Overview of Topics

- Reporting on Internal Control over Financial Reporting
  - Historical Perspective
  - Current Reporting Requirements
  - Summary of Reporting Statistics for the First Four Years
- COSO's New Guidance on Monitoring
  - Project Overview
  - The Value of Monitoring
  - A Model for Monitoring

Presented by Audrey A. Gramling, PhD, CPA, CIA
November 18, 2008

The Sarbanes-Oxley Act of 2002

Paul Sarbanes

US Senator – Maryland

(Democrat)

Michael Oxley

US Senator – Ohio

(Republican)

SOX – A MAJOR CHANGE

- Sarbanes-Oxley (SOX) – "The most far-reaching reforms of American business practices since Franklin Roosevelt was president"

  Pres. George W. Bush

- SOX formerly "...would have been an unimaginable incursion of the federal government into the corporate governance arena."

  SEC Commissioner Paul Atkins

- Entirely new regulatory regime created for auditors of public companies (issuers)

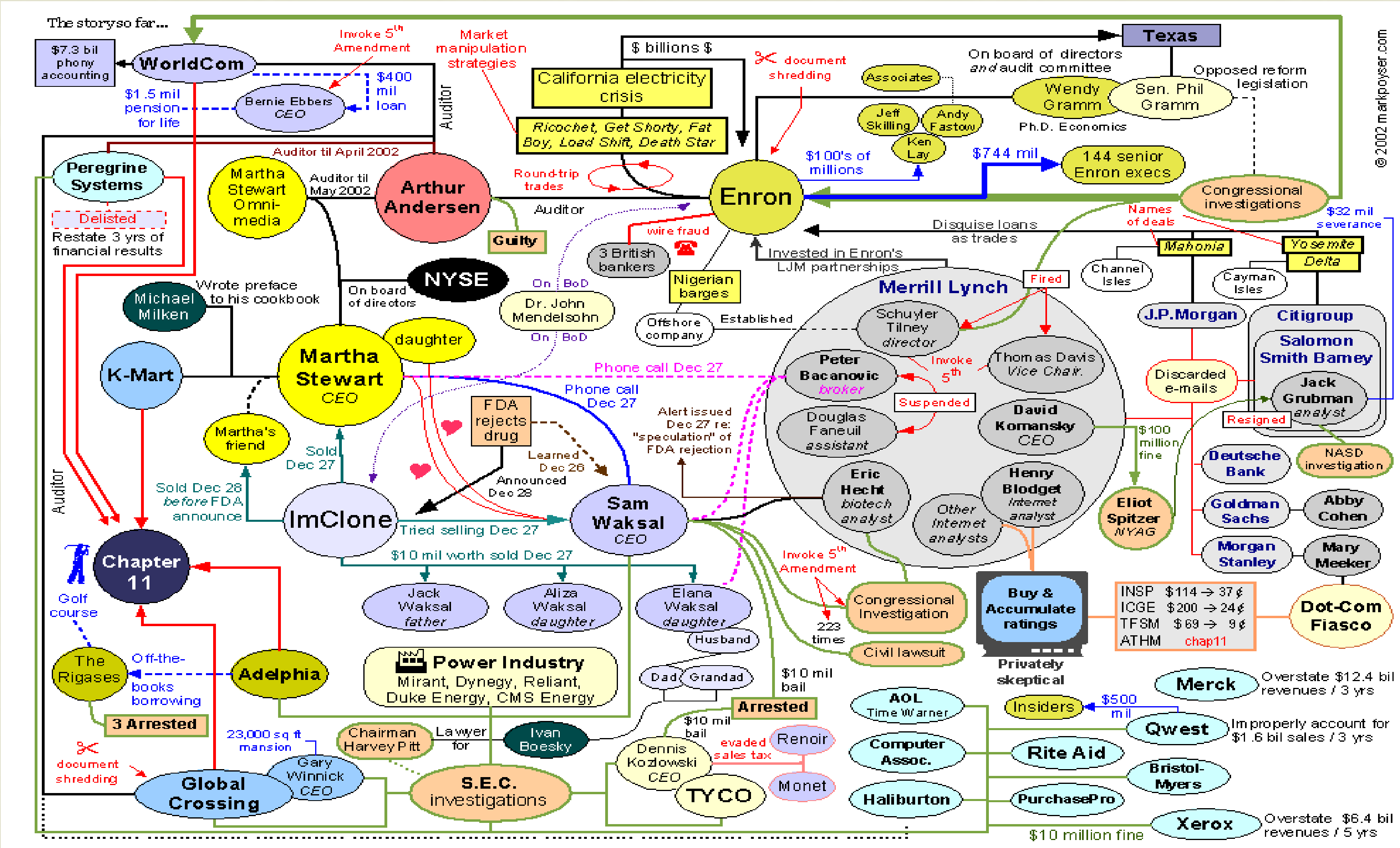
Adapted from Ronald S. Boster, Special Advisor, PCAOB

AND YET...

SOX passed Congress with only 3 dissenting votes

How did this come about?

IN A NUTSHELL……



Adapted from Ronald S. Boster, Special Advisor, PCAOB

POLITICAL CALCULUS

AND THE PENDULUM SWINGS

Corporate Scandals From A to Z

- **Adelphia** (Rigas)
- Dynegy (Olis)
- **Enron** (Skilling, Lay, Fastow)
- **Global Crossing** (Winnick)
- Healthsouth (Scrushy)
- ImClone (Martha Stewart, Waksal, Baconovic)
- Nortel (Dunn, Beatty)
- Quattrone, Frank (IPO) & Qwest (Grass, Brown)
- Rite Aid (Grass, Brown)
- Royal Ahold & Parmalat (not just a U.S. problem)
- **Tyco** (Kozlowski, Swartz, Belnick)
- **Worldcom** (Ebbers, Sullivan)
- Zerox
- ZZZ Best

Adapted from Ronald S. Boster, Special Advisor, PCAOB

A POLITICAL "PERFECT STORM"

- Loss of <u>Public Confidence</u>
  - **In financial reporting**
  - **In the accounting/auditing profession**
  - **In the SEC's willingness & capacity to enforce securities laws**
  - **In U.S. capital markets**

- Loss of <u>Money</u>
  - **"Dot-com bubble" burst**
  - **Shareholders/employees of "bad" companies**

Adapted from Ronald S. Boster, Special Advisor, PCAOB

In Sum: CORP. SCANDALS → PUBLIC OUTRAGE → SOX

- Implicit focus is broad: to restore public confidence in U.S. capital markets

- Explicit focus is narrow: "To protect *investors* by improving the accuracy and reliability of corporate disclosures..."

  - **SOX is clearly aimed at enhancing public corporate governance, management & board responsibility, and transparency**

Adapted from Ronald S. Boster, Special Advisor, PCAOB

OVER FIVE YEARS LATER -- MIXED REACTIONS & REVIEWS

- SOX has been good for audit <u>firms</u>,
  - **"..widely regarded as a licence (sic) for audit firms to print money – " (Economist, July 28, 2007)**
- SOX has been savaged by many <u>issuers</u>, primarily smaller companies:
  - **Mostly over <u>costs</u> associated w/ internal-control provisions (sec. 404 & AS 2)**
  - **Larger issuers have generally been supportive or quiet**

Adapted from Ronald S. Boster, Special Advisor, PCAOB

Section 404

Reliable Financial Statements

Effective
Internal Controls over
Financial Reporting
(ICFR)

ICFR Reporting Requirements SOX 404

- Internal control report in annual report stating:
  - Management's responsibility for establishing and maintaining adequate internal control over financial reporting
  - Framework used by management to conduct evaluation of effectiveness of internal control over financial reporting
  - Management's conclusions about effectiveness of internal control over financial reporting as of year-end, based on management's evaluation

Requirements of SOX 404 – Cont.

- Internal control report in annual report stating:
  - Any material weaknesses in internal control over financial reporting identified by management
  - That external auditor has attested to, and reported on, <u>management's evaluation</u> **
- External auditor shall attest to and report on <u>management's assessment of internal control for financial reporting</u> **

** Change due to new SEC guidance and AS No. 5

Some important dates for “large” domestic issuers

- Large US Accelerated and Accelerated Filers
  - Public float of more than $75MM
- Management report and auditor attestation already required

- Most of these companies have filed 4 management and auditor reports under SOX 404

Some important dates for “smaller” issuers

- First management assessments
  - Fiscal years on or after December 15, 2007
- First audit reports
  - Fiscal years on or after December 15, 2009

Summary Information on ICFR Reporting

- Four years of required ICFR reporting by accelerated filers

- Do companies have effective ICFR?
  - NO material weaknesses
    - consider likelihood and magnitude of potential error

Let's get your viewpoint!

Which of the following terms would suggest that an event is more likely to occur?

A. More than remote possibility
B. Reasonable possibility
C. More than remote possibility suggests the same likelihood as reasonable possibility

What is a material weakness? For the first three years.....

- A *material weakness* is a significant deficiency, or combination of significant deficiencies, that results in **more than a remote likelihood** that a **material misstatement** of the annual or interim financial statements will not be prevented or detected.

What is a material weakness? Going forward .....

- . . . a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a **reasonable possibility** that a **material misstatement** of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Let's try one.
Is this a material weakness in ICFR?

- Until August 2006, we did not have any personnel who were familiar with US GAAP
- We currently do not have sufficient personnel with adequate expertise to ensure that we can produce financial statements in accordance with US GAAP on a timely basis.

Deficiency Example

Your company sells software. Its contracts with customers often have non-standard terms which impact the timing of revenue recognition.

All non-standard contracts greater than $1 million are reviewed on a timely basis by your accounting department for appropriate accounting, prior to revenue being recorded.

Non-standard contracts less than $1 million are not reviewed. These non-standard contracts less than $1 million dollar represent approximately 25% of the dollar value of all software sales (and represents 20% of total pre-tax income) for your company.

Reporting Results So Far…

First year:

- 3,812 companies
- 623 (16.3%) had at least one MW

Second year:

- 3,969 companies
- 445 (11.2%) had a least one MW

Third year:

- 4,569 filings
- 427 (9.3%) had a least one MW

**Fourth year:

- 7,697 companies
- 1,124 (14.6%) had at least one MW

Data compiled from AuditAnaltyics.com, filings through 8/31/08.

Number of Material Weaknesses

First year:

- *1,520 MWs*
- *Average of 2.42*

Second year:

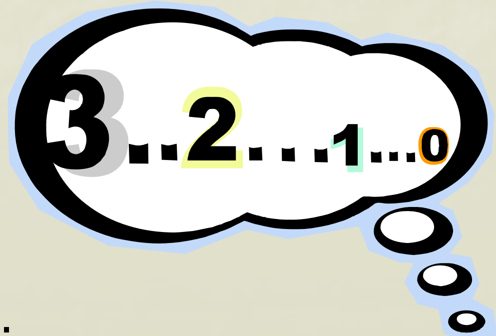
- *1,071MWs*
- *Average of 2.41*

Third year:

- *984 MWs*
- *Average of 2.30*

Fourth year:

- *2,342 MWs*
- *Average of 2.08*



Data compiled from AuditAnaltyics.com, filings through 8/31/08.

What about the smaller companies?

- Percentage of MW registrants with revenues <u>less than</u> $500 million

- Year 1: 56.7% (49.7%)
- Year 2: 57.3% (49.3%)
- Year 3: 56.7% (46.1%)
- Year 4: 74.4% (56.1%)

Data compiled from AuditAnaltyics.com, filings through 8/31/08.

Comparing MW and non-MW registrants

- On average, registrants with MWs:
  - Are smaller
  - Are less profitable
  - Pay higher audit fees

Data compiled from AuditAnaltyics.com, filings through 8/31/08.

Audit Fee Observation

- Difference in fees between those with and without MW

	Year 2	Year 3	Year 4
With MW	4,151	4,105	2,970
No MW	2,103	2,762	2,725
Difference	2,048	1,343	245

Data compiled from AuditAnaltyics.com, filings through 8/31/08.

(Only includes Accelerated Filers)

The Top Four ICFR Issues

	Year 1	Year 2	Year 3	Year 4
Accounting rule application failures (GAAP)	98%	99%	99%	100%
Accounting documentation, policy and procedures	94%	99%	99%	97%
Accounting personnel resources, training and competency issues	52%	58%	58%	72%
Segregation of duties/design of controls (personnel)**		16%	17%	45%

Data compiled from AuditAnaltyics.com, filings through 8/31/08.

Insufficient Accounting Resources

- During the fourth quarter of 2006, management identified a material weakness in internal controls related to insufficient accounting and financial resources.
- Management has concluded that additional accounting and finance resources are required.
- As a result of the insufficient resources the Company did not adequately address the accounting and disclosures for complex transactions, properly monitor internal controls and did not perform a timely and adequate evaluation of general computer controls.

Insufficient Procedures

We did not design and implement controls necessary to provide reasonable assurance that the measurement date for stock option grants was appropriately determined.

In particular, the procedures used to approve and process stock option grants were insufficient to ensure that all option grants complied with our stock option plans and the selection of measurement dates conformed to the requirements of applicable accounting rules.

Competency Issues

Our financial and accounting organization was not adequate to support our financial accounting and reporting needs.

Specifically, we did not maintain a sufficient complement of personnel with an appropriate level of accounting knowledge, experience with Dana and training in the application of GAAP commensurate with our financial reporting requirements.

Low Occurrence MW in Year 4

- Ineffective/understaffed internal audit function
- Senior management resources, competency, reliability
- Inadequate disclosure controls
- Ethical compliance issues with personnel
- Ineffective regulatory compliance issues

Data compiled from AuditAnaltyics.com, filings through 8/31/08.

Audit Committee Problems

- Our Audit Committee does not have a financial expert (as defined by SEC rules).
  - We lack a qualified financial executive to perform independent secondary reviews over complex and non-routine accounting matters to ensure they are reported in accordance with GAAP.

Regulation Compliance Issues

The Company failed to prevent or detect non-compliance with established policies and procedures intended to ensure compliance with laws and regulations.

Specifically, this control deficiency may have permitted violations of certain Securities and Exchange Commission (“SEC”) regulations related to previous financial disclosures and the Foreign Corrupt Practices Act (“FCPA”), related to alleged potential payments made to government officials.

Top GAAP Application Failures

	Year 1	Year 2	Year 3	Year 4 (AF)
Accounts, loans receivable, investments / cash	27%	26%	20%	15% (25%)
Revenue recognition	**33%**	**31%**	**26%**	**13% (24%)**
Income taxes	33%	34%	30%	12% (30%)
Liabilities and payables	28%	28%	24%	11% (19%)
Inventory, vendor, costs of sales		27%	19%	11% (20%)

Data compiled from AuditAnaltyics.com, filings through 8/31/08.

RALPH LAUREN

Tax Issues

. . . largely related to inadequate internal tax resources for a sufficient period of time,

lack of formal training for tax personnel and

inadequate controls and procedures over the tax accounting process to complete a comprehensive and timely review of the income tax accounts and required tax footnote disclosures . . .

Newpark Resources INCORPORATED

Revenue Recognition (fraud)

This ineffective **<u>control environment</u>** permitted those former members of senior management to override certain controls. As a result of these overrides, a number of transactions were not properly accounted for in our consolidated financial statements, which resulted in the need to restate our historical consolidated financial statements.

Specifically, former senior management entered into licensing agreements with a third-party vendor that lacked commercial and economic substance or proper supporting documentation resulting in the inappropriate capitalization of assets.

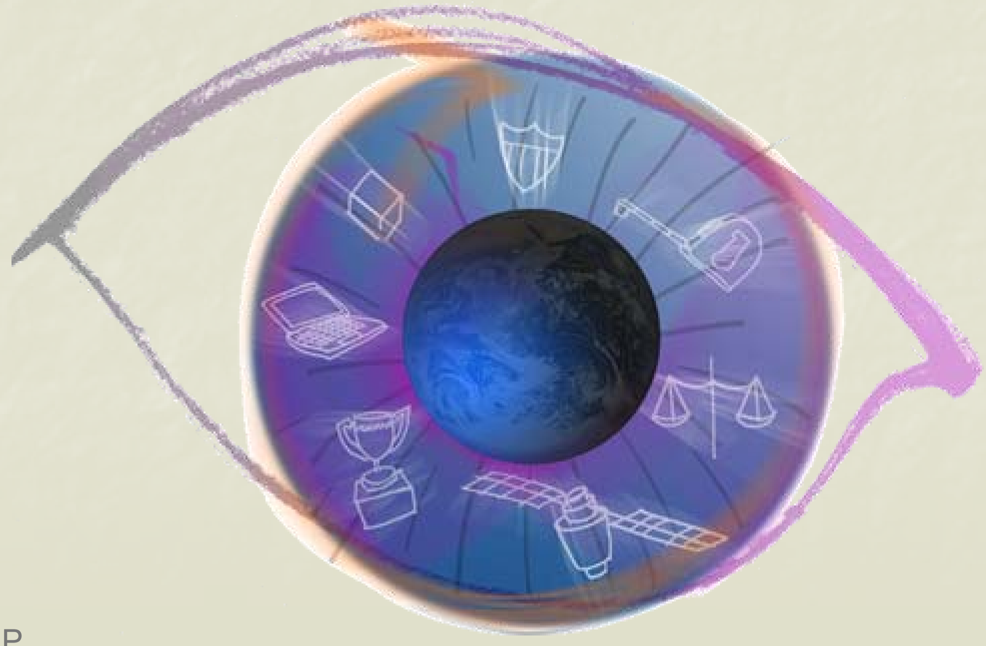
Former senior management also authorized several sales transactions to this same third-party that lacked economic substance or proper supporting documentation, resulting in the overstatement of earnings in certain periods. Additional transactions with this third-party, which also lacked commercial and economic substance . . .

Now that everything is in place...there is a need to monitor

- What is monitoring?

- Those involved in the COSO's Monitoring Project spent many months developing several draft documents in an attempt to answer that question!

An Overview:
COSO's Guidance on Monitoring Internal Controls



Based on Presentation Developed by Grant Thornton LLP.

Source: COSO

COSO's Internal Control – Integrated Framework

- Committee of Sponsoring Organizations (COSO)
  - American Institute of Certified Public Accountants
  - Institute of Internal Auditors
  - Financial Executives Institute (International)
  - Institute of Management Accountants
  - American Accounting Association

- 1992 / 1994 Two-volume set (about 360 pages)
  - Framework
  - Evaluation tools

COSO Definition of Internal Control

- Internal control is a ***process***, effected by an entity's people (board of directors, management and other personnel) designed to provide reasonable assurance regarding the achievement of objectives in
  - ***Reliability of financial reporting***
  - Effectiveness and efficiency of operations
  - Compliance with applicable laws and regulations

Overview of COSO's Monitoring Project

- "Monitoring ensures that internal control continues to operate effectively."
  - –1992 COSO Framework
    Chapter 6

Source: COSO

What's the problem?

- not recognizing good monitoring
- not implementing good monitoring

COSO's Monitoring Project Overview

started project in **January 2007**

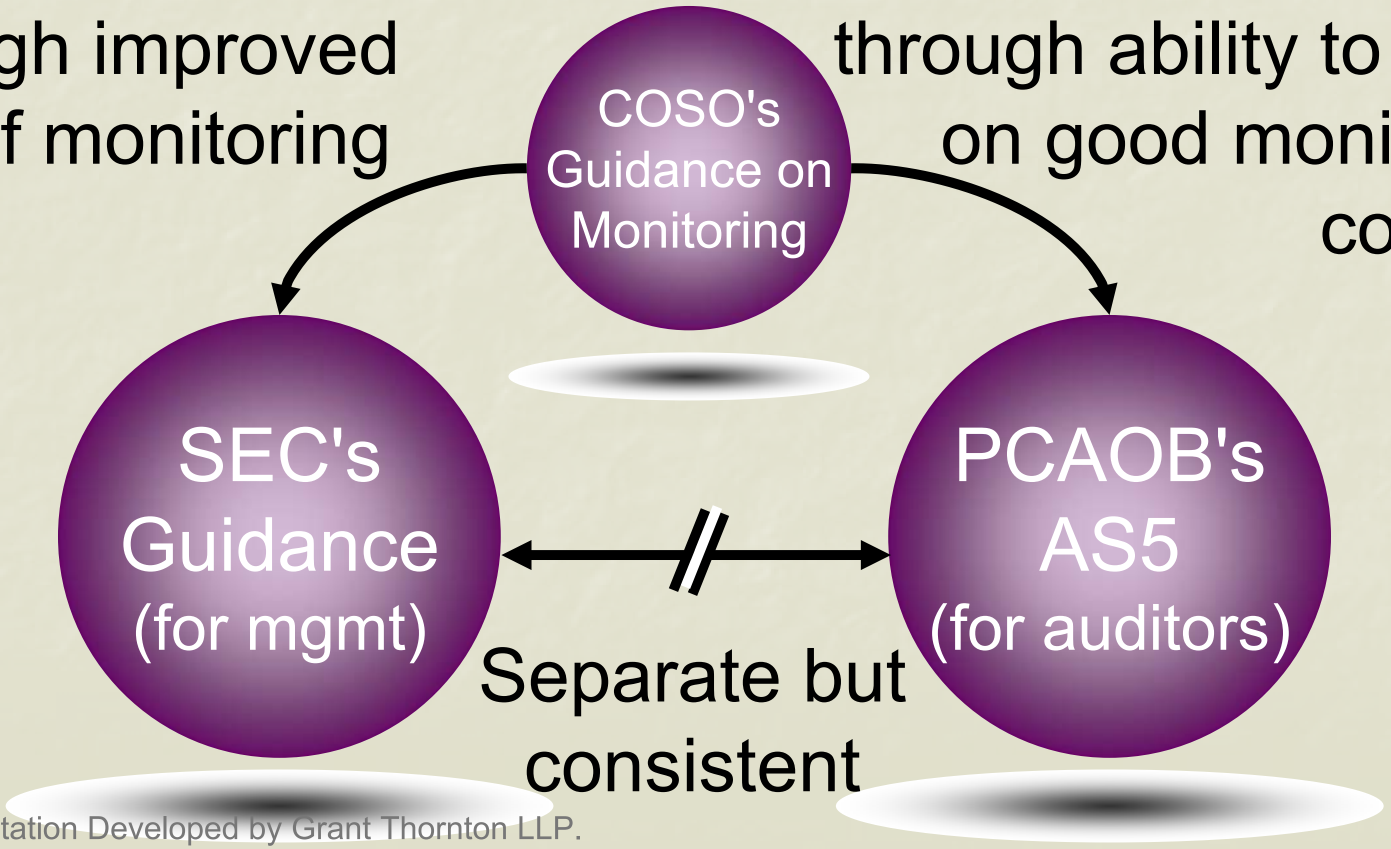
participants:

core team	7
review team	4
COSO board	6
COSO taskforce	16
SEC/PCAOB observers	2
	35

Three legs to the "404-improvement" stool

Value to **companies** through improved use of monitoring

Value to **auditors** through ability to focus on good monitoring controls



Based on Presentation Developed by Grant Thornton LLP.

Example: recognizing the value of monitoring

Let's look at a simple example of the concept. Assume:

- a reconciliation control is deemed important to financial reporting
- the supervisor of the area performs an appropriately detailed review of the reconciliation each time it is prepared

Example: recognizing the value of monitoring

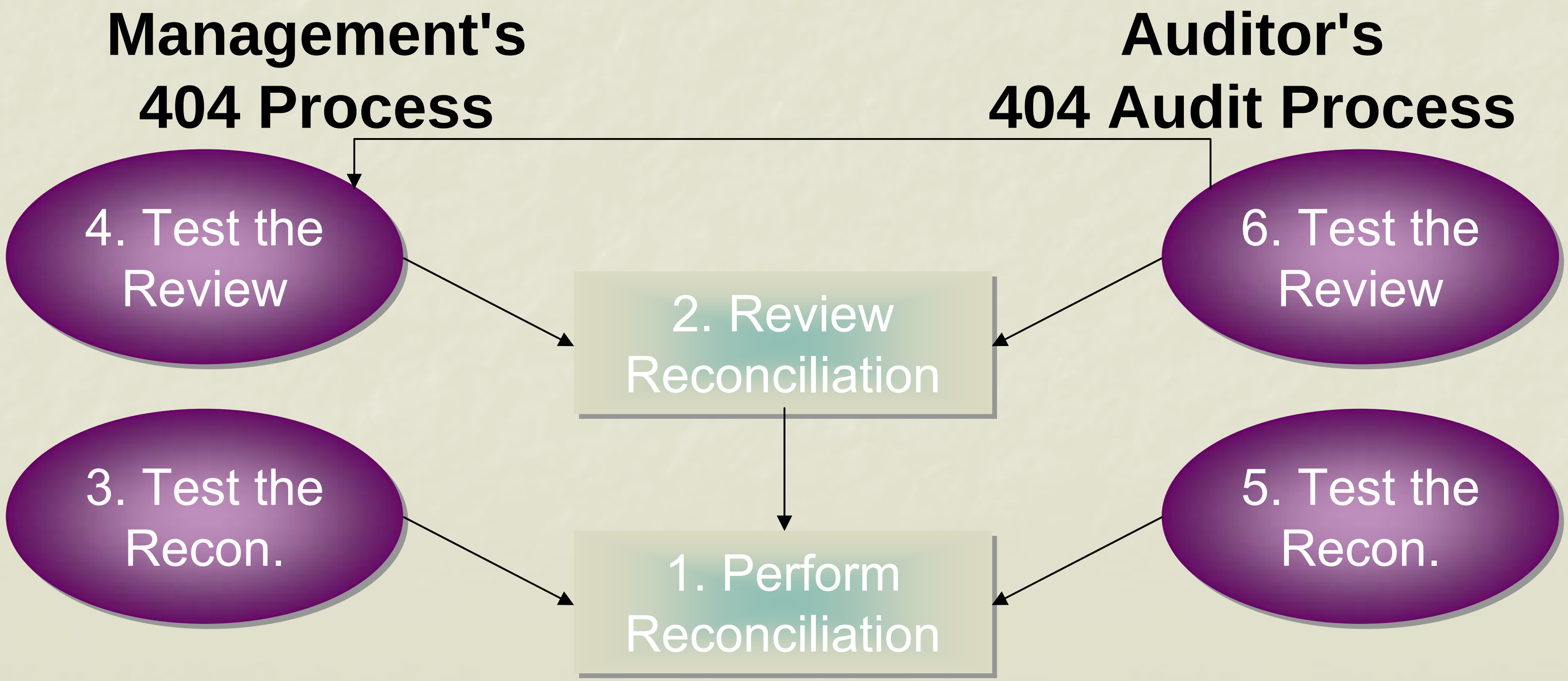
simple example (cont'd)

the supervisor's review accomplishes two things:

- tells him or her whether the control is working
- encourages continued effective operation of the control

Example: recognizing the value of monitoring

How do we often deal with this risk in **today's** 404 environment?



Example: recognizing the value of monitoring

How might it be done better in a **large** organization?

Management's Monitoring Process

Auditor's 404 Audit Process

3. Test the Review

2. Review Reconciliation

1. Perform Reconciliation

4a. Possibly Use the Work of Others

or

4b. Test the Review

Any further testing of the reconciliation will start with lessons learned from testing the reconciliation review

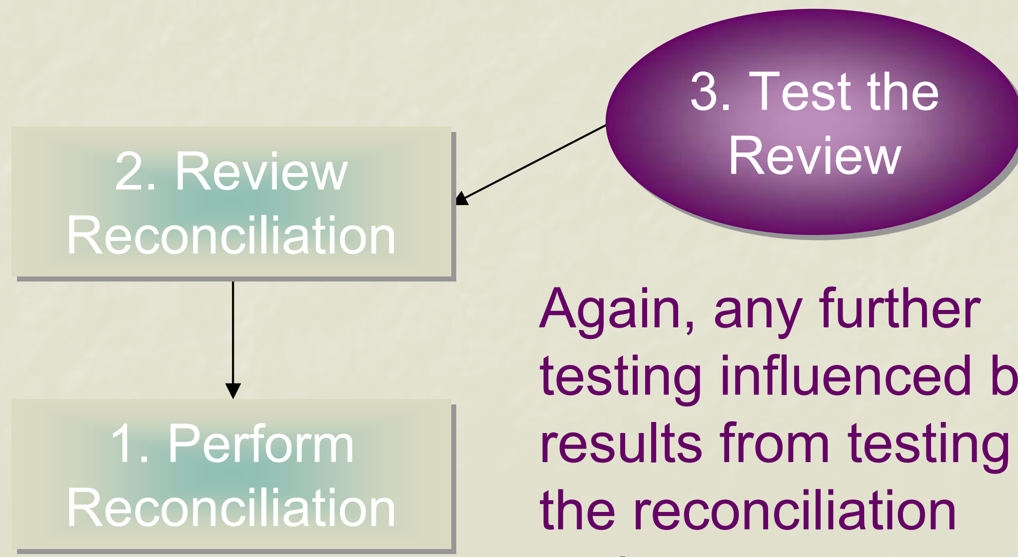
Example: recognizing the value of monitoring

How might it be done better in a **small** organization?

Management's Monitoring Process

Auditor's 404 Audit Process

If the reconciliation review is performed at the senior-mgmt level, no further evaluation may be necessary



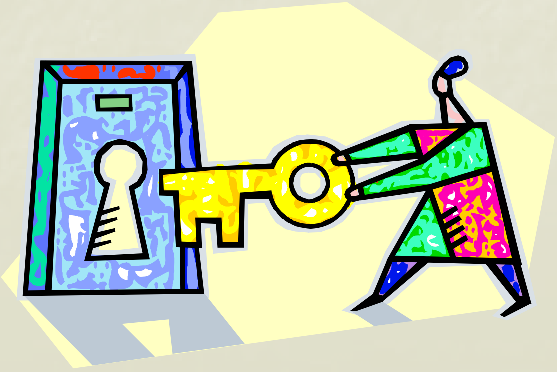
Again, any further testing influenced by results from testing the reconciliation review

A risk-based revenue example – which controls to monitor and how

- Set Objective: Recognize revenue in the proper period
- Identify Risks:
  - (1) Revenue is recorded before delivery or title transfer.
  - (2) Sales agents may encourage customers to purchase goods at the period-end by allowing for customers to have a right of return and future credit allowances for unsold goods.

A risk-based revenue example – which controls to monitor and how

- Prioritize Risks:
  - an organization may prioritize the first risk as moderate, and the second risk as high.
- Identify controls to mitigate this risk
  - 11 controls are relevant; which are key?



A risk-based revenue example – which controls to monitor and how

- *Possible key controls*
  - *tone at the top whereby management's philosophy and communication clearly identify that such activity is unacceptable.*
  - *compensation of sales personnel is reviewed quarterly by the sales manager and adjusted if returns exceed a threshold percentage of sales.*

A risk-based revenue example – which controls to monitor and how

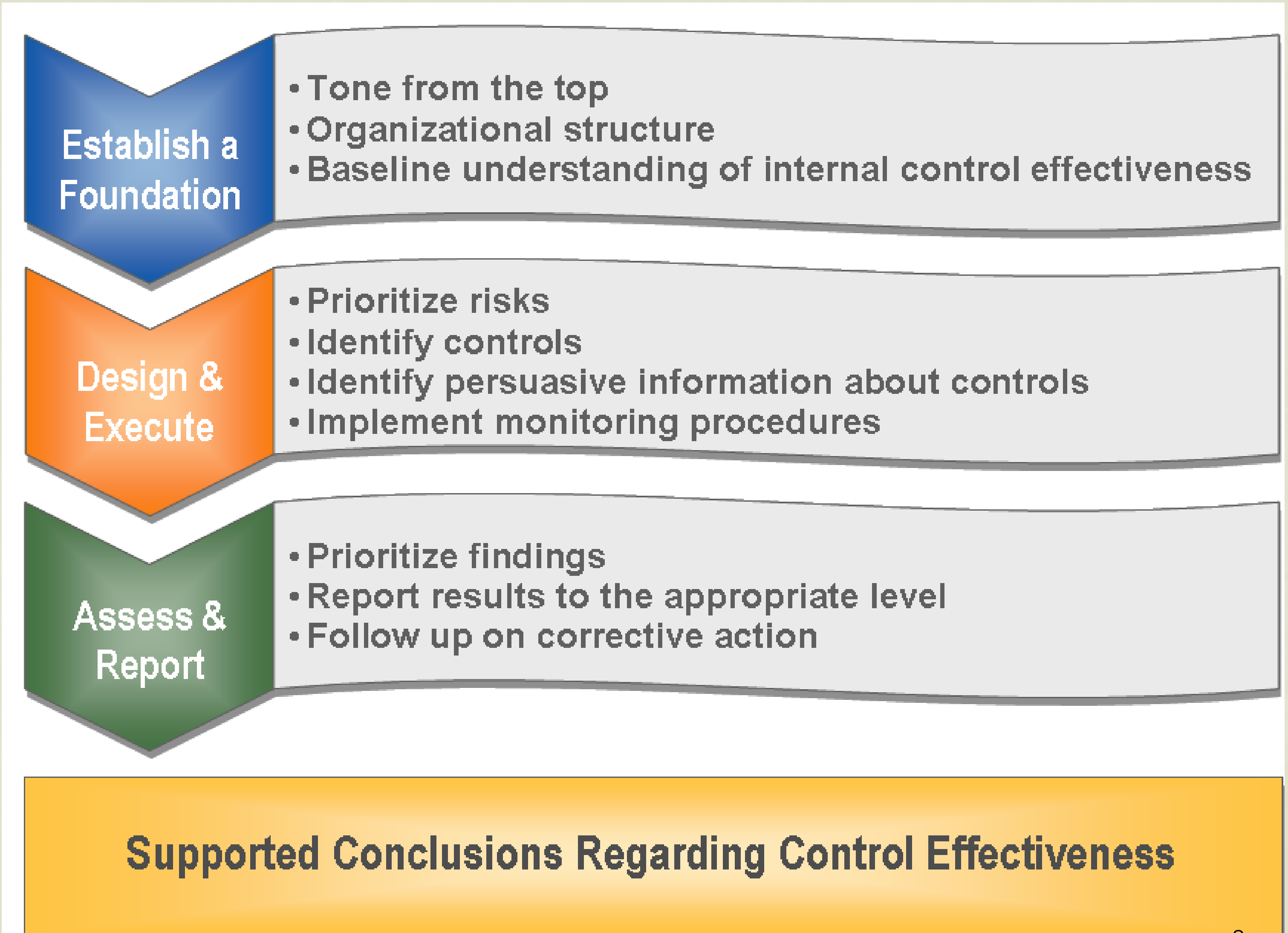
- Tone at the top control
- Compensation review / possible adjustment

A risk-based revenue example – which controls to monitor and how

- Then determine:
  - the mix of ongoing monitoring procedures and separate evaluations, and
  - the mix of direct and indirect information

that will be employed to determine whether the control system is working properly.

A model for monitoring

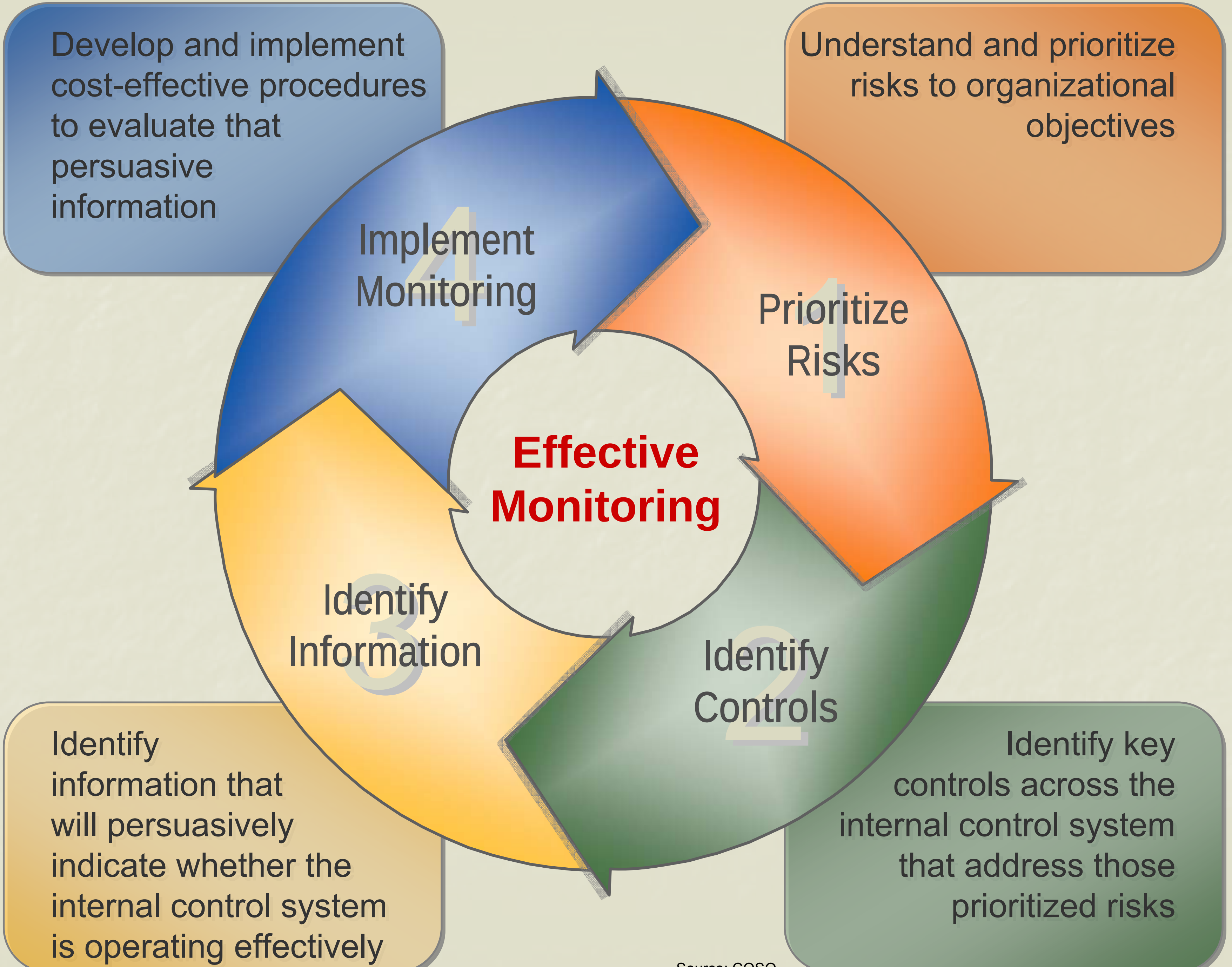


Source: COSO

Establishing a foundation for monitoring

- tone from the top
- role of management and the board
- right people in monitoring roles
- baseline of effective internal control

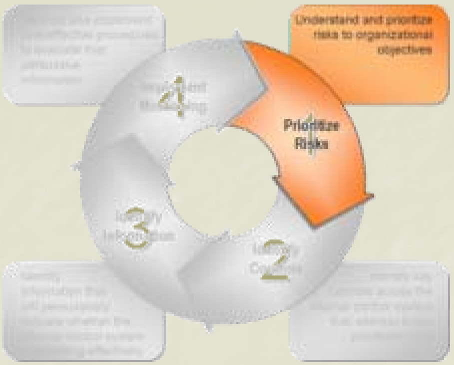
Let's focus for a minute on the role of management and the board, and the baseline understanding of internal control effectiveness.

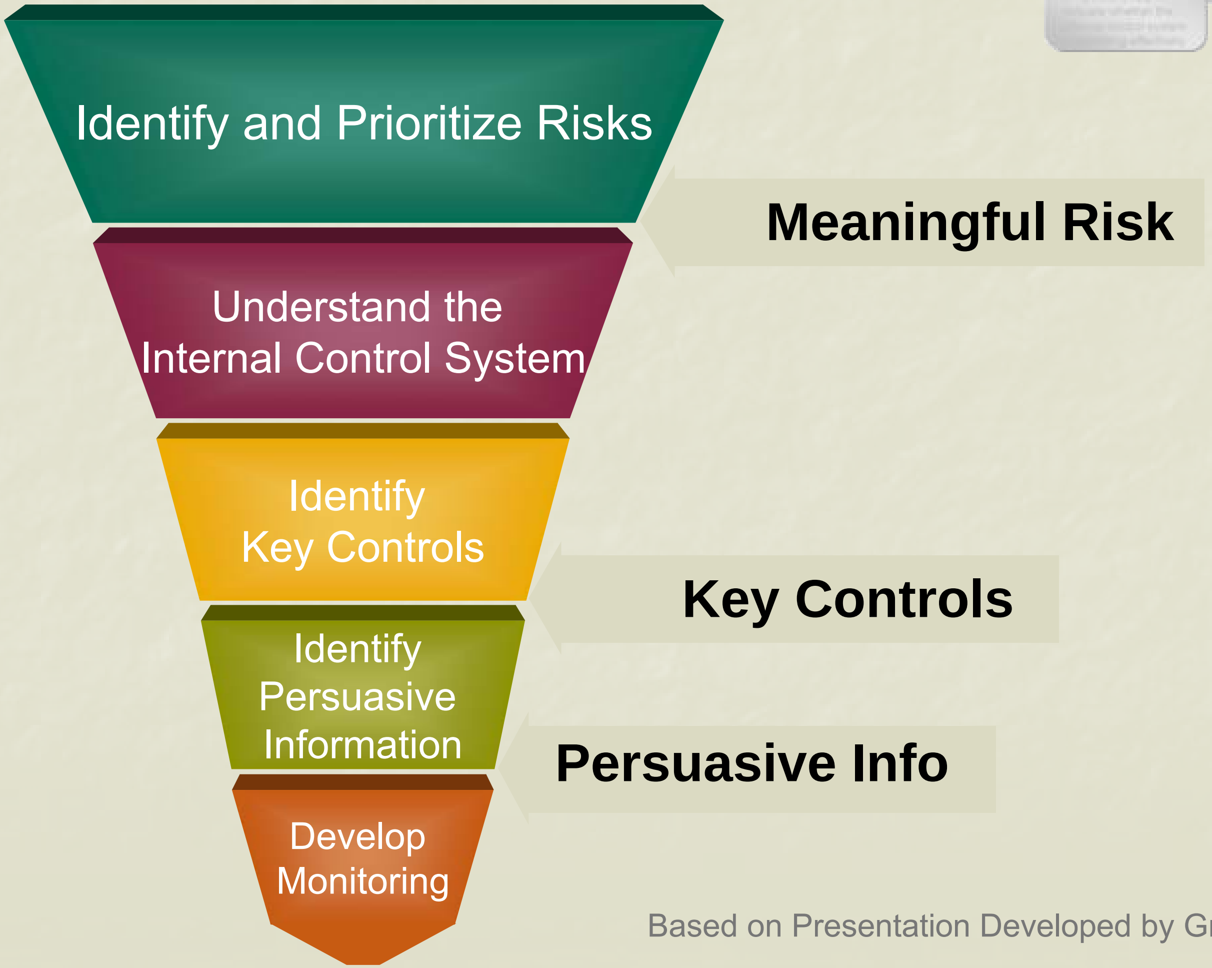


Source: COSO

Based on Presentation Developed by Grant Thornton LLP.

1. Risk-based approach





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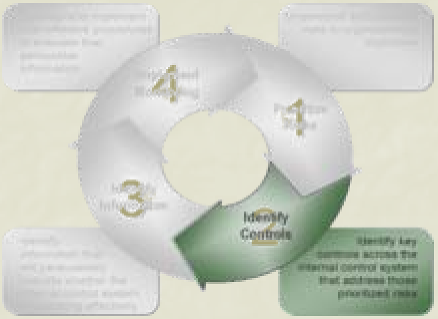
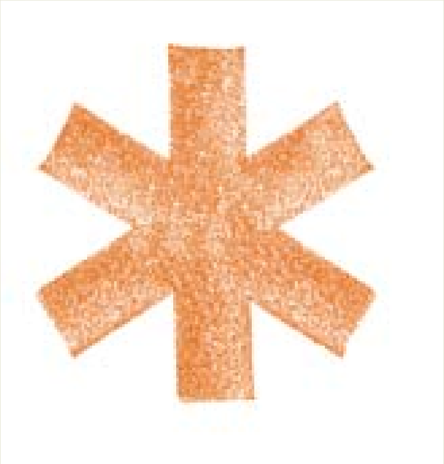
2. Understand internal controls and identify key controls



- understand how the internal control system manages **meaningful** risks
- identify those controls that are **"key"**
  - their failure (a) is reasonably possible, (b) is material, and (c) would not be detected by other controls, and/or
  - their operation will catch other weaknesses before they can become material

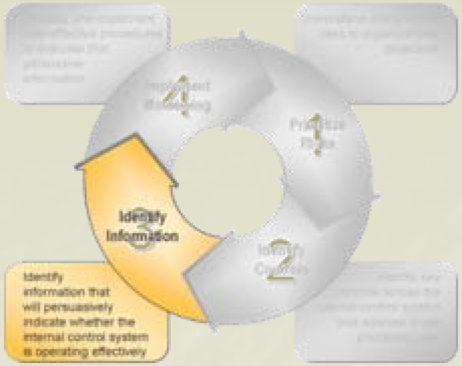
Two important questions

- What information should the company evaluate?
  (Hint: it should be **relevant, reliable** and **timely**.)
- What procedures should it employ?
  - ongoing monitoring
  - separate evaluations

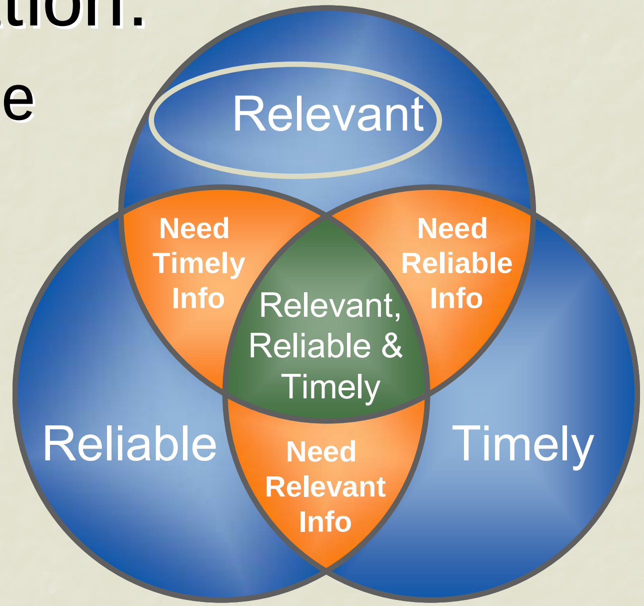


3. Identify persuasive information

(with a focus here on relevance)



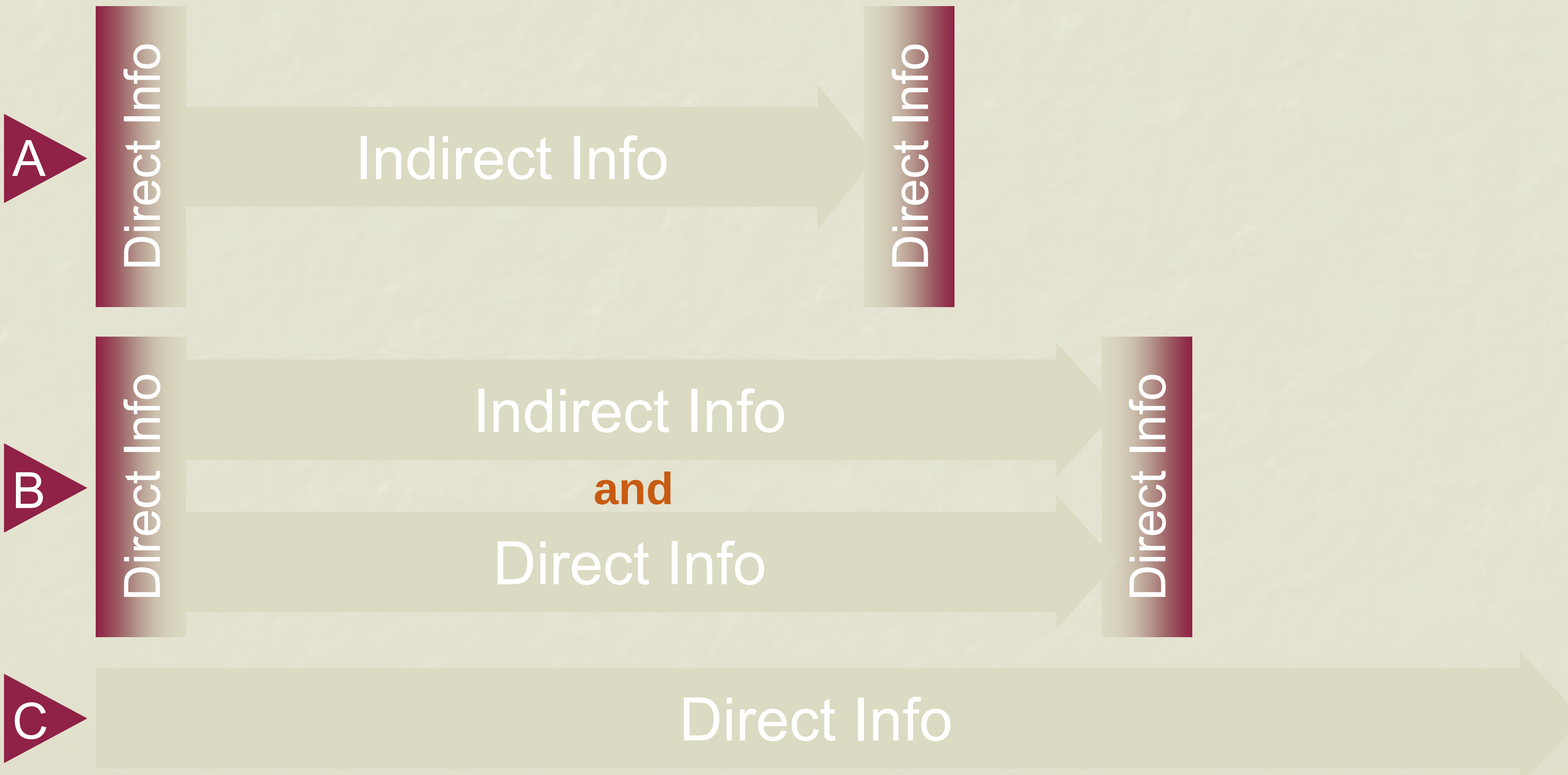
- two types of **relevant** information:
  - **direct** — clearly substantiates the operation of controls and is most relevant
  - **indirect** — all other information that relates to the operation of controls and is less relevant than direct information



Source: COSO

- **indirect information can help identify when controls fail, but does not provide absolute support that controls operated effectively**

Proper balance of direct vs. indirect is risk dependent



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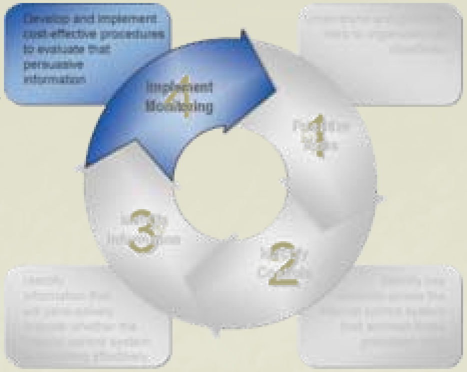
4. Implement monitoring procedures



- "An entity that perceives a need for frequent separate evaluations should focus on ways to enhance its ongoing monitoring activities and, thereby, to emphasize 'building in' versus 'adding on' controls."–1992 COSO Framework, Chapter 6

Ongoing monitoring:

- often closer to operation of controls
- offers earliest opportunity to identify weaknesses

Separate evaluations:

- often more objective
- can revalidate results of ongoing monitoring

Putting it all together

	Direct	Indirect
Ongoing monitoring	• Typically most persuasive • Especially valuable in high-risk areas	• Can enhance monitoring efficiency • Provides support to direct info
Separate evaluation	• Primarily used to revalidate conclusions reached through ongoing monitoring	• Typically least persuasive • Can help scope other SE procedures

Based on Presentation Developed by Grant Thornton LLP.

A corporate governance perspective on reporting results

- How should monitoring results be communicated within an organization?

  - Is top management fully aware of the key results?
  - Is the ***audit committee*** tracking the monitoring results in a meaningful way?
  - Are the efforts of ***management***, ***internal audit***, and the ***external auditors*** communicated such that each party understands the larger picture of monitoring?

A model for monitoring

Establish a Foundation

- Tone from the top
- Organizational structure
- Baseline understanding of internal control effectiveness

Design & Execute

- Prioritize risks
- Identify controls
- Identify persuasive information about controls
- Implement monitoring procedures

Assess & Report

- Prioritize findings
- Report results to the appropriate level
- Follow up on corrective action

Supported Conclusions Regarding Control Effectiveness

Source: COSO

Questions/comments