Assurance and Advisory Business Services

May 2004

Ernst & Young

Quality In Everything We Do

# Emerging Trends in Internal Controls

## Second Survey

The survey results and observations included herein are not scientific. The results are meant to provide you with general information as to how companies are acting and reacting to key issues they encounter in implementing the requirements of Section 404 of the Sarbanes Oxley Act of 2002.

# To Our Clients and Friends

As companies approach deadlines for implementing Section 404 of the Sarbanes-Oxley Act of 2002, they are concerned about many of the same issues they were facing a year ago, and are now also addressing newer challenges. Ernst & Young continues to share information we have gathered about Section 404 implementation activities from our ongoing surveys and meetings with major businesses. We hope you find this information helpful as your company drives toward the deadline for addressing the effectiveness of internal controls over financial reporting.

Our December 2003 survey polled companies on the early phases of Section 404 implementation and was summarized in our publication, *Emerging Trends in Internal Controls—Initial Survey*. Our current survey was conducted in April 2004 and, like the previous survey, is representative of a wide cross-section of industries. The survey identifies what we believe to be current key Section 404 issues. We then add our findings, observations, and analyses derived from interactions with corporate executives, including executives participating in our Ernst & Young Section 404 Roundtable series.

This survey addresses the following issues:

- Section 404 project progress and level of effort
- Approaches for evaluating company-wide controls
- Documentation and testing: who, what, and how much?
- Ongoing monitoring
- 404+1 and beyond—achieving sustainability

Understanding these issues is important as your company completes its Section 404 implementation activities and drives toward compliance. We hope our ongoing research and communications are helpful to your company at this critical time. Ernst & Young will continue to observe and analyze key issues around Section 404 and will provide updates to help make your path clearer and more predictable.

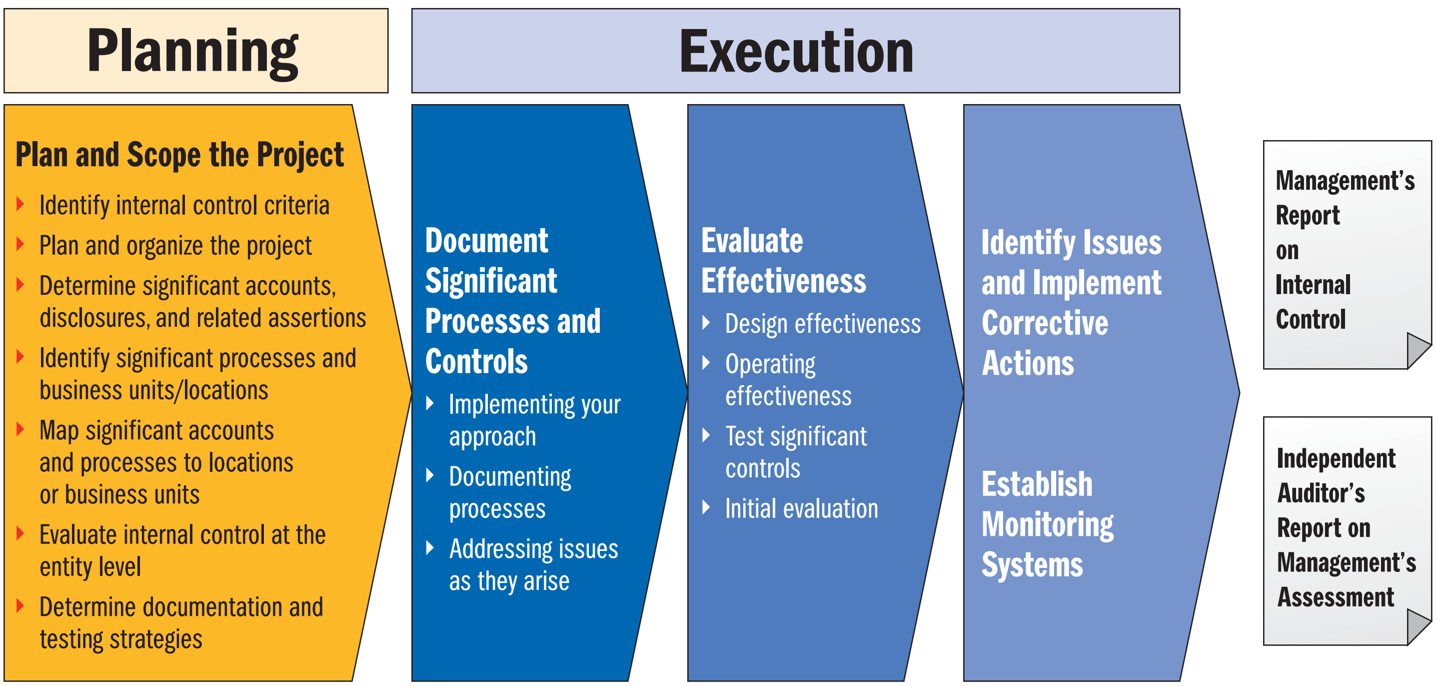
To provide comments, ask questions, or obtain additional information, contact Tom Bussa, global director of Business Risk Services at Thomas.Bussa@ey.com or your local Ernst & Young office.

Ernst + Young

# Process Overview

Businesses today are now in their second year of implementing the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404). Most companies are focused, committed to their processes, and building toward successful implementation, mindful of the uncertain consequences of an other-than-qualified opinion on the effectiveness of internal control over financial reporting.

This represents our second survey undertaken with almost 100 companies as they prepare to make their assertion on the effectiveness of internal controls over financial reporting. Those familiar with our first survey, *Emerging Trends in Internal Controls—Initial Survey,* will recognize the high-level framework, illustrated below, we have used to organize and share key issues, findings, and observations.




Our first survey was conducted in December 2003. Companies have now progressed substantially with their work and we chart their progress towards completion. As the cost of compliance continues to be a source of concern for many companies, we also revisit management's estimates of total effort.

While our first survey focused on the planning phase, this survey examines the nature and scale of the work around execution—in particular, documentation, evaluation, and remediation. We also begin to examine the various approaches that leading companies are adopting to sustain their compliance process beyond year one.

We hope you find this information useful in your own efforts to implement the requirements of Section 404. As the companies in our surveys approach their end goal, we will provide further insights.

# Progress and the Level of Effort

## KEY ISSUE – WHERE ARE MOST COMPANIES IN THE PROCESS?

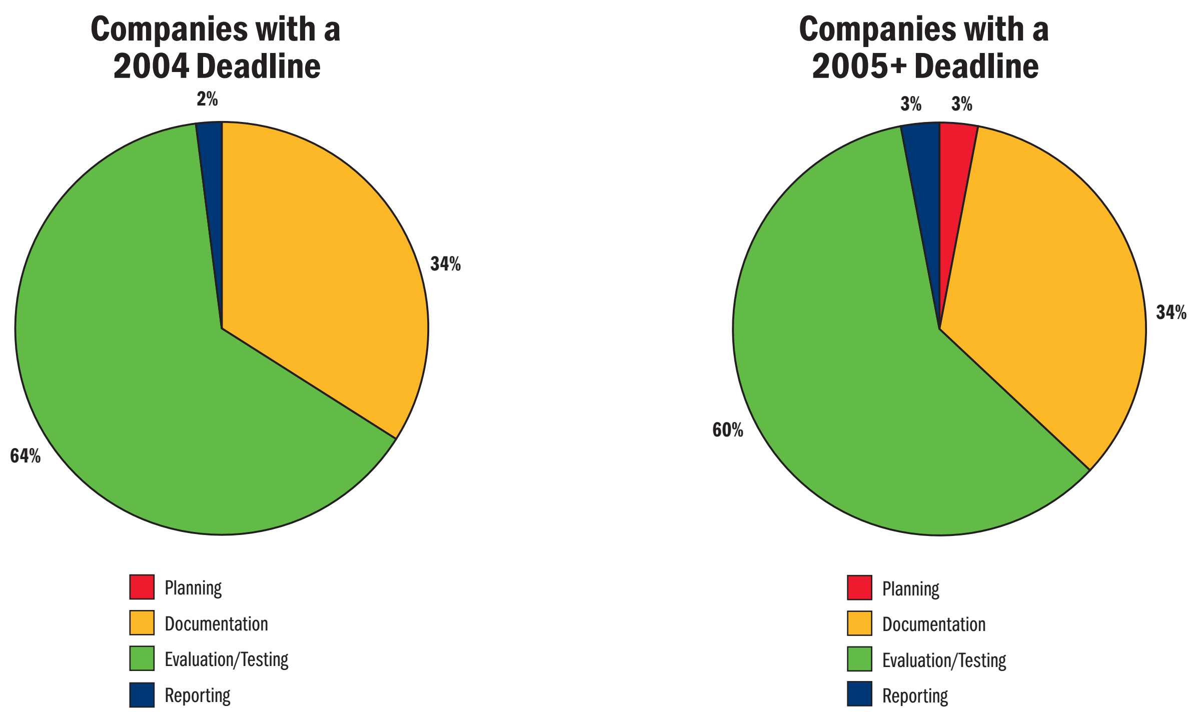
With rapidly approaching deadlines, executives want to be able to benchmark their companies' progress against their industry peers.

### *Findings*

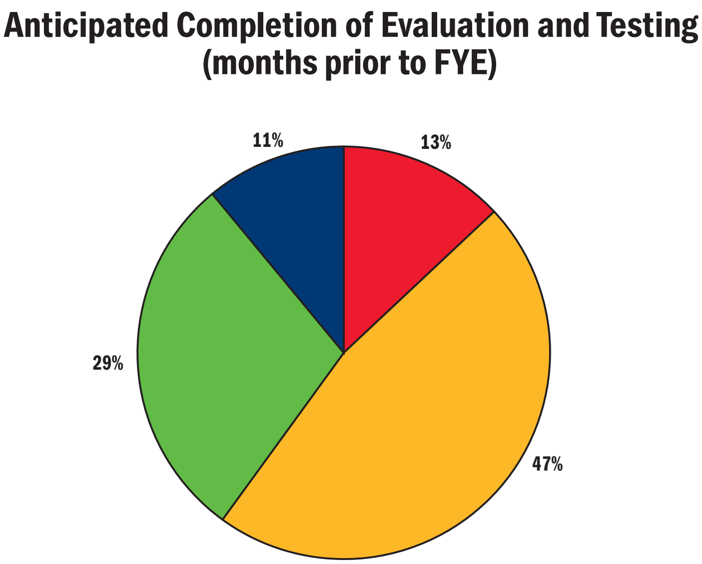
Half of the companies in our initial survey in December had begun documenting their systems and processes. Today, 34% are still in this phase, but most (64%) have moved on to the evaluation and testing phase.

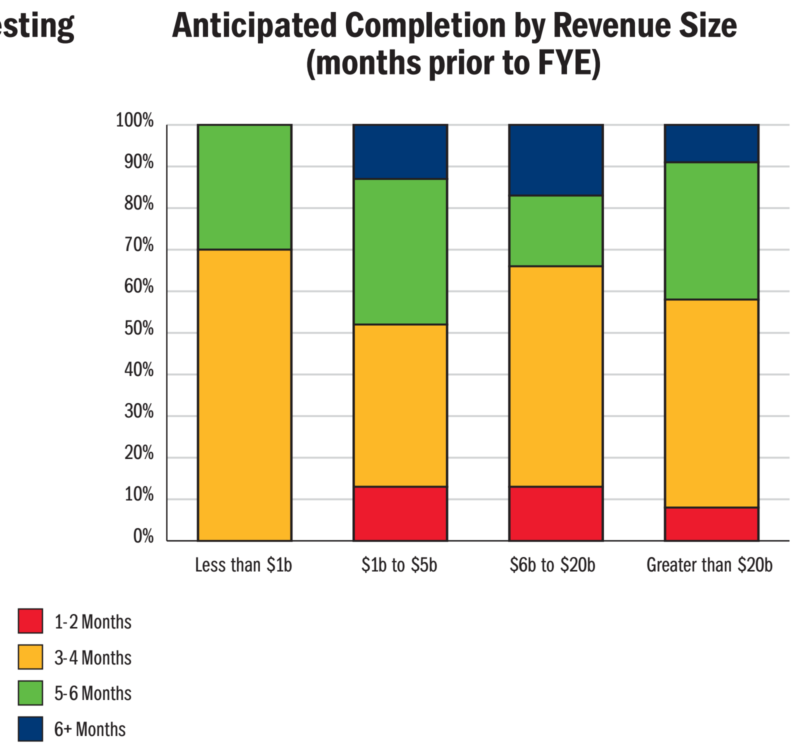
Since December, the Securities and Exchange Commission (SEC) has provided relief to those companies with reporting periods ending prior to November 15, as well as to foreign registrants. Our survey showed that these companies have not slowed down their implementation activities.

**Current Phase of Implementation**



Most companies are targeting completion of the evaluation and testing (which includes remediation) phase well before the end of their reporting period. Only 13% of companies predict they will still be working in this area in the last two months leading to year end.




## *Ernst & Young Observations*

As they did when the SEC initially extended the implementation date, most companies that received a reprieve are staying on pace for an earlier completion. The few companies planning to complete the evaluation and testing phases in the last quarter run the risk of being unable to assert effectively at year end, as well as being unable to coordinate resources effectively with their external auditors.

## KEY ISSUE – WHAT IS THE LEVEL OF EFFORT ON INITIAL IMPLEMENTATION AND COMPLIANCE?

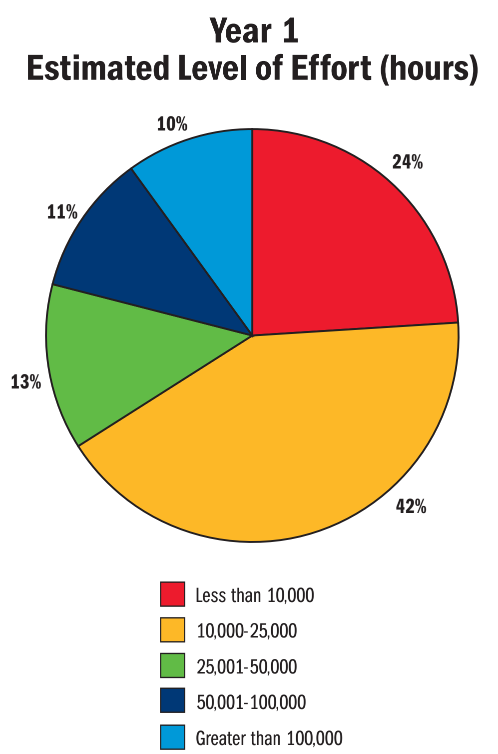
Companies are committing significant effort, both internally and externally, to implement the requirements of Section 404. With the issuance of PCAOB Standard No. 2 (although still subject to final approval by the SEC), and based on experience developed during the process, companies' earlier estimates of effort are being reevaluated. The question still remains, "How do I compare to my peers, and how much are current estimates likely to change?"

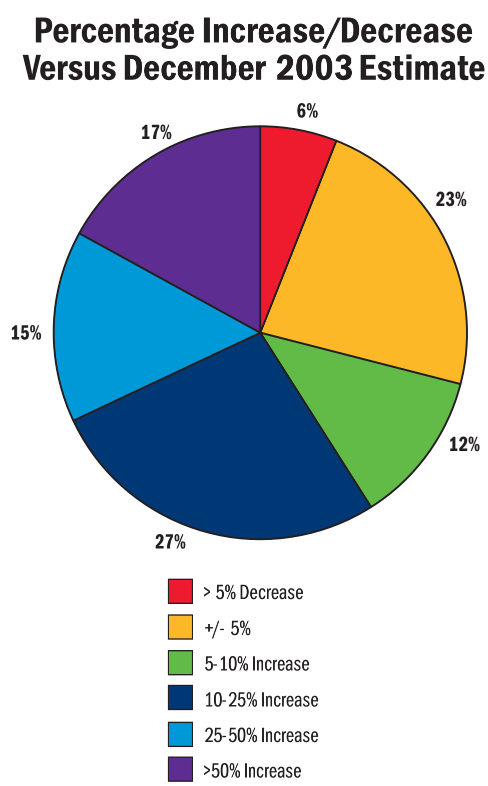
### *Findings*

In December, the estimated level of effort for year-one Section 404 implementation ranged from approximately 8,000 hours for those with revenues less than $1 billion to more than 80,000 hours for those with revenues greater than $20 billion. Today nearly one third of all companies have increased their December estimates by more than 25%, with a substantial number (17%) increasing by more than 50%.

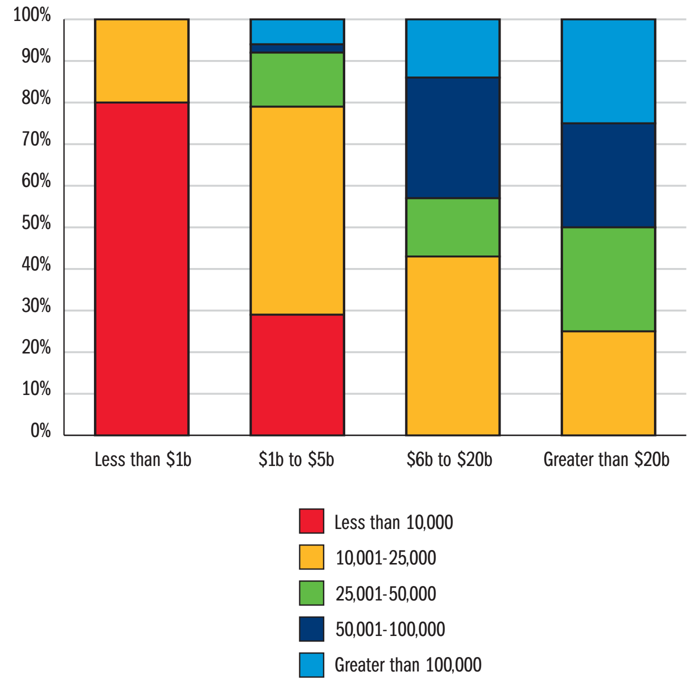
The number of companies in the $1 billion to $20 billion revenue range that are planning to spend more than 100,000 hours has increased dramatically. Nearly half of companies with revenue greater than $5 billion plan to spend more than 50,000 hours.

While companies are now beginning to consider remediation processes in their budgets, the real cost of remediation will not be known until the projects are further along.



## Updated Level of Effort by Revenue Size (in hours)




## *Ernst & Young Observations*

The degree of effort necessary to implement Section 404 compliance processes will continue to rise. However, the rate of increase in estimates will likely reduce as companies near completion, as they understand the process better, and as the number of unknowns decreases. The most significant unknown is likely to be the overall cost of remediation.

Companies continue to look for ways to reduce the cost of compliance. Our survey results indicate that “best in class performers” have successfully negotiated a number of potential pitfalls.

- Companies are recognizing that the role of the Project Management Office (PMO) changes throughout the project. As the program develops, the role shifts from development to management, with the focus more on deadlines and resources. This requires a different set of skills. Well-planned PMOs are dynamic and able to respond with skills that vary to suit the changing needs of the business.
- One of the most significant sources of rising cost is re-work. Many companies have initially developed an ultimately inefficient approach or methodology. For instance, some focused their review efforts at the process level, anticipating a link to the financial statements at the end. Without a clear mapping of processes to financial statement accounts, they realized after much wasted effort that the scope of work was nearly impossible to contain. Now, they must refocus only on those transaction streams that directly affect the financial statements. Large, decentralized companies that have delegated responsibility for documentation to teams in outlying locations have struggled to achieve the consistency and quality of documentation required for the work to be audited. Successful documentation efforts have involved an integrated quality assurance program to build consistency and quality into the process.
- Some companies have implemented expensive technologies to help enable their Section 404 activities, only to realize that their needs could be met with more simple solutions.
- External auditors plan their work based on how much they can rely on the work of others, based on the competence and objectivity of the individuals performing that work. Using an objective internal audit function and/or a third-party resource with the appropriate skills to perform testing of controls may reduce additional audit fees.

# Execution

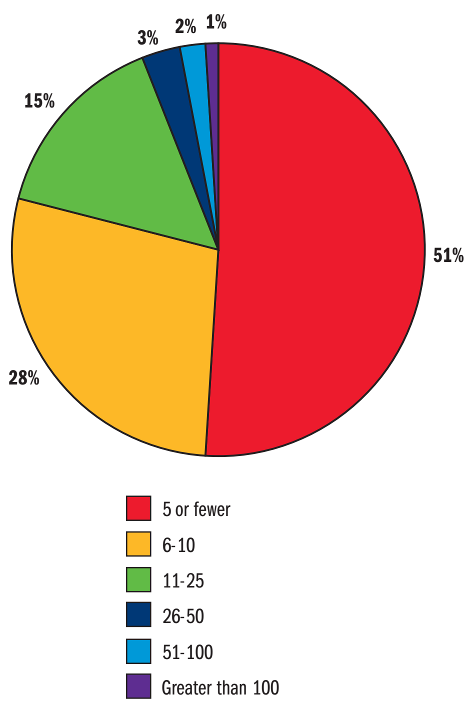
## KEY ISSUE – WHAT IS THE RIGHT APPROACH TO EVALUATING COMPANY-WIDE CONTROLS?

We reported in *Emerging Trends* in December that teams were planning to use three main techniques to document and assess company-wide or entity-level controls. These techniques included interviews with senior management, surveys, and direct testing of controls. Most planned to apply a combination of these techniques to document, assess, and then evaluate those controls. Many companies are now carrying out this work and are looking for leading practices in this area.

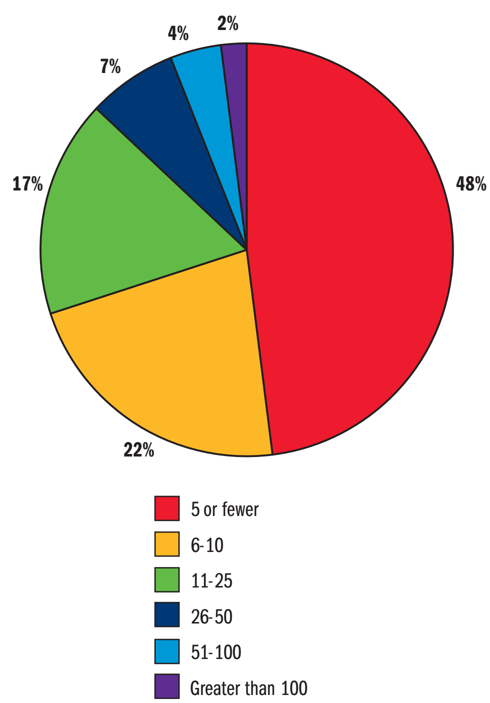
### *Findings*

As a means of capturing information on entity-level controls, interviews appear to be an efficient mechanism. Of our sample of companies, just over half of the interview activity involved five or fewer people, and 28% involved more than five but fewer than 10. Nearly 80% interviewed 10 or fewer people. Surveys generally have been carried out on a small scale as well, with just under half going to fewer than five people. Only 2% of our sample surveyed more than 100 people in the organization.

**Number of Interviews to Support the Entity-Level Assessment**

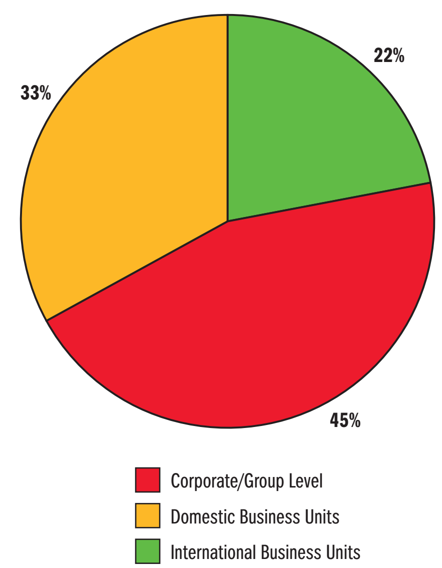



**Number of Surveys to Support the Entity-Level Assessment**



Evidence that the appropriate entity-level controls are functioning correctly is divided almost evenly between tests at the corporate headquarters and tests carried out at business units. Some 22% of companies were performing testing at business units at international locations.

**Entity-Level Controls
Locations Covered Through Direct Testing**




## *Ernst & Young Observations*

The evaluation of entity-level controls has proven to be one of the most challenging areas in implementing the requirements of Section 404. Evaluating the effective design and operation of entity-level controls is, in many respects, a subjective process requiring a great deal of judgment. Many of the entity-level controls that management identifies can be documented only through additional inquiry, observations, or inspection of documentation. This is especially the case when evaluating the "tone at the top," or the company's control consciousness and operating style.

Effective assessments have included a discussion with senior management at the outset to establish the process and controls. A checklist may be useful to guide the interview process. As part of the discussion, asking senior management how they know the controls are in place can help determine whether a control has been placed in operation, as well as its operating effectiveness. Only after obtaining this insight can an effective testing strategy be developed. That strategy may be a combination of different activities, i.e., additional inquiries, including in-depth surveys, direct re-performance of the controls, or observation of the control being performed.

# Documentation

## KEY ISSUE – WHAT LEVEL OF COVERAGE IS BEING ACHIEVED?

Extent of coverage was a key topic during the planning phase. As the guidance provided by PCAOB Standard No. 2 requires extensive further interpretation by issuers and auditors, executives remain interested in knowing on what level of coverage their peers are basing their assessments.

### *Findings*

Section 404 project teams are performing transaction-level documentation and control testing to provide coverage of more than 80% of revenues in all but the largest companies, 70% of business unit locations, between 75% and 90% of net assets, and between 70% and 85% of pre-tax income of their companies.

Our findings indicate that 75% of those locations selected for detailed documentation and controls evaluation were on the list because of their relative size to the overall company, 14% because they include a process that presents a particular financial statement risk, and 11% because they were aggregated with other immaterial locations that, taken together, could contain a material misstatement if controls were to be inadequate.

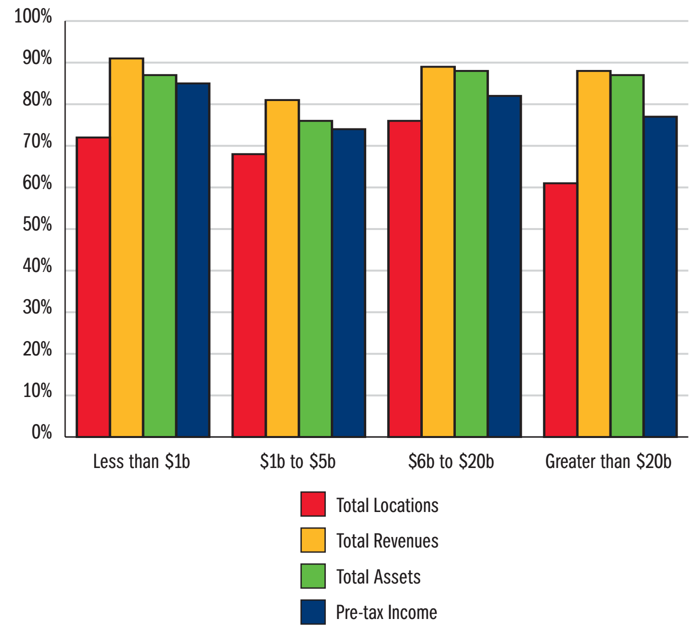
In our survey group of companies, one third had selected fewer than five locations and only 10% had selected more than 50 locations to include in their Section 404 project scope.

### *Ernst & Young Observations*

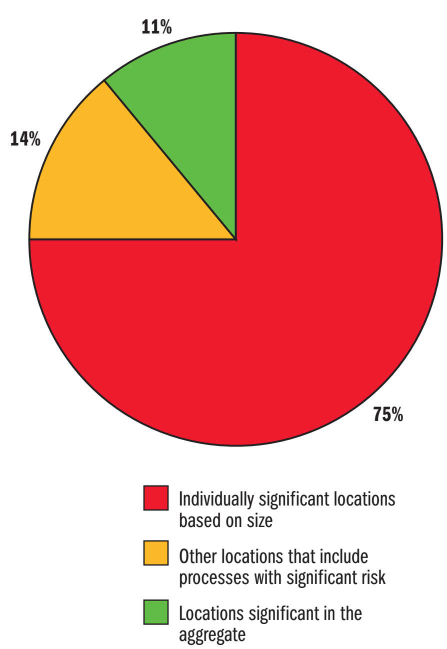
Overall coverage appears to be in line with interpretations of PCAOB guidance suggesting that transaction-level testing of controls cover a large portion of the company's operations and financial position.

Seeing the benefits of increased control consciousness, many companies plan to extend the work to remaining locations post-implementation to achieve as close to 100% coverage as possible.

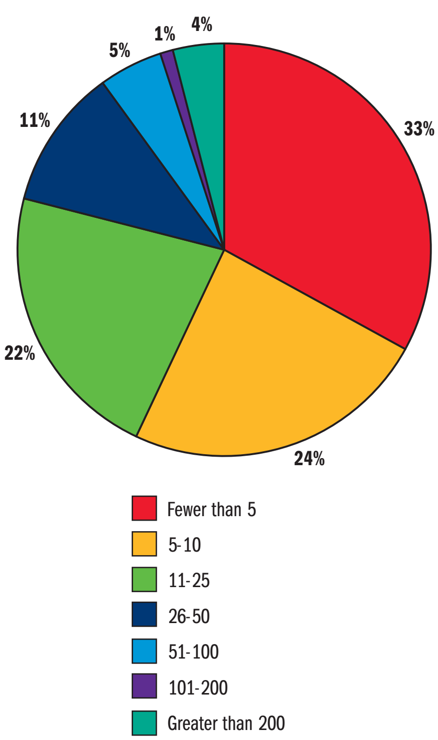
**Extent of Coverage**




**Location Selection**




**Number of Locations**



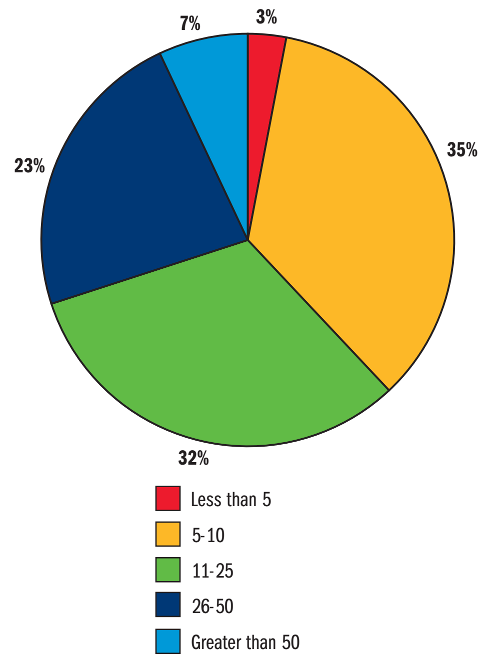
## KEY ISSUE – HOW MUCH TO DOCUMENT?

While there is little variation in the extent of coverage, the amount of work done at each location varies considerably. Determining the appropriate amount of documentation breaks down into some simple component questions: How many processes are being documented? How many controls are being documented within each process? What is a reasonable benchmark?

### *Findings*

We found that two thirds of all companies evaluated fewer than 25 processes per location, and that very few (7%) were documenting more than 50 processes at a location. Companies documenting more than 50 processes per location were predominantly in the energy, chemicals, utility, and financial services sectors.

**Average Number of Processes Per Location**




### *Ernst & Young Observations*

The number of processes being documented at each location depends on a number of factors, including the complexity of the significant accounts, the industry, the significance of each underlying process, the span of each location (e.g., whether the location handles only sales or is a fully functioning business unit with procurement, manufacturing, and sales) and the overall depth of analysis (e.g., major or sub-process level analysis). Our survey findings reflect the mix described above.

It is not easy to determine a benchmark for the number of processes to evaluate within each location. It is essential to make the appropriate linkage between the overall financial statements accounts, related assertions, and the transactions/processes at each location. Processes identified and documented should support classes of transactions that represent significant risks for which the related controls need to be documented, tested, and evaluated. Missteps in this area can magnify the overall level of effort and can jeopardize completion of the project if not managed carefully.

Leading practices include:

- Centrally managing scope (rather than allowing local management to determine the detailed scope), which contributes to consistency.
- Installing a central quality function across the organization to ensure consistent determination of the appropriate controls to document and test.
- Involving external audit early in the process to provide feedback on location approach.
- Using industry peer groups to develop a consensus, normative view.

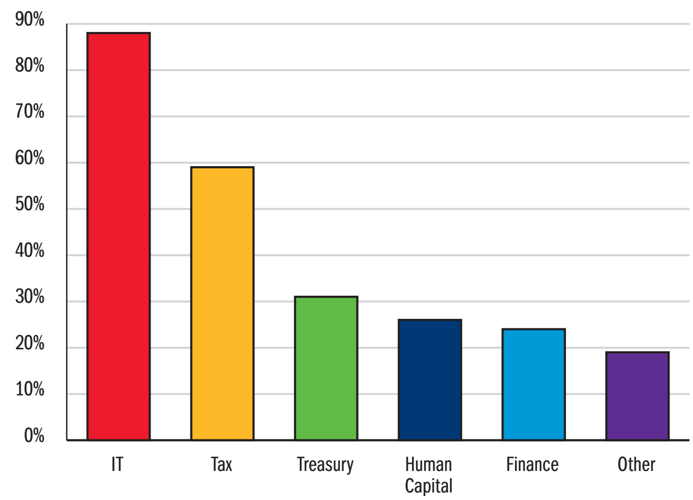
## KEY ISSUE – WHAT IS THE APPROPRIATE MIX OF EXTERNAL SPECIALIST ASSISTANCE AND RESOURCES?

Integrating external resources into Section 404 processes takes organizational effort. Benefits can include a more rigorous process and a lower risk of an eventual audit finding. Section 404 executives and project team leaders frequently ask, “What are the types of external specialist resources being deployed, and how are companies using them?”

### *Findings*

Nearly all of the companies in our survey used some form of external assistance. IT and tax continue to be primary areas where in-house skills have been supplemented.

**External Specialists Skills**




### *Ernst & Young Observations*

Information technology remains an area where many companies have requested external help. One reason for this is the lack of internal resources within the corporate IT department and/or internal audit function with the appropriate skills to evaluate IT general controls and make the appropriate linkages from business process to financial reporting objectives. Given the reliance on IT pervasive throughout many organizations, this is a high-priority area. Below we analyze current remediation experiences (albeit currently at an early stage), highlighting a number of failures in IT general and application-specific controls.

Tax also continues to be an area where process and control documentation is deficient or missing: at the same time, it is an area where the non-systematic nature of the underlying processes and the degree of judgment involved in calculating the tax provision and accounting for other taxes heightens the risk of misstatement, whether due to error or management override. An aspect of tax that has caught the attention of many CFOs, particularly in large, complex companies, is the detailed process compliance requirements associated with many tax savings schemes. Non-compliance may result in large material unrecorded tax liabilities for some organizations.

## KEY ISSUE – WHAT IS THE RIGHT APPROACH TO CONTROLS AT SERVICE ORGANIZATIONS?

In our *Emerging Trends* survey in December, we reviewed the approaches companies were taking with service organizations. Since then, a clearer picture of the scale and nature of the effort, as well as the range of such approaches, is taking shape.

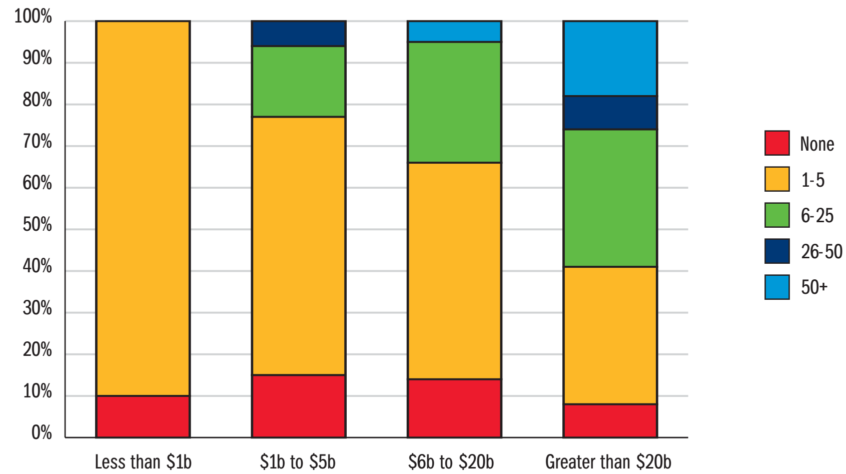
### *Findings*

Most organizations have between one and five third-party service organizations that are significant to the implementation of Section 404 requirements. Some of the largest companies in our survey have retained more than 50 third-party service organization relationships.

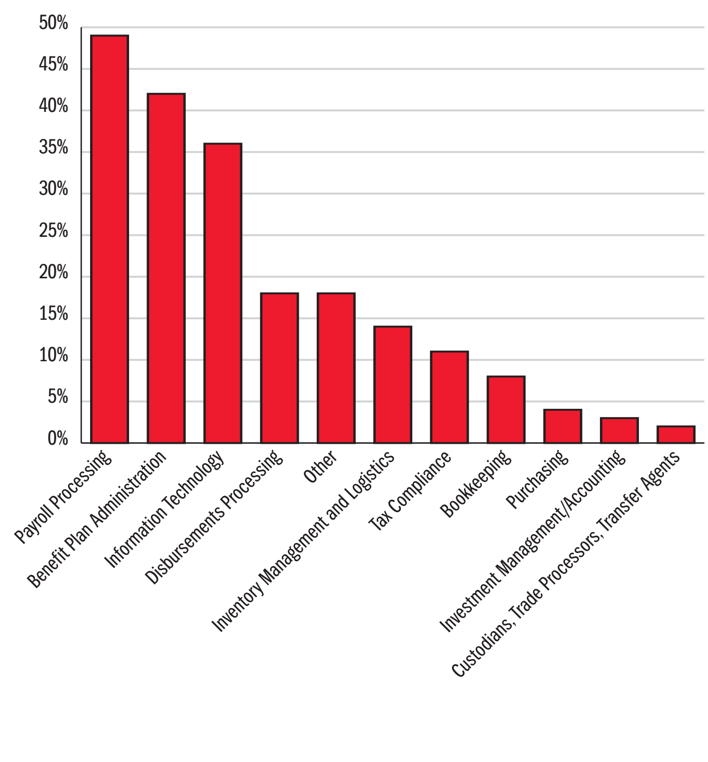
The most common areas of outsourced processing include human resources, such as payroll processing and benefits administration, and IT.

Of those with more than one service provider, approximately 43% of companies plan to use a Service Auditor Report, an opinion based on Statement on Auditing Standards No. 70 (SAS 70).

**Number of Service Organizations Included Within the Scope of 404 Activities**




**Areas of Outsourced Processing**



## *Ernst & Young Observations*

Outsourcing is prevalent in today's business environment. Very few companies, across all revenue ranges, have no outsourced services. Our observations on the implications of this on Section 404 requirements remain unchanged from our preliminary survey.

In recent discussions during our *Ernst & Young Section 404 Roundtable Series,* company executives have expressed concern about whether audit firms have the capacity to perform the necessary number of SAS 70-type audits that may be required.

Best-in-class public companies are cataloging all third-party relationships, risk rating those outsourced operations, analyzing the number and size of the transactions that are being processed, and then determining the effect on their systems of internal control. Next, these companies are proactively challenging their service providers as to the scope and timing of the Service Auditor Reports and other information they are provided, in some cases requesting the service organizations to provide more timely or thorough information to better assist the companies with their Section 404 projects.

Outsourcers are proactively managing public company expectations by soliciting feedback from their user organizations and their auditors and establishing plans for addressing common issues, including clients' and their affiliates' fiscal year-ends occurring throughout the year. (Best-in-class outsourcers have elected to issue semi-annual Service Auditor Reports (i.e., for the period ended May 31 and November 30) covering a rolling 12 months.) In contrast, outsourcers that have not yet been required to build these obligations into their service contracts, or are not planning to meet these new requests in 2004, can expect more frequent requests for on-site audit visits from public company customers and their auditors.

## KEY ISSUE – HOW WILL COMPANIES MANAGE SIGNIFICANT EVENTS OCCURRING NEAR YEAR END?

Business cannot stop to allow time for company management to implement the requirements of Section 404. Many companies now are grappling with the issue of significant business transactions, such as acquisitions, and IT implementations that occur close to the end of the annual reporting period.

### *Findings*

Approximately 30% of the surveyed companies plan to implement or change an IT system in the last quarter of their fiscal year; 20% of companies anticipate merger or acquisition activity. Many others have ongoing process-reengineering programs that will span the year end. An additional 25% were planning similar activities but have postponed them until after year end.

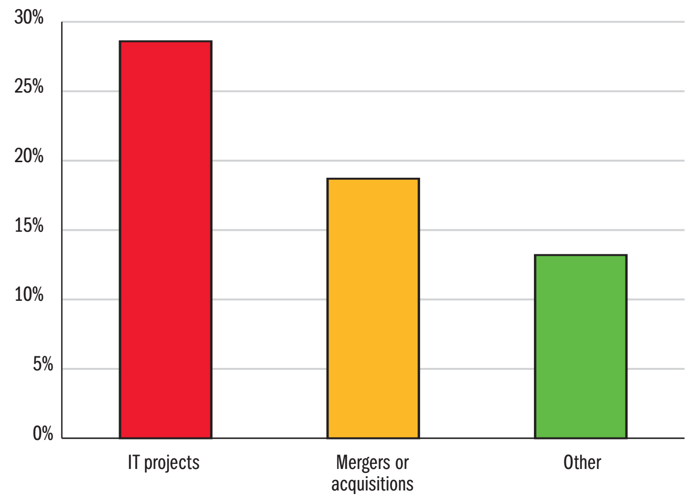
### *Ernst & Young Observations*

Companies with good control environments and well-established approaches to documenting systems and processes—including risks and controls through each stage of the system development life cycle—are in a good position to implement change close to the end of the company's annual reporting period. However, even those companies need to establish a timetable including a sufficient period to demonstrate that controls are operating as designed, and to allow management and external auditors sufficient time to evaluate the operating effectiveness of controls before the end of the reporting period. Effective coordination and communication with external auditors on systems implementation is essential for close-to-year-end implementations.

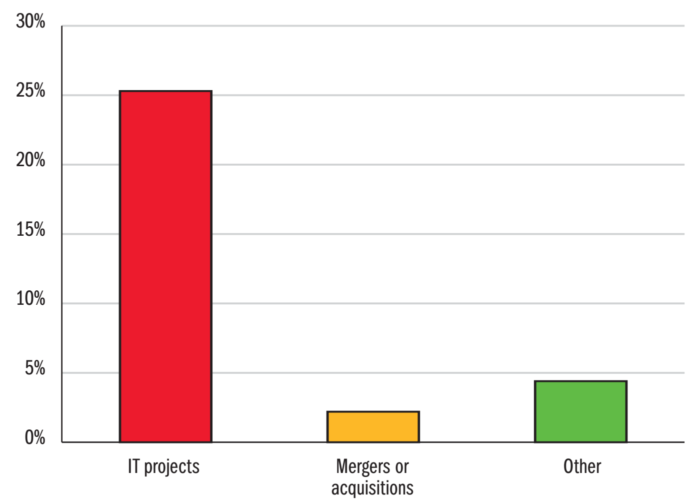
Acquiring an entity immediately prior to year end can have a significant effect on a company's ability to make its assertion on internal controls over financial reporting.

In general, companies need to plan their Section 404 activities in conjunction with proposed business projects and activities from the beginning of the process. They must take into account their effect on the annual assessment of internal control over financial reporting in the management and implementation of those projects and activities.

**Events Occurring During the Quarter Preceding the FYE**




**Events Postponed Beyond the FYE**



# Testing

## KEY ISSUE – HOW MUCH TESTING SHOULD BE DONE?

Management must determine upon which documented controls it relies to prevent or detect a material error in the financial statements. Management must identify and test the number of controls that will together provide the necessary level of assurance. Companies are seeking guidance as to a reasonable benchmark.

### *Findings*

We have analyzed the relationship between the number of controls that each of the company's Section 404 teams have documented for a typical process to the number of controls they test within the same process. We have segregated the analysis for routine transaction processes, non-routine processes, and accounting estimation processes.

For routine transaction processes, the emerging trend is to test approximately two thirds of the controls documented. For non-routine processes, the trend is to test approximately 50% of the documented controls. Accounting and estimation processes have the fewest number of controls documented per process, but the number of those controls selected for testing varies considerably.

Not surprisingly, there is a strong correlation between company size and the total number of controls identified for testing. Of the companies surveyed, nearly one third are testing more than 1,000 controls, predominantly those companies with greater than $5 billion in revenue. Among companies with greater than $20 billion in revenue, more than 20% are testing in excess of 5,000 controls.

**Routine Processes**

| | | Number of Controls Documented | | | | |
|---|---|---|---|---|---|---|
| **Percentage of Companies** | | *7%* | *23%* | *33%* | *20%* | *17%* |
| | | *1-5* | *6-10* | *11-20* | *21-50* | *>50* |
| **Number of Controls Tested** | *1-5* | **100%** | **69%** | 17% | 0% | 0% |
| | *6-10* | 0% | 31% | **57%** | 7% | 0% |
| | *11-20* | 0% | 0% | 26% | **64%** | 8% |
| | *21-50* | 0% | 0% | 0% | 29% | 42% |
| | *>50* | 0% | 0% | 0% | 0% | **50%** |

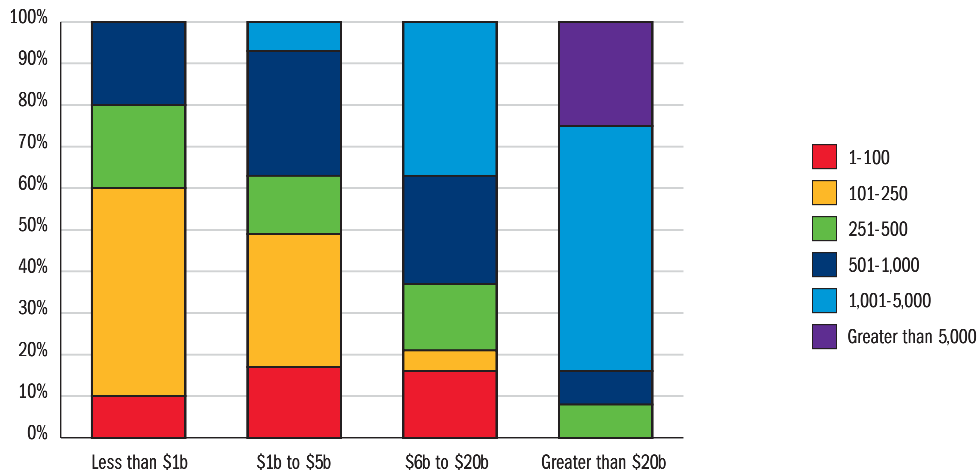
**Non-Routine Processes**

| | | Number of Controls Documented | | | | |
|---|---|---|---|---|---|---|
| **Percentage of Companies** | | *23%* | *24%* | *31%* | *10%* | *11%* |
| | | *1-5* | *6-10* | *11-20* | *21-50* | *>50* |
| **Number of Controls Tested** | *1-5* | **100%** | **53%** | 5% | 0% | 0% |
| | *6-10* | 0% | 47% | **50%** | 14% | 0% |
| | *11-20* | 0% | 0% | 45% | **57%** | 0% |
| | *21-50* | 0% | 0% | 0% | 29% | 13% |
| | *>50* | 0% | 0% | 0% | 0% | **88%** |

**Accounting Estimation Processes**

| | | Number of Controls Documented | | | | |
|---|---|---|---|---|---|---|
| **Percentage of Companies** | | *31%* | *31%* | *23%* | *6%* | *10%* |
| | | *1-5* | *6-10* | *11-20* | *21-50* | *>50* |
| **Number of Controls Tested** | *1-5* | **100%** | 41% | 25% | 0% | 14% |
| | *6-10* | 0% | **59%** | **56%** | 25% | 0% |
| | *11-20* | 0% | 0% | 19% | **75%** | 14% |
| | *21-50* | 0% | 0% | 0% | 0% | **43%** |
| | *>50* | 0% | 0% | 0% | 0% | 29% |

### Total Number of Controls Identified for Both Documentation and Testing




## *Ernst & Young Observations*

Developing an efficient and effective testing strategy is more of an art than a science. Management has to weigh carefully the specific risks or situations that could give rise to errors, and develop an appropriate testing strategy that matches the level of effort expended to test controls to the quality and evidence obtained from the tests. When evaluating controls to test, management should take into account the sensitivity of the control to prevent or detect errors of importance, the competence of the persons performing the control, and the evidence that can be obtained from testing a particular control. Also, management should try to identify common controls that cover multiple risks or "what can go wrong" situations.

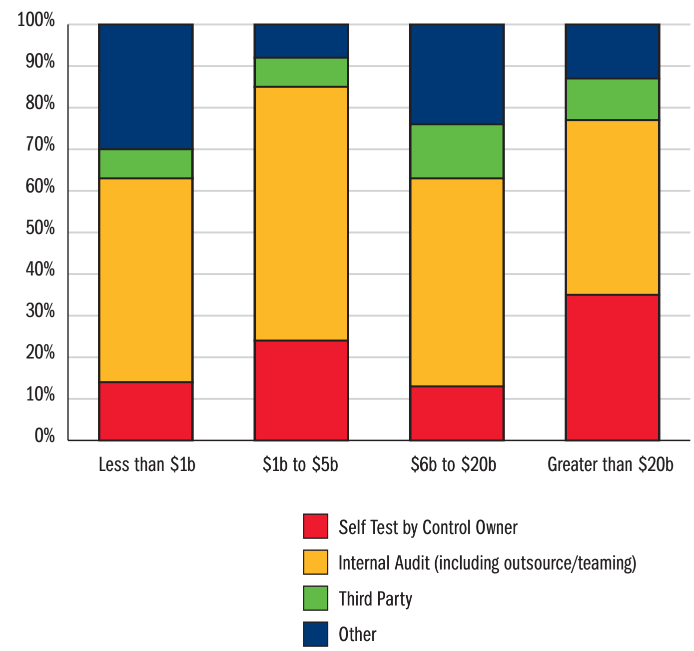
Project teams may encounter some level of redundant or "over-controlled" situations as they develop testing strategies. Many companies are currently focusing wholly on implementing the requirements of Section 404 and plan to go back to obtain process improvements and cost savings after implementation.

## KEY ISSUE – WHO IS DOING THE TESTING WORK?

Testing represents a substantial portion of the work required to evaluate controls over financial reporting. (Our survey indicated 25% for year one, increasing to 45% for year two.) However, the skills required to test effectively and efficiently are not readily found in most employees. Where will the resources come from to do all this work?

### *Findings*

**Who Performs Testing?**




Internal audit functions are undertaking a significant role in testing for many companies. Typically, 50% to 60% of the companies in each revenue category employ internal audit to perform testing. (Internal audit in this analysis includes internal audit that has been outsourced and/or third-party teaming with internal audit to perform the control testing.) A relatively low percentage of surveyed companies has placed this responsibility on the process or control owners. Other resources include dedicated personnel from a financial controller group, and teams established as part of a wider network of compliance functions, including use of third parties as a part of this team. Some companies have engaged other professional services firms to do the work. While over half of the companies have employed internal audit to perform Section 404 testing, there has been considerable debate and some divergence of views as to their role. A substantial number of internal audit directors feel Section 404 compliance is essentially a line management issue and that managing the Section 404 project or leading remediation efforts can impair their objectivity because these are management responsibilities. Many internal audit directors see more value in presenting senior management with a balanced perspective on how the entire process is working, essentially auditing the process rather than playing an active role in it.

### *Ernst & Young Observations*

Clearly, internal audit is playing an important role in testing at the majority of clients. While some internal audit directors are reluctant to take on the testing role because of perceived impairment of objectivity, others are not well equipped for the role in any case. Internal auditors may have fewer of the skills required to do the work because their focus may have moved from financial compliance to operational improvement over time. Those internal audit functions that have been outsourced—particularly those that have outsourced to a Big Four auditing firm—are in a better position to tap into the financial statement auditing expertise and readily available global networks of those firms.

The Institute of Internal Auditors is drafting a practice advisory, "Internal Audit's Role in Sections 302 and 404 of the Sarbanes-Oxley Act." This practice advisory, when issued, should provide greater clarification for assessing the appropriate role of internal audit in testing controls as part of management's assessment.

Most executives now agree on the need for objectivity when ensuring that controls are operating and have a better understanding of the external auditor's ability to use testing performed by competent and objective individuals and the potential effect on the external audit fee. So, while a distributive self-assessment process remains a valid approach to evaluating internal controls, it is being supplemented by objective testing.

Audit committees are becoming more influential in decisions about the allocation of internal audit resources to the areas of most significant business risk. They will have to weigh carefully the balance between the testing requirements of Section 404 and good risk management.

## KEY ISSUE – WHAT ARE THE INITIALLY IDENTIFIED REMEDIATION AREAS?

Although most companies are still in the evaluation and testing phase, some early remediation trends are forming.

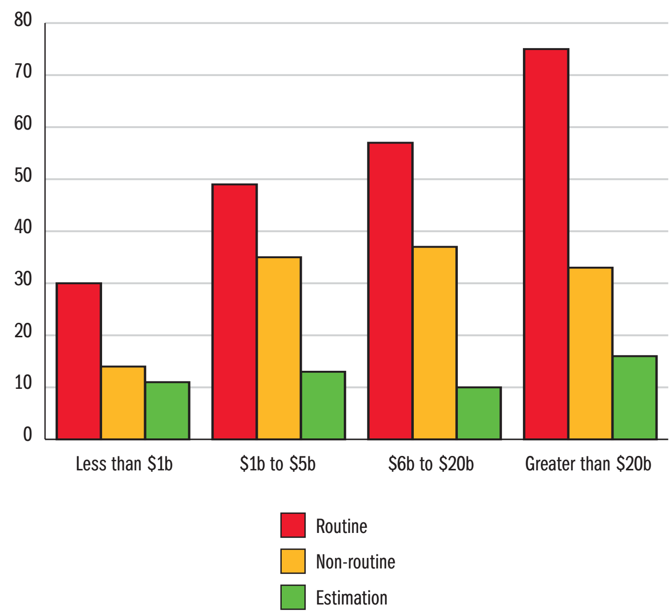
### *Findings*

Perhaps not surprisingly, the amount of remediation in routine data processes increases with the size of the company. The largest companies are typically identifying 70 to 80 control failures that require correction, and the remediation process can affect multiple business units and locations.

Most issues to be remediated arose in the IT general controls area and were associated with inadequate design or lack of key controls.

In general, most weaknesses were found in the design of controls, possibly because most companies are still testing the operating effectiveness of controls and are therefore likely to uncover more weaknesses in that area going forward.

**Average Number of Controls Identified for Remediation (By Process Type)**




### *Ernst & Young Observations*

When we analyze the root cause of control failures that could represent a significant deficiency and/or a potential material weakness, a troubling picture begins to emerge.

The majority of deficiencies were in the IT area, particularly IT general controls. This is a concern because of the pervasive nature of these controls and the degree of work and cost to remedy.

Management needs to consider carefully the timing of work to assess controls in the IT area so that appropriate remediation time can be budgeted. This calls for tight coordination between the work performed over IT and the work performed in other areas of the business. The Section 404 teams cannot afford to make incorrect assumptions about the reliability of computer-generated reports used in executing review and approval controls and the effectiveness of underlying programmed controls in many routine business processes.

**Nature or Type of Control**

| | Entity-Level | Manual | IT-General | IT-Application |
|---|---|---|---|---|
| **Significant deficiency or material weakness caused by design ineffectiveness** | *13%* | *40%* | *42%* | *26%* |
| **Significant deficiency or material weakness caused by operating ineffectiveness** | *9%* | *28%* | *32%* | *26%* |

# Ongoing Monitoring

## KEY ISSUE – WHAT ARE THE EMERGING APPROACHES TO ONGOING MONITORING OF CONTROLS AND HOW CAN THEY GENERATE VALUE?

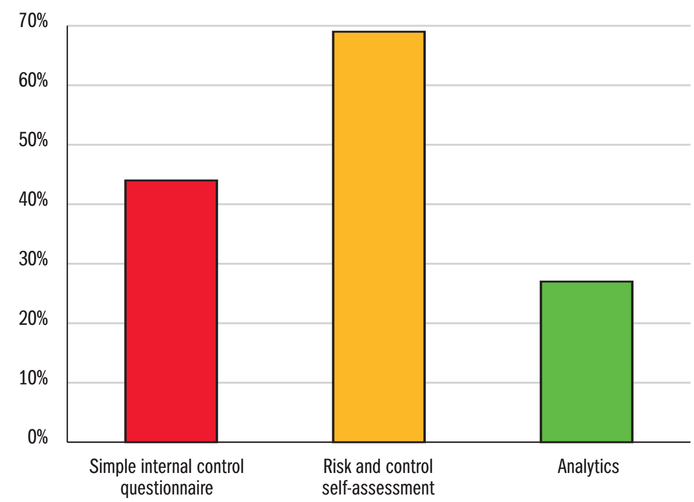
While companies are still evaluating controls over financial reporting for the first time, many have begun to analyze how to make the process sustainable—in particular, the approaches they will use to monitor controls going forward. With the current-year effort and the likely ongoing effort representing a significant cost to companies, many executives want to know where value can be gained. What is emerging?

### *Findings*

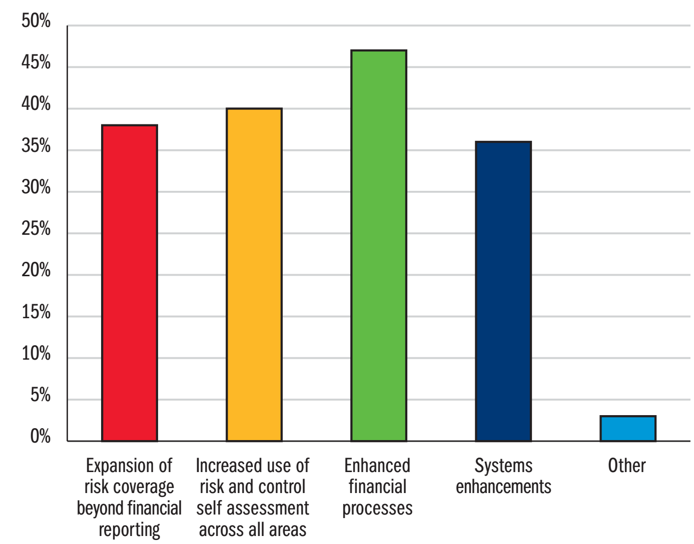
Almost two thirds of all surveyed companies plan to use some form of control self-assessment process to monitor the ongoing effectiveness of controls over financial reporting; 44% plan to use some form of periodic survey questionnaire approach; and 27% plan to use data analytics as part of their monitoring process.

Nearly half of the companies we surveyed pointed to improved financial processes as a benefit of the Section 404 exercise. More than one third anticipate making more general systems improvements. Forty percent expect to gain benefits from implementing a broader risk and controls self-assessment program, and more than one third also plan to extend their coverage to include control objectives beyond controls over financial reporting.

**Ongoing Evaluation and Monitoring**




**Evaluation and Monitoring Value**



## *Ernst & Young Observations*

Companies that distribute or assign ownership for appropriate portions of the assessment process to line management and staff should benefit from decreased ongoing cost of compliance, but more importantly, should realize benefits from an increased control consciousness throughout the organization. Most executives see some form of self-assessment process (a distributive approach for ongoing design effectiveness assessment) for ongoing control evaluation and monitoring as key to this effort. When combined with such a self-assessment process, surveys can provide additional valuable insight into the operation of entity-level controls and the softer factors that contribute to a good control environment. Certain technology tools purchased to implement the first-year process have the capability to enable self-assessment, but have not yet been fully engaged. Some companies will use this approach in the first year of compliance; others plan to build out the infrastructure in year two.

Leading-edge companies will leverage their current significant investment in Section 404 activities and infrastructure into a more broad, sustainable, and structured risk and control self-assessment process as part of a wider approach to manage risk more effectively. They plan to harness the self-assessment process, using technology enablers to provide better-aggregated and more real-time information on risk and controls to senior management and to the audit committee.

Some companies will proceed at a slower pace, broadening their infrastructure to include other COSO control objectives, such as compliance and operations, before tackling a more comprehensive approach to risk.

Many attempts at developing self-assessment programs have failed in the past. It is vitally important that management establish a clear, integrated framework for success that addresses the need to gain real commitment and sponsorship from the top, a solid, tried-and-trusted approach, the right methodology and tools, adequate resources (including specialists), the right support for people on the ground (including training and documentation), and objective testing.

# 404+1 and Beyond – Achieving Sustainability

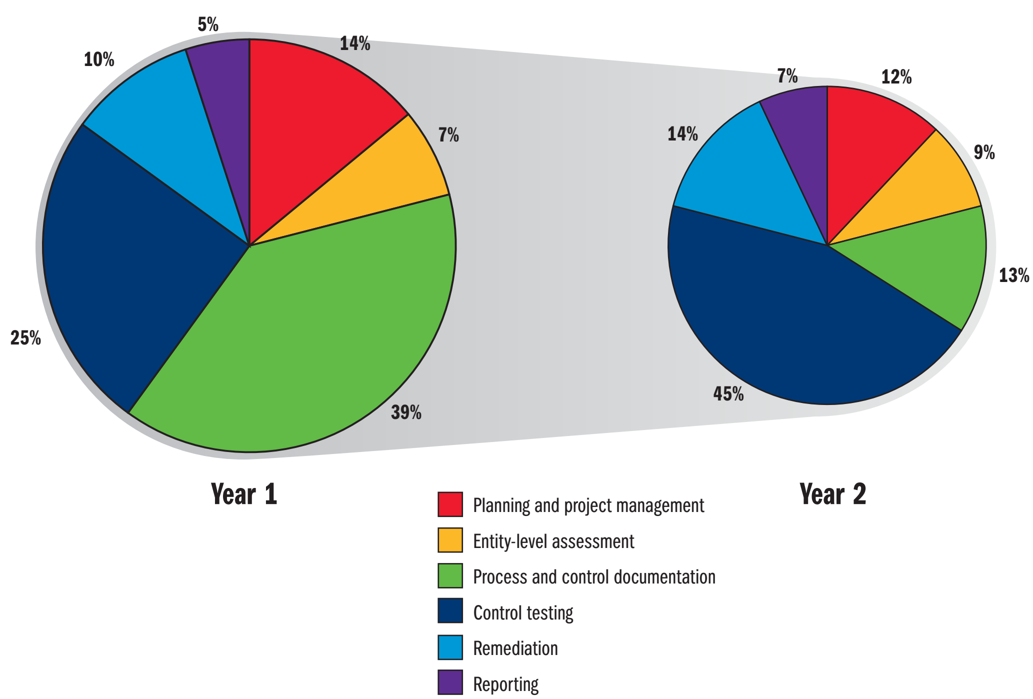
## KEY ISSUE – HOW MUCH EFFORT WILL BE REQUIRED IN YEAR TWO AND BEYOND?

Now that companies are further along in the process of year-one implementation, the full picture of this effort is becoming visible. Although management is focusing heavily on the immediate issues, executives are beginning to think about the sustainability of the process. The first question is how big will the post-implementation effort be?

### *Findings*

When we look at the level of effort being forecast for year one and break it down into the different activities necessary to implement the requirements of Section 404, we can use some simple assumptions to predict the likely needs of ongoing compliance. Let us assume that the level of documentation is reduced by 80% of year-one levels, with the remaining 20% covering walkthroughs, changes in systems and processes, and acquisitions. Further assume that the level of testing will have minimum change, as management will need to demonstrate that controls continue to operate effectively beyond year one. Last, let us assume that reporting and other activities can be reduced by 25% (with project management being reduced by 50%) because the processes associated with these activities have now been established.

**Effort by Activity—Years 1 and 2**



## *Ernst & Young Observations*

The charts show the level of effort analyzed by activity in the first year and the projected scale and analysis of effort in hours for future years, based on the stated assumptions. The conclusion is that between 50% and 75% of the first-year effort will be required in subsequent years. Testing, in particular, will comprise the largest portion of effort. For nearly half of companies with greater than $5 billion in revenue, the estimated level of effort for testing in year two exceeds 12,500 hours. The largest companies in this survey estimate more than 25,000 hours for Section 404-related testing in year two. This is a process that is not going to go away.

Companies must begin thinking now about infrastructure and people requirements for future compliance. Questions to address include:

- Who will manage this process going forward?
- How do we address ongoing documentation?
- Who will do the testing?
- What is the role of internal audit and other risk functions?
- What enablers can be used to make the process as efficient as possible?
- Can any value be extracted from this process?

Several models and approaches are beginning to emerge. These will be discussed in our next publication, *Section 404 Post-Implementation—What You Should Be Thinking About Now.*

## Documenting Controls Over Financial Reporting

**Significant Accounts Selected Based Upon:**
- Errors of importance*
- Size and composition
- Susceptibility to loss or fraud
- High transaction volume
- Transaction complexity
- Subjectivity in determining account balance
- Nature of the account

**Financial Statement Assertions:**
- Existence or occurrence
- Completeness
- Valuation or measurement
- Rights and obligations
- Presentation and disclosure

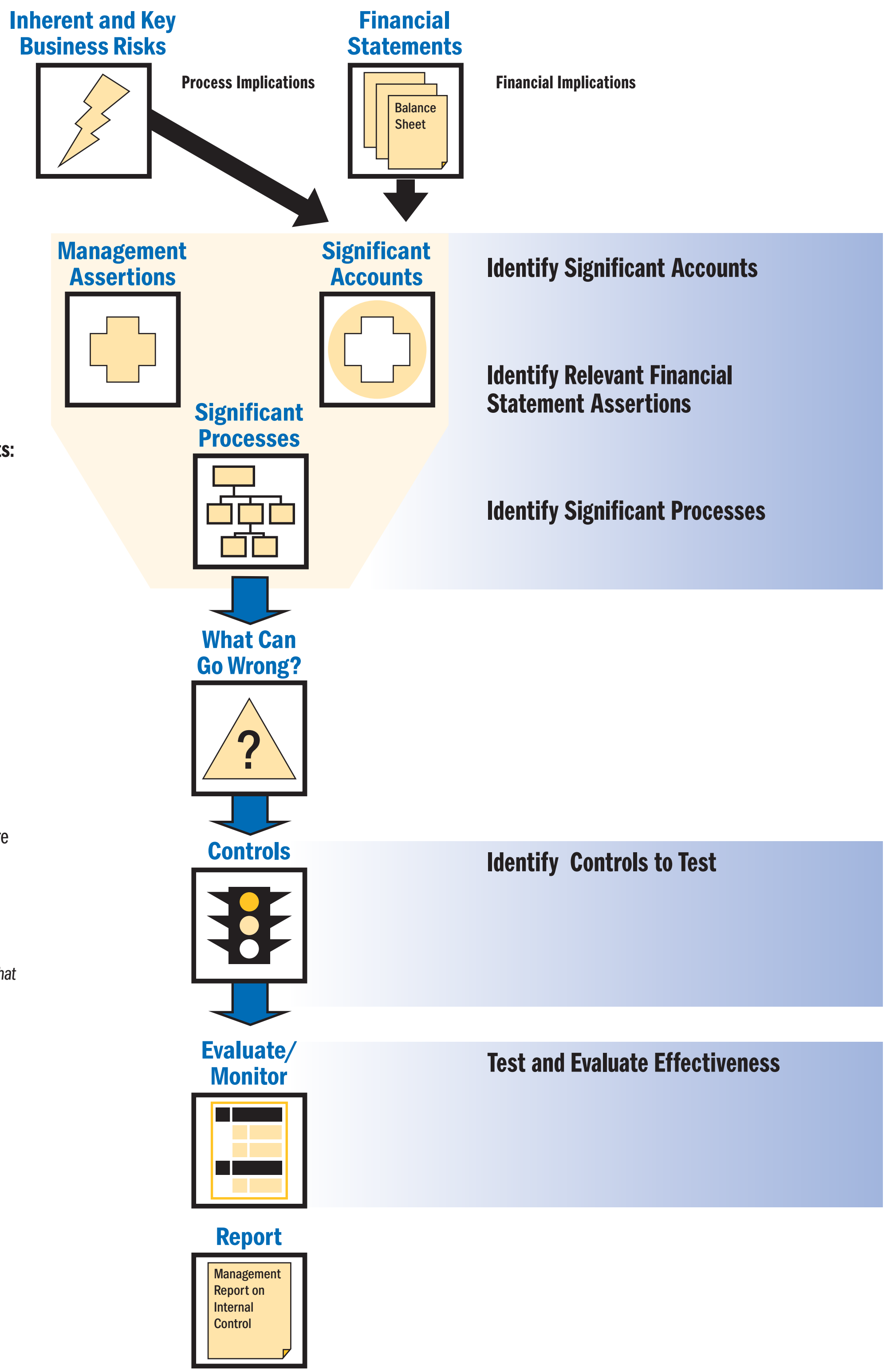
**Processes That Influence the Significant Accounts:**
- Flows of transactions
  - Routine
  - Non-routine
  - Estimation
- IT processes
- Financial statement close process

**For Each Assertion Ask:**
- Where are the points in the flow of transactions where errors can occur?
- Example:

  **Accounts:** Cash or payables
  **Process:** Disbursements
  **Assertion:** Valuation

  *What are the manual and programmed procedures to ensure that the amount of a check or transfer agrees with the amount approved for payment?*

**Controls That Prevent or Detect Errors of Importance* or Fraud:**
- Who Performs?
  - Segregation of duties
- Control Dependent on IT?
  - Application control
  - Electronic evidence
- Company policies and procedures for:
  - Authorization of transactions
  - Safeguarding of assets
  - Asset accountability




* Errors that individually or collectively could have a material effect on the financial statements

ERNST & YOUNG

www.ey.com



SCORE Retrieval File
No. AN0093