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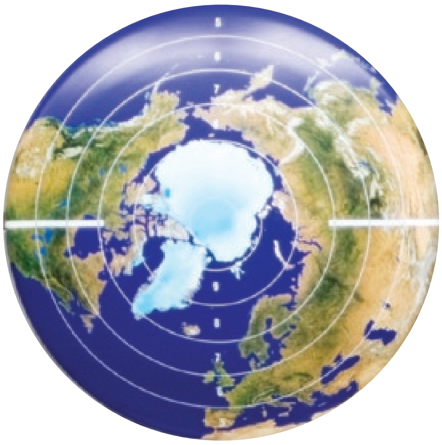
Leveraging Value from Internal Controls

The Challenges of Improving the Internal Control Structure



Many non-SEC companies, not forced to comply with Sarbanes-Oxley Section 404 (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, and 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.

This article examines how leading non-SEC companies are leveraging their investments in internal control. These companies are developing programs that monitor and improve risk and control processes across the enterprise—financial, business, and operational. In particular, this article addresses why leading companies are making these investments, how they are implementing an efficient and effective value-based internal control program, and the key business benefits they are gaining from this type of program.

Why Are Leading Companies Investing in Internal Control?

The financial markets do not like surprises, and increasingly, the investment community is scrutinizing companies' disclosures relating to their corporate governance standards, risk management processes, and internal control structure as part of the investment decision.

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 remediated, 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.

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

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. This is driving boards, audit committees, and senior executives of Swiss Registrants to revisit and evaluate the financial processes across the enterprise and develop an enhanced internal control structure. Many Swiss companies also are using this evaluation process as a springboard to evaluate the entire risk management 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.

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.

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.

The success of these programs is predicated upon the delivery of a defined benefit, the effective use of capital resources, and the assumption of measured business risks. How comfortable, though, are companies that the business risks around these major programs and change initiatives are being properly controlled and managed? Almost daily, companies are reporting the failure to realize desired outcomes of major programs, significant overruns in budgets, and the late delivery of programs due to the failure to adequately manage associated risks.

A 2006 Ernst & Young survey of 441 senior executives from companies in the Americas, Europe, and Asia identified concerns across the executive suite regarding the degree of risk in today's business environment, and how well this risk is being managed. This survey reported:

- 66% of respondents perceive a change and rise in risk levels over the last two to three years.
- 42% say that there are gaps in their risk coverage.
- 40% do not have formal processes to align risk management with corporate strategy and major programs that enable that strategy.

These survey results suggest that companies still have some distance to go with their risk management and internal control programs. By not aligning risk management and internal controls investments with strategic initiatives, companies are jeopardizing operational and financial performance and, over the long run, will not optimize return to shareholders.

Creating a Value-Based Internal Control Program

The Right Risk Focus

Common themes have emerged from analyzing the results of companies' SOX 404 disclosures. Processes with the greatest likelihood of failure or error include the financial statement close, tax, revenue recognition, and the IT control environment processes. These processes tend to be less understood and less well controlled by management teams. Company-level controls and weaknesses in the tone at the top of the company and inadequate monitoring controls have been sources of control failures and breakdowns. Non-SEC listed companies may want to focus their financial reporting internal control improvement programs in these areas.

In addition, risk focus is expanding to address not just financial reporting risks but all business risks. Listing requirements in the U.S. and regulations in many countries outside of the U.S. are requiring that boards have appropriate oversight of business and operational, as well as financial, processes. Moreover, significant risks to any company reside in its operational processes and functions. Thus, the most effective internal control programs cover the full risk profile of the company, adopting an enterprise-wide view of risk that includes both financial reporting as well as key business/operational processes.

Beyond Control Monitoring to Process Improvement

A true value-based review of enterprise-wide risks and controls transcends the traditional view—with its emphasis on monitoring adherence to policy and procedures and identifying and reporting areas of non-compliance. A value-based view of internal controls is augmented through a control/process improvement approach, which is factored into each stage of the work. This approach represents a step-change for many internal control and compliance professionals, and demands that the team performing the review or assessment, identify opportunities to improve controls and processes, introduce increased efficiency, and drive greater return on investment.

An Expanded View of Risk & Control

Key Elements of the Value-Based Internal Control Approach

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.

Five Stage Approach to Internal Control Review

Value-Based Approach to Internal Control

Enterprise Risk Assessment	Prioritize Risks & Processes	Top-Down Control Review	Monitor/Report	Improvement
• Risk assessment • Risk analysis • Align with key initiatives and strategies	• Quantify risk assessment • Align processes to risks • Assess likelihood of error or process failure • Identify processes of significance	• Assess company-level controls • Map the influence of company-level controls to processes controls to processes	• What to monitor • Who will monitor • How to monitor • When to monitor	• Rationalize • Optimize • Enhance

→ ASSESS ← → IMPROVE ← → MONITOR ←

Enterprise Risk Assessment

The risk assessment process is a fundamental activity in any internal control program.

In performing the risk assessment process, the following questions should be addressed to focus the internal control program on the areas of greatest concern to stakeholders.

- What is the scope of the internal control program (financial reporting, business and/or operational, or a combination)?
- Which locations and processes are of major concern?
- What areas of the company have had control problems in the past?
- Where have our competitors had control problems?
- Which operations have consistently underperformed?

- Which capital projects or major change initiatives are the most strategic to the company's results?
- Where are the greatest risks of fraud?
- Is the internal control structure aligned with the company's future direction?

The outcome from this assessment should be a clear understanding of the company's risk profile as well as the purpose and mandate of the internal control program.

Prioritize Risks and Processes

Risks are prioritized based on a range of qualitative and quantitative criteria, which indicate the likelihood of an error or sub-optimal performance for a given process. This defines the significance of the work to be performed, the type of review required, and the associated business benefit.

Top-Down Control Review

Company-level controls are the foundation of any company's internal control environment. These controls fall into two broad categories: "setting the tone" and monitoring activity. "Setting the tone" includes issuing policies and procedures and defining terms of reference for the board and its standing committees and ethic programs. Monitoring activities include the financial statement close process, financial and operational variance analyses, and internal audit's capabilities and coverage of major risk areas.

The value and importance of an appropriate suite of company-level controls has come into sharper focus over the last few years through the implementation of SOX 404. Company-level controls, if designed and operated effectively, can provide a key source of reliance and reduce evaluation of controls at the transaction level when performing compliance or regulatory reviews. This reduces the cost of the compliance program.

In addition, strong company-level controls are one of the most important elements of a highly effective internal control structure. They are the backbone of an effective control environment and integral to the control culture in a company. These controls guide and enable execution of day-to-day business operations, provide the flags and tools to measure delivery of objectives, and reduce the risk of a major process failure.

Monitoring and Reporting

The extent of detailed internal control monitoring and assurance is based on the risk associated with the process or program and is aligned with board, audit committee, and senior executive requirements. A key challenge in this area is to balance the source of the assurance and monitoring, the cost of its provision, levels of objectivity, and the competency of the provider versus the nature of the risk and complexity of the control. Leading companies are implementing innovative responses to monitoring and assurance demands through the appropriate use of multiple sources: self-assessment by managers and process owners, internal audit functions, and third-party service providers.

Improvement

The results of the risk assessment, process/risk mapping, and monitoring activities at a company provide detailed insights into the effectiveness and efficiency of the controls and associated processes. Historically, findings and recommendations from internal control programs have addressed each individual issue and replaced an ineffective control with an effective alternative and may have ignored process inefficiencies. A value-based approach also considers the sum of control and process issues from both effectiveness and efficiency perspectives, including the root causes of failures or performance variability, and identifies how the control and business process can be improved or enhanced.

The improvement stage of this approach is the actual improvement process itself. This is an on-going controls efficiency and process improvement focus that is built into the program. Whenever an issue is identified from the risk assessment, process/risk mapping, or monitoring activities, it is perceived as an opportunity to do things better, not merely to fix an isolated compliance issue.

This stage comprises three phases, which are not necessarily sequential.

- **Control Rationalization**—the removal of redundant and ineffective controls from the process.
- **Control Optimization**—aligning the most cost effective control processes across the company for like operations and maximizing the use of IT controls.
- **Process and Control Improvement**—fixing the root cause of the issue and improving the process rather than addressing each control deficiency separately. This is achieved through the application of a series of business improvement techniques to design the right process with embedded efficient controls.

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.

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 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?

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.

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