is the requirement that companies have and follow an ethics policy. Digital signatures will not only ensure that key employees have read and agreed to abide by the policy, but they will allow the whole process to be conducted easily online.

◆ Can your solution provider offer analytics if you request it? Data mining software can hunt for outliers that might signal fraud. Take a purchasing manager who doesn't need authorization for purchases under $10,000. How would your company spot payments sent to the same vendor each month for $9,999? Or uncover suspicious patterns in revenue bookings? Or unearth accounts that aren't suspicious but whose monthly increases and decreases aren't behaving in synchronous fashion?

Sarbanes-Oxley doesn't mandate analytic software to uncover patterns of wrongdoing, and it doesn't require companies to improve their budgeting process. But it would be hard to find a CFO who wouldn't want an executive dashboard at his or her fingertips that presented real-time data or tools to detect fraud. So when company executives look at Sarbanes-Oxley, they could choose to see a bitter serving of exhausting, time-consuming hassles. Or they can seize the opportunity to achieve something more valuable. You could call it trading that mess of bland greens for a crispy, fresh spinach and mandarin orange salad with a sprinkle of bacon bits—tasty, but healthy. And in a zero-tolerance market environment, good health is an enterprise goal worth aiming for.

What must be taken into consideration when looking into the future is the need to sustain. Like sustaining your daily diet and weight habits, you must build a sustainable enterprise compliance strategy. Look to the core—inside yourself or your organization—and either rebuild or add to the structure to ensure its long-lasting capabilities. Complying with Sarbanes-Oxley is just fixing a symptom. Building an enterprise structure using financial intelligence focuses on the overall problem and provides long-lasting success. ■

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Sarbanes-Oxley is a featured topic at IMA's Annual Conference June 26-30. For details, visit www.imanet.org/chicago.