

# Sustaining SOX 404 Overtime

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# Agenda

1. Methodology for 404 Sustainability
2. 404 + 1 Scoping
3. 404 + 1 Control Management
4. 404 + 1 Testing Strategy
5. The Internal Audit Function and its Evolving Role in a 404 World
6. Sustaining 404 with Control Self Assessment
7. Leveraging Value from Internal Controls

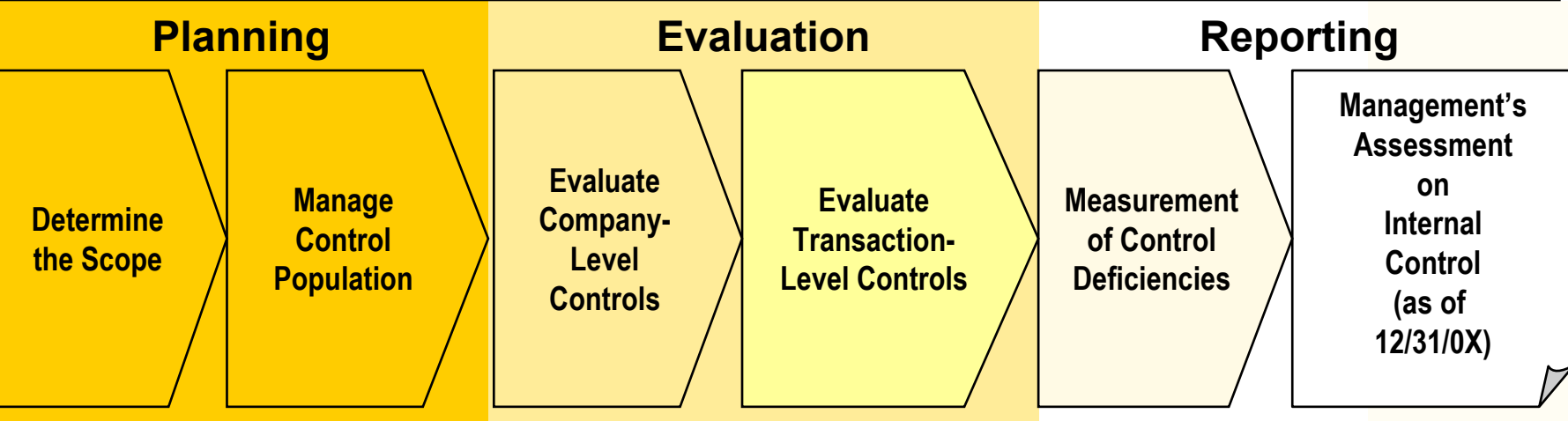
# Methodology for 404 Sustainability

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# Sustainability Management

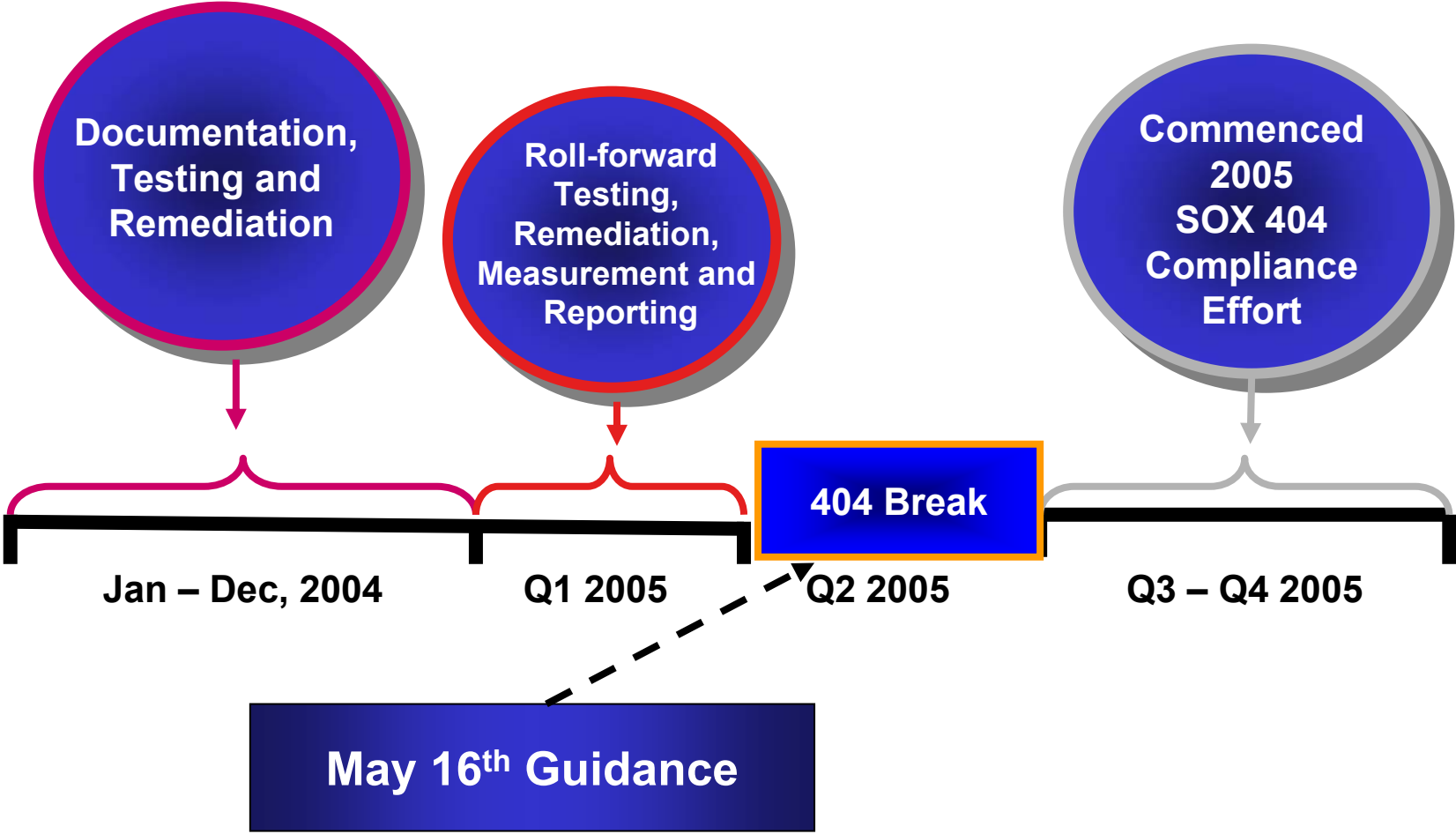
## Project Management



SOX 302-Update Documentation & Design Effectiveness

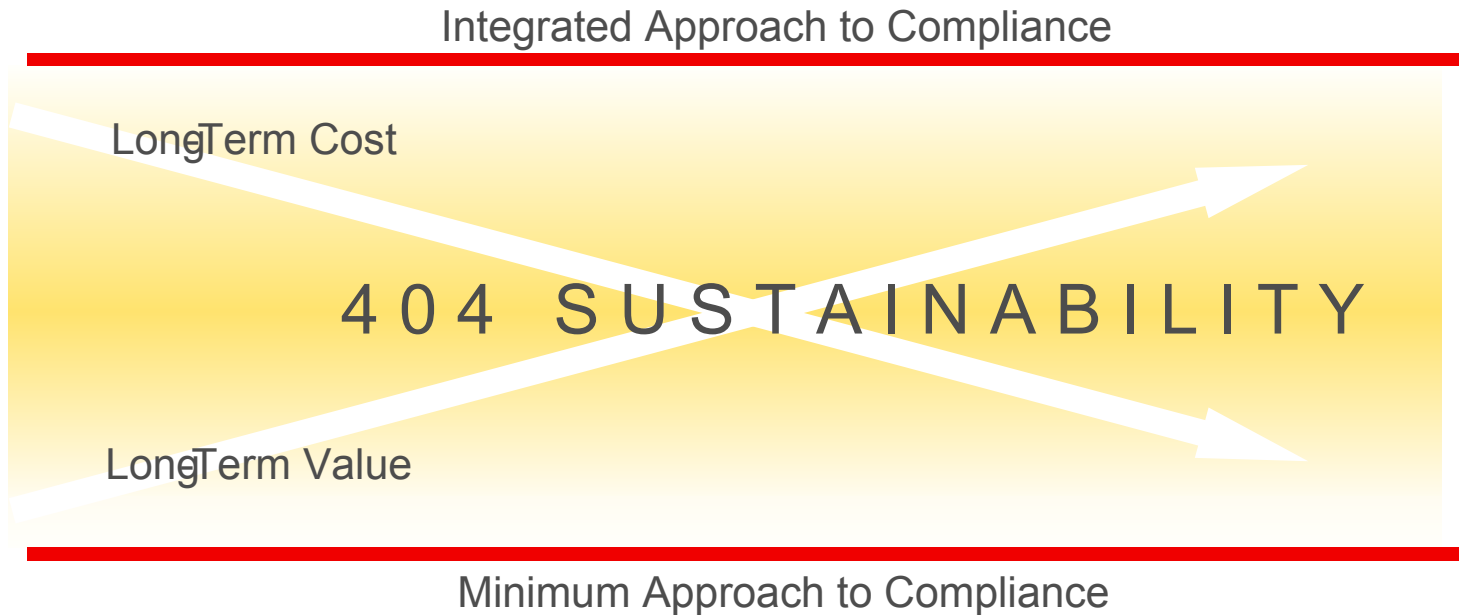
Remediation

# Second Year Time Line



# What We are Hearing from Our Clients?

- Reduce the cost of compliance
- Sustainability of the 404 process
- Drive “some” value from compliance process



# May16th Guidance —Significant Themes

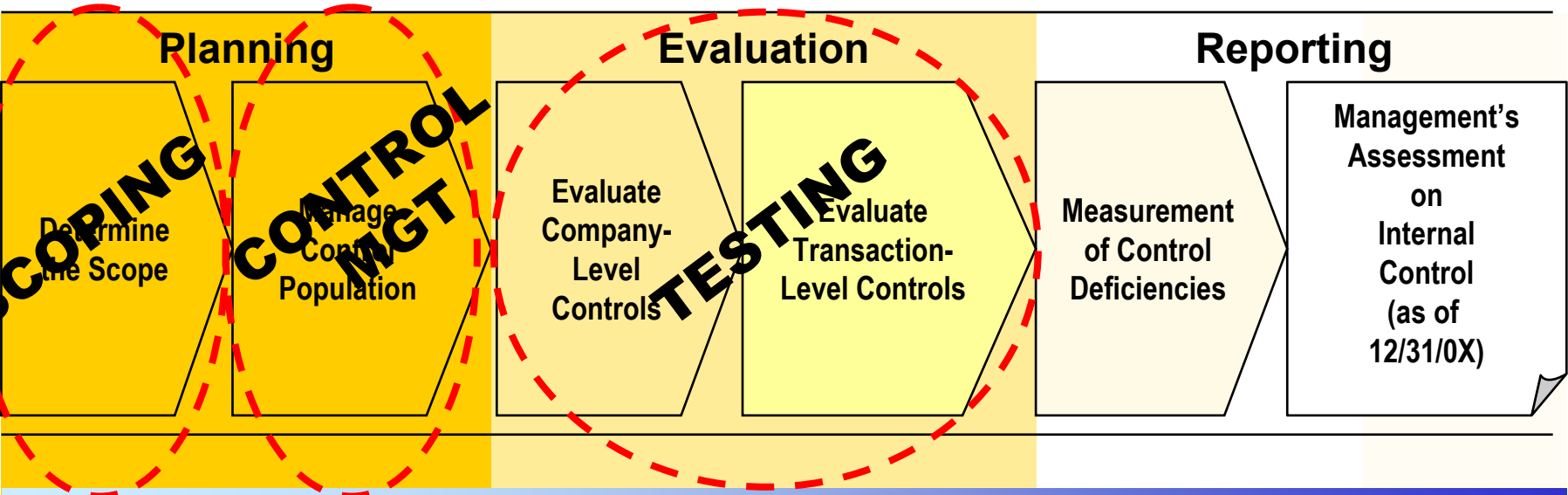
- “Top-Down” Approach prevents auditor from spending unnecessary time and effort on insignificant, low risk areas. Approach should include:
  - Company-Level Controls
  - Significant Accounts and Relevant Assertions
  - Significant Processes and Major Classes of Transactions
  - Identification of Points where Errors may occur
  - Linkage of Controls with Significant Accounts and Assertions
- “Risk-Based” Approach provides direct relationship between the degree of risk of material weakness and the amount of audit work performed by the external auditor
- Greater leverage of company and higher-level controls
- Flexibility in the nature, extent and timing of testing based on risk
- Greater reliance, by the auditors, on the work performed by others

# May16th Guidance —Impact on Management

- Ability to leverage “Top-Down” Vs “Bottom-Up” Approach
- Focus on areas of risk, significant accounts and locations
- Opportunity to leverage different testing strategies based on risk
- Ability to leverage company-level and monitoring controls to a greater extent
- Opportunity to remove insignificant and lower risk areas from SOX scope
- Potential for auditors to rely on more work performed by or on behalf of management

# Areas with Highest Opportunity of Return

## Project Management



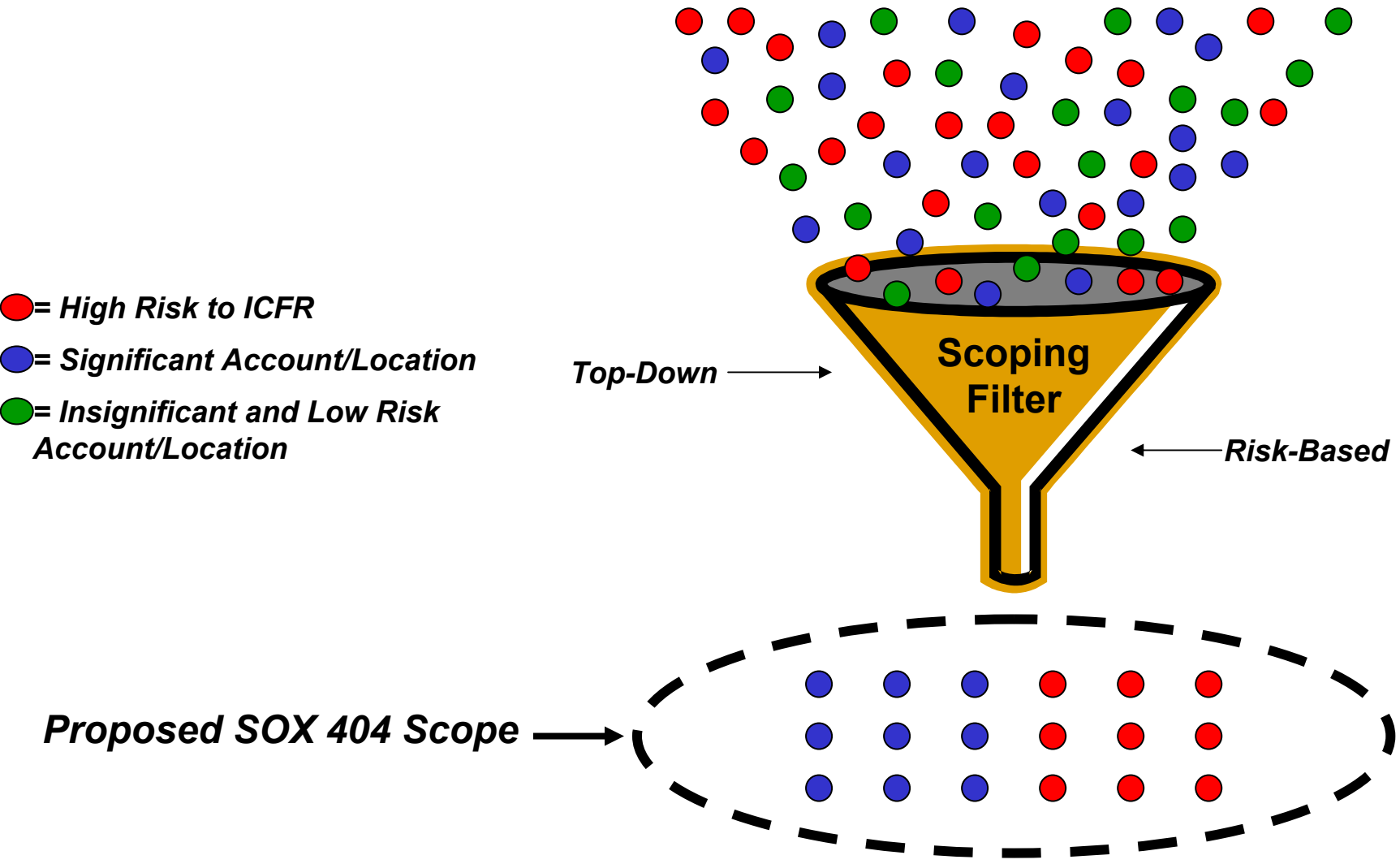
## Remediation

# 404 + 1 Scoping

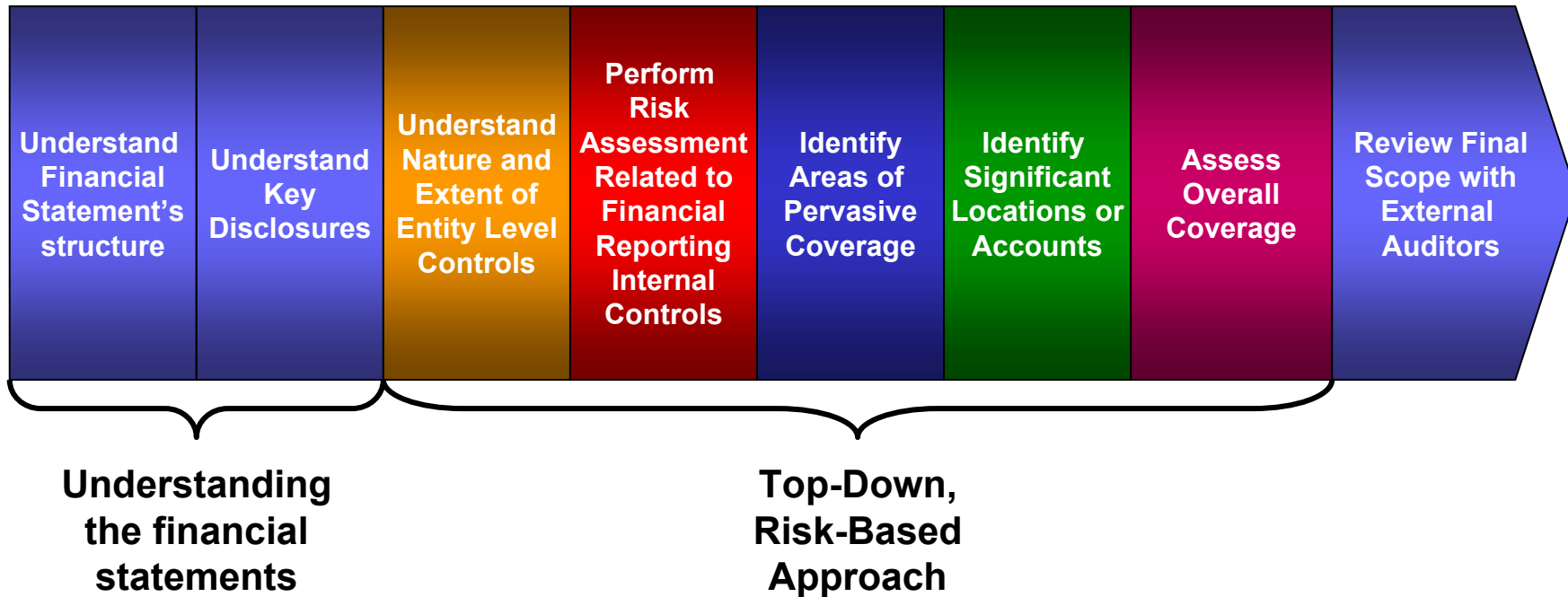
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# 404 + 1 Scoping - Objective



# 404 + 1 Scoping – Key Steps



# Scoping Considerations

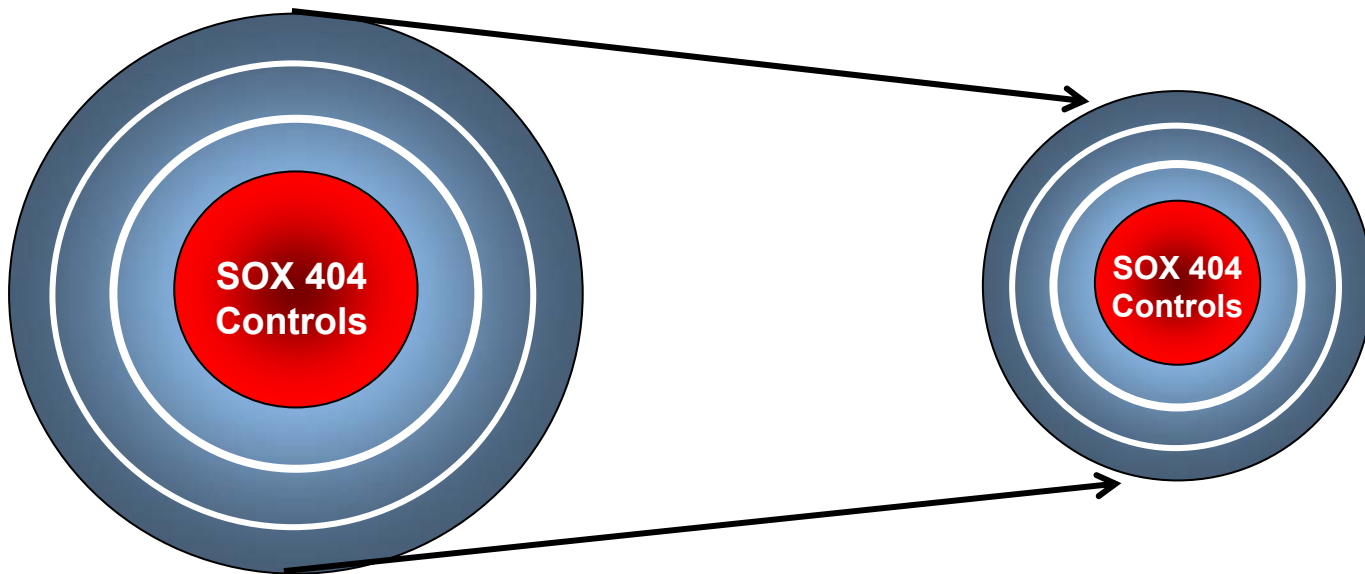
- The primary goal of the “top-down”, “risk-based” approach should be to attain the appropriate coverage for management’s assessment
- In many cases, the actual scope may be reduced
- Higher risk areas should be considered early in the scoping effort
- Remember all significant accounts at financially significant locations have to be included in the scope regardless of the level of coverage attained
- The SOX scope should be reviewed with the external auditors

# 404 + 1 Control Management

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# Objective of Control Management Process

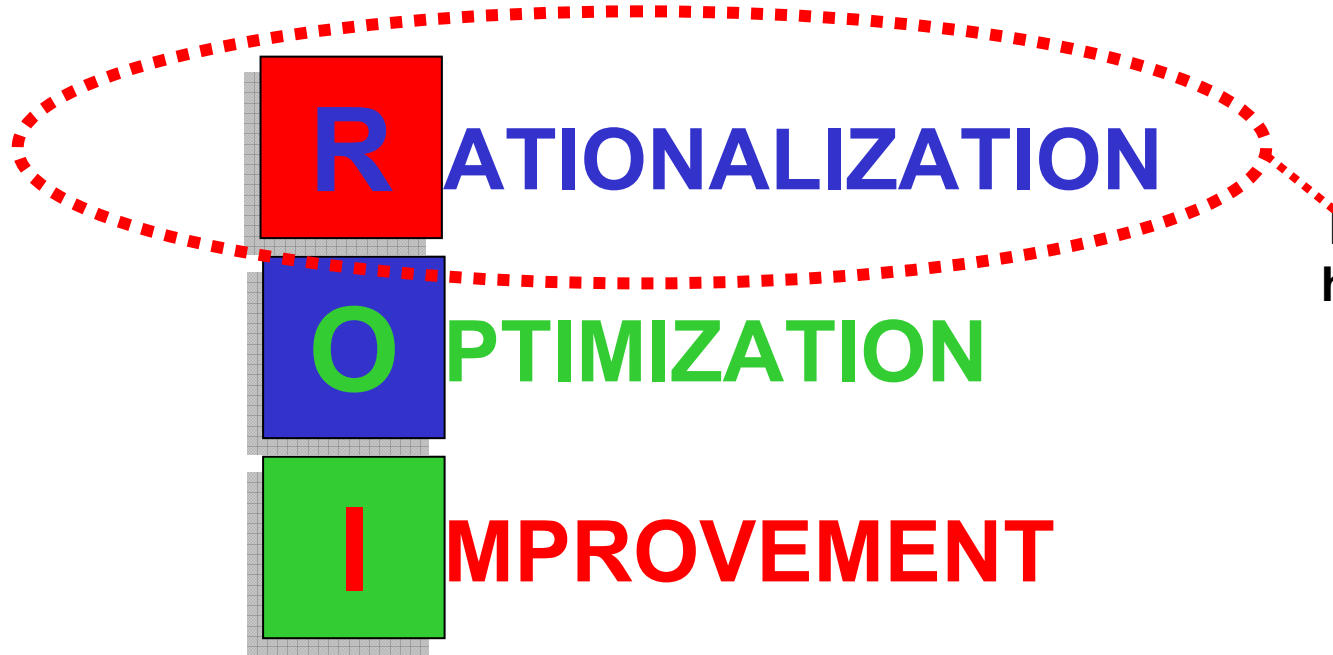


***Reduce population of controls tested for SOX 404 without compromising appropriate coverage of all relevant assertions for the significant accounts.***

# Control Management

- Other firms describe the “control rationalization” process without differentiating the associated levels of control management
- Add comment about many companies
- Each level has a different impact on costs and requires varying levels of investment to achieve the savings
- Each company may chose to implement different levels of control management over different populations of controls or processes
- It is important to note that regardless of the approach, coverage over the relevant assertions for the significant accounts should not be compromised

# Three Distinct Levels of Control Management

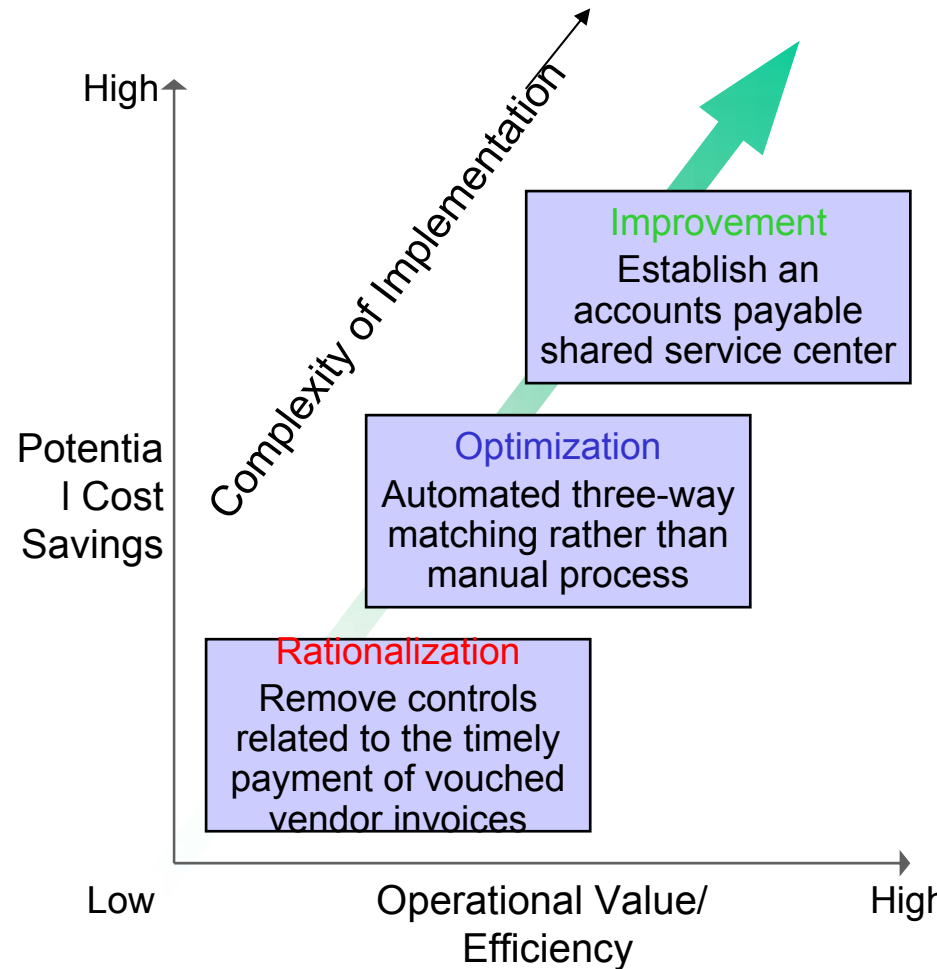


Many companies have commenced this process in 2005

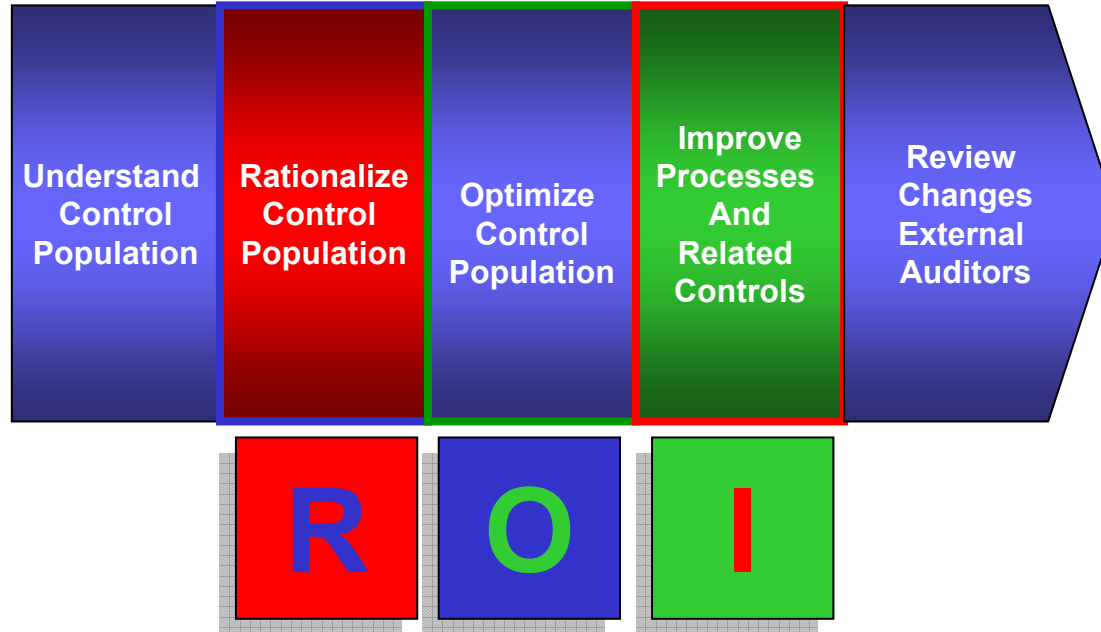
*Companies should select a control management technique that provides the appropriate level of **Return On Investment (ROI)***

# Controls Management - ROI

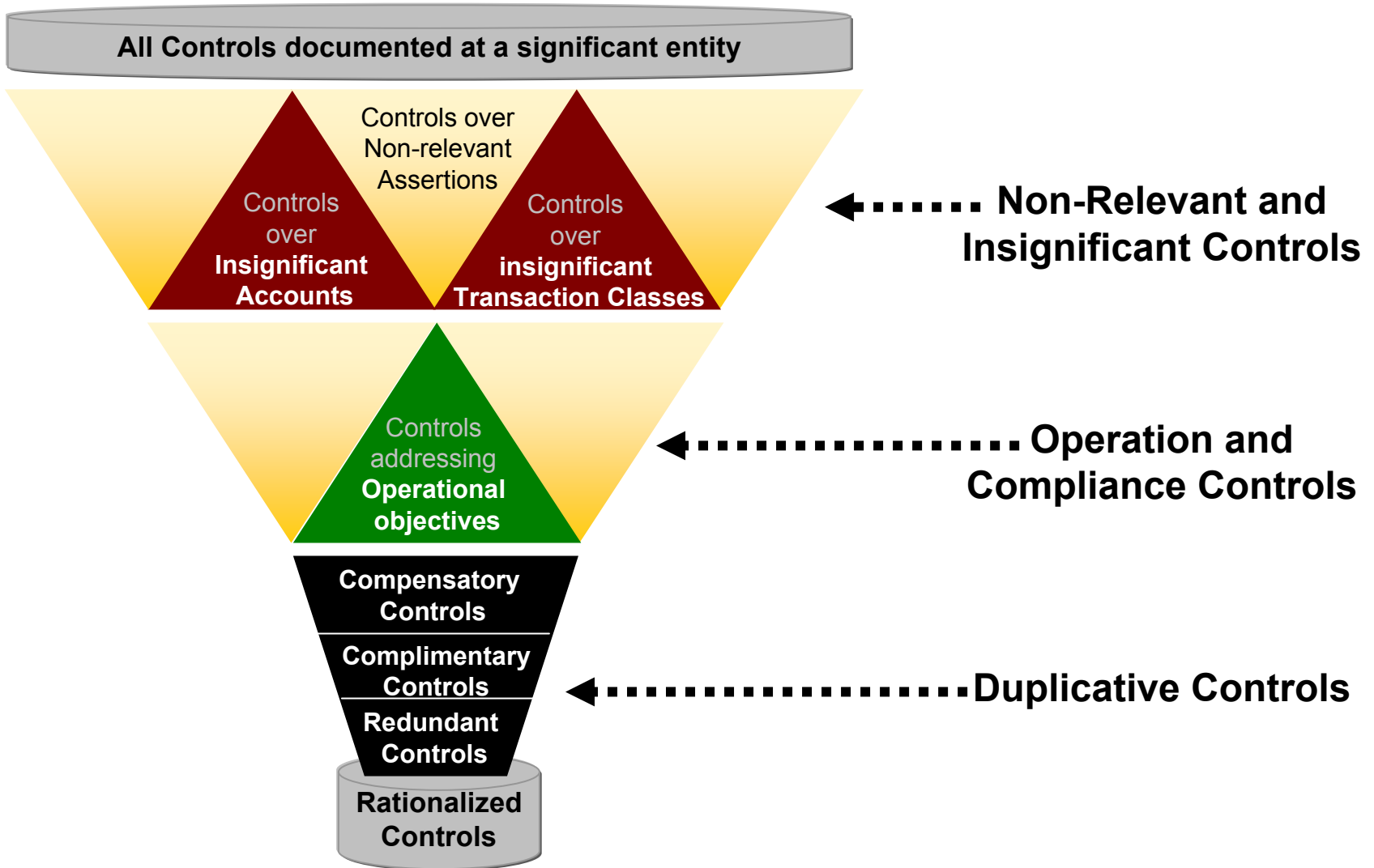
- **Rationalization** – Removing controls that are not significant or related to internal control over financial reporting (e.g., operational and compliance controls) and removal of redundant controls
- **Optimization** – Selecting controls over financial reporting that are more efficient to test than other controls which mitigate the same risk (e.g., automated control vs. manual control); leveraging strong company-level controls to reduce the need to rely solely on transaction-level controls
- **Improvement** – Modifying, re-designing or enhancing a process and the underlying control structure to drive operational efficiency and effectiveness (e.g., centralization of accounts payable)



# 2006 Scoping – Key Steps



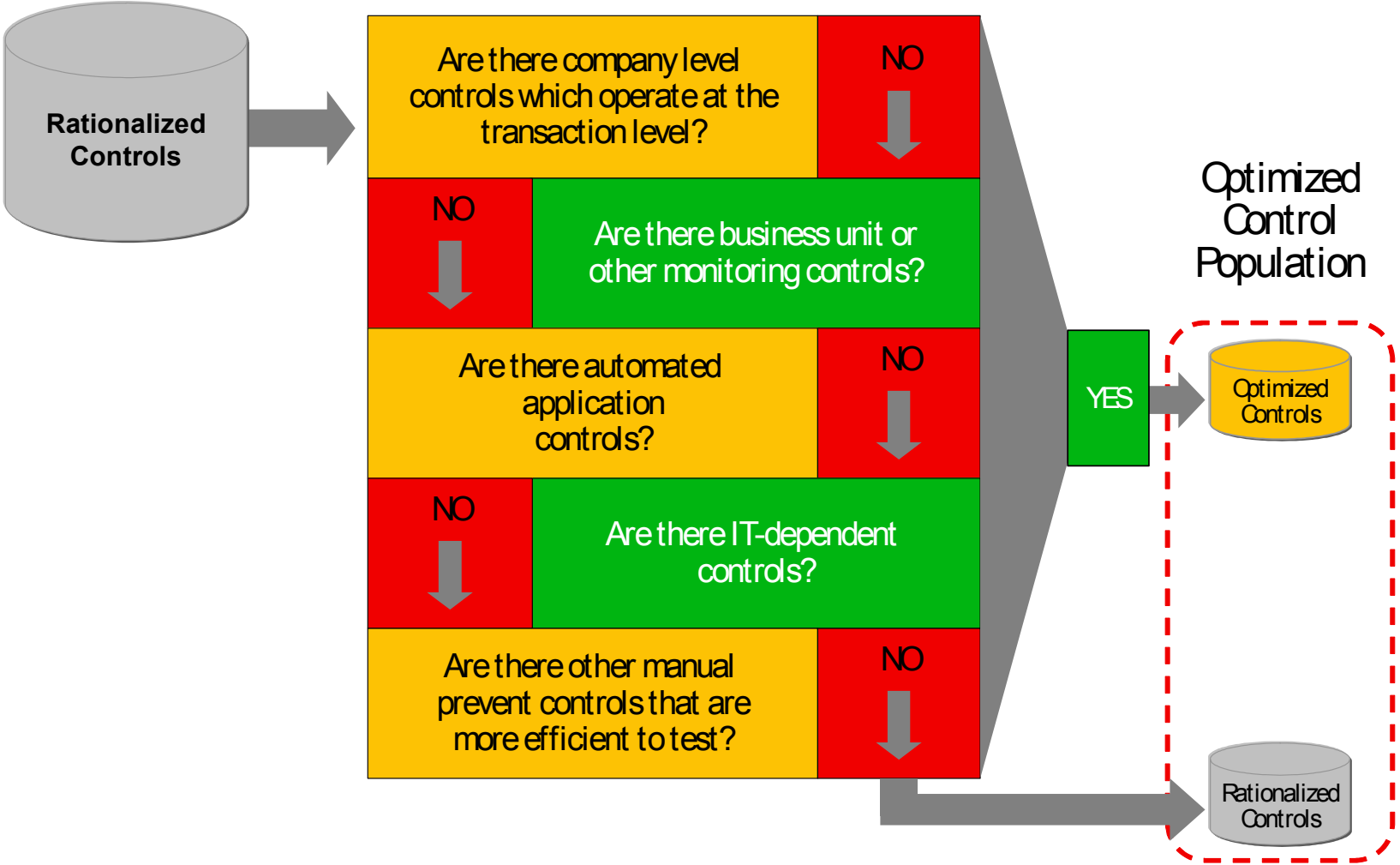
# Rationalization



# Rationalization Considerations

- The primary focus of the rationalization process is to identify and remove non-relevant controls from the control population
- Appropriate coverage over the relevant assertions should not be compromised
- Thorough documentation should be maintained to evidence the rationale for removing controls and the appropriate coverage of the relevant assertions
- Level of rationalization will vary based on the quantity and quality of the controls
- In some cases, controls may need to be added

# Optimization

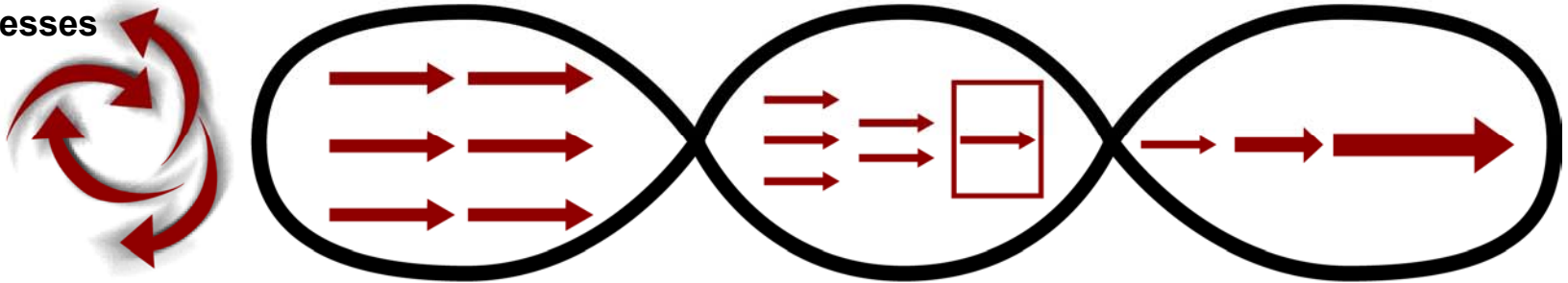


# Optimization Considerations

- The primary purpose of the optimization process is to displace existing controls with controls which are more efficient to test
- It is important to note that design effectiveness should not be compromised during the optimization process
- It is important to involve process and control owners in the optimization process
- It is also important to involve staff who are very familiar with the IT systems used to support the related processes

# Improvement

Processes



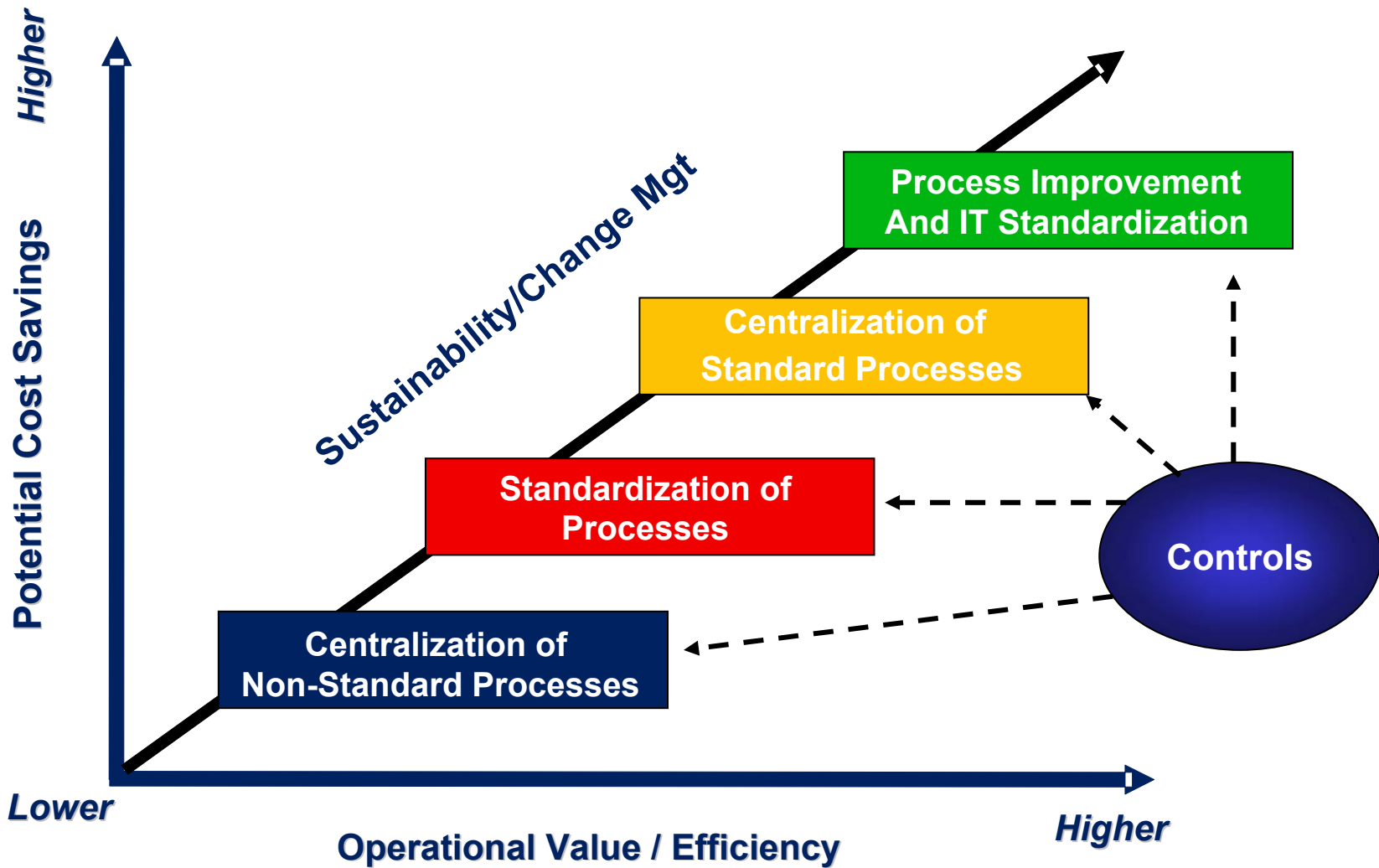
Standardize

Centralize

Improve and  
Standardize  
Automation

Improvement focuses on the efficiency and effectiveness of a process while embedding more efficient controls therein

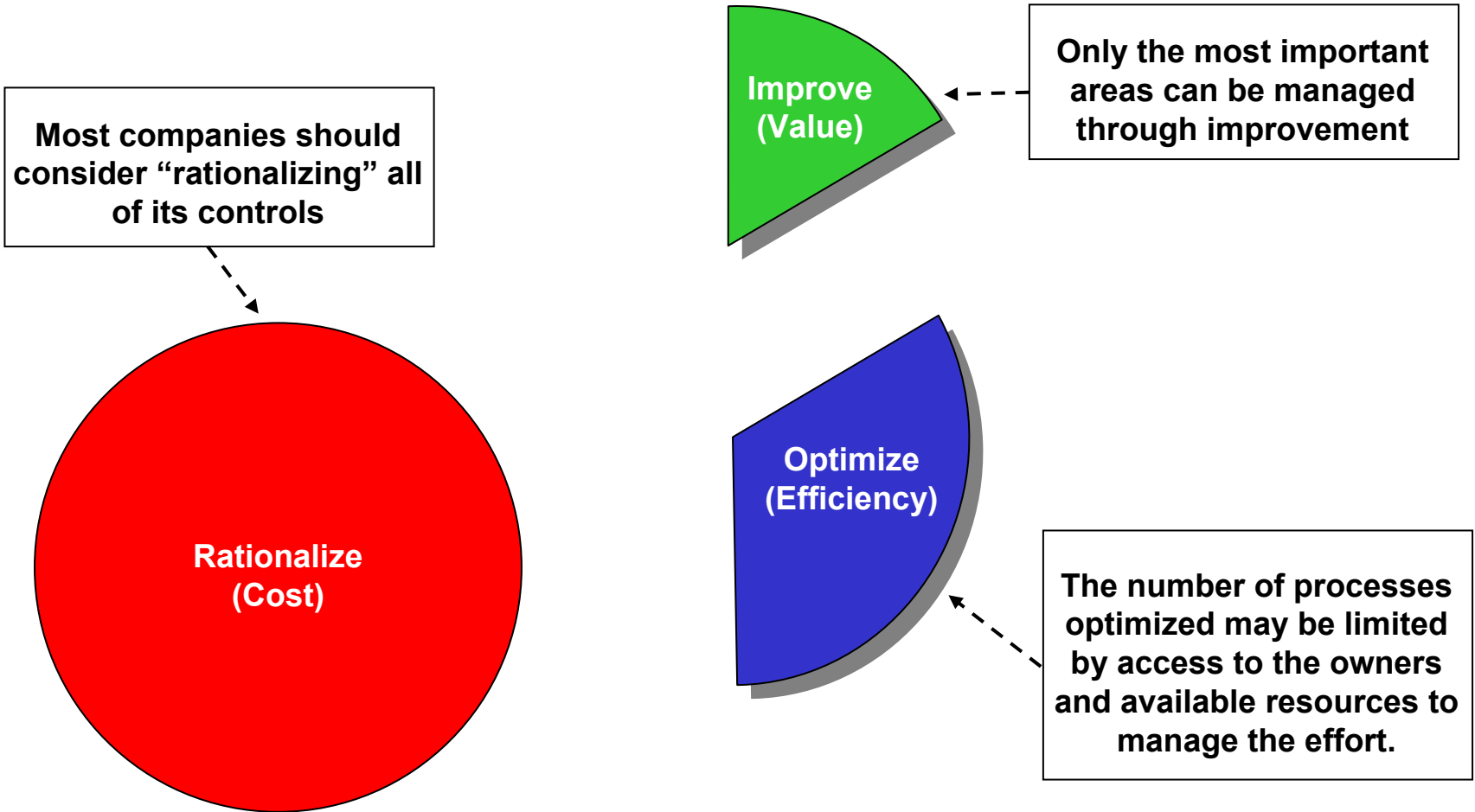
# Improvement



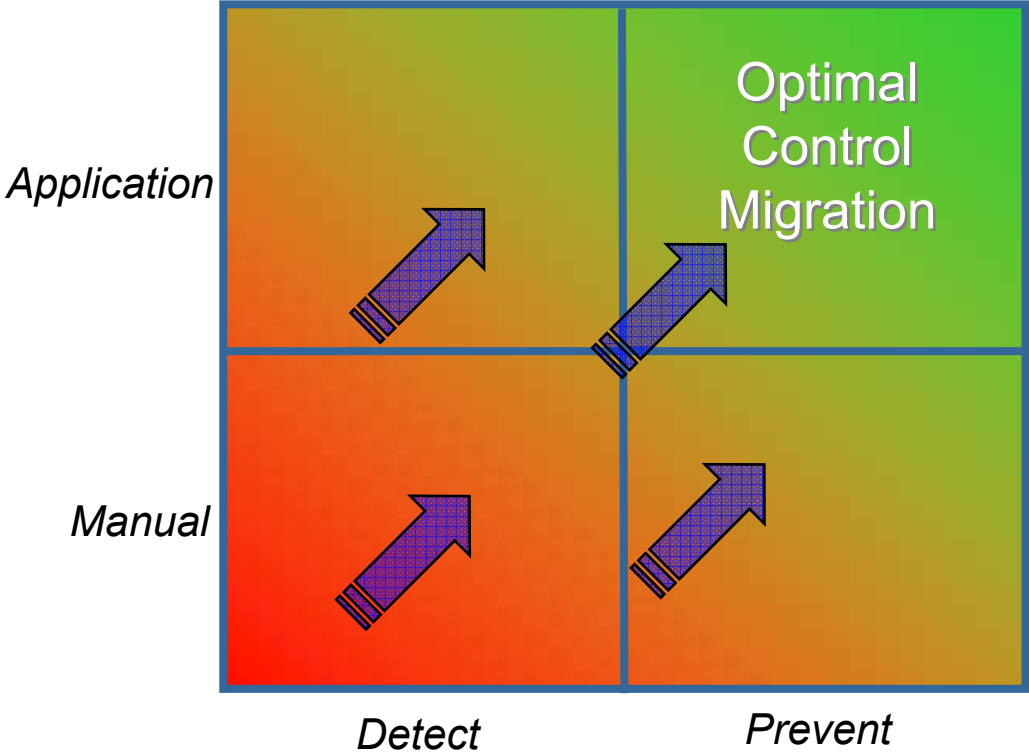
# Improvement Consideration

- The improvement process creates the greatest opportunity to drive value from the SOX 404 effort
- Areas with several control deficiencies or require significant testing resources may be good candidates for improvement opportunities
- Improvement opportunities should embed more effective and efficient controls within the related processes
- Engagement teams should identify improvement opportunities to:
  - Drive incremental value to our clients
  - Potential expansion of services

# Control Management – Allocation of Effort



# Control Management – Objective



# 404 + 1 Testing Strategy

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# Risk-Based Testing Strategy

- Per the May 16<sup>th</sup> guidance, the amount and extent of procedures performed by the external auditors should take the level of risk into consideration
- This principle also applies to management and its risk based approach
- Areas of higher risk should be tested with more thoroughly by independent resources, while areas of lower risk might tested using smaller samples by process owners
- By adjusting the extent, nature and timing of testing based on the level of risk, management has a significant opportunity to potential reduce the scope of testing and spread its testing more ratably throughout the year

# Risk-Based Testing Strategy

What to Test?      Who will Test?      How to Test?      When to Test?

HIGH

Transaction Controls

Internal Audit  
3rd Party

RePerformance

Closer to year end  
rollforward

MEDIUM

Monitoring Controls

Self Test +  
Validation

Inspection

Anytime +  
rollforward

LOW

Entity Level Controls

Process Owner  
SelfTest

Walkthrough/  
Observation/  
Inquiry

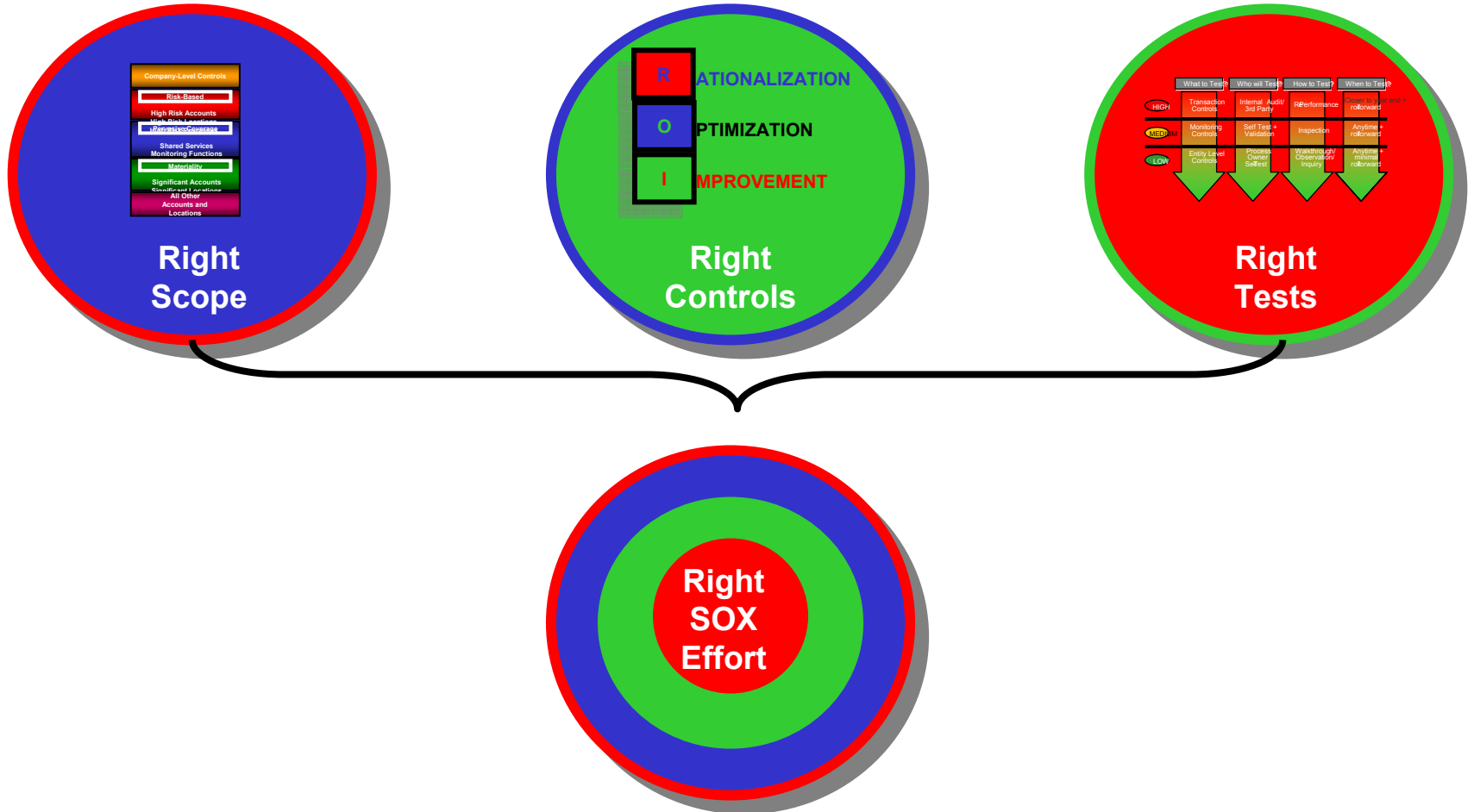
Anytime +  
minimal  
rollforward

*Sample sizes may also vary based on risk.*

# Testing Considerations

- Testing should consider both design and operation effectiveness
- There should be a direct correlation between risk and the amount of testing performed and the timing thereof
- Testing resources should be competent and well trained to maintain the integrity of management's assessment process
- Testing strategies should be reviewed with the external auditors to confirm:
  - Sample sizes
  - Timing
  - Nature
  - Extent

# 2006 SOX Planning - Pulling It All Together



# The Internal Audit Function and its Evolving Role in a 404 World

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# Internal Audit Survey Process

- E&Y conducted in-depth, face-to-face discussion with 115 chief audit executives and their direct reports
  - Large, multinational internal audit functions, based in North America
  - 2005 revenues exceeded \$8 billion for most respondents
  - Wide range of industries
  - Discussions conducted January – July 2006
- Discussion focused on four areas:
  - Governance
  - Infrastructure
  - Resources
  - Operations

# 10 Trends From the Internal Audit Survey

1. The Role of IA in Today's Market
2. IA in the Overall Risk Management Structure
3. IA Risk Assessment Process
4. Importance of Communications
5. Fraud Detection and Prevention
6. Maximizing Technology and Knowledge Investments
7. Continuing Shortage of Resources
8. Training and Retention
9. Maintaining Quality
10. Challenges of a Global Environment

# Trend 1 – The Role of IA in Today's Market

- Although Section 404 continues to be an important focus, Internal Audit (IA) functions are looking ahead and re-defining their role
- Expectations of the IA function by both Audit Committees and executive management are increasing
- Over the next three years, most IA functions are projecting a decrease in audit hours spent on financial reporting and an increase in hours spent on strategic and operational risk areas
- An expanded IA mandate may include:
  - Increased responsibility for regulatory compliance
  - Increased risk management responsibilities
  - Fraud prevention/detection and code of conduct investigations
  - Risks associated with mergers, acquisitions and joint ventures

# Trend 2 – IA in the Overall Risk Management Structure

- IA executives are seeking ways to better integrate SOX testing into normal scope of IA work
- IA is increasingly being viewed as a key driver for implementation of Enterprise Risk Management (ERM) programs
- IA is being asked to better coordinate activities with other risk management functions: External Audit, Internal Control, Insurance, Treasury, Regulatory Compliance, etc.

# Trend 3 – IA Risk Assessment Process

- Many companies are concerned that their current risk assessments are not adequately identifying the right risks
- IA executives are developing more robust inventories of what should be audited (audit universe)
- Risk assessments are being more closely linked to organizations' strategic and business objectives

# Trend 4 – Importance of Communications

- Balancing the expectations and reporting relationships between the Audit Committee and executive management is an increasingly difficult challenge for IA functions
- Establishing a charter keeps IA's purpose and function front and center with leadership
- Although communication has increased significantly with the Audit Committee as a result of Section 404, IA functions want more access and dialogue to better understand expectations and needs as well as better communicate issues and potential concerns

# Sustaining 404 with Control Self Assessment

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# Control Self Assessment (CSA) – What Is It?

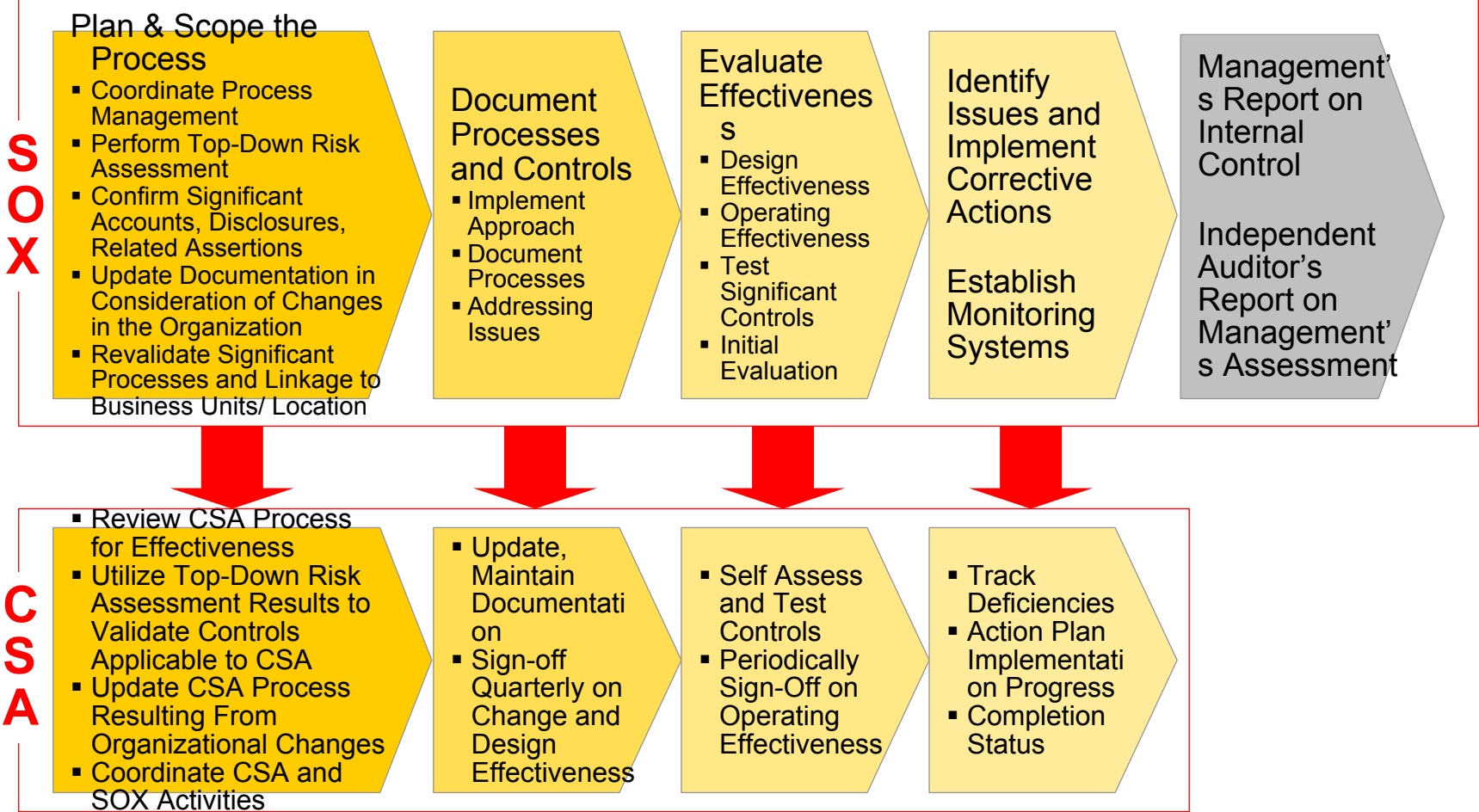
**A process where management,  
process owners and control owners  
review and test the controls  
under their responsibility**

# Control Self Assessment (CSA) – Why Now?

CSA has become more relevant to Sarbanes-Oxley (SOX) as a result of the May 2005 FAQ guidance:

FAQ 47	FAQ 48
<p><u>Management could use to obtain sufficient evidence of the operating effectiveness of controls through inspection of evidence or by means of a self assessment process some of which might occur as part of management's ongoing monitoring activities.</u></p>	<p>Paragraph 126 of Auditing Standard No. 2 uses self assessment in a specific and narrow way to mean an <u>assessment made by the same personnel who are responsible for performing the control</u>. On the other hand, the broader set of procedures that some issuers and auditors currently label as self-assessment includes <u>assessments and tests of controls performed by persons who are members of management but are not the same personnel who are responsible for performing the control</u>.</p>

# CSA in a SOX Environment

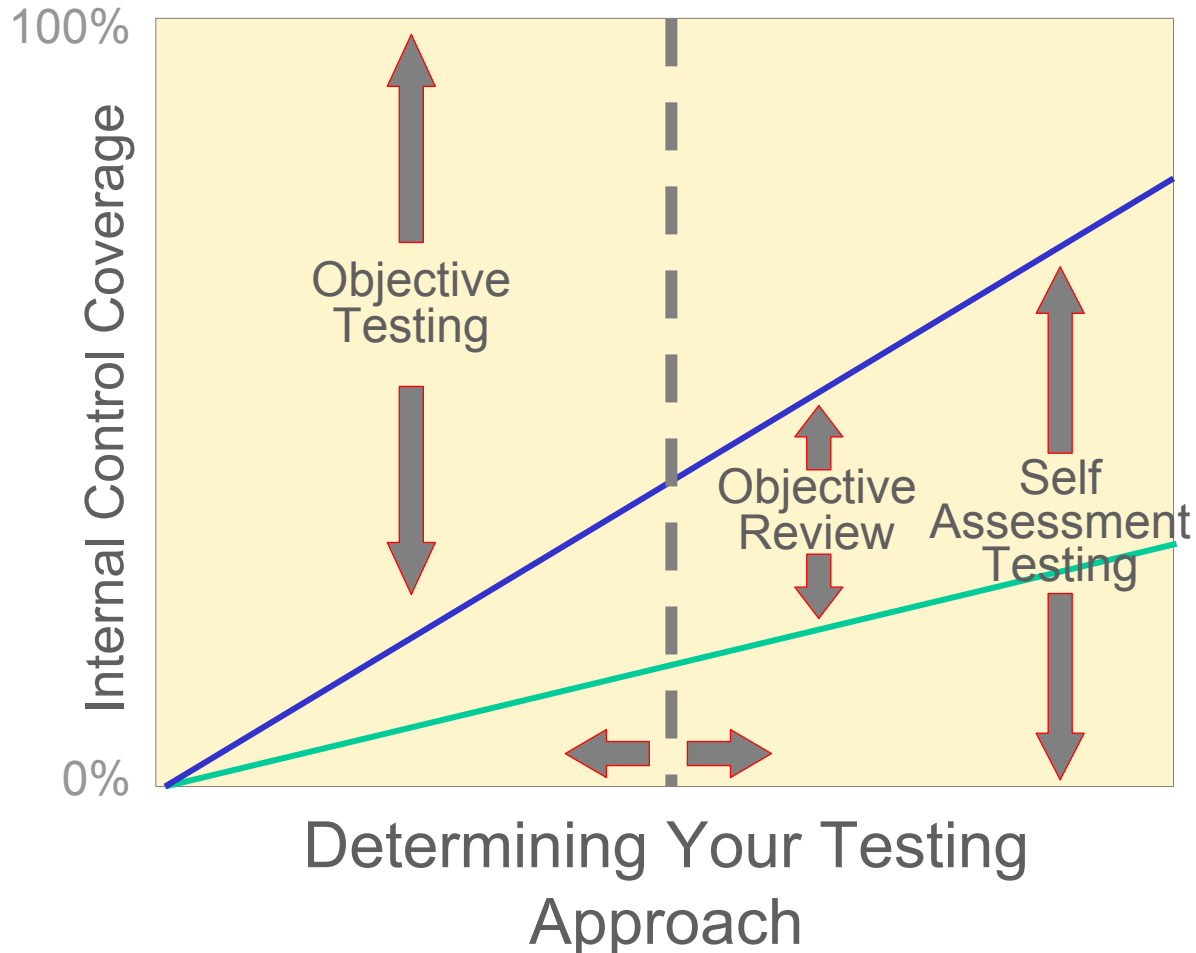


# How is CSA Applied to SOX?

<b>CSA-Based Activities</b>	<b>404 Annual</b>	<b>302 Quarterly</b>
<b>Determination of business changes that could materially affect internal control over financial reporting</b>		✓
<b>Documentation of changes including key risks and controls</b>		✓
<b>Tests of controls by management (management testing)*</b>	✓	
<b>Evaluation and assertion of control design and operating effectiveness</b>	✓	✓

\* Including testing performed by those responsible for the operation of the control as well as other members of management

# Testing Considerations



# Advantages and Disadvantages

## *Control Self Assessment*

### **Advantages**

- Increases the “Control IQ” of the organization resulting in a better control environment
- Management takes responsibility and is held accountable for control effectiveness
- Management is closer to the business process so assessment data is more accurate
- Management is more likely to effect smart remediation from a business perspective
- Testing performed by management may be less expensive than alternatives

### **Disadvantages**

- Line Management may not have the skills or aptitude (to do testing in particular)
- In the long run, costs to build CSA capability may make it more expensive to operate
- Independent Audit may rely less on Control Self Assessment as it is less objective
- Line Management may lose focus on day to day business priorities
- CSA may provide a false sense of security and lower the potential for fraud identification

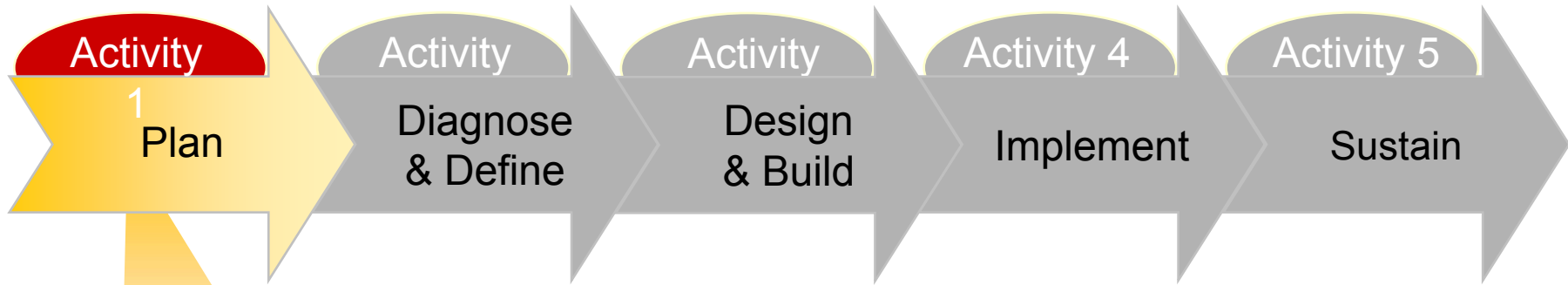
# Lessons Learned in Implementing CSA

Avoid These Mistakes	Focus On
Lack of adequate leadership commitment and sponsorship	<ul style="list-style-type: none"> <li>▪ Identify true CSA sponsors and champions</li> <li>▪ Implement strategy for gaining management 'buy-in', communicating results and benefits</li> <li>▪ Establish expectations for completion of CSA by process/control owners</li> </ul>
Putting the "cart before the horse" and implementing complex, sophisticated technologies	<ul style="list-style-type: none"> <li>▪ Understand your CSA process first</li> <li>▪ Technology should support your CSA process, not complicate it</li> </ul>
Implementing a 'cookie cutter' approach without considering the company's culture and organizational structure	<ul style="list-style-type: none"> <li>▪ Build upon existing methodologies and apply specific organizational knowledge in tailoring CSA process</li> <li>▪ Modify approach to meet the changing business environment</li> </ul>
Inconsistent or non-standardized entity level controls across the company	<ul style="list-style-type: none"> <li>▪ As much as possible, standardize entity level controls across the company</li> <li>▪ Develop / maintain a strong entity level control culture to allow for more reliance on CSA</li> </ul>
Testing of controls across the company is inconsistent and lack the quality required for management certification and independent audit reliance	<ul style="list-style-type: none"> <li>▪ Establish a core 404 / CSA support network to drive quality and consistency across the company</li> <li>▪ Create and sustain an effective learning environment for process and control owners</li> </ul>
Failure to implement action plans	<ul style="list-style-type: none"> <li>▪ Develop <b>definitive</b> action plans</li> <li>▪ Follow-up and monitor action plan implementation</li> <li>▪ Assist in determining effectiveness of implementing action plans</li> </ul>
Not establishing a CSA support infrastructure including an appropriate learning environment for long-term sustainability	<ul style="list-style-type: none"> <li>▪ Identify resources to support implementation across the company</li> <li>▪ Provide an effective CSA learning environment for process / control owners and other stakeholders</li> <li>▪ Develop on-going reporting and monitoring activities</li> <li>▪ Create measurement criteria and incentives to support program</li> </ul>

# CSA Benefits

- Build and retain risk and control knowledge
- Effective coverage of key controls
- Efficiently leverages resources by utilizing the process and control owners with working knowledge of control operation
- Ability to share best practices throughout the organization
- Ongoing monitoring and reporting
- Transparent and embedded in the organization
- Enables better business decision making

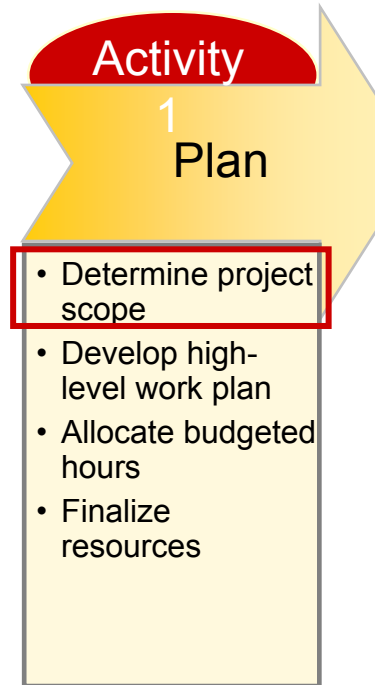
# Implementing CSA



- Determine project scope
- Develop high level work plan
- Allocate budgeted hours
- Finalize resources

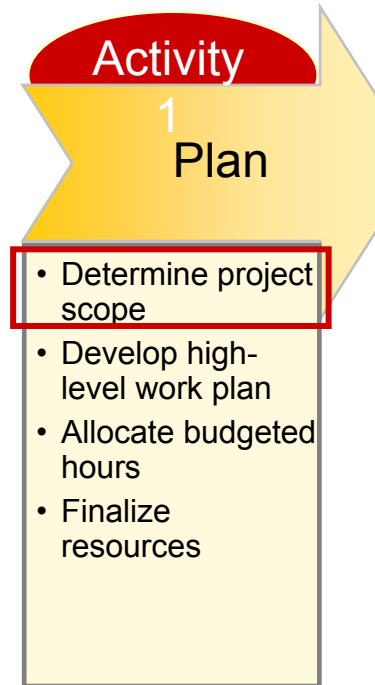
# Determine Project Scope

- Scoping:
  - Nature of CSA services to be performed
  - Client-prepared documentation
  - Expected outputs
  - Timelines, key milestones and critical success factors
  - Communication protocols
  - Understanding of relevant business issues
  - Team experience
- Review engagement letter for discrepancies



# Determine Project Scope

- Bring draft material
- Finalize scope, roles and responsibilities, outputs, etc.
- Expectations for the project should be a two-way street
  - Are the expectations reasonable?
  - Do they fit within the scope of work?
  - What are our expectations of the client?
    - Strong sponsorship and support
    - Reaction to the results
    - Other?



**Hold an open dialogue with the client  
Work to manage unrealistic expectations**

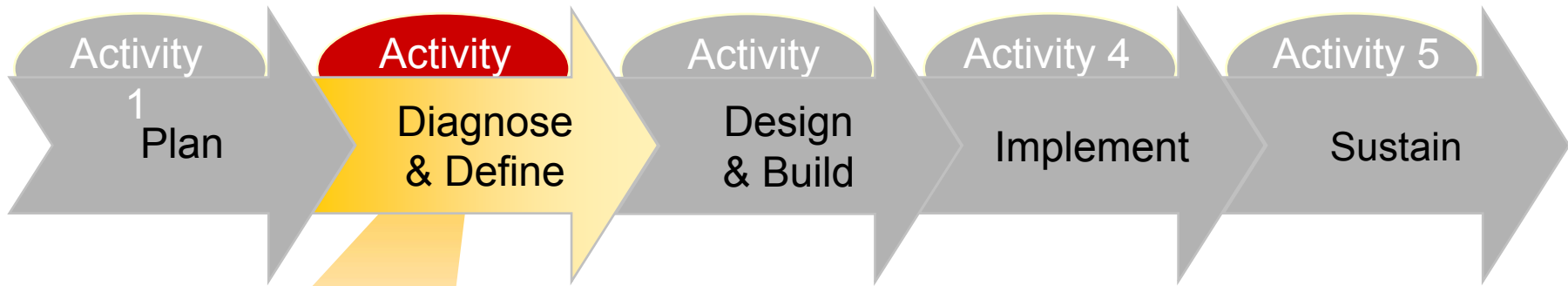
# Develop High-Level Workplan

- Use draft work plan as basis for developing client-specific work plan
  - Co-develop with client
  - Develop high-level work plan only. Detail steps can be flushed out further during 'Plan' activities
  - Include key milestones for monitoring implementation of CSA
- Use work plan to determine resource assignments and timing for completion of work

**Exhibit 1**



# Implementing CSA



- Gain understanding of current SOX and CSA processes
- Define CSA process and SOX/CSA integration
- Validate CSA vision with key stakeholders
- Develop CSA content

# Gain Understanding of Current SOX Processes

*We want a clear picture of what needs to be done to integrate CSA into SOX*

- Understanding is obtained through interviews with knowledgeable stakeholders involved in SOX
  - Knowledge / documentation on SOX processes may already exist
  - Determine if company currently uses CSA

## Activity

### Diagnose & Define

- Gain understanding of current SOX and CSA processes
- Define CSA process and SOX/CSA integration
- Validate CSA Vision with Key Stakeholders

# Gain Understanding of Current SOX Processes

- Co-determine stakeholders to interview with the client – SOX and CSA
- How many interviews?
  - Enough to obtain a broad working knowledge of the current SOX process and any related CSA activities

## Activity

### Diagnose & Define

- Gain understanding of current SOX and CSA processes
- Define CSA process and SOX/CSA integration
- Validate CSA Vision with Key Stakeholders

# Gain Understanding of Current SOX Processes

- During interviews:
  - Explain what CSA is
  - Gathering information:
    - Current state of SOX process
    - Issues/concerns around current process
    - Future state requirements impacting CSA implementation
    - Input on CSA design
    - Gaps/issues to integrating CSA into SOX

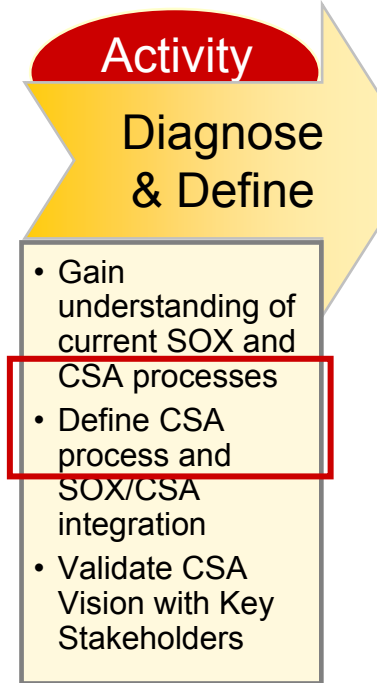
## Activity

### Diagnose & Define

- Gain understanding of current SOX and CSA processes
- Define CSA process and SOX/CSA integration
- Validate CSA Vision with Key Stakeholders

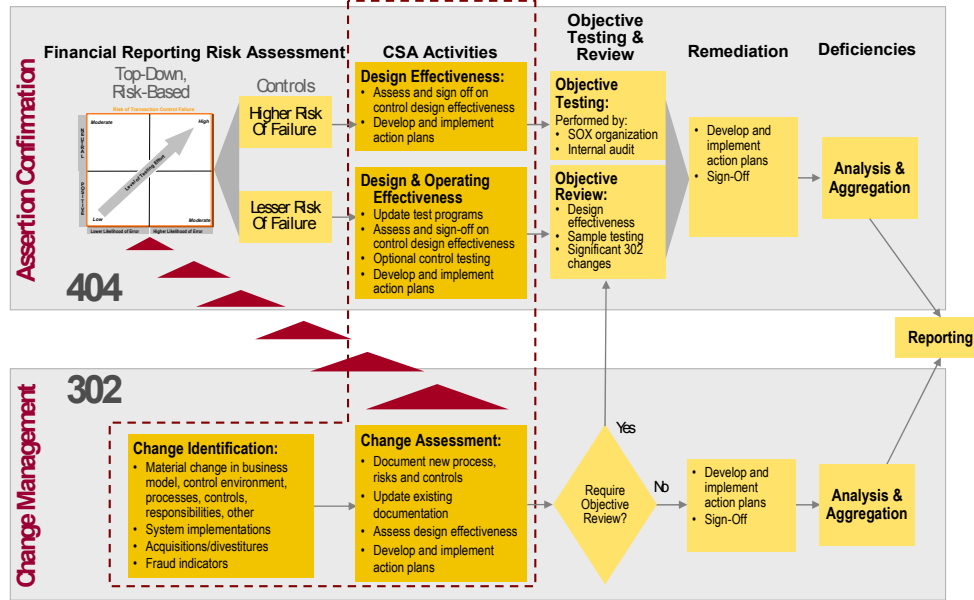
# Define CSA Process and SOX/CSA Integration

- Evaluate interview results by:
  - Questions
  - Identified gaps
  - Input on CSA design
- Use interview results and other documentation to draft design



# Define CSA Process and SOX/CSA Integration

- Conduct meeting with client
- Present results of interviews
- Present draft SOX/CSA integrated design



**Activity**

**Diagnose & Define**

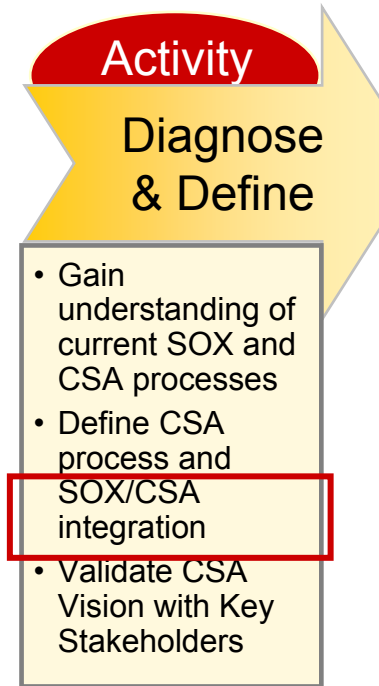
- Gain understanding of current SOX and CSA processes
- Define CSA process and SOX/CSA integration
- Validate CSA Vision with Key Stakeholders

**Exhibit 3**

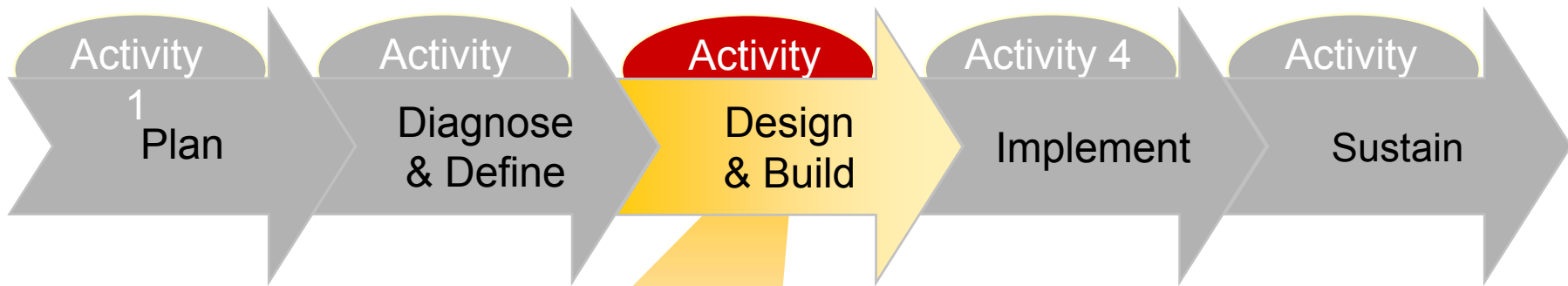
- Facilitate discussion and further development
- Develop design and obtain initial approval

# Validate CSA Vision with Key Stakeholders

- Identify other key stakeholders
  - Key process owners, select members of management, independent auditor
- Present CSA integrated design
- Solicit input
- Finalize design and present to stakeholders for approval



# Implementing CSA



- Develop CSA enablers
- Identify and procure technology
- Develop the CSA organization structure
- Develop detailed implementation work plan
- Identify and initiate training

# Develop CSA Enablers

- Use of CSA assessment template
  - General information and review
  - Walkthrough questionnaire
  - Walkthrough instructions
  - Walkthrough results
  - Testing instructions
  - Control test program
  - Population and sampling
  - Test evidence
  - Test results summary
  - Remediation plans
  - Quality assurance checklist

**Exhibit 7** →

**Exhibit 4** →

Activity

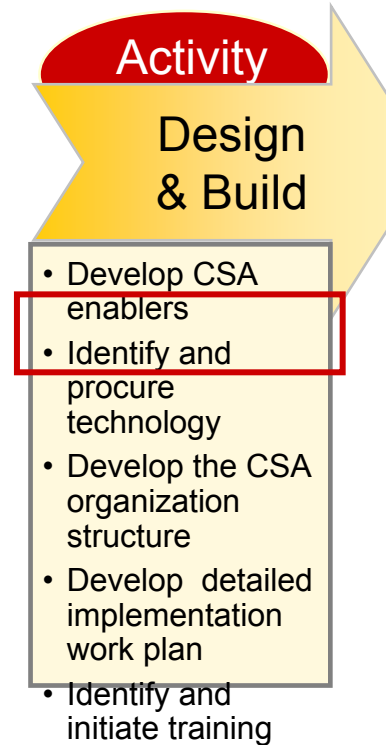
Design  
& Build

- Develop CSA enablers
- Identify and procure technology
- Develop the CSA organization structure
- Develop detailed implementation work plan
- Identify and initiate training

# Identify and Procure Technology

- Is client satisfied with current technology?
- Identify technology alternatives
- Prepare and schedule technology demonstrations
  - Utilize SOX/CSA integrated design
  - Develop questions for vendors
  - Complete technology viability analysis after demonstrations
- Co-determine optimal technology solution

**Exhibit 8**



# Identify and Procure Technology

- Prepare technology to support implementation
  - Org structure and reporting hierarchy
  - Risk / control data and ownership
  - Build desired report formats
  - Other preparatory content
    - Use of CSA assessment template
    - Other
- Stress test technology prior to implementation

**Exhibit 5**

**Exhibit 4**

Activity

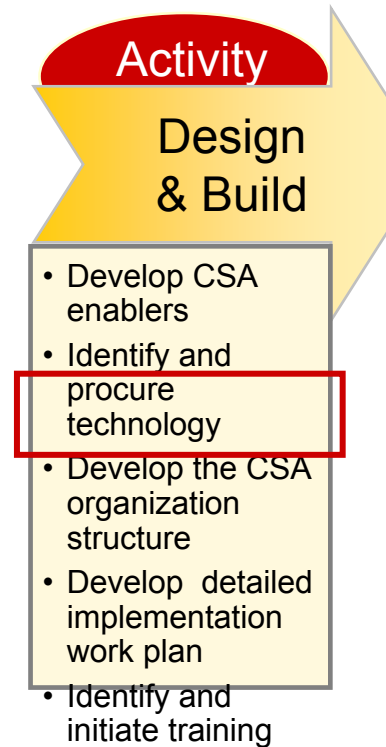
Design  
& Build

- Develop CSA enablers
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# Develop the CSA Organization Structure

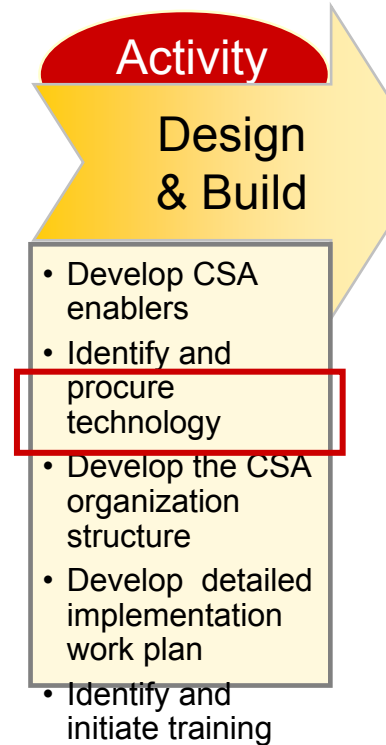
- Evaluate current SOX org structure
  - Use example CSA organization structure to assist in evaluation
  - Will it support initial CSA implementation?
- Co-develop optimal organization structure with client

**Exhibit 9**



# CSA Implementation

- Determine initial level of implementation
  - Pilot
  - Partial implementation
  - Full implementation
- Full implementation
  - Most aggressive approach
  - Riskiest approach
    - Increased risk due to company-wide implementation
    - Does not allow as much flexibility to address and contain issues on a smaller scale



# Develop Detailed Implementation Work Plan

- Utilize example CSA workplan as starting point
  - Further flush out workplan co-developed with client under ‘Define Expectations’ activity
  - Build steps based on type of launch: full, partial, pilot
  - Validate:
    - Roles and responsibilities
    - Timing for launch
  - Share with other key stakeholders including the independent auditor

**Exhibit 1**

Activity

Design  
& Build

- Develop CSA enablers
- Identify and procure technology
- **Develop the CSA organization structure**
- Develop detailed implementation work plan
- Identify and initiate training

# Identify and Train Resources – Developing Training

- Training needed for two distinct groups
  1. CSA support team
    - Responsible for supporting the efforts of the process and control owners
    - Will include a broad coverage of the CSA process and responsibilities for providing support during assessment activities
  2. Business process and control owners
    - Similar training requirements as provided to the CSA support team
    - Working knowledge of internal control
    - More tactical ‘how-to’ perform assessments
    - Trained prior to launch

## Activity

### Design & Build

- Develop CSA enablers
- Identify and procure technology
- Develop the CSA organization structure
- Develop detailed implementation work plan
- Identify and initiate training

# Identify and Train Resources to Support Implementation

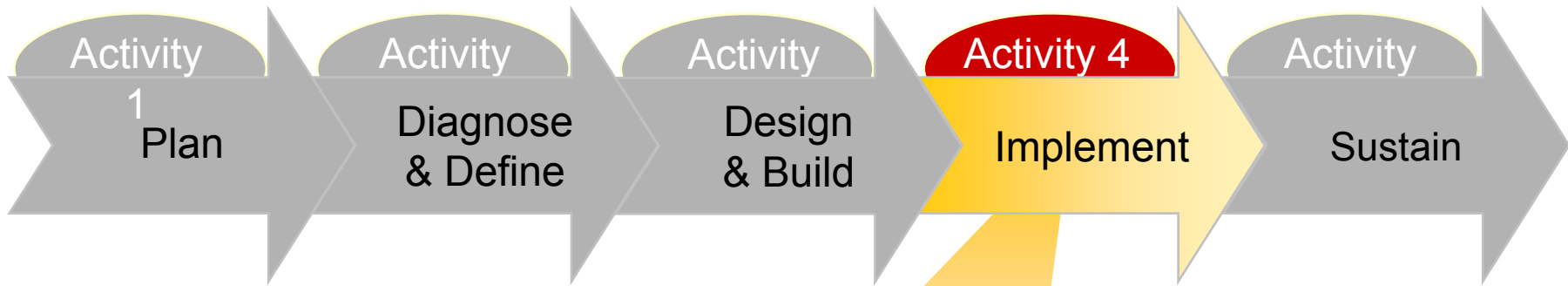
- CSA support team – Looking for distinct skill sets
  - Working knowledge of risk, control and SOX
  - Ability to develop control testing programs or test steps
  - Ability to evaluate and test controls
  - Ability to mentor and train process and control owners during control assessment and testing

## Activity

### Design & Build

- Develop CSA enablers
- Identify and procure technology
- Develop the CSA organization structure
- Develop detailed implementation work plan
- Identify and initiate training

# Implementing CSA



- Build CSA awareness and commitment
- Launch CSA
- Implement CSA support network and oversight
- Assist in transition and training of resources

# Build CSA Awareness and Commitment

- Establishing a proper level of support and commitment
  - Initial communication from project sponsor or other executive stakeholders

- Introduction of CSA to process and control owners
- Provide high-level explanation of CSA
- Establish a positive tone
- Indicate timing for implementation

**Exhibit 11**

- Communication should come from the sponsor

- Look for additional opportunities build awareness and support

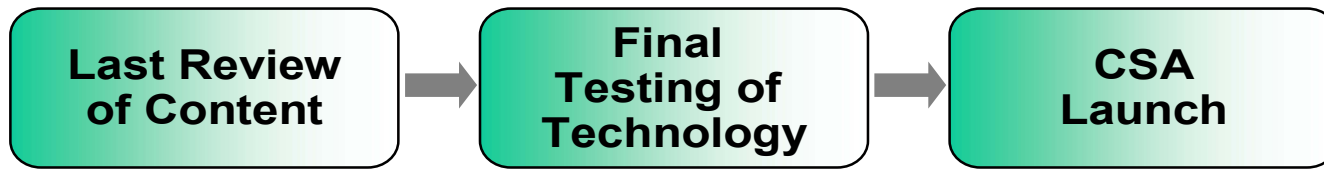
**Exhibit 12**

Activity 4

Implement

- Build CSA awareness and commitment
- Launch CSA
- Implement CSA support network and oversight
- Assist in transition and training of resources

# Launch CSA



## • Last review of content

- Anything of importance missing
- Objective review will provide a level of quality assurance

## • Final testing of technology

- Can it withstand significant transaction volume?
- Will it maintain optimal performance?
- Any unnoticed functional design flaws?

## • CSA launch

- Distribution of material and templates
- Availability of technology to process and control owners

## Activity 4

### Implement

- Build CSA awareness and commitment
- Launch CSA
- Implement CSA support network and oversight
- Assist in transition and training of resources

# Implement CSA Support Network and Oversight

- Establish support network for business process and control owners
  - Maintained by CSA support team members
  - On-site support during initial implementation is ideal
- Implementation oversight
  - At key points of implementation (pre-determined with client)
  - Reporting status to management

## Activity 4

### Implement

- Build CSA awareness and commitment
- Launch CSA
- Implement CSA support network and oversight
- Assist in transition and training of resources

# Assist in Transition and Training of Resources

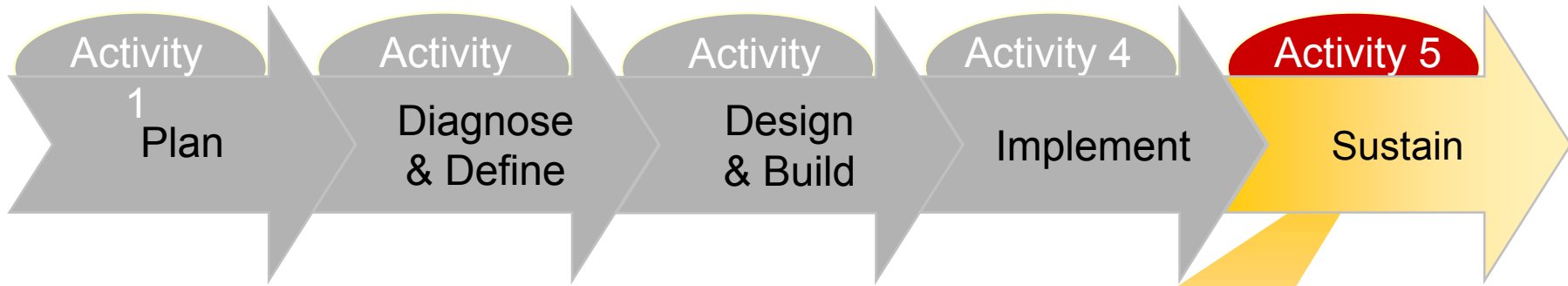
- Provide training to support implementation
- Training is provided based on implementation plan: pilot, partial, full
  - Part of implementation strategy
- Training provided by CSA support teams
  - E&Y should provide oversight

## Activity 4

### Implement

- Build CSA awareness and commitment
- Launch CSA
- Implement CSA support network and oversight
- Assist in transition and training of resources

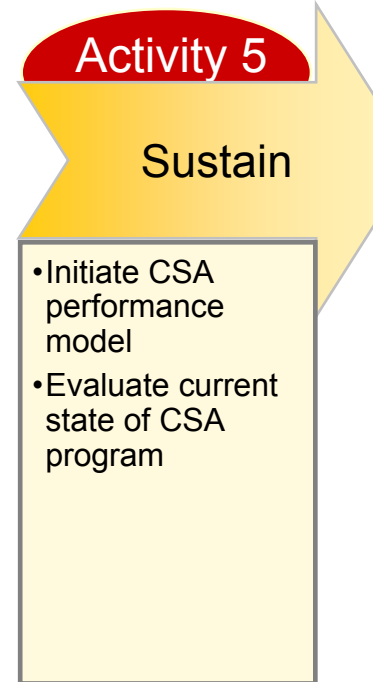
# Implementing CSA: Sustain



- Initiate CSA performance model
- Evaluate current state of CSA program

# Initiate CSA Performance Model

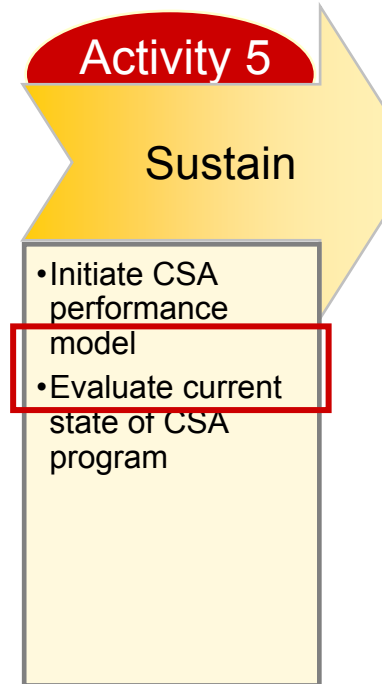
- Used to help create:
  - Accountability
  - Responsibility
  - Ownership
- Use of balanced scorecard
  - Applies to:
    - CSA Support team
    - Business process and control owners



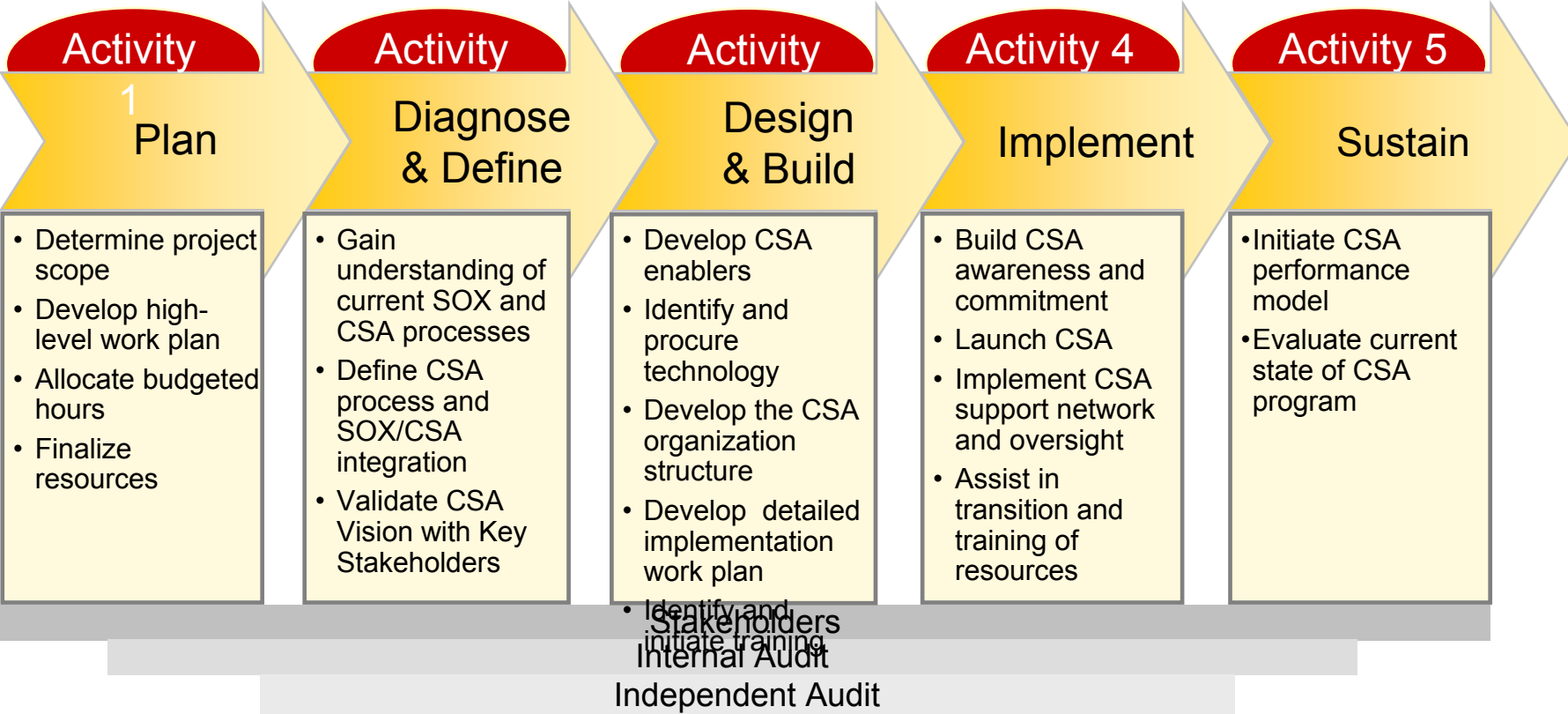
# Evaluate Current Activities for Sustaining Implementation

• Structured current state evaluation by:

- Commitment
- Organizational structure
- Process
- Technology
- Resources
- Training
- Measurement Incentives



# Final Questions



Week: 1 | 2-13 | 14-18 | 19-20

# Leveraging Value From Internal Controls

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# The Challenges of Improving the Internal Control Structure

- Many non-SEC companies, not forced to comply with SOX 404, are facing the dilemma of developing the “right” internal control structure while continuing the important job of running the business:
  - Growing revenue
  - Expanding market share
  - Increasing operational efficiency.
- Although privately held companies do not have the same imperatives around internal controls as SEC-registered companies, other stakeholders—financiers, bond rating agencies, private equity concerns, insurance carriers, bonding companies, and outside board members—have increasing expectations that mirror many of the regulatory initiatives aimed at public companies.
- Boards, audit committees, and senior executives of non-SEC companies are being challenged to develop and maintain an approach to internal control that meets the governance expectations of stakeholders and anticipates future regulatory requirements. At the same time, they must demonstrate that the approach provides value to the business in order to justify the investment. Most non-SEC companies are reluctant to adopt SOX 404 as the standard approach; it is perceived as too expensive to implement and too narrow in its focus, only covering financial reporting processes and not addressing other important business and/or operational risk areas.

# Why Are Leading Companies Investing in Internal Control?

- Globally, investors are seeking higher standards around risk management programs and communications with the market. In 2005, an Ernst & Young survey of 137 major international institutional fund investors reported that:
  - 69% of investors identified transparency as a top priority in considering an initial investment.
  - 82% responded that they would pay a premium for companies that can demonstrate a successful approach to risk management.
  - 61% said they had avoided investing in companies with suboptimal risk management functions and 48% had divested if they thought risk management was insufficient.
- SEC-listed companies already have begun to experience the impact of these heightened investor expectations. According to a Lord & Benoit report published in May 2006, over the last two years, market capitalization has increased most significantly for SEC-listed companies that have SOX 404 disclosures with effective internal control systems and no material weaknesses. Companies that had 404 material weaknesses and filed an adverse internal control opinion saw stock prices fall. However, once remediate, stock prices at these companies rebounded, although stock price growth remained at levels lower than at companies with a history of sound SOX 404 internal controls.

# Why Are Leading Companies Investing in Internal Control?

- A response to this has been the voluntary adoption of a more structured internal control program (similar to SOX 404) by an increasing number of privately held U.S. companies and non-listed companies, particularly in regulated industries. This would suggest that these companies believe that the ability to disclose effective controls levels the competitive playing field with potential investors and other stakeholders and offsets any competitive advantage gained by SEC registrants that have filed compliance with SOX 404.

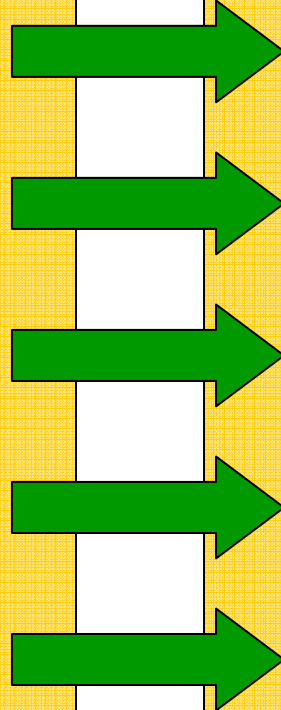
# The Global Regulatory Imperative

- In response to corporate control concerns and the increased demands of the investor community, governments and regulators around the world have introduced, and will continue to introduce, increasing levels of corporate governance regulation. The timing of new regulations varies from country to country, but the trend toward stronger governance requirements and improved transparency is clear.
- The most pervasive legislative change was the Sarbanes-Oxley Act of 2002 in the United States. The mandated requirements of Sections 302 and 404 affected SEC-listed companies around the world. The effectiveness of these requirements, and the full value from these investments, are still the center of on-going debate among legislators, regulators, and companies.
- However, many other governments and regulators outside of the U.S. have responded to the need for better corporate governance over the last few years through the adoption of their own legislative requirements or the introduction of best practice codes. Most major markets in Europe have updated, or are in the process of updating, corporate governance requirements. Many of these regulations and codes include sections on best practice risk management and internal control processes and have a broader scope than the financial reporting focus of Section 404. Company disclosures pursuant to these regulations or codes are being closely monitored in the business press and institutional investment community.

# Overview of Global Regulatory Developments

## Global & Emerging Regulations

- USA: SOX
- UK: Combined Code
- France: LSF
- Italy: 231 & 262
- Sweden: Corporate Code
- Switzerland: Swiss Code
- Japan: J-Sox
- Basel II
- EU: 4th, 7th, 8th Directives
- China: SASAC Directive
- Brazil: Governanca Corporativa
- Russia: Order No. 04-1245
- India: Clause 49
- Australia: CLERP 9
- Others



## Primary Objectives

- Increased investors' trust
- Increased management responsibility and accountability
- Increased transparency
- Reduced number of financial surprises and related business failures
- More reliable financial reporting

# The Global Regulatory Imperative

- A limited, but growing, number of European countries are starting to introduce much “tougher” regulation and disclosure requirements. Changes in Switzerland’s Code of Obligations regarding audit and disclosure arrangements include the requirement for the external auditor to report on the adequacy of the internal control system.
- In Italy, with the introduction of Legislative Decree 262, CEOs and CFOs of public companies are required to make a disclosure regarding the adequacy of financial controls beginning in January 2007.
- This places the responsibility for internal control effectiveness squarely on the shoulders of the most senior executives and builds on Legislative Decree 231, which required companies to introduce a governance and internal control model.

# The Global Regulatory Imperative

- In June 2006, the European Union's 8th Directive (the Directive) was officially published. It outlines changes in external audit arrangements and audit committee requirements for public companies across the European Community. The Directive clearly will affect significant aspects of governance across the corporation.
- This includes higher standards of internal control as audit committees discharge their responsibilities for monitoring the effectiveness of internal control.
- In addition, and similar to the modified Swiss legislation, external auditors will be required to report to the audit committee on material weaknesses in internal control in the financial reporting process.
- The full impact of the Directive will crystallize over the next two years as Member States adopt its articles into national law.

# The Global Regulatory Imperative

- This trend toward increased corporate governance guidance and regulations is not limited to the U.S. and Europe.
- Corporate governance requirements have been introduced and refined in Australia, South Africa, China, India, and many other countries around the globe.
- Japan is one of the markets to recently introduce a new regulation. It is expected to become effective in 2008 and places very specific internal control reporting requirements on Japanese public companies.

# Support of Key Business Initiatives

- Against this backdrop of increased investor scrutiny and regulation, senior executives still face the daily demands of running the enterprise. Company performance is measured, and shareholder value still is driven primarily, by managing margins and the expectation for year-over-year revenue growth and increased market share.
- Companies increasingly are looking for better ways to deliver on the financial performance expected by stakeholders through a variety of key business initiatives.
- These initiatives may include capital investments and change management activities, such as IT implementations and upgrades, acquisitions, off-shoring various operations, establishing shared service centers, and expanding into international markets.

# Key Elements of the Value-Based Internal Control

- The challenge of delivering a value-based internal control program is to build a methodology that is flexible in its application but includes appropriate rigor. The following multi-step approach can be applied sequentially or in any order depending on the regulatory and business imperatives faced by a company when responding to its risk agenda. It emphasizes three major components of control evaluation — Assessment, Improvement, and ongoing Monitoring— and an ability to balance these activities depending on the drivers of the program—compliance, improvement, or both. This flexible and adaptive approach is fundamental in changing the paradigm from a one-size-fits-all internal control program to a framework that delivers value based on the requirements of specific company stakeholders.

# What Value Should Be Delivered from the Internal Control Investment?

- Leading companies are realizing competitive advantages from investments in a value-driven approach. These benefits include:
  - Positive influence on investor confidence through increased transparency and fewer surprises.
  - Better understanding and alignment of appropriate controls to key risks for major capital programs and change initiatives vital to the successful execution of the company's business strategy.
  - More timely and reliable financial and business reporting.
  - Elimination of outdated, redundant, and ineffective controls.
  - Enhancement of processes, and the underlying control structures, to drive operating effectiveness and cost efficiencies.

# What Value Should Be Delivered from the Internal Control Investment?

- For a company to determine if it is maximizing the risk coverage and value from its internal control investments, these questions may help in evaluating its current state:
  - What are the significant financial and business/operational risks within the company, and is the internal control program aligned with these risks?
  - What are the evolving expectations of your key stakeholders around corporate governance and risk management?
  - How do you plan to address anticipated regulatory changes around risk and management and internal control?
  - Is your current internal control program adequate to address these expectations and future requirements?
  - Does the company leverage the results and knowledge from internal control, compliance and monitoring programs to improve financial and business/operational processes?

# What Value Should Be Delivered from the Internal Control Investment?

- Answers to these questions will vary by company and will be influenced by the business and regulatory environment. However, companies should not forget that regulators and investors will continue to increase pressure to improve risk management and disclosures around internal control programs.
- How a company approaches risk management and internal control can be a competitive advantage. Boards of directors, audit committees, and senior executives should not view an internal control program as a compliance expense, but as an investment to better achieve its strategic goals and objectives.