

Sustainable from the start*

Sarbanes-Oxley 404 implementation by oil & gas
and utility foreign private issuers

*connectedthinking

PRICEWATERHOUSECOOPERS 

“...It was a challenge. My head is still spinning. We did it on time. Unlike some other US companies we got a clean bill of health but we’ve got to rein in the cost. The European and other foreign private issuers have the chance to make it **sustainable from the start***. If we knew things up front that we know now we would have done it differently...”

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Executive summary

The Sarbanes-Oxley Act of 2002, the US Congress's sweeping reaction to a series of corporate scandals, is having a profound impact on US companies. Section 404, which places new obligations on companies to assess and report on the effectiveness of internal controls, has been particularly challenging. European and other non-US companies with a US listing have a period of grace and now must implement this part of the Act for fiscal years ending after 15 July 2006. But the fundamental nature of the change they are facing leaves no room for relaxation.

In Spring 2005, we brought 26 senior executives from US and European energy and utility companies around the table to gain first-hand insight into 404 compliance. The US executives were just beginning to prepare for year two of Sarbanes-Oxley compliance. The European companies were exploring the most effective means of achieving first-time compliance.

The message from the US executives is 'make no mistake, this is a reform of immense scale and complexity'. Oil and gas and utility companies operate in an increasingly complex environment where internal control deficiencies can have an important impact on the accuracy of financial reporting. Reserves reporting, decommissioning, customer account collection difficulties, energy trading, taxation and carbon allowances are just a few of the areas posing specific challenges.

The section 404 requirement to report on the effectiveness of internal control over financial reporting will increase the pressure on oil and gas and utility companies to prove that their governance and control practices are up to the challenge through the detailed documentation of internal control processes and the identification and correction of deficiencies.

The challenge for companies is to manage their response to the reform so that, from the outset, it is efficient and effective. This means ensuring that the costs of change are affordable and internal control reforms are designed and implemented in ways that become integral to company practice and useful to company management. The process will generate insights into the underlying business as well and these should be used to add value for the company.

Compliance with section 404 is a major task. The extension of the deadline for non-US companies, even combined with recent clarifications of the rules from US regulators won't change this fact. US participants in our roundtable reported that they managed to pull off their implementation of 404 reporting in time but at significant cost, through the use of some inefficient fixes and with substantial lessons learnt along the way. The message for European companies and other foreign private issuers is to keep their feet firmly on the accelerator and seize the opportunity to implement 404 as a sustainable process from the start.

In this publication on the roundtable event, we report on the reality faced by US energy companies and facing their European counterparts. What were the surprises? What were the regrets? What are the lessons learnt? What are the key challenges? The results provide useful insights and guidance for oil and gas and utilities companies as they strive to ensure that they control the process rather than the process controlling them.

The extent of change

The new compliance requirements

Section 404 of the Sarbanes-Oxley Act requires that annual financial statements filed with the Securities and Exchange Commission include two declarations regarding internal financial controls systems. First, company management must state its responsibility for creating and maintaining adequate internal controls over financial reporting, certifying the effectiveness of those controls. In addition, the company's public auditor must report whether it believes the internal controls are effective and indicate whether it agrees with management's conclusion.

Any observer might reasonably conclude this is nothing revolutionary. After all, companies need to operate effective internal controls to run their businesses properly. It is natural that they should be able to reassure investors on this point and have it externally verified. William Donaldson, Chairman of the US Securities and Exchange Commission, put it simply in a speech to a European audience at the London School of Economics. "The disclosures that have been, and will be, made under Section 404 involve facts that investors should know about a company when making an investment decision. But they are also facts that management and the board of directors should know about the companies for which they have responsibility." (William H. Donaldson, Chairman, US Securities and Exchange Commission (SEC), 25 January 2005).

Yet the introduction of Section 404 has resulted in some considerable disquiet in corporate America. A concept that sounds simple – effective internal controls over financial reporting – becomes much more challenging to prove. The details involved in looking at how all of the transactions entered into by a company make it into the financial statements are vast. Companies point to the complexity of compliance and the potential for high costs.

A common complaint of US companies across all sectors who have been through the first year of 404 is that it has distorted management time and priorities. In turn, the SEC has held a roundtable with companies and the US Public Company Accounting Oversight Board (PCAOB) has issued policy guidance and Q&A encapsulating the lessons learnt from the first year of implementation by US companies¹. It emphasises the importance of a top-down approach, the exercise of judgement and the integration of the audit of internal control with the audit of the financial statements. The SEC has also issued a statement giving further clarification following the discussion of issues raised at the SEC roundtable event².

The SEC had already recognised the significant burden on companies, especially in Europe where companies are also grappling with the conversion to International Financial Reporting Standards (IFRS). It has twice extended deadlines for compliance, for smaller accelerated filers and also for European and other foreign private issuers listed on US exchanges.

¹ Policy Statement Regarding Implementation of Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Conducted in Conjunction With an Audit of Financial Statements", and "Staff Questions and Answers, Auditing Internal Control Over Financial Reporting", PCAOB, 16 May 2005.

² US Securities and Exchange Commission, Staff Statement on Management's Report on Internal Control Over Financial Reporting, 16 May 2005.

Profound impact

So, if the changes reflect practices that should already be operating at a well-run company, why the protestations and upheaval as companies come to terms with section 404? Internal controls are nothing new for companies. What is new is for companies to make sure they are documented in their current state and to actively verify that they are designed and operating effectively. As one US participant in our round table commented: “It is a new ball game. We have had to step up our approach to values. We already had trust. But now it is not enough. We have to trust and verify.” The change is profound. His colleague, the Chief Compliance Officer in the same company, observed: “some of these things were learnt from experience in the ‘school of hard knocks’. Leading up to Sarbox we believed we had a strong control environment and an effective disclosure process in place. But there is a challenge in the ‘trust and verify’ area and we had to deliver a culture change that everyone in the company had to go through.”

The effect of section 404, and related regulations, is that companies and their auditors put a much greater emphasis on documentation than in the past. This applies at two levels. First, the controls must be documented so that management can assess their design and test them. Second, in the testing, the execution of the controls should have been evidenced in some way. The same US participant in the roundtable pointed out: “Good documentation early on was crucial. We had always done it at a desk level but this was raising it up a level to have top-level flow charts.”

Key terms

Internal control over financial reporting

– focuses on policies and procedures that pertain to reliable financial reporting. This is obviously narrower in scope than the term ‘internal control’ on its own which would also encompass things such as the effectiveness and efficiency of operations and compliance with laws and regulations. The dilemma for companies is to judge which controls can impact the reliability of financial reporting.

Frameworks for assessment – both management and the auditor are required to base their assessments on a suitable recognised control framework such as the framework developed by the Committee of Sponsoring Organisations (COSO) of the Treadway Commission.

Types of deficiencies – if any deficiencies are identified, both management and the auditor are required to determine if they are a ‘significant deficiency’ or, more serious, a ‘material weakness’.

Significant deficiency – a control deficiency that adversely affects the company’s ability to initiate, authorise, record, process or report external financial data reliably in accordance with GAAP. It could result in “more than a remote likelihood that a more than inconsequential misstatement of the annual or interim financial statements will not be prevented or detected.” This type of deficiency does not have to be publicly reported, but it is reported to the audit committee.

Material weakness – where there is a “more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.” This type of deficiency has to be publicly reported.

Aggregation of deficiencies – 404 also includes a concept where companies must look at individual deficiencies to see how they might interact with each other. A combination of deficiencies might individually not be significant, but together they might rise to the level of a material weakness.

Because accountability for testifying to the effectiveness of internal controls is part of the reporting process, controls have to be visible to the CEO, board of directors and the audit committee. Senior officers have to be confident they have a clear view of all that is going on.

This move from 'trust' to 'trust and verify' poses immense challenges. Audit committees now have new responsibilities and play a pivotal role. Also, internal audit teams are well-placed to be proactive in assisting line management to evaluate and test internal controls and to provide quality control. Compliance with section 404 demands difficult judgements about the depth of verification. It requires the design and management of information flows that are sufficient to deliver effective control while, at the same time, staying cost effective and striking the right balance between control, creativity and outward-facing enterprise.

Large-scale reach

None of the senior managers from the US and European companies at our roundtable felt that Sarbanes-Oxley compliance had gone as far as tilting their companies out of balance. However, they were all in little doubt of the scale of the challenge. Both the US managers who had been through year one and European managers who were part-way through their preparations reported a common theme – “It’s a massive undertaking.” A manager from one leading oil and gas company said: “We started by identifying 21 major processes, then 700 key controls. We ended up with 29,000 controls being tested as the 700 were replicated in many territories worldwide. It required the active involvement of many, many people. As we moved towards the completion deadline we had 4,000 people using our Sarbox system to assess, review and monitor.” The implications for budget were immense: “When we first got started we were thinking of spending less than US\$1million on the core project. Now it is in excess of US\$10million.”

Another manager involved in a US Sarbanes-Oxley project commented: “The time commitment was a lot greater than expected. I don’t know what would have happened if we had to meet the 2003 deadline. We would not have done it.” Indeed, a PricewaterhouseCoopers survey found that Sarbanes-Oxley was having a significant impact on internal resources in US companies. 37% of companies said that actual resources dedicated to Sarbanes-Oxley were higher than expected in the original 2004 internal audit budget (PricewaterhouseCoopers, Internal Audit: Sarbanes-Oxley Survey, 2004).

“I thought we had pretty strong controls but 404 raises it to a whole new level... it’s a new ball game”*

The emotional as well as the financial cost to the company should not be underestimated. The Sarbanes-Oxley project director of a European company that is steering its way towards 404 reporting looked around the room and said: “There are not many project directors who look young anymore. I nearly cried when I heard about deadline change – another year of this!” But, as the same director observed, the deadline change presents an immense opportunity for foreign companies. “We’re going to run this live regardless of the extension. We have a lot more information that we can use to make our processes more efficient.” The opportunity is there to avoid the balance difficulties that have bedevilled some US companies and, instead, introduce Sarbanes-Oxley 404 reporting in a way that can be sustainable, cost-effective and business-efficient from day one.

“I started out thinking we would only have to involve 500 users or something like that. We ended up with 4,000 involved.”*

Key challenges

The immense task of getting a company equipped for 404 reporting poses a range of challenges for boards of directors and those tasked with leading 404 projects. Some of these are addressed by tools such as the COSO integrated control framework³ and the framework for evaluating exceptions and deficiencies developed by leading advisory and audit firms⁴. This report of the roundtable proceedings does not seek to duplicate or provide a detailed commentary on these ways of addressing the challenges. Instead, we focus on three key challenges that dominated the discussion.

The challenge of understanding and scoping controls

One of the biggest challenges for companies is identifying which controls are key to financial reporting and ensuring that people within their companies understand how controls work, what objectives they aim to meet and how to develop and operate them. Roundtable participants could not emphasise enough how much 404 implementation projects can succeed or founder on the basis of the initial scoping and the embedding of good understanding of controls. At a fundamental level “you need a very thorough analysis of where you are and where you need to go,” said one US participant. “I wish we had spent more time on up front – documentation, knowledge of internal controls and understanding of controls. I must have spent a month simply looking for documentation!”

In the roundtable, both the US companies that had been through the full 404 reporting process and the European companies that were midway through their preparations reported that one of their biggest challenges was simply gaining a good understanding of internal controls. The project leader of one US company commented: “I naively assumed that everyone would understand internal controls. It did not turn out that way. I thought that everyone could flowchart a process but I found that I could not automatically assume that the base-level knowledge is there. It was another level of learning we had to put in place. The organisation had moved over time to specialisation. When we spoke to people they could not identify all the processes involved. They were very familiar with what they did individually but could not see the linkages with wider impacts.”

Gaining clarity and understanding of the nature and purpose of controls within the organisation is vital. The global leader of 404 implementation for a large European oil and gas company observed: “We found staff were not very good at describing controls in ways that would allow them to be tested. That was one of the big challenges. You need to be very specific on control description.” A PricewaterhouseCoopers partner emphasised the need to be clear about which controls are critical to 404 reporting: “It is vital to remember that tests only need to be run on matters that can impact the financial assertions. The final guidance on the standards did not come out until late in the implementation for US companies, so a lot of companies got bogged down in trying to run all controls through. It is important to narrow down to just those ones that are required to meet the assertions. But this, in itself, is not easy and requires heavy assessment. The scoping stage needs to be rigorous.”

“With 404 it is always a question of what might have been; are there gaps that someone could have taken advantage of?”*

3 Committee of Sponsoring Organisations (COSO) of the Treadway Commission, *Internal Control – Integrated Framework*, 1992.

4 *Framework for evaluating process/transaction-level exceptions and deficiencies and Framework for evaluating general computer control (GCC) exceptions and deficiencies*, developed by representatives of the following nine firms: BDO Seidman LLP, Crowe Chizek and Company LLC, Deloitte & Touche LLP, Ernst & Young LLP, Grant Thornton LLP, Harbinger PLC, KPMG LLP, McGladrey & Pullen LLP, PricewaterhouseCoopers LLP, together with Professor William F. Messier, Jr., Professor, Georgia State University, 2004.

A good understanding of the control process is fundamental in building confidence as well as competence in managing controls. One European roundtable participant reflected on experience in her own company: “People are nervous about making these decisions on their own. When it came to identifying automated application controls, for example, we were going over things again and again because people did not feel confident.” A PricewaterhouseCoopers 404 audit partner for a large energy company pointed out that companies underestimate the human dimension at their peril: “Most people are not auditors. The concept of controls and testing is not so familiar or understood – things like knowing what is an exception to a test. I also found that the further away you get from HQ and the core team, the general knowledge and appreciation of the changed environment gets less. Company-wide controls present a particular challenge and need thinking about very early on in the process.” Similarly, companies ought to be scrutinising, early on, those areas where they believe that internal controls are weak.

Achieving a high level/low level balance

“How do we manage Sarbanes-Oxley and make sure we don’t take our eye off the ball of managing the business?” Many US companies who have been through the first year of 404 reporting have publicly questioned the potential for the legislation to divert and distort their business priorities. Getting the balance right between the high level risks, and associated controls, that can harm the business if they go wrong and the low level detail that will not impact is, of course, one of the key challenges facing companies.

Some feel that section 404 has tipped the emphasis the wrong way and forced companies to get stuck in process at the expense of productivity and profit. But the feeling in the roundtable was that such an imbalance could be avoided. One senior global oil and gas manager commented: “As an industry we got a reputation for looking at the forest, at the overall risks and not the detail. Of course 404 swings it over the other way. The 404 requirements are not going to significantly weaken and so we’ve got to make it part of successful business life.” A PricewaterhouseCoopers’ assurance partner responded by emphasising the need to “encourage auditors to get out and visit branch locations. Redirect their efforts to focus on the high-risk elements. It is very easy to get bogged down in the details, to miss the wood for the trees by, for example, worrying whether every time sheet is completed and forget about controls for suspended wells.”

Key 404 preparation challenges experienced by one major oil company:

Sheer size and number of locations – exacerbated by a historical culture of decentralisation and limited standardisation.

Competing priorities – not just on line functions but also big organisation change projects making demands on the same skill sets needed for 404 preparation.

Interaction with field – developing a standard approach while interacting with what works in the field.

Communication – the challenge of getting 404 reporting into working practices in the business.

Moving from ‘tell me’ to ‘show me’ – a move that works against the cultural grain that staff were used to.

Centrally-led project management – a critical success factor.

Quality review – the need to constantly reinforce good document management and retention.

Getting to grips with difficult areas

As the roundtable discussion moved on, it was evident that certain areas consistently posed more 404 reporting problems for companies than others. Joint ventures in the oil and gas sector posed dilemmas. Do they require assessment of controls at the investor companies or controls all the way in to the joint ventures? One PricewaterhouseCoopers' sector specialist emphasised that: "This is an area that requires a lot of attention especially for larger joint ventures. You must look at each case on its merits. Communication about controls between operating companies and investors is now critical". Other participants in the roundtable highlighted other difficult areas: "As we went along the 404 path, we realised it was much more difficult to think about controls in areas such as litigation accruals and reserves. It is useful to think hard about the less obvious things and check that controls are documented and there are ways of testing for these things."

Controls over IT processes emerged as an area of common concern for many participants. At one level there are the difficulties of summarising IT deficiencies and relating an IT deficiency to an accounts assessment and statement. On another level, there are the issues of access to data – how many people can access programmes, the control environment for installing new programmes and the need for effective segregation of duties. The number of Excel spreadsheets feeding into enterprise resource planning (ERP) systems, for instance, highlights the potential complexity of running effective controls over IT processes; 404 reporting will lead companies to examine much more closely whether effective controls are actually built into IT applications, both for existing systems and when commissioning new programmes.

The ultimate litmus test of difficult control areas for companies is to examine the filings of US companies. The results are instructive, both in terms of the numbers of companies with adverse opinions and in terms of the type of 'material weaknesses' that gave rise to the adverse opinions. Figures 1 and 2 show an analysis of 10-K filings made with a 'material weakness' disclosure. The analysis covers companies with year ends after 15 November 2004 that reported in the period from 28 January 2005 to 4 May 2005. Of total SEC 10-K filings in the period covered, 353, or 11.7%, included adverse opinions.

Many of the companies who had adverse opinions reported more than one material weakness, with a higher proportion of material weaknesses at smaller companies. The review of 'material weaknesses' disclosed by energy and utility companies reflects the concerns expressed by our roundtable participants about the difficulties of achieving the appropriate level of expertise and training and effective internal controls in the IT area. An area not discussed in detail by our participants, but underlying a number of their concerns, relates to the application of generally accepted accounting principles and the companies' accounting policies. The accounting standards are becoming ever more complex and the material weaknesses indicate that registrants may not have sufficient understanding of these standards among those responsible for implementing them.

In addition to the specific concerns raised by roundtable participants, the table of results for companies from all sectors highlights several other areas of focus that cross industries. We deliberately include the full list of different specific types of material weaknesses as the variety of issues is instructive on its own. However, there are themes that can be drawn from the list.

Figure 1: Oil & Gas and Utilities sector – categorisation of 'material weaknesses'

	10-Ks	
	Number	%
Review of transactions	2	6%
Staffing Issues (levels/expertise/training)	7	19%
Application of GAAP/accounting policies	8	22%
Financial statement closing process/consol	2	6%
Policies/documentation issues	3	8%
Control environment	3	8%
Segregation of duties	1	3%
IT & applications – security/user access	4	11%
Tax issues	4	11%
Other	2	6%
Total	36	100%

Source: PricewaterhouseCoopers

The financial statement closing process, review of transactions, consideration of appropriate GAAP, staffing issues and segregation of duties together account for 38% of the weaknesses cited. A number of the other weaknesses that are attributed to specific accounts may stem from the same root causes. The controls in these processes have generally not been documented with great detail in past years. The controls tend to be more reliant on the education and experience of those executing them and to cover broader areas. The results from US companies in the first year indicate that more specific consideration of the duties executed by these staff may benefit financial reporting.

Several of the areas covered in the table below are areas that have very technical accounting standards – tax issues, lease accounting and employee benefit/pensions. Many US companies found that there is much room for improvement in these areas where individuals with deep specialised knowledge (of an area like tax or benefits) are also required to execute controls that are related to particularly complex accounting standards. These companies are now entering into remediation efforts that involve others in the controls and provide training for all involved.

The results disclosed in figure 2 may, in part, result from the scramble that many US companies face to comply with the new regulations. Due to the tight timeline, many remediation efforts were designed as temporary fixes and are not sustainable. European companies and other foreign private issuers have the advantage of more time and can make some of the remediation more sustainable from the beginning. Steps to be undertaken in remediation include:

- evaluating the root cause of the control failure;
- addressing the end-to-end process to ensure that solutions do not negatively affect up-and down-stream processes;
- eliminating duplicate controls and replacing detective controls with preventive controls;
- automating controls to eliminate slower, error-prone manual processes; and
- improving the underlying business processes.

Figure 2: All sectors – categorisation of 'material weaknesses'

	10-Ks	
	Number	%
Review of transactions	87	10%
Staffing issues (levels/expertise/training)	80	9%
Application of GAAP/accounting policies	96	11%
Merger/predecessor issues	29	3%
Financial statement closing process/consol	47	5%
Policies/documentation issues	61	7%
Control environment	53	6%
Segregation of duties	28	3%
Compliance monitoring	10	1%
Inventory management	24	3%
Revenue/billing	16	2%
Employee benefit/pension	16	2%
Contracts/loan/third-party transactions	28	3%
IT & applications – infrastructure	12	1%
IT & applications – security/user access	37	4%
IT & applications – change control & data protection	12	2%
Anti-fraud controls	6	1%
Accounts payable	9	1%
Accounts receivable	10	1%
Property/equipment/leases	61	7%
Tax issues	80	9%
Accruals/restructuring costs	3	0%
International operations/subsidiaries	35	4%
Intercompany accounts/reconciliation	13	2%
Other	26	3%
Total	879	100%

Source: PricewaterhouseCoopers

Underlying success factors

What are the key factors that underpin successful 404 reporting? Both the US and European participants identified many specific factors that were helping their companies. Four key points of focus emerged from our roundtable discussion.

Leadership

Strong and clear leadership was seen as vital by roundtable participants – both leadership from the top and effective 404 project leadership. Direction from the top of the organisation is critical to communicating the priorities that line management need to give to 404-related projects. In turn, the involvement of top management in the project can give important impetus and meaning to the ongoing development of internal control processes. As one US company manager pointed out: “Our CEO was trained in how to get into the reporting tool. Having that engagement is very important and satisfying to the team. We were able to say to our people that this is not just something that is required to satisfy the SEC, the top deck running the company is continually involved too.” A PricewaterhouseCoopers assurance partner emphasised that it is also important to manage expectations realistically: “It is crucial to build the right expectations and relationships with senior management and audit committees. They need to understand that there are likely to be significant deficiencies so that they don’t see these as a sign of failure but rather as an opportunity to strengthen the business.”

People and culture

The importance of building commitment and understanding from people throughout the organisation was emphasised time and time again during the roundtable. Its importance is even greater in energy and utility companies that work across many different territories with the attendant challenge of managing a range of different local cultures and practices. One roundtable participant described how important overcoming cultural difference was to his company’s 404 project: “We had to create an environment where people felt able to raise issues. When we were testing in foreign locations some people had trouble identifying a colleague’s failure to do something. We had to identify those parts of the world where we had cultural changes to overcome. Everyone was committed to doing the right thing but it was a difference of culture. It required more time with the individual. We had workshops in countries, spending time identifying problems and discussing how these changes can happen.”

“We did a Sarbox handbook. It expanded to 30 pages but in retrospect that was probably too long. Make sure you have something that is a ‘Sarbox Lite’ executive checklist because you have got to get everybody’s attention.”*

But even where there are not cultural differences to contend with, companies found that ‘people issues’ were critical to project success. “The 404 message is difficult, especially when staff may not be getting it from their direct supervisors. You can never assume everyone has heard the same message, so constant reinforcement is critical.” Another European company project leader said: “I had assumed knowledge was there but it was not. I would have gone for a lot more training if I had known.” This was reinforced by experiences from the US: “We decided early on that it would be management staff responsibility to do the testing, not something to be left to the audit team. It was a very important decision but that does make it a learning curve. Be prepared for a lot of training.”

“Unless you have a strong organisational culture already in place where you absolutely require people to only do it one way, be prepared for a lot of variability and a lot of work.”*

“Internal audit needs to be closely integrated with the Board’s risk management strategy and can play a proactive role in quality control.”

Alignment

Alignment came through in the roundtable discussion as a critical success factor for 404 implementation projects in a number of ways – alignment of local staff understanding with corporate understanding; alignment of control systems with business purpose; the ability to spot when deficiency patterns and themes are aligning across diverse territories or business units; and, finally, alignment of the company’s approach and that of the external auditor. One European 404 project leader talked about how a key challenge was encouraging staff to see the alignment with their own work: “It is seen as a finance project in the company and we are always trying to communicate that it is not just finance but about what they do.” Another company found “there were times when local teams were looking at things in a local context and had to be reminded that what might be a significant problem at a local level was not necessarily significant at corporate level. It again reinforces the need to be very specific about guidance for local teams.”

A PricewaterhouseCoopers participant pointed out that: “Our first assessments of materiality were taken into account in defining significant accounts and individually important locations. We found, however, that a substantial part of the work in assessing materiality regarding deficiencies came in the aggregation process. The new requirement to aggregate deficiencies had a learning curve associated with it and required (like the rest of 404) lots of communication between our teams and the company. It is important that you get good at identifying themes early on to address those deficiencies that might become significant or material by virtue of aggregation.” Both the company and the auditor have to develop these antennae and it helps if they share the same approach. One US participant recalled: “Even though we ensured everyone understood the definitions of material weakness and significant weakness, the aggregation assessment was time-consuming. All similar control deficiencies (considered by account and by location) have to be aggregated to establish significance. It helps to make sure you do this in the same way that the external auditors will.”

“We avoided last minute adjustments and that was because we were well aligned all the way through. Encourage the auditor to take the same approach that you are following. It is essential that registrants and auditors are on the same page from the start.”*

Capturing the potential for business improvement

The reports on internal control over financial reporting required by section 404 are intended to help restore investor confidence following the corporate scandals of recent years. They will be important for companies to compete for capital effectively. By documenting the internal control process and identifying and correcting deficiencies, companies can clearly strengthen their business. But do they have the potential to reinforce and support wider business performance and improvement? The feeling from energy and utility companies was positive. For one participant the requirements provided the impetus to sort out problems that had remained further down the list of priorities: "We knew we had issues in the area of general computer controls. In the past there was maybe not the appetite to fix them but now people are going through fixing things and being delighted that they are doing that. It has raised the profile of control. Control is more on the agenda of business boards. There is less reliance on key individuals because people have had to document what they do. We have a lot more information that we can use to make our processes more efficient and people have much more understanding of end to end processes, not just their bit."

"Integrating computer controls and business processes has gone fairly well for us. It has led to greater convergence of business and IT processes."

"We have bought entities in the US and there has been a lot more sharing of knowledge as a result of Sarbox processes."*

Looking ahead

“Everyone recognises that a sustainable solution needs to be less costly. In the first year it was a question of readiness but now it is about sustainability” observed one of the US participants in the roundtable. The experience of many US companies is that the rush to meet the requirements of Section 404 was achieved by moving into a high cost project mode that is not sustainable for their businesses moving forward. The challenge reported by US participants in our roundtable is to embed but also simplify the start they have made in the first year. “We are not cutting back in 2005. We have it ready to go at the same level but we want to simplify and refine how we test.” From an audit perspective, a PricewaterhouseCoopers partner added: “One of the first exercises is to look at how to substitute control-based testing for substantive testing.”

The opportunity for European companies and other foreign private issuers, arising from the SEC decision to defer the start date for foreign companies, is to embed sustainable 404-related controls and reporting into the business in cost-effective ways from day one. The roundtable participants wanted to seize that opportunity but one acknowledged a possible negative effect of the deadline shift: “People in the field have scaled back projects to make way for 404 and there might be a temptation to relax the urgency. Emotionally people have been going at 100mph and there is a temptation to slow down.” It is a temptation that this participant and other European participants were keen to avoid: “We’re not changing anything. Over the next six months we’re trying to move from project mode to permanent mode. We want to transition it into live practice and an enduring solution as early as possible and embed it more in the business.”

What will dictate whether European and other foreign companies are successful in making 404 implementation sustainable from day one and avoid the project difficulties encountered by US companies? Companies must recognise and proactively address the impact of change on business processes and related internal controls, and therefore their ability to sustain Sarbanes-Oxley compliance. Success will require a focused, defined programme designed to operate year after year as a natural part of the business. That means delivering an organisational structure with clear accountability, an efficient operating structure and an enabling technology structure (see panel). In the US, companies have been a long way from universally succeeding in getting these three things in place by day one. The deadline extension makes possible a different outcome for European and other foreign companies. Those companies that maintain momentum have the opportunity of raising their sights and achieving an ‘ahead of time permanent solution’. Those that relax risk falling into the trap of a ‘just in time but unsustainable project fix’.

“It’s an opportunity to improve the quality. Instead of having to rework and refine in year two, the delay enables you to do that as you go along.”*

Delivering a sustainable 404 compliance environment in your company

A sustainable environment relies on **three** key structural elements: organisation, operations and technology*.

Clear organisational accountability

1

- Clear responsibilities of the Board, Audit Committee, senior management and business unit leaders
- Place active Sarbanes-Oxley compliance oversight and standards development responsibility in a Chief Internal Control Officer or similar position
- Count on managers to identify change, own documentation and testing and recommend key controls
- Put risk and control specialist in the business to support managers with guidance and hands-on assistance
- Place internal audit in a quality control role rather than active participant on behalf of management
- Create and update job descriptions, internal control policies, charters etc. to include details about Sarbanes-Oxley compliance responsibilities
- Develop performance measures aligned with Sarbanes-Oxley compliance activities

Efficient operating structure

2

- Perform quarterly assessments to ensure that effective internal control over financial reporting is maintained throughout the year and provide management assurance for quarterly reporting.
- Build Sarbanes-Oxley requirements into the project plans for major changes.
- Institute processes, such as self-assessment and walkthroughs, to identify minor changes that could affect Sarbanes-Oxley compliance.
- Leverage the results of an annual risk assessment to confirm identification of all relevant changes
- Establish standardised documentation methods (e.g. flow charts, narratives, control matrices) as well as guidance related to the level of detail to be included.
- Develop standards for the ongoing development and approval of test plans.
- Involve departmental employees in testing to reduce cost and reinforce operating principles that employees are expected to follow.
- Develop a timely and quality-driven exception resolution process.
- Provide central monitoring and management of remediation progress and the status of re-testing.
- Capture performance measures, prepare relevant analyses and share information with senior executives, the Disclosure Committee and the Audit Committee and the Board.

Enabling technology support

3

- Provide comprehensive training and sharing of best practice tailored to the audience – from the Board to new employees.
- Engage the IT department in proactively identifying opportunities to leverage technology, both to improve controls and to enable an effective compliance programme.
- Define a compliance technology architecture that pulls data from disparate systems and uses them to enforce accountability, improve data quality and identify exceptions.
- Leverage existing technology infrastructures to support the compliance process and to improve the control environment.
- Review the company's broader risk and compliance requirements to identify other needs that can be met while building a technology base to support Sarbanes-Oxley compliance.

* for more information see 'How to move your company to sustainable Sarbanes-Oxley compliance – from project to process', PwC Advisory, 2005.

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