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Sarbanes-Oxley: The Next Phase

The US Congress passed the Sarbanes-Oxley Act in July of 2002 to establish a fundamental mechanism and best practices for improving internal and external auditing and corporate governance procedures. Historically, the states had exclusive jurisdiction over corporate governance matters, however in the wake of the recent market decline and corporate failures resulting from lax accounting and corporate governance practices, the federal government stepped in to protect employees and investors.

The Sarbanes-Oxley Act is a complex piece of legislation covering a wide range of activities. To make matters even more complex, in several instances, Congress has passed the task of defining the specifics regarding implementation to the Securities and Exchange Commission (SEC). The SEC has gone through a management change since the Act was passed and while some regulations have been issued, others will be delayed as the SEC monitors the effects of the existing Sarbanes-Oxley SEC regulations.

The Act itself is made up of 11 major sections, called Titles, and some 66 minor sections, each section containing multiple requirements. One of the best overviews we have found is from PricewaterhouseCoopers. It's entitled, *Navigating the Sarbanes-Oxley Act of 2002: Overview and Observations*. (It's available online. Go to www.cfodirect.com and enter the article title in search.)

While the Sarbanes Oxley Act has many implications for business process managers and analysts, the issue that has received the most attention is *Section 404: Management Assessment of Internal Controls*. This section requires that management define an adequate internal control structure and procedures for financial reporting, and then report the effectiveness of the structure and procedures at the end of each fiscal year.

The SEC commented on Section 404 as follows:

"We believe that the purpose of internal controls and procedures for financial reporting is to ensure that companies have processes designed to provide reasonable assurance that:

- The company's transactions are properly authorized
- The company's assets are safeguarded against unauthorized or improper use
- The company's transactions are properly recorded and reported to permit the preparation of the registrant's financial statements in conformity with general accepted accounting practices."

Obviously you could respond to the above in a number of different ways. Most interpret the Act and the SEC's guidelines as requiring some kind of business process documentation proving that controls are in place and that, in fact, they are effective when the processes are executed.

Requiring that companies document all their processes and be able to trace all authorizations has been easy for those companies that already understand their business processes, but has proved hard for many. The SEC and Congress have already granted extensions to companies that are struggling to comply with the Sarbanes-Oxley requirements.

In the BPTrends Advisor published on May 20, 2003, we urged companies to think of this as an opportunity to define good processes and to put a system in place that would support future process changes. At the time, we realized that most companies wouldn't do this. The time allowed for the Sarbanes-Oxley implementation was too short and we fully expected that most companies would do something quick and dirty to satisfy the requirement. MasterCard International, for example, reported that the Sarbanes-Oxley regulations required some 45,000 staff hours by outside consultant, Deloitte & Touche, in order to comply.

In many cases, consulting companies have created checklists that indicate what steps are required. This documentation is being delivered to companies in notebooks that auditors will use, in the near future, to monitor processes to determine if the company is following the specified procedures.

We've talked to lots of people who have been involved in the Sarbanes-Oxley effort and they have all reported that their organizations aren't thinking beyond compliance. They are simply struggling to get the required documentation done in time to comply with the act. This is unfortunate, but again predictable, given the scope of the task and the time allowed.

Now is the time, however, for process oriented managers to begin to think about what happens next. Just as the initial response was predictable, phase two in this unfortunate saga is equally predictable. Processes change! Core processes in many industries change frequently as customer tastes, regulations and competitors keep redefining the nature of markets and products and the services that support them. No sooner will the Sarbanes-Oxley documentation be set on the shelf in most companies, than the processes the documentation defines will begin to mutate. Who will maintain the documentation? Who will record the changes?

In 12 months an auditor will show up holding a copy of the documentation and want to see that the process is being performed according to the documentation. What will that auditor have in his or her hands - up to date documentation, or something that is months out of date? What fines will accrue as companies realize that their already extensive documentation effort is already out of date?

In an ideal world companies define their business processes with business process modeling software suites and store all their process data in a repository. Moreover, in such an ideal world, the company's managers understand the process descriptions developed during the documentation effort and are in a position to make changes in processes to keep them up-to-date. This approach is not without pitfalls, since the whole purpose of Sarbanes-Oxley is to prevent managers from making casual changes in processes to divert funds from their proper channels. Thus, security and tracking procedures are required. Luckily, well designed software tools can incorporate these safeguards.

The point, however, is that most companies don't function in an ideal world. They didn't plan and record their Sarbanes-Oxley documentation in a manner that supports rapid change, and they will face huge maintenance problems as soon as they complete the initial documentation phase. Smart process-focused managers will begin now to look for second generation Sarbanes-Oxley tools and begin planning to re-document their most dynamic processes in a digital format that will support ongoing maintenance.

Companies that didn't treat the first round of Sarbanes-Oxley as an opportunity are sure to be given a second chance. Maintenance costs will force a second round of Sarbanes-Oxley work upon them. Hopefully, with more time, some serious process thinking, and some carefully chosen priorities, companies will be able to plan, document and manage their processes better during the second phase.

'Til next time,

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