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Non-accelerated filers: SOX 404 is coming (and it doesn't have to hurt)

By Trent Gazzaway, national managing partner
of Public Policy and Corporate Governance

After numerous delays, non-accelerated filers have rightly believed for some time that compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) was merely a distant possibility. However, upon the SEC's announcement of the final extension of SOX 404(b) for non-accelerated filers, the questions of "if" and "when" have largely been answered. The Commission moved the deadline six months from fiscal years ending on or after Dec. 15, 2009, to fiscal years ending on or after June 15, 2010. Chairman Mary L. Schapiro advised, "Since there will be no further Commission extensions, it is important for all public companies and their auditors to act with deliberate speed to move toward full Section 404 compliance." The only remaining hurdle is a bill proposed by U.S. Congressman Scott Garrett, R-N.J., that would exempt non-accelerated filers from 404(b). The fate of that bill should be determined relatively soon.

Assuming the Garrett bill does not pass both houses of Congress — and it has an uphill climb — the deadline for non-accelerated filers will soon change from a distant possibility to a present reality. What's more, companies that take the *right approach* in complying with 404 will find that it does not have to be painful. In fact, it can be very beneficial.

With the aim of protecting investors, SOX 404 requires that all public companies publicly assert what should be a matter of course — namely, whether they have effective internal control over financial reporting. Independent auditors are charged with validating management's assertion. In the years since SOX 404's introduction, strides have been made in defining "effective" internal control, but one thing is certain: It should not be something drastically different or more expensive than what well-run companies were doing before SOX was passed. In fact, an SEC study on the costs compliance stated,

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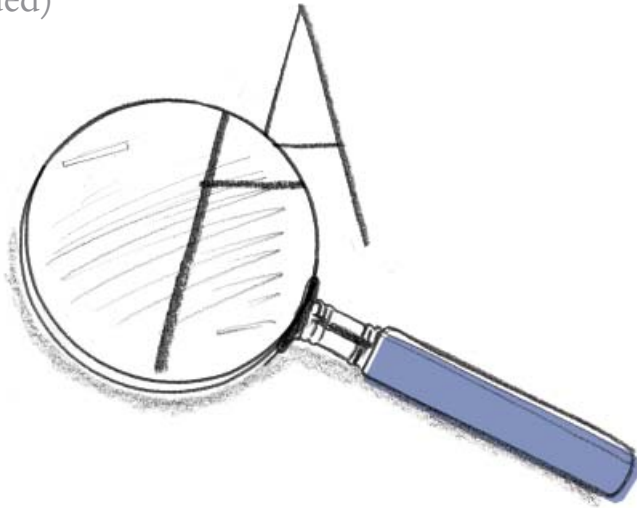
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"There is an economically and statistically significant reduction in Section 404 compliance costs following the 2007 reforms."

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This spring, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), a globally recognized organization that provides guidance on organizational governance, released its *Guidance on Monitoring Internal Control Systems*. Developed by COSO and led by a diverse Grant Thornton LLP team, this comprehensive report provides practical guidance on how to bolster an often overlooked aspect of internal control: monitoring. The original COSO Framework says monitoring “ensures that internal control continues to operate effectively.” In other words, good monitoring — which should be in place already for every organization, public or private, for-profit or not-for-profit — provides the majority of support necessary for management to conclude on internal control’s effectiveness. The key is (1) understanding what good monitoring looks like and taking credit for it, and (2) correcting ineffective monitoring where it may exist. Note that these aren’t compliance exercises, this is just good business.

Make the most of monitoring

The heart of effective monitoring lies in first prioritizing the risks that are meaningful to the organization’s objectives — and then identifying the key controls that, when monitored, will provide adequate support for a conclusion about the effectiveness of the whole system. This risk-based approach helps focus monitoring efforts where they are most needed.

The COSO guidance outlines a three-pronged approach:

Establish a foundation

Is monitoring currently a priority in your organization? Set a tone from the top that conveys the importance of monitoring. Consider the roles of management and the board with respect to monitoring and the use of evaluators. Identify who oversees which control areas and any potential impairment to objectivity. Then make sure that risk owners in your organization have a baseline understanding of the internal control system’s effectiveness. Doing a thorough once-over of the internal control system provides a springboard to launch more efficient monitoring.

Design and execute

The crux of monitoring is designing and executing procedures to evaluate important controls over meaningful risks. Design and execution comprise the following steps.

- **Prioritize risks:** Understand and prioritize risks that can prevent the organization from meeting its objectives.
- **Identify controls:** Identify key controls across the internal control system that address those prioritized risks. All controls are important, but not all controls need to be specifically monitored in order to conclude that the internal control system is working. The COSO guidance can help you identify those key controls — and thus reduce unnecessary testing.
- **Identify information:** Identify information that will persuasively indicate whether the internal control system is operating effectively. Budget-to-actual cost comparisons might provide helpful information, but they rarely provide all the necessary information over a long period of time to support a conclusion that controls are effective. The COSO guidance is designed to help you identify supporting information that will be appropriately persuasive in supporting your conclusions.

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- Implement monitoring: Develop and implement cost-effective procedures to evaluate that persuasive information. Building ongoing monitoring into everyday operations is usually the most effective and efficient way to monitor, but sometimes a good periodic tire-kicking by an internal audit function or another department is helpful too. Work to develop a good balance between ongoing and periodic monitoring.

Assess and report

The final step is assessing and reporting the results. Prioritize deficiencies by the likelihood a deficiency will result in an error, as well as the effectiveness of other compensating controls. Control deficiencies should be reported to the responsible party as well as to management. As far as documentation is concerned, keep in mind that external reports need to be able to withstand the scrutiny of outsiders who may not have as much knowledge of the organization's control systems, but don't create documentation just for documentation's sake. This is where a healthy dialogue with your external auditor can be helpful.

If your monitoring program is not quite up to par, it may take some time and effort to get it where it needs to be, but there will be true economic rewards. After fulfilling the rigorous requirements of SOX (even using the relatively inefficient methods often employed before the COSO guidance was developed), many companies have been able to improve the quality and efficiency of not only their financial reporting, but also their general business operations. In fact, companies that go beyond the minimum required for compliance and truly delve into their processes can identify hidden resources and areas to cut costs.

| Internal control/business process improvement | Benefits |
|---|---|
| Financial reporting | <ul style="list-style-type: none"> • Improved quality of financial information • Fewer financial restatements and resultant decrease in litigation risk • Better information for decision-making |
| Budgeting and planning | <ul style="list-style-type: none"> • Enhanced ability to respond to market changes • Reduced budget complexity • Elimination of unnecessary and manual activities |
| Order to cash | <ul style="list-style-type: none"> • Increased cash flow • Decreased cost and cycle time of billing and collecting • Greater accuracy in orders and bills |
| Inventory management | <ul style="list-style-type: none"> • Reduced inventory costs • Increased cash flow |

Learn more about how to maximize SOX activities in Grant Thornton's *Knock your SOX off* — *Getting business benefits from 404 compliance*.

For instance, one financial services firm seized upon compliance as an opportunity to centralize its purchasing and consolidate its data centers, saving \$5 million per year.

More effective internal control can greatly contribute to reduced costs by reallocating resources from compliance risk to other priorities like operational or IT risk. Minimizing or eliminating insignificant risks and reducing external audit efforts through decreased scope and increased reliance on management's testing can also curb costs.

As the SEC recently announced, compliance with SOX 404 will be required for non-accelerated filers in the near future, and the time and cost of preparing are considerable, but ultimately valuable. An organization's efforts to prepare for compliance often uncover costly inefficiencies and potentially damaging risks. Companies that wait for another delay could also be delaying opportunities to make enhancements that could improve their bottom lines. •

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Fighting increased fraud risk during a downturn

By William Olsen, principal and Investigations practice leader, and Kelly Gentenaar, Forensic Accounting and Investigative Services senior manager

Pessimism isn't the only thing on the rise in a down economy. History has proven that as the economy contracts, fraud rises. The current recession has been no different. The number of identity theft victims in the United States jumped 22 percent last year,¹ and according to the FBI, 965 mortgage fraud cases had been opened in FY09 as of April 30, 2009, compared with only 136 in all of FY04.² With the combined pressures of fighting fraud with fewer resources and new compliance initiatives, organizations can find themselves struggling to keep up. Organizations need a proactive approach when combating fraud, not only from the perspective of asset protection, but also to ensure regulatory compliance. Is your company in fighting shape?

Why fraud grows in a recession

As organizations are distracted by searching for ways to cut costs, they can become more vulnerable to fraud. Middle management, which can serve as a control operator against fraud, is often a target for layoffs. As salaries and bonuses decrease and even jobs become scarce, financial pressure can motivate people to supplement income through illegal means. On the flip side, individuals can view the current financial crisis, sparked by a mortgage meltdown that resulted from the actions of others, and feel that any means to supplement their income can be rationalized. The fraud triangle, first presented by Donald Cressey, identifies the three elements that exist in all frauds: opportunity, pressure and rationalization. All of these elements are exacerbated in an economic downturn.

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Risk factors

The warning signs of fraud can often mimic the effects of poor performance in a down economy, making its detection all the more difficult. Fraud indicators can include:

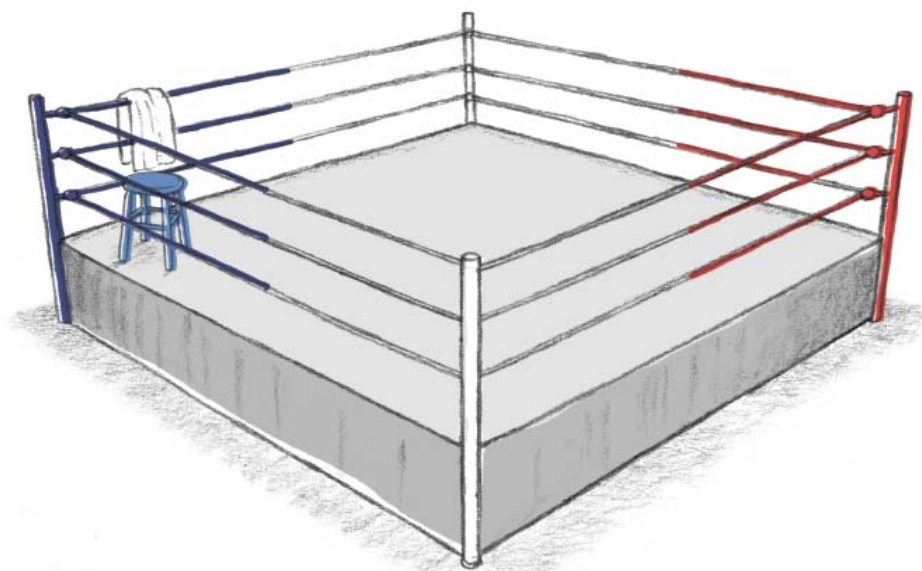
- decrease in working capital or cash flows,
- decrease in liquidity,
- significant drop in sales or profits,
- deterioration in quality of earnings, and
- poor or deteriorating market share.

Compliance pressures

Organizations must also tend to compliance needs that are a direct result of government attempts to "fix" the activities that created the current economic environment. For instance, companies that extend any sort of credit to customers must have plans in place to identify, detect and respond to attempts to use stolen identity information under the Red Flags Rule. After Nov. 1, 2009, any occurrence of identity theft exposes your organization to a Federal Trade Commission investigation. The rule lists 26 possible red flags, but the burden of determining how someone could steal from you is ultimately yours.

Your organization's compliance strategy should begin with an assessment of two critical factors: the number of covered account types and the number of ways those accounts are created and accessed. Learn more about how you can develop a plan in Grant Thornton's *The Red Flags Rule: What you need to know*.

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¹ Javelin Strategy & Research, 2009 Identity Fraud Survey Report

² Federal Bureau of Investigation, The Latest Mortgage Fraud Statistics, http://www.fbi.gov/hq/mortgage_fraud.htm

Fighting increased fraud risk during a downturn (continued)

Building a defense

To mitigate the heightened fraud risk in a recession, organizations can take steps right now to prevent fraud from occurring.

Step 1: Assess the environment

- Does your organization have a code of conduct?
- Is there a clear tone at the top that emphasizes ethics, and does management ardently enforce ethics rules?
- How is recurring misconduct prevented?
- Is there an effective whistleblower program?

Step 2: Assess anti-fraud controls

- Interview key employees about integrity risks and test for adherence to existing policies and procedures.
- Perform computer-assisted audit tests to identify any suspicious activity.
- Review existing whistleblower and document retention procedures.
- Perform public-record searches to verify selected employee and vendor information.

Step 3: Make improvements

- Develop a corrective action plan.
- Implement policy, procedural and organizational changes and communicate these changes.
- Review summary findings with the audit committee and senior management.
- Develop procedures for an ongoing monitoring process.

Benefits of improved fraud prevention

During a recession, it can be difficult to justify spending additional money and resources on new processes. Yet according to the Association of Certified Fraud Examiners' *2008 Report to the Nation on Occupational Fraud and Abuse*,³ those surveyed estimated that U.S. businesses lose seven percent of annual revenues to fraud; this percentage translates to \$994 billion in losses when applied to the U.S. gross domestic product. In an environment where every dollar counts, organizations cannot afford to be lax.

Investing in stronger fraud prevention presents benefits that often outweigh their costs. Beyond averting monetary theft, a comprehensive fraud prevention program can help organizations steer clear of government investigations and other litigation. In addition, the reputational damage that accompanies fraud allegations is difficult to overcome. With the growing emphasis on transparency in both business and government, organizations will be pushed to clearly demonstrate a commitment to integrity. In an economic downturn, consumer — and stakeholder — confidence is priceless.



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