

Addressing the concerns of the  
**Corporate Governance Community**

Grant Thornton 

**Sustaining SOX Compliance:**  
Moving from chaos  
to consistency

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Dear Corporate Governor:

Welcome to the inaugural issue of Grant Thornton's *Corporate Governor Series*. The first decade of the 21st Century has so far proved to be one of the most turbulent times since the late 1920s and 30s for corporate governors — the directors, officers, and executives responsible for ensuring that our public companies are run well and in accordance with applicable laws and regulations.

The notion of good corporate governance transcends the directives that have garnered so many headlines in recent years. Sarbanes-Oxley, Auditing Standard No. 2, the Public Company Accounting Oversight Board, etc., may have upped the ante, but the essential elements of fiduciary responsibility have not changed, nor will they. What's more, these hold true beyond the public company arena. Accordingly, the concepts presented in this series will often be relevant to private and not-for-profit organizations.

The purpose of the *Corporate Governor Series* is to keep the regulatory requirements in view, and more importantly to focus on the fundamentals behind the requirements. We plan to address such issues as financial reporting control evaluations; preventing, detecting and addressing fraud; and effective financial statement review procedures to name just a few. Our goal will be to publish at least one issue per quarter containing timely and relevant information.

The series is designed to be useful on two levels. First, we intend to thoroughly but efficiently cover the stated topics. By "thoroughly" we mean that we want to give you all the critical information you need. By "efficient" we mean that we are striving more for brevity and quality than volume. We want each issue to be educational and to provide potential best practices without burdening you with less-valuable information.

On a second level, the series is designed to be used by corporate governors as a quick-reference guide. Throughout each issue you will find a set of *Potential Governance Considerations*. These are open-ended questions that an executive or director might pose in relation to the organizations they govern. Reading the questions provides a quick summary of the content of the section. Asking and obtaining answers to the questions can help you check the pulse of your organization's governance processes.

In the end, our goal is to equip you with the tools you need to meet the responsibilities of being a good corporate governor. We hope you enjoy the series.



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## 2 Introduction

Few would argue that the first half of this decade has been one of the most volatile for financial reporting in recent memory. In the wake of the misdeeds and mistakes of a few we have been left with the realization that good financial reporting, and indeed good corporate governance, requires more than a belief that “we have good people, and we have never had a problem in the past.” There are certain fundamental principles that are the foundation for an effective process for gathering, summarizing and presenting an organization’s financial results. Sarbanes-Oxley (SOX) Section 404 and the resulting regulations have been an attempt to inject those principles into every public company’s financial reporting process.

Much has been written about the cost and effort of complying with Section 404 in the first year. Given that compliance is an ongoing requirement, all public companies are concerned with how they can create financial control systems and evaluation processes that are both efficient and effective. This guide outlines recommendations for companies seeking to make their financial control systems and evaluations sustainable, and it should offer value on two levels. First, it provides a useful set of approaches and best practices for executives and managers who must implement sustainable financial control systems. Second, for each of the areas discussed, it outlines considerations for audit committee members and others charged with corporate governance as they work to fulfill their expanded responsibilities.

Prior to Sarbanes-Oxley, a prevalent misconception was that “getting the financial statements right” was the responsibility of the independent auditor. In other words, the audit would “catch” anything amiss with the financial statements. *Unfortunately, even the best audit process cannot compensate for a poor financial reporting process.* The auditor is not in a position to cost-effectively audit every transaction or to know everything the organization’s personnel know about every transaction.<sup>1</sup> Therefore, it falls to the policies, procedures, people and technology that management puts in place to create an environment in which there is reasonable assurance that the financial statements are right in the first place. The independent auditor’s job is to perform testing to determine that those policies, procedures and people are effective, and to confirm that they produced materially correct financial statements.

Sarbanes-Oxley makes it clear that management is ultimately responsible for ensuring that **internal controls over financial reporting** (commonly referred to as **ICFR**) are operating effectively. Management can choose to view this responsibility as a necessary evil or as an opportunity to improve financial reporting and mitigate risk.

How management communicates its expectations to employees, in financial reporting and in other areas of business practice, is often referred to as the “tone at the top.” In other words, it is an attitude that cascades down to the rest of the organization. This point is of paramount importance. If employees perceive that management has the right attitude regarding risk and control, they are more likely to exhibit that same attitude because they know they will be held accountable.<sup>2</sup> On the other hand, if management does not have the right attitude, or employees do not believe management means what it says, there is a much higher likelihood, even a certainty over time, that some employees will forsake what they know is right to achieve what they perceive is expedient.

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<sup>1</sup> The lone possible exception is when auditors are engaged to conduct what is called a “forensic audit” in which they undertake a very costly effort to obtain and audit evidence for every or nearly every transaction.

<sup>2</sup> This, of course, presumes that management follows what it says with appropriate actions. Words describing management’s expectations are not enough. They must be followed by appropriate and consistent rewards when those expectations are met and by penalties when they are not.

## 4 Culture and mindset

### Possible governance considerations

- ✓ Does management have the right attitude regarding the evaluation of internal controls, or does it view it simply as a regulatory burden?
- ✓ Does the organization look at evaluation of internal controls as a continuous process, rather than a one-off project?
- ✓ Does the “tone at the top” convey that 404 compliance should be at minimal acceptable levels, or that evaluation and testing are an opportunity to improve financial reporting?
- ✓ Are management’s actions (both rewarding and disciplinary actions) consistent with the messages and policies communicated to personnel?

To effectively achieve 404 sustainability, companies need to have a structured program for the assessment of ICFR. Such programs should incorporate:

1. a robust planning process,
2. action items or “responses” to the plan, and
3. a routine assessment or review of the program.

There is a “business as usual” component to this effort that should be embedded into day-to-day business processes. At the same time, there needs to be a mechanism for recognizing when changes to the business have implications for ICFR. This will enable the organization to adapt its process accordingly. Figure 1<sup>3</sup> shows the Plan, Respond, Assess cycle for examining ICFR.

**Figure 1: The plan, respond, assess cycle for 404 compliance**



<sup>3</sup> This graphic was adapted from a graphic created by the Open Compliance and Ethics Group ([www.oceg.org](http://www.oceg.org)), which represents the components of the OCEG Framework, and has been used with their permission.

## 6 Structuring for sustainability - PLAN

### PLAN: Risk identification, resource allocation and scheduling

#### Identifying risks and controls

Due to the speed with which the 404 rules and audit requirements were enacted, many companies and auditors were not in a position to plan their initial work based on an effective risk assessment. This was especially true for companies that started their evaluation process within the last two to three quarters of the year. Instead, in an effort to ensure that enough financial reporting risks were addressed, many companies and auditors planned their ICFR evaluation to achieve a certain “coverage percentage.” In other words, rather than weigh the financial reporting risks inherent in particular business processes, some processes were selected for review because they comprised between 60 and 90 percent of the balance sheet or income statement. This approach was more or less guaranteed to cover the majority of financial reporting risks due to the sheer volume of testing involved. But it was inefficient because included in the scope were some risks that were probably not significant enough or likely enough to materially impact the financial

statements. These organizations can now benefit from a more strategic approach to risk assessment.

Whether a company is a first-time filer or is stepping back to assess how it can improve its process, the most efficient way to perform an effective evaluation of ICFR is to **first identify where the significant financial reporting risks reside**. Significant risks are those risks that have a more than remote likelihood of causing an error of meaningful magnitude in the financial statements if they are not properly controlled.

Generally, risk factors are evaluated at two levels: first, at the level of business units and/or locations (we will call this the “**entity-level assessment**”), and second, at the level of the organization where transactions such as buying, selling, manufacturing, reporting, etc., actually occur (we will call this the “**activity-level assessment**”).<sup>4</sup>

For the purposes of 404 compliance, all risk assessment is viewed through the lens of **critical financial statement components**<sup>5</sup> that might be at risk of misstatement and the **significant processes** that impact those components.

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<sup>4</sup> Paragraphs 60-75 of Auditing Standard No. 2 (AS2) contain useful criteria for identifying risk at various levels. Auditing Standard No. 2, An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, is the Public Company Accounting Oversight Board’s (PCAOB’s) standard that dictates how auditors are to audit internal controls over financial reporting for a public company. The standard can be found at: [www.pcaobus.org/Rules\\_of\\_the\\_Board/Documents/Rules\\_of\\_the\\_Board/Auditing\\_Standard\\_2.pdf](http://www.pcaobus.org/Rules_of_the_Board/Documents/Rules_of_the_Board/Auditing_Standard_2.pdf).

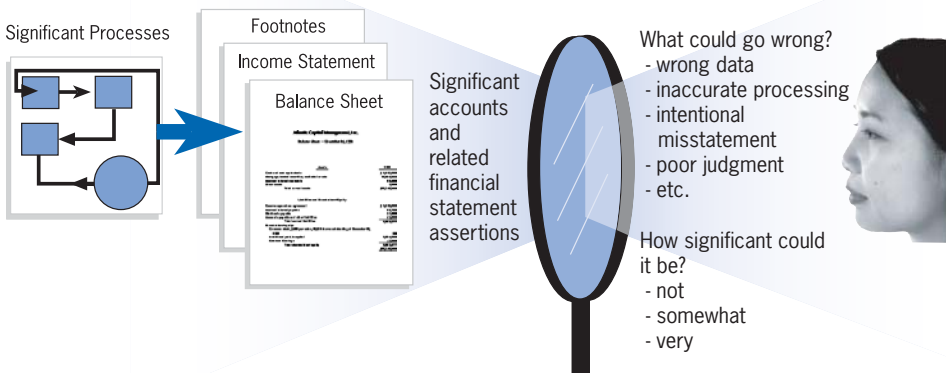
<sup>5</sup> Critical financial statement components include significant accounts and related critical financial statement assertions (e.g., the existence of inventory, the completeness of accounts payable, etc.).

In other words, what could go wrong and where could it go wrong? Figure 2 illustrates this view of how risks are identified.

Once financial reporting risks have been identified, management must link them to the key controls that mitigate

them. Some risks may be effectively reduced through centralized procedures at the top of the organization. This can serve to minimize control evaluation effort necessary at the activity level.

**Figure 2: Identifying financial reporting risks**



### Examples of good entity-level (also known as company-level) controls include<sup>6</sup>:

- Those within the control environment itself, such as tone at the top, assignment of authority, consistent policies and procedures, codes of conduct and fraud prevention programs
- Management's risk assessment process
- Centralized processing, including shared service environments
- Controls to monitor results of operations
- Controls that monitor such activities as the internal audit function, the audit committee and self-assessment programs
- The period-end financial reporting process
- Board-approved policies that address significant business control and risk management practices

<sup>6</sup> Examples are adapted from Paragraphs 52-53 of AS2.

## 8 Structuring for sustainability - PLAN

After the organization has conducted a thorough risk assessment, periodic updates should be relatively easy to perform. The update process will incorporate answers to such questions as:

- Where have there been significant changes in people, processes or technology?
- Where did we have problems last year?
- Where did our testing last year indicate that the risk may be lower than originally expected?

In essence, the planning process should always involve adjusting to new information or changes in the business. We will address this concept in more detail later when we discuss adapting to change.

### Resource allocation and training

For companies filing for the first time under 404, most of the burden falls on the shoulders of the internal audit group and outside consultants. However, this should not be a permanent state of affairs. In a mature 404 evaluation process, it probably makes sense for internal auditors (either in-sourced or out-sourced) to perform evaluation in the areas where the risks are more significant (either due to materiality, complexity or risk of fraud). At the same time, there

are significant efficiencies to be gained by assigning evaluation responsibilities to personnel who are responsible for day-to-day operations.

To be sure, there is some risk involved in allowing operating personnel to perform the control evaluation procedures. For one thing, operating personnel do not usually have a full grasp of the relationship between the controls they might be evaluating and the GAAP-based financial statements those controls impact. Secondly, few operating people are experienced at testing internal controls, including developing a test routine, appropriately selecting items to test or interpreting the results. In addition, it may be difficult to find personnel within operations who both understand the control being tested and are independent of those same controls.

Despite these challenges, there are many opportunities for operating personnel to contribute to the control evaluation and testing process, given the appropriate training and oversight. In fact, even professionals involved in the controls evaluation process (including accounting professionals whose primary focus has been cost accounting, technical financial accounting, operational improvement or taxes) may need to obtain some supplemental training on internal controls. Specific training on the COSO Framework<sup>7</sup> can be very useful in this regard.

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<sup>7</sup> In 1992 the Committee of Sponsoring Organizations (COSO) issued the Internal Control Integrated Framework (the COSO Framework), which is now the preeminent benchmark for evaluating the effectiveness of a system of internal controls.

Other topics that might be covered in training include:

- the risk assessment process
- how to identify changes in the internal control structure
- selection of controls to test
- how to perform testing
- what to do when an error is discovered

## Scheduling tasks

The basic 404 compliance process follows a timeline that incorporates milestones and spells out what needs to be done at the end of each quarter (or month). If tasks are performed quarterly, they can serve as the primary source from which management aggregates information related to material changes in internal controls for disclosure as required by Section 302 of Sarbanes-Oxley (see next section). Table 1 on the next page might serve as a starting point for planning the ICFR evaluation process.

## Possible governance considerations

- ✓ Has the organization identified or attempted to identify areas where efficiencies could be created either in the evaluation process or in the system of internal controls?
- ✓ Has the organization put together a timetable for ongoing compliance or a timeline for first-time compliance?
- ✓ Who are the key resources for the internal control evaluation program?
- ✓ Are these resources sufficient both in quantity and quality?
- ✓ Do these resources have adequate training and guidance to complete required tasks?

# 10 Structuring for sustainability - PLAN

**Table 1: ICFR timetable**

Qtr.	Procedures	J	F	M	A	M	J	J	A	S	O	N	D	J	F	
<b>1</b>	<p>Prepare ICFR evaluation plan, including risk assessment, scope, staffing and timing.</p> <p>Prepare, update and/or execute remediation plans based on prior findings.</p> <p>Search for, identify, document and disclose any significant changes in internal controls</p>															
<b>2</b>	<p>Update documentation and evaluate effectiveness of control design in the current control environment.</p> <p>Begin testing of internal controls.</p> <p>Identify and begin any necessary remediation.</p> <p>Search for, identify, document and disclose any significant changes in internal controls.</p>															
<b>3</b>	<p>Complete majority of internal control testing.</p> <p>Test controls remediated in the 1st and/or 2nd quarters.</p> <p>Search for, identify, document and disclose any significant changes in internal controls.</p>															
<b>4</b>	<p>Update control testing for items tested in the 2nd qtr or early in the 3rd qtr (especially in high-risk areas).</p> <p>Complete year-end control testing.</p> <p>Search for, identify, document and disclose any significant changes in internal controls.</p> <p>Conduct a thorough review of the documentation to ensure completeness and accuracy.</p>															

Legend:

Sales & A/R	Treasury
Procurement & A/P	Capital Assets
Finance & Accounting	Payroll & HR

## RESPOND: Update, test, remediate

### Updating documentation and reporting changes in internal controls

Section 302 of Sarbanes-Oxley requires public companies to disclose *“any changes in the company’s internal control over financial reporting that occurred during the most recent fiscal quarter . . . that have materially affected, or are reasonably likely to materially affect, the company’s internal control over financial reporting.”* Accordingly, the organization must have a process in place to identify such changes and report them to senior management for quarterly disclosure consideration.

In small organizations, this may be done effectively through a simple quarterly verbal or written confirmation process. In larger organizations, it may be more effective to initiate a formal update where key process, risk and control owners are asked to confirm in writing when they have reported any significant changes in their area of responsibility. There is no reason why this process should be time consuming unless significant changes have occurred. However, it is important that it be done effectively and that responses be independently tracked.

### Testing key controls

Testing the internal controls helps support management’s conclusion that everything is working the way it is supposed to. Testing can take many forms, from simply observing a control in operation to selecting a statistical sample and testing the control in detail. The testing methodology will depend largely on the **significance of the risk involved** and the **susceptibility of the control to failure**.

Management should have a plan to review testing methodologies periodically, taking into consideration the impact of recent changes and past testing results. As the organization gains experience in performing these tests and modifying the test plans, a reasonable level of efficiency can be expected in just a few testing cycles.

One way the organization can enhance efficiency is by incorporating **self-evaluation** procedures into the normal operating environment. For the purposes of control testing, the term “self-evaluation” refers to having someone with appropriate skills and experience checking or testing the work of: a) others within their group; or b) others with similar job responsibilities.<sup>8</sup>

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<sup>8</sup> When someone tests their own work, they are in fact performing a control (i.e., double-checking their work). While this form of self evaluation is always advisable, it is not sufficient support for management’s ICFR assertions because the personnel performing the tests naturally lack the necessary objectivity.

## 12 Structuring for sustainability - RESPOND

When determining who will test internal controls for a specific purpose, there are two important conditions:

1. The person performing the testing should be independent of the operation of the control(s) being tested;
2. The person performing the test should be adequately trained and qualified to perform the testing.

If either of these conditions is in question, it may impact management's ability to rely on the tests. It will also impact the ability of the independent auditor to use the tester's work as support for their audit conclusions without having to perform independent tests. Auditing standards will not allow the auditors to use self-evaluations to support their audit conclusions if the evaluations were performed by someone testing his or her own work.

### Classifying and remediating weaknesses

Throughout the documentation and testing phases some control weaknesses will likely be identified. These weaknesses must be categorized as being one of the following, from least to most significant:

- deficiencies
- significant deficiencies
- material weaknesses

Table 2 shows a definition of each of these categories. A framework published in December of 2004 titled, "*A Framework for Evaluating Control Exceptions and Deficiencies*,"<sup>9</sup> has quickly become the established methodology for evaluating the significance of control weaknesses.

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<sup>9</sup> In December of 2004, a coalition of nine accounting firms and one accounting professor published this framework to assist in the deficiency evaluation process. You can obtain a copy on Grant Thornton's website at <http://www.grantthornton.com/framework>. Grant Thornton has also developed a spreadsheet model based on this framework to assist in documenting control deficiency evaluations. Please contact your local Grant Thornton partner to obtain a copy.

**Table 2: Control deficiency categories**

<b>Control deficiency</b>	A deficiency in the design or operation of a control that does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.
<b>Significant deficiency</b>	A control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process or report external financial data reliably in accordance with GAAP such that there is a more than remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.
<b>Material weakness</b>	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.

Material weaknesses must be disclosed when identified. In addition, their presence prevents management or the auditor from concluding that internal controls over financial reporting are effective. Accordingly, they garner the highest priority in remediation. Public companies are not required to publicly disclose deficiencies or significant deficiencies, but they should take steps to correct them. If uncorrected, such

deficiencies (especially significant deficiencies) can become material to the financial statements. For any deficiencies, significant deficiencies or material weaknesses noted in the prior period, the organization should take steps to correct them using a timetable with specific deadlines. Uncorrected control weaknesses could become more severe over time.

## 14 Structuring for sustainability - RESPOND

### Possible governance considerations

- ✓ Does the plan call for updating the financial reporting risk assessment and identifying/testing appropriate company-level controls?
- ✓ Is the testing methodology well established and does it properly consider the level of risk in the related processes and controls?
- ✓ Has the organization effectively incorporated testing into daily operations (e.g., through self-evaluations) in cases where it would not hinder operations?
- ✓ Does the organization have a process in place to identify and disclose significant changes in internal controls?
- ✓ Does management have a way of tracking and addressing identified control weaknesses?
- ✓ Is there a due date set for remediation of internal control deficiencies identified in the prior period?
- ✓ Is the audit committee updated when the remediation of key issues is completed?

## **ASSESS: Determine effectiveness of the evaluation process and report results**

In the **Respond** section, we addressed the effective design and operation of the key internal controls over financial reporting and considered the remedial actions that might be necessary. In this section, we will address issues management should consider when it reviews its evaluation methodology and how it should report its conclusions to the appropriate parties.

Assessment can actually begin before the evaluation process is complete. In fact, milestone assessment procedures and reporting are critical to keeping the process efficient and effective.

### **Assessing the effectiveness of the evaluation process**

There are two internal audiences that have primary input into this assessment. First is the evaluation team, including the internal auditors, any external consultants and other trained evaluation team personnel. The evaluation team generally has the best understanding of ICFR and the evaluation process. Second are the operating personnel who have the best understanding of the actual environment in which the controls operate. Both groups' opinions are important to the overall assessment. Table 3 on the next page can be used to help identify areas where the efficiency and effectiveness of the evaluation process could be improved.

# 16 Structuring for sustainability - ASSESS

**Table 3: Evaluation process assessment worksheet**

Process: (e.g., procurement)

	Evaluation team response	Operating personnel response	Corrective action needed
Are there significant financial reporting risks that are not addressed by the controls being evaluated?			
Are the risks associated with the controls being evaluated insignificant or are they covered through other control tests?			
Do the personnel performing the tests possess the appropriate skills?			
Are the personnel performing the tests independent of the control operation?			
Are the control deficiency categorizations (i.e., deficiency, significant deficiency or material weakness) reasonable and consistent with the established framework?			
Are the remedial actions identified appropriate and reasonable?			

### Reporting to the audit committee

The audit committee and management have two primary but interrelated responsibilities with respect to the assessment process. One, they must see to it that the organization conducts an appropriate evaluation of ICFR. Two, they need to understand the results of that evaluation (i.e., the control conclusions reached, the remedial actions taken and any public disclosures made) and reasonably believe that those results are complete and accurate.

Among the tools available to assist them are:

1. Reports from the evaluation team (including workplans, budgets, assessment results, remediation efforts and questionnaires such as the one on the previous page)
2. Questions and checklists from the American Institute of Certified Public Accountants' Audit Committee Toolkit<sup>10</sup>
3. Feedback from the internal and external auditors

### Possible governance considerations

- ✓ Has the organization gathered feedback from both the evaluation team and the operating personnel regarding the effectiveness of the evaluation in key areas?
- ✓ Do management and the audit committee participate in at least quarterly updates of the ICFR evaluation process?
- ✓ Does the audit committee spend one-on-one time with the internal and external auditors discussing the ICFR evaluation process?

<sup>10</sup> This *Toolkit* and other useful audit committee material can be found on the AICPA's website at <http://www.aicpa.org/audcommctr/homepage.htm>. Note that management and auditors can gain great insights from this material as well.

## 18 Structuring for sustainability - ADAPT

### ADAPT: Respond to changes in the business environment

Even the most well-documented, smooth-running financial control system will require tweaking and sometimes major adjustment. This is particularly true when changes occur to the business and the environment in which it operates. Examples include:

- mergers and acquisitions
- new information technology environments
- unusual or infrequent transactions
- new accounting rules

The financial reporting implications for these areas do not consistently apply in every year, and thus may be subject to a higher degree of risk. In addition, the accounting and financial reporting requirements in some of these areas are complex and call for specialized skills and processes.

#### Mergers and acquisitions

Many companies are “serial acquirers.” If so, they generally have a process for both due diligence and integrating new companies. In today’s regulatory environment, due diligence processes generally should incorporate an analysis of the internal control structure of the acquired company. At the very least,

addressing control issues early in the integration process is highly recommended. Note that, when it is reasonable to do so, the Securities and Exchange Commission (SEC) expects companies to include an acquired entity within the scope of its ICFR evaluation in the year of acquisition. If inclusion is not reasonable because the acquisition occurred late in the year, the SEC allows companies to exclude the acquired entity from the scope of the evaluation until the following year (as long as certain disclosures are provided).

Issues to consider regarding the controls of an acquired company include:

- relative size of the target entity in relation to the acquiring entity
- control weaknesses or recommendations identified by the target company’s internal or external auditors
- specific controls that differ from those in place at the acquiring company
- pros and cons of placing the acquired company on the same system of controls as the parent company vs. leaving its current control structure intact

## Possible governance considerations

- ✓ Has someone been designated to examine the internal control structure of the proposed acquisition during due diligence?
- ✓ What are the organization's plans for integrating the acquired company from the control perspective?
- ✓ What is the timetable for ensuring 404 compliance of the acquired company?

## New information technology environments

When a company is selecting a new computer system or ERP platform, or is making a significant change to an existing system, the impact on financial reporting is a key factor to consider in establishing the procedures to implement the change. The transition should allow adequate time to test controls post-implementation and ensure compliance with the testing requirements of the independent auditors. If the transition occurs at or near a period end, or if the change is very significant, it may be

necessary to implement temporary supplemental controls that test the system outputs to ensure that the information used in the financial reporting process is accurate.

Organizations should also make certain their external auditors are aware of the pending system changes to avoid unnecessary testing on outgoing systems and to allow them time to test the new system and related conversion. It is a good idea to set up a timetable identifying key milestones and to have meetings with the auditors at those points.

## Possible governance considerations

- ✓ Has the organization developed a transition timetable for the new technology that will allow enough time for testing (and remediation, if needed) and ensure operating effectiveness of controls by the end of the fiscal year?
- ✓ Has the organization implemented appropriate controls, such as temporary supplemental controls, to address the risk of system changes near period end?
- ✓ Has the organization ensured that the auditors are made aware of the implementation timetable prior to the conversion?

## 20 Structuring for sustainability - ADAPT

### Unusual or infrequent transactions

Not all transactions will come under the aegis of “business as usual.” Nevertheless, guidelines and procedures need to be in place documenting how to handle the control issues for such one-time situations. The following three primary control elements must be in place to effectively control these types of transactions.

1. The transactions must be identified (this is typically done through an effective communication structure within the organization).
2. Someone with appropriate technical skills (accounting, tax, legal, etc.) must be identified, trained or engaged to make sure the transaction is handled appropriately.
3. Someone qualified and independent must review the end result.

For example, assume an organization that has never entered into a derivative<sup>11</sup> transaction plans to do so. Many treasurers know the economics and cash flows associated with derivatives, but they may not understand the related accounting requirements. There are certain documentation requirements associated with derivatives that could negatively impact the accounting if they are not addressed appropriately. It is therefore imperative that the personnel responsible for financial reporting and the personnel responsible for evaluating ICFR know that a derivative transaction is in process. It is also important that someone with the appropriate derivative accounting knowledge be identified, trained or engaged to help ensure that all of the requirements are met. Finally, because these items are often significant and complex, someone independent of the actual accounting for, and reporting of, the transaction should review the accounting and reporting to ensure that they were executed properly.

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<sup>11</sup> Derivatives are financial instruments (often complex) that are settled based on an underlying reference rate or price. They are frequently used to accomplish such goals as swapping variable rate debt for fixed, locking in commodity prices, etc.

## Possible governance considerations

- ✓ Does the organization have a process to identify unusual or infrequent transactions (e.g., how would financial reporting management and the ICFR evaluation team know that a non-routine transaction was entered into)?
- ✓ Does the organization have qualified people in place to address such issues when they arise or has it identified qualified external professionals who can assist?
- ✓ Are there required review mechanisms in place?
- ✓ Does management inform the audit committee of such issues in a timely fashion?

## New accounting rules

It is important for companies to regularly monitor the accounting literature and evaluate the impact of new pronouncements, not only on the

financial statements, but also on the internal control structure. It would be beneficial to have ongoing training for key accounting personnel to ensure their technical knowledge remains up to date.

## Possible governance considerations

- ✓ Does the organization have a process to identify new accounting issues?
- ✓ Does the organization have qualified people in place to address such issues when they arise?
- ✓ Does management inform the audit committee of new accounting pronouncements and their impact in a timely manner?

## 22 Costs

Every company can expect the first-time-through costs for effectively documenting and evaluating internal controls to be higher than subsequent years. There are four primary factors that should reduce the total effort in years two and beyond:

1. Organizations will have completed the tedious task of documenting their key controls and evaluating the effectiveness of their design. Future years will primarily involve maintenance, provided processes or the business do not change dramatically.
2. Organizations will have developed their core testing methodologies. Future years will involve tweaking that methodology to address the current risk environment rather than reinventing it every year.
3. Organizations will have addressed the majority, if not all, of their control weaknesses in the previous year, thus making the ongoing process more efficient.
4. Management and the auditors will gain efficiencies through lessons learned and through additional guidance provided by the SEC and the Public Company Accounting Oversight Board (PCAOB).

The challenge for companies will be separating up-front costs from those required for ongoing compliance. Identifying those one-time costs will assist companies in determining a total budget for sustaining the program. The ongoing costs can then be allocated to the various departments and absorbed as part of the cost of their day-to-day operations.

An effective cost analysis should begin with an aggregation of *all* the costs (e.g., internal time, external consultant time, external auditor time and software costs) associated with the previous year's compliance activities. Some questions to consider include:

1. *What portion of the original risk assessment process was attributable to the establishment of the methodology?* To the extent that methodology remains constant, those costs should be minimized going forward.
2. *What portion of the documentation stage was attributable to the fact that little control documentation existed previously?* To the extent that last year's processes and controls do not change, there should be substantial cost reductions here.

3. *How much time was spent last year on evaluating deficiencies?* To the extent those deficiencies have now been addressed, there should be little effort spent here in future years.
4. *Where have we greatly expanded or reduced our business, including acquisitions and divestitures?*  
Expansion in new areas or geographies may generate additional up-front effort, whereas divestitures of previously significant businesses will entirely eliminate some work. Note, however, that significant divestitures may increase the relative importance of other, previously immaterial entities, even if there is no inherent growth in those entities.
5. *Would better use of our control documentation software make this process more cost effective?* Or, if the organization does not use control documentation software, could we achieve cost savings by implementing a software package?

**Possible governance considerations**

- ✓ Have actual costs from the previous year been analyzed to identify changes in expected ongoing costs?
- ✓ Has a realistic budget been established for completion of the evaluation?
- ✓ Is the audit committee periodically updated on budgeted versus actual costs?

## 24 Conclusion

Internal controls over financial reporting are more than just procedures required to be 404 compliant. They help ensure that management is able to generate the primary information the public uses to make investing decisions. Just as a good manufacturer builds in efficient controls and inspections to make certain its end product is reliable, good companies who use public capital seek to efficiently and effectively provide reliable financial information.

Furthermore, identifying and testing internal controls yields benefits beyond delivering the financial information that will create credibility in the financial markets. It can be a goldmine when it comes to uncovering ways to make business processes more efficient and delivering information that assists management in making more prudent business decisions.

Using SOX compliance as a tool to improve operational effectiveness will be a topic for our next paper.

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