



Assessing Awareness and Impact of Sarbanes Oxley Section 404 in the Global Capital Markets

A global survey commissioned by PricewaterhouseCoopers aims to identify the potential impacts of Sarbanes Oxley Section 404 on the global capital markets.

Section 404 requires all SEC-registered companies to include in their annual report a statement by management and the external auditors on the effectiveness of the company's internal controls over financial reporting.

Other studies have assessed issues relating to Section 404, such as public companies' state of readiness, the cost of implementation and the time within which companies are likely to achieve the standards required by Section 404. This survey is the first to investigate the potential impact of Section 404 on the global capital markets. Among its objectives were to find out what the global markets' perception of a negative disclosure under Section 404 might mean for their valuation of public companies, and to gauge the understanding of Section 404 in the different regions comprising the global capital markets. To achieve this, a total of 105 analysts, investors and ratings agencies from Asia Pacific, Europe and the Americas were asked to participate in detailed telephone interviews.

A potentially uncertain market place

The survey, conducted by MORI in January 2005, reveals a global market in which almost six in ten respondents say that they know at least a little about Section 404, but it also shows that more detailed awareness is lacking in many parts of the world. This lack of more detailed awareness is creating some uncertainty about the implications of Section 404, though there are considerable regional variations. For example, 77 per cent of respondents in the United States compared to 54 per cent of their counterparts in Asia Pacific said that they understood 'at least a little' about Section 404.

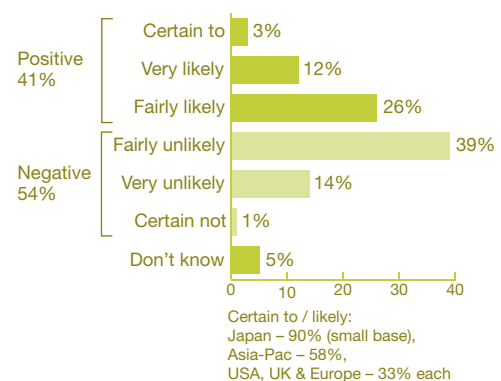
The survey reveals that although a third of respondents believe that Section 404 delivers better information, increases their ability to rely on audited accounts and improves transparency (graph 1),

only one in ten believes that Section 404 has achieved its principal objective: reducing investors' overall risk. This perception may well be linked to the generally low level of understanding of Section 404 identified by the survey in some of the specific regional markets.

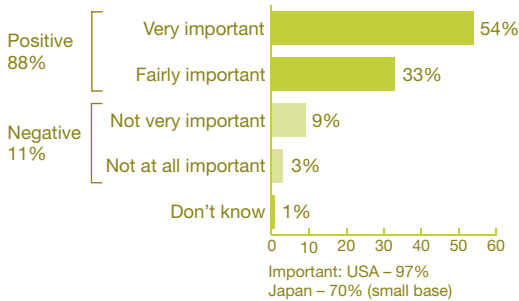
Graph 1 What, if any, will be the benefits to you of the increased disclosure of information on internal controls over financial reporting, due to Section 404?



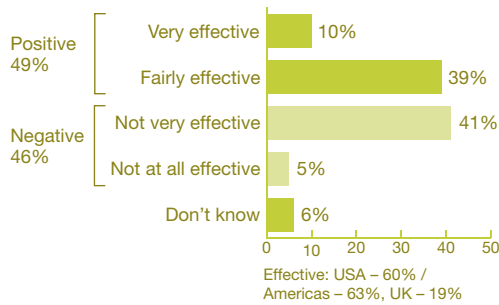
Graph 2 How likely or unlikely is it that local companies will voluntarily begin to meet the Section 404 requirements, irrespective of whether they are registered with the SEC?



Graph 3 Although implementing Section 404 is the direct responsibility of management, how important, if at all, would you say the role of the non-executive director is in ensuring robust financial controls within a company?



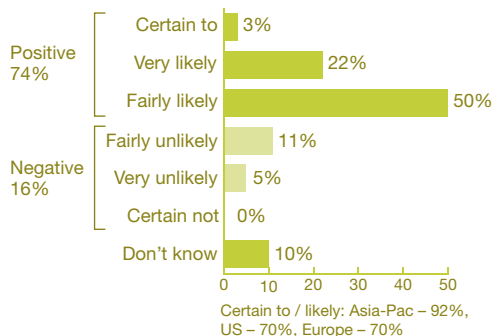
Graph 4 And generally how effective would you say non-executive directors / audit committees are in helping to maintain robust financial and internal controls?



Graph 5 How much of a positive or negative impact, if at all, will a Section 404 negative disclosure have on a company's valuation?



Graph 6 How likely or unlikely would you personally be to mark down the shares or securities of a company / to consider selling the shares of a company if they received a negative Section 404 report from the auditor?



Voluntary adoption unlikely, local controls adequate

Almost twice as many investors and analysts in Asia Pacific are inclined to believe that non-SEC registered companies will voluntarily meet Section 404 requirements than are their counterparts in Europe and the US, where only one-third of investors and analysts believe that non-SEC registered companies would voluntarily seek to meet the requirements (graph 2). Despite the perception that the oversight of financial controls outlined in the regulations represents best practice, most respondents clearly believe that enforcement rather than aspiration is driving their adoption. For those investors and analysts who claimed to know at least a fair amount about Section 404, some two-thirds believe that local controls would be adequate to meet the standards required by Section 404. This suggests perhaps that as understanding of Section 404 develops across the globe, the pressure for non SEC-registered companies to conform to its requirements may lessen, provided that local controls are perceived to offer equivalent protection.

Non-Executive Directors and audit committees in the spotlight

One way in which the market clearly expects those controls to be assured is through non-executive directors and the audit committee. Nearly 90 per cent of those surveyed believe that non-executive directors and audit committees have an important role to play in understanding and ensuring robust financial controls (graph 3). But fewer than half believe non-executive directors and audit committees currently play an effective role in this regard, a perception that was particularly pronounced in the UK where only one in five respondents say that non-executive directors and audit committees are effective in this role today (graph 4).

An overwhelming impression from the survey is the importance that the market attaches to the role of non-executive directors and the audit committee in providing comfort that the necessary financial controls are in place and operating at the appropriate level. Their relative independence is seen as providing them with an effective platform from which to oversee the implementation and operation of controls. Company boards need to ensure that they meet these expectations and are able to respond to the market's demands.

Understanding: a key factor

Only one in five of the investors and analysts surveyed claim to know at least a fair amount about Section 404 and responses to the survey reveal a level of uncertainty in the markets about the implications of a negative disclosure under Section 404. That uncertainty could translate into significant loss in value as the markets punish any oversight by selling and downgrading

their shares. Some three quarters of respondents say that this would be their reaction to a negative disclosure. The relative lack of knowledge identified may well give rise to some potentially damaging reactions since some two-thirds of investors and analysts believe that a negative disclosure would have an adverse impact on a company's valuation, with one fifth believing that the impact would be significant (graph 5).

However, there is some evidence from the survey to suggest that as the market understands more, it will take a more discriminating approach. The more knowledgeable that investors and analysts say they are about the impact of Section 404, the less likely they would be automatically to mark-down or sell shares in the event of a negative disclosure. Nine out of ten analysts and investors based in the Asia Pacific region – where awareness of Section 404 was generally lowest – say that they would be likely to sell or mark down shares in a company that was the subject of a negative disclosure (graph 6). By way of contrast only seven out of ten of investors and analysts surveyed in Europe and the US think that they would take the same action in similar circumstances (graph 6).

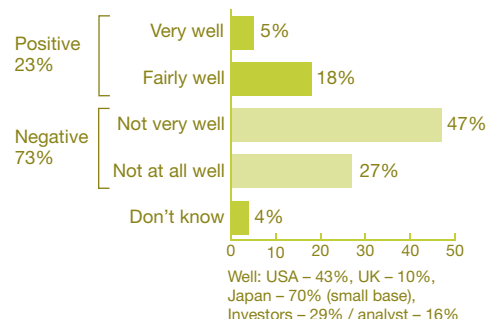
Impact on deals – Section 404-related due diligence called for

Though the markets generally do not claim a detailed understanding of the possible implications of Section 404 on mergers and acquisitions (graph 7), three quarters of investors and analysts believe that a post-acquisition negative assessment would have a significant impact (graph 8). In light of this finding, it's perhaps unsurprising that almost 90 per cent believe that at least a 'fair amount' of due diligence will be necessary to ensure that a target acquisition meets Section 404 standards (graph 9). In the US, nearly 100 per cent of respondents (graph 9) believe this to be the case.

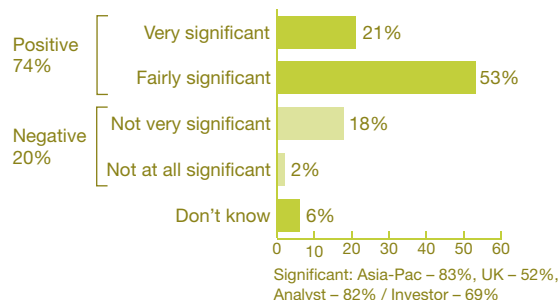
The implications for joint ventures with non-SEC registered entities – of which SEC-registered companies are likely to have a great many – are less clearly understood. Just over half of all those surveyed believe that a negative assessment would have a significant impact on the value of an SEC-registered company (graph 10).

The uncertainty reflected in these responses certainly should lead companies to reflect on the Section 404-related due diligence that they undertake prior to either an acquisition or entering a joint venture. A negative disclosure after a deal has been transacted could, according to the survey, have serious repercussions on market value.

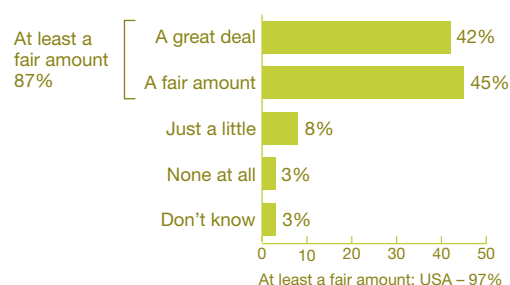
Graph 7 How well, if at all, do you feel you currently understand the possible impact of Section 404 on mergers and acquisitions specifically?



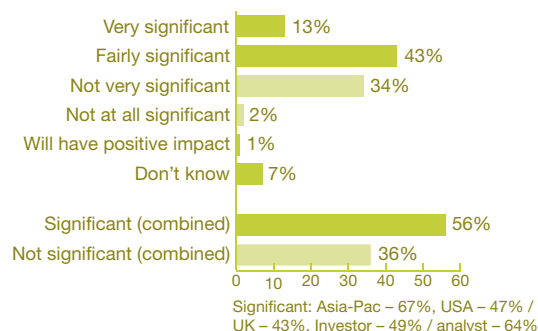
Graph 8 And in general, how much impact, if at all, do you believe a post-acquisition negative assessment would have on an acquisition by an SEC-listed company of a non-SEC listed company?



Graph 9 How much due diligence would you expect a company to do before an acquisition, to satisfy itself that the target met Section 404 control standards?



Graph 10 How significant a problem, if at all, do you believe a negative disclosure from a Section 404 assessment would have on a joint venture between a SEC-listed and a non-SEC listed company?



A window of opportunity for foreign issuers?

Since the survey was commissioned, the SEC has extended by twelve months the deadline for foreign issuers and smaller companies to meet the standards required by Section 404. The extension of the deadline for SEC-registered foreign companies gives them perhaps some breathing space. Some of the value destroying scenarios indicated in this survey may be avoided as the market's understanding of Section 404 deepens and matures.

The influence of Section 404 reaches out across the global market and the results of the survey point to several key areas for businesses to focus on. These include:

- To help businesses to manage the risks that this survey identifies, efforts to increase the markets' understanding and awareness – particularly focused outside the United States as understanding there is already at a high level – are crucial.
- Detailed preparation and a cautious approach to M&A activities are also likely to be important to make sure that businesses are not exposed to negative market reactions.
- The role of non-executive directors and the audit committee also needs to evolve to meet the markets' expectations of the role they have to play in ensuring financial reporting meets the required standards.
- The development of issues relating to Section 404 should be closely monitored.

There is certainly no room for complacency. As this survey shows, the option to do nothing is one that no business can afford to take.

Fieldwork was conducted by MORI from 24th January - 25th February 2005. MORI, (Market and Opinion Research International) is one of Britain's fastest growing market and public opinion research agencies.

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