Enterprise Risk Assessment

Lord & Benoit, LLC, a SOX 404(a) Consulting Firm focused on small to mid-sized public companies

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Today's Speakers

Bob Benoit is President and Director of SOX Research for Lord & Benoit. Served on the most recent COSO Monitoring Project Task Force. Served on AICPA Peer Review Acceptance Board for ten years. Author of most the Lord & Benoit Reports, which have been referenced by the SEC, PCAOB, Wall Street Journal, all Big 4 firms and over 150 trade journals worldwide. First evaluator to use the 2006 COSO Guidance for Smaller Public Companies. Invented Virtual SOX.

Today's Speakers

Michael Mooradian, CISA is Vice President, Operations & IT Compliance at Lord & Benoit, LLC, and a seasoned professional with over twenty years of senior management experience in information technology. Prior to joining Lord & Benoit, Michael directed IT organizations supporting multi-national locations for Digital Equipment Corporation, Brooks Automation and The Thomson Corporation. He has provided consulting services to clients such as AT&T, the Securities and Exchange Commission (SEC), Dun & Bradstreet, IBES, Business Wire, Ziff-Davis Publishing and Pfizer.

Today's Topics

- Regulatory Update
- Enterprise Risk Assessment:
  - Financial Reporting Risk Assessment
  - Controls Addressing Financial Reporting Risks
  - Entity-Level Risk Assessment
  - Role of Information Technology
  - Evidential Matter for Risk Assessment
  - Evaluation of Risk Assessment results

Regulatory Update

Regulatory Update

SEC Pushes Companies for More Risk Information

The regulator pushes back on companies' risk disclosures and considers changing its related rules

August 2, 2010
CFO.com

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Enterprise Risk Assessment

Enterprise Risk is organized around the following principles.

- Management should evaluate/test whether their controls adequately address the risk that a material misstatement would not be prevented or detected in a timely manner
- Management's evaluation must be based on evidence about the operation of its controls and evidence should be based on its assessment of risk.

Financial Reporting Risk Assessment

- Management should identify those risks that could individually or collectively result in a material misstatement of the financial statements (“financial reporting risks”).

Financial Reporting Risk Assessment

1. Begins with evaluating how the requirements of GAAP apply to the company's business, operations and transactions.
   - Management has the fiduciary responsibility to ensure investors are provided financial statements that are fairly presented in accordance with GAAP (financial statements, disclosures, misstatements and omissions)

Financial Reporting Risk Assessment

- Sample GAAP Application Questions…

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Financial Reporting Risk Assessment

- Sample GAAP Application Questions…
  - Assets
  - Liabilities and Equity
  - Revenues and Expenses
  - General

Financial Reporting Risk Assessment

2. Management should consider "what *could* go wrong" within a financial reporting element, then determine the magnitude and likelihood of a material misstatement of the financial statements.

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Financial Reporting Risk Assessment

3. Management should consider internal and external risk factors that impact the business, including the nature and extent of any changes in those risks, may give rise to a risk of misstatement.

Financial Reporting Risk Assessment

- Sample Enterprise Risk Factors and Questions…

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Financial Reporting Risk Assessment

- Sample Enterprise Risk Factors and Questions…
  - Revenue Recognition & Marketing Risks
  - Political and Social Risks
  - Production Related Risks
  - Expenses
  - Regulatory Risks
  - Economic Risks

Financial Reporting Risk Assessment

- Sample Enterprise Risk Factors and Questions…
  - Environmental Risks
  - Related Party Risks
  - Financing, leases, equity risks
  - Prospective Financial Conditions
  - Strategic Risks
  - Other Risks

Financial Reporting Risk Assessment

4. Management's evaluation of the risk of material misstatement should include the consideration of the entity to fraudulent activity (fraudulent financial reporting, misappropriation of assets and corruption)

Financial Reporting Risk Assessment

- Management should recognize that the risk of material misstatement due to fraud exists in any size organization, location or business unit.

Financial Reporting Risk Assessment

- Sample Fraud Risk Questions…

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Financial Reporting Risk Assessment

- Sample Fraud Risk Questions…
  - Receipts and Disbursement Risks
  - Financial Reporting Fraud Risks
  - IT Fraud Risks
  - Management Incentive Risks
  - Industry Risks
  - Attitudes/Rationalization Risks

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Financial Reporting Risk Assessment

- Fraud Risk Resources…

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Controls Addressing Risk

1. Management should evaluate/test whether its controls adequately address its financial reporting risks, including risks in different locations or business units.

Controls Addressing Risk

Financial Statement Accont/ Disclosure	As % of Total	Impact on F/S	Account Charac-teristics	Business Process Charac-teristics	Fraud Risk	Entity-wide Factors	Overall Rating	Significant Assertions*				
								E	C	V/A	R&O	P&D
BALANCE SHEET												
Assets												
Cash & Cash Equivalents	6%	M	H	M	H	M	H	✓	✓		✓	✓
Accounts Receivable	30%	H	H	H	H	L	H	✓	✓	✓	✓	✓
Prepaid Expenses	4%	L	M	L	L	L	L					✓
Inventory	35%	H	M	M	M	L	M	✓	✓	✓	✓	✓
Property & Equipment	15%	H	L	L	L	L	L	✓		✓	✓	✓
Intangible Assets	10%	H	M	M	M	M	M	✓		✓	✓	✓
Total Assets	**100%**											
Liabilities												
Accounts Payable	25%	H	H	L	M	L	M	✓	✓		✓	✓
Accrued Expenses	15%	H	M	M	H	L	H	✓	✓	✓	✓	✓
Warranty	15%	H	M	M	M	L	M	✓	✓	✓	✓	✓
Long-Term Debt	10%	H	L	L	L	L	M	✓	✓	✓	✓	✓
Total Liabilities	**65%**											
Shareholders' Equity												
Common Stock	5%	M	M	M	L	L	L	✓		✓	✓	✓

Entity Level Controls

- In addition to identifying ICFR risks, management must also evaluate whether it has controls in place to address the entity-level or enterprise risks.
  - Control environment
  - Controls over management override
  - Entity-level risk assessment process
  - Monitoring activities
  - Controls over the period-end financial reporting
  - Procedures that address significant business control
  - Risk management practices

Role of Information Technology

- Mapping of process level controls to the underlying IT infrastructure…
  - Do information systems produce information that is timely, current, accurate, and accessible?

Role of Information Technology

- Sarbanes-Oxley recognizes IT as a significant component in the controls process.
- If the security or integrity of IT systems can be compromised, then the information in them can be compromised.
- Failures in IT have wide reaching impact even beyond the scope of SOX.

Role of Information Technology

- In a “top-down” approach, SOX IT risk assessment should cascade from the enterprise (financial) risk assessment process.
- For SOX, IT risk assessment should be restricted to those IT factors that could impact the accuracy financial reporting.
- Significant accounts and financial processes can be “mapped” to specific IT applications and related processes.

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Role of Information Technology

Business Process and Sub-Process	Overall Rating	Application Name	Database	Operating System	Critical Spreadsheet Name	Supported by a Third Party	Hosted by a Third Party Provider
Cash Management	H	MS Dynamics	MS SQL	Windows 2008	N/A	Yes	Yes
Investment Securities							
Order Processing							
Credit and Collections							
Revenue Recognition							
Purchasing to Payables							
A/P and Cash Disbursements							
Employee Master File Maintenance							
Process Payroll							

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Role of Information Technology

- IT Risk Methodology includes identifying critical IT assets (staff, systems, processes)
- Consider relationships among these assets
- Identify and evaluate risks in operational context
- Establish control objectives and key controls to mitigate risks

Evidential Support for Risk Assess

- Management must maintain reasonable support for its assessment (documentation of testing, design, financial reporting risks, entity-level risks and other pervasive elements necessary for effective ICFR).

Evaluation of Results

- The criteria for determining whether an individual control or a combination of controls adequately addresses a financial reporting risk is judgment about whether a material weakness could be prevented or detected
  - A deficiency in the design of ICFR exists when either (a) the control is missing or (b) not properly designed

Enterprise Risk Assessment

- In Conclusion…

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