Assurance and Advisory Business Services

October 2004

Ernst & Young

Quality In Everything We Do

Emerging Trends in Internal Controls

Third 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

Many companies are approaching their deadline to implement Section 404 of the Sarbanes-Oxley Act of 2002 (the Act), and the need for effective coordination and communication of related activities is more crucial than ever. Ernst & Young continues to provide information we have gathered about Section 404 implementation activities from our ongoing survey work and discussions with major companies across all industries. We hope you find this information useful as your company completes its efforts to report on the effectiveness of internal controls over financial reporting.

Beginning in December 2003, we polled companies on their experiences during the early phases of Section 404 implementation. This survey was summarized in our *Emerging Trends in Internal Controls—Initial Survey* publication. After several months we carried out a follow-up survey, supplementing our findings with observations and analysis based on our interactions with clients, as well as non-client executives. *Emerging Trends in Internal Controls—Second Survey* was published in May 2004. Our current survey was completed in September 2004, and, like the previous two surveys, draws from a cross-section of industries. Following on previous publications, this third survey identifies key issues companies are facing as they approach the deadline for completing their initial assessment of internal control.

Specifically, the third survey covers:

- Project progress and level of effort
- Testing and remediation: who, what, and how much?
- Leadership and oversight
- Looking ahead to next year and beyond

We hope our continuing research and communications are helpful in your company's ongoing efforts. We continue to seek your comments and questions, and welcome the opportunities to discuss additional information with you. Please contact Tom Bussa, global director of Business Risk Services, at Thomas.Bussa@ey.com, or your local Ernst & Young office.

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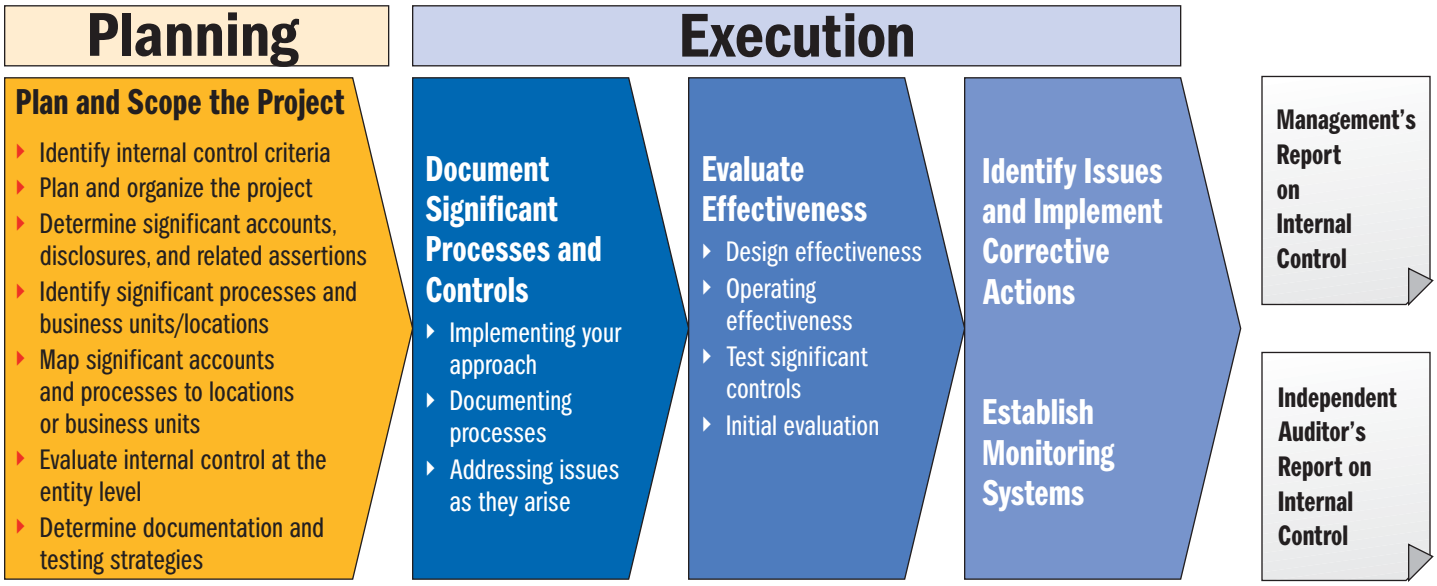
Overview

Since the issuance of our second survey, companies and their auditors have had more time to absorb the detailed guidance provided to auditors in PCAOB Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements." More familiarity with this guidance, together with the increasing involvement of external audit firms in Section 404 considerations and requirements, have led to a clearer understanding of how companies must demonstrate compliance with the Act. However, areas of considerable uncertainty remain.

This is the third publication in our Emerging Trends in Internal Controls series. As before, we surveyed about 100 companies as they rapidly approach their deadlines for reporting on the effectiveness of controls over financial reporting.



Using the same framework as the previous two surveys, we report on key issues and add our findings, observations, and matters for consideration.

Our main focus in this survey is on execution, including evaluation, remediation, and sustainability going forward.

Significant findings include:

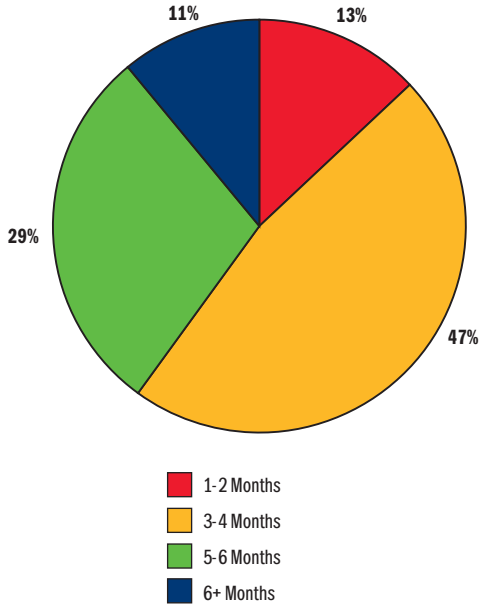
- Since March, estimates of the total effort required to complete the project have continued to climb.
- Many companies that anticipated completion before the end of the third quarter now predict a narrower gap between project close and the year end.
- The number of controls being selected for evaluation and testing continues to increase, with many large companies testing tens of thousands of controls across their organizations.
- Key areas of remediation include IT general controls and entity-level controls, such as controls related to risk assessment.
- The level of involvement of audit committees and executive management will need to increase significantly during the closing months of the project.

Progress

KEY ISSUE: WHERE ARE MOST COMPANIES IN THE PROCESS?

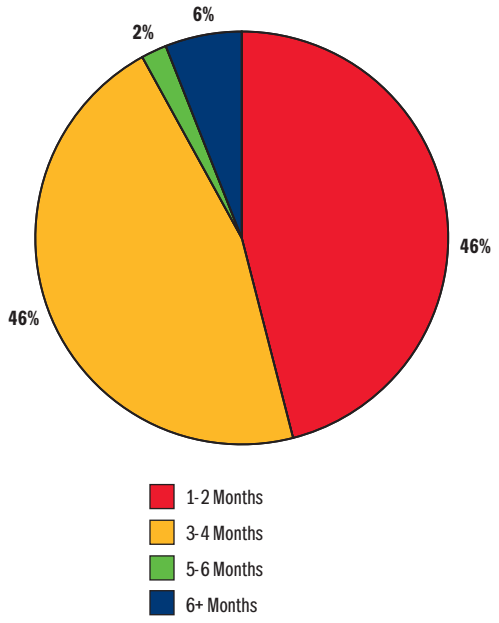
Executives of companies now in their last quarter are keenly focused on those activities on the critical path to completion. Benchmarking progress against peers can provide additional insights and generate discussions with boards of directors and their audit committees.

Anticipated Completion of Evaluation and Testing (Months Prior to FYE)



Second Survey Estimates

Anticipated Completion of Evaluation and Testing (Months Prior to FYE)



Third Survey Estimates

Findings

Anticipated completion has shifted significantly from the estimates found in our second survey. Nearly half of companies now estimate evaluation and testing will be completed only 1-2 months prior to their fiscal year end (FYE). This contrasts with only 13% estimating completion that close to the deadline in our second survey.

Conversely, those companies looking to finish 5+ months in advance of their FYE have diminished from 40% in the second survey to only 8% now.

Documentation—Most companies are finished or nearing completion.

Testing—Testing is progressing but taking longer than anticipated in our last survey.

Remediation—Nearly 30% of companies with a 2004 compliance deadline are conducting more than 75% of remediation during their last quarter as well.

Most companies with a 2005 compliance deadline are progressing at a rate largely on par with their 2004 counterparts.

Smaller companies (those with less than $5 billion in total revenues) are lagging somewhat behind their larger counterparts in testing and remediation. For some, resource availability is a key challenge. The larger companies are among the farthest ahead in remediation. In addition to company size, other factors affecting progress include business complexity and diversity, geographic spread, and IT systems diversity and complexity.

Observations

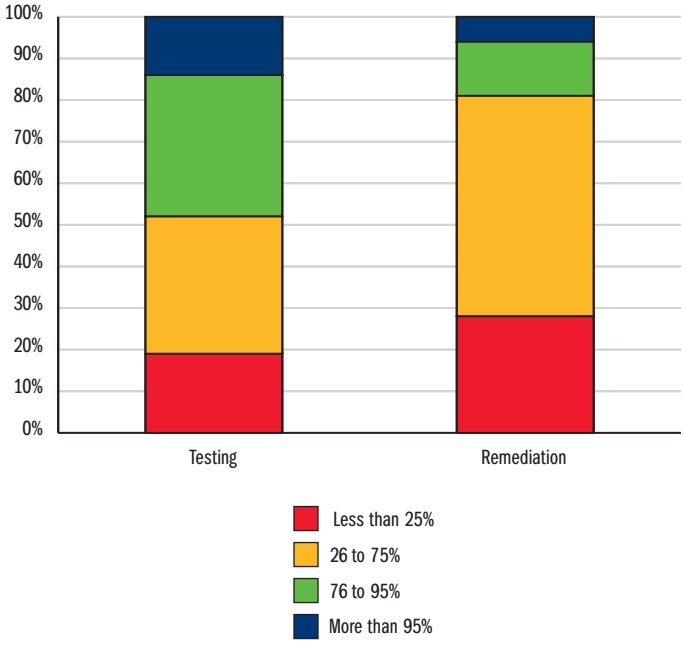
As 2004 deadlines approach, companies will be increasingly challenged to track and manage the volume of Section 404-related activities occurring in the last quarter. In particular, remediation and re-testing activities need to be monitored carefully and coordinated with the external auditor's activities to facilitate organized completion.

Many companies may be facing the real prospect of failure to complete the project on time. For those companies, an even sharper focus on materiality, strict prioritization of remediation activities, and an extra infusion of skilled resources may help to achieve success.

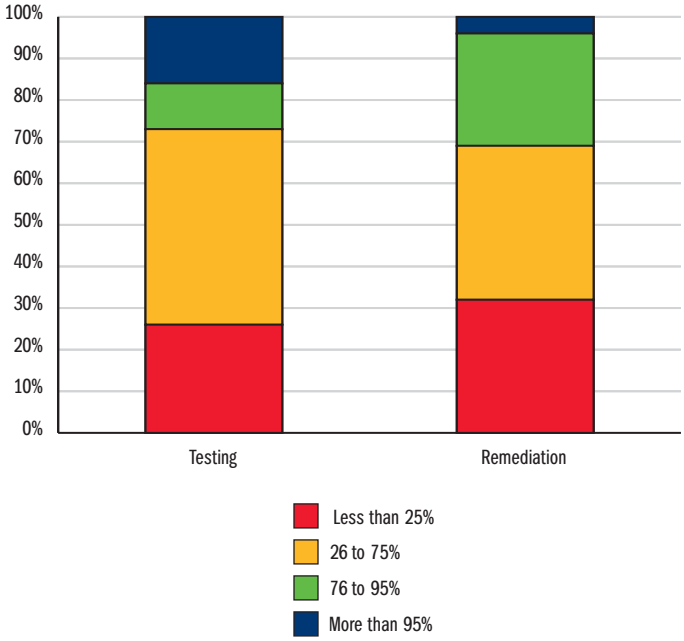
Considerations

- Are adequate resources being deployed on the most critical activities to facilitate timely completion?
- Are testing plans based on the most effective combination of controls that allow efficient coverage of the assertions over significant accounts?
- Is technology being used to make the process as efficient as possible, or is it slowing the project down?
- Have any doubts about timely completion been properly communicated to senior management, the board, or the audit committee?

Percent Completion by Phase (Companies with a 2004 Deadline)



Percent Completion by Phase (Companies with a 2005 Deadline)

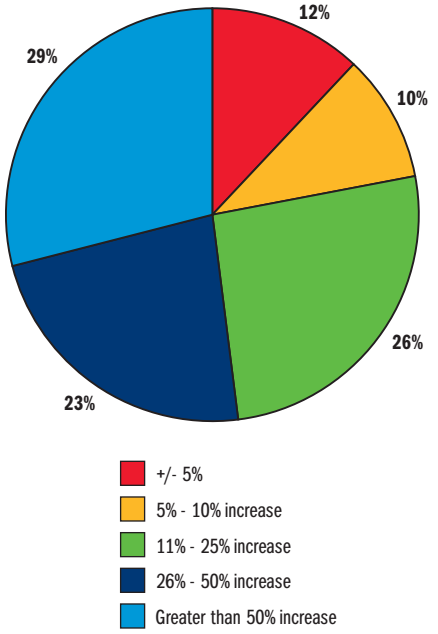


Level of Effort

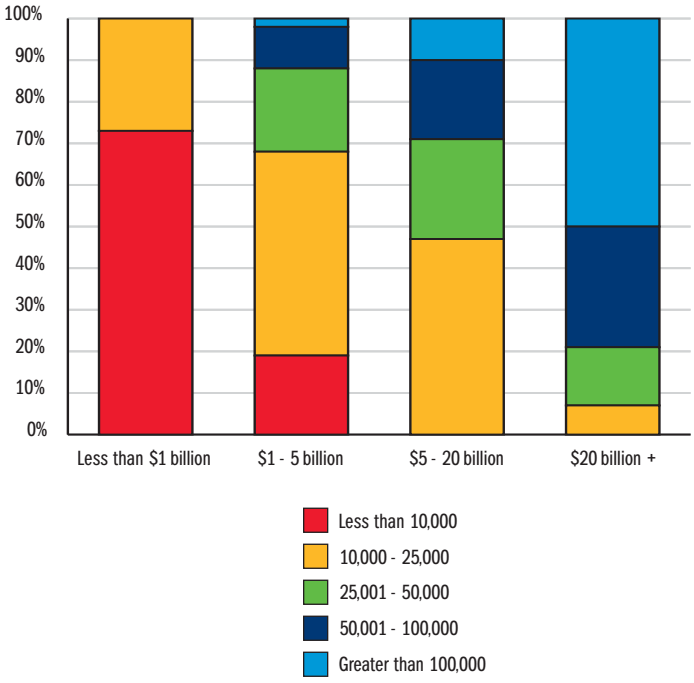
KEY ISSUE: WHAT IS THE LEVEL OF EFFORT ON IMPLEMENTATION AND COMPLIANCE?

Much has been said about the higher-than-expected cost of compliance with the Sarbanes-Oxley Act, and Section 404 in particular. At this stage, the total project effort can be more accurately assessed, and analysis can provide a useful benchmark for companies that do not need to comply until after 2004, as well as those aiming for completion at the end of the year.

Percentage Increase/Decrease Versus December 2003 Estimate



Updated Level of Effort by Revenue Size (in hours)



Findings

The estimated level of effort continues to increase. Nearly 30% of companies now anticipate an increase of 50% or more over estimates provided in our initial survey in December. This is almost double the number of respondents in our second survey.

The largest companies (those with greater than $20 billion in annual revenues) have experienced the most significant increase in estimates, with half anticipating a spend of over 100,000 hours. This compares to only one quarter anticipating the same spend in April 2004.

Observations

Not surprisingly, as companies progressed in their efforts and obtained greater clarity about requirements from the PCAOB's final auditing standard, the estimated levels of effort typically rose. Companies are now working to address the resource challenges associated with this increased project scope and size. Leading companies are thinking now about sustainability and efficiencies for Year 2 and beyond.

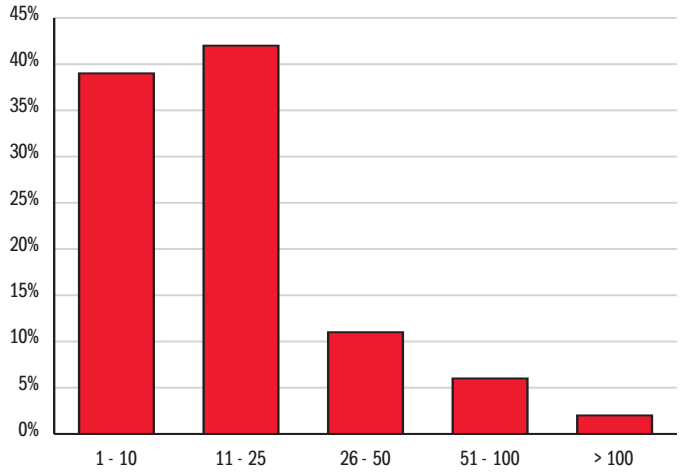
Considerations

- What lessons can be learned from the first-year implementation that would provide a more efficient process in Year 2 and beyond?
- Was the scope of the project sufficiently narrow?
- Were all resources managed effectively?
- Did the company take an efficient approach to documentation and testing?

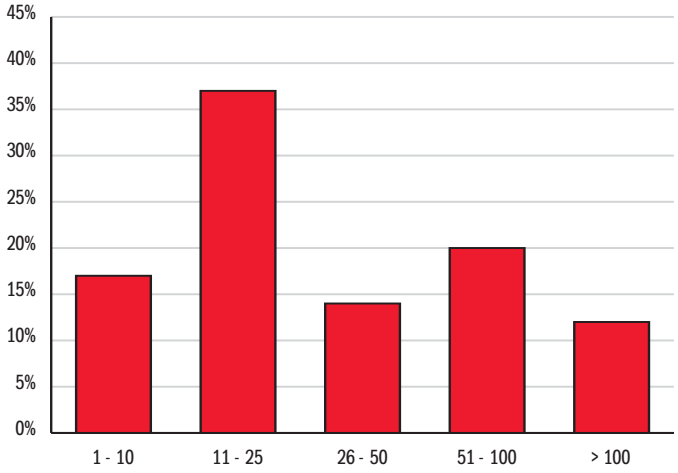
Entity-Level Assessment

KEY ISSUE: WHAT APPROACHES ARE BEING USED?

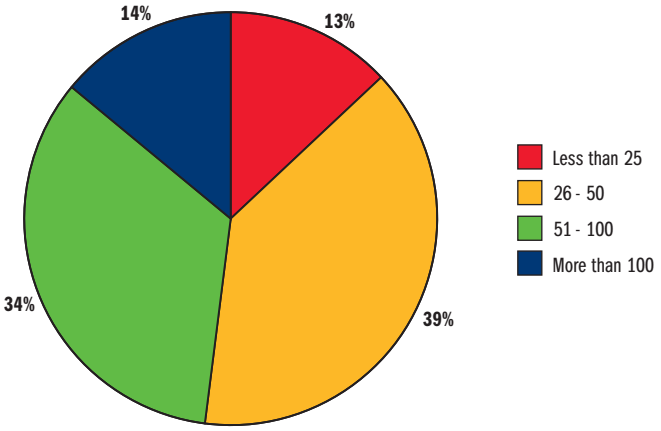
Companies are using a mix of interviews, surveys, and direct testing to support their entity-level assessments. Since our last survey, the use of surveys has become significantly more focused upon a narrower scope and audience.



Number of Individuals Interviewed



Number of Individuals Surveyed



Number of Entity-Level Survey Questions

Findings

Almost 90% of companies are conducting interviews to support the entity-level assessment. Of these, more than 80% are interviewing less than 25 individuals. Seventy-five percent of companies are conducting surveys. Of those companies, 70% are surveying fewer than 50 people.

This focused approach also extends to the number of questions asked. Of the companies employing surveys, 86% contain fewer than 101 questions. Nearly 40% of surveys contain between 26 and 50 questions, with a third containing between 51 and 100.

Observations

Companies that had originally cast a wide net through extensive surveys and interviews have scaled back and focused their entity-level assessment activities. To supplement surveys and interviews with other activities to evaluate the effectiveness of company-wide controls, companies have also included inspections of documentary evidence, observations of controls in operation, and verification of follow-up.

Considerations

- How is your company assessing entity-level controls?
- Have areas or components been properly prioritized for maximum impact?
- Have surveys and interviews been properly supplemented with sufficient direct testing?

Testing and Remediation

KEY ISSUE: HOW MUCH TESTING IS BEING DONE?

This is a key area of interest for most companies as there is a strong correlation between the number of controls identified for testing and the costs associated with compliance.

Findings

The largest companies (those with greater than $20 billion in annual revenue) have significantly increased the number of controls identified for testing. In our second survey, only 25% of companies in this category anticipated testing more than 5,000 controls. That number has doubled to 50% of companies.

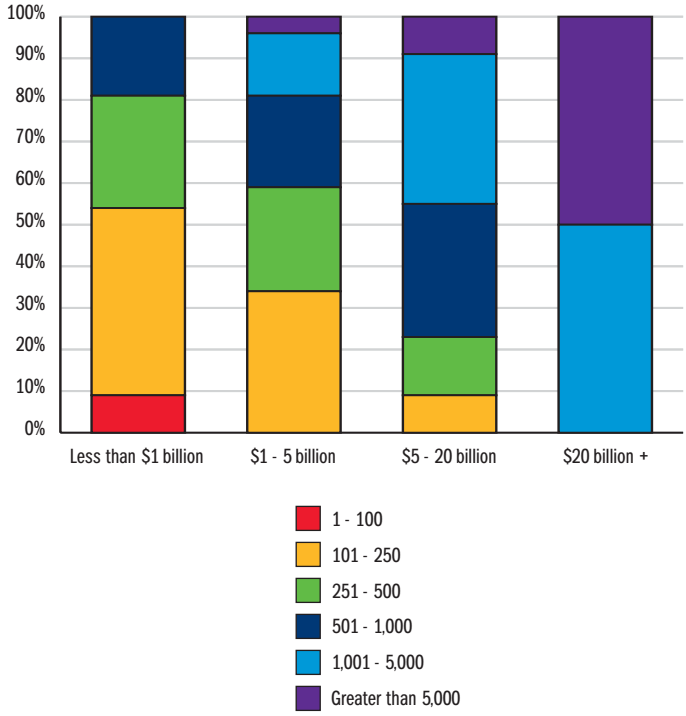
For smaller companies, the number of controls also has edged up from previous estimates.

Observations

Since our last survey, a number of factors may have contributed to the upward revisions of estimates of controls identified for testing. These include:

- Alignment of methodologies and approaches with the PCAOB's final rules
- Increased 404 activity, generally, has improved companies' precision with respect to estimates, as well as revealed additional areas for review.
- Increased communication and coordination with the external auditor about its expectations

Total Number of Controls Identified for Testing



Considerations

- Is the project team focusing on key controls, and testing only those that are necessary?
- Is the project team validating or refining the scope of controls identified for testing?
- Has the project team appropriately balanced company-wide controls versus transaction-level controls, manual controls versus computer controls, and high-level detect controls versus those designed to prevent errors?
- Is there opportunity to reduce the number of controls to be included in the evaluation going forward?

Testing and Remediation

KEY ISSUE: WHO IS DOING THE TESTING?

A variety of testing strategies is beginning to emerge. Most of these are Year 1-only strategies; some are being deployed for both implementation and ongoing compliance. Key questions include how to balance the involvement of line/business unit management with the need for reliable evidence to back up management's assertions and maintain reasonable external audit fees, and how to build and maintain the skills necessary for these activities in the future.

Year 1 - Testing Performed by (Average Percentage)*

	Process or Control Owner	IT Function	Internal Audit	Dedicated 404 Project Resources
Less than $1 Billion	23%	2%	51%	24%
$1-5 Billion	13%	3%	56%	28%
$5-20 Billion	16%	3%	44%	37%
$20 Billion +	31%	3%	29%	37%

Year 2 - Possible Sources (Average Percentage)*

	Process or Control Owner	IT Function	Internal Audit	Dedicated 404 Project Resources
Less than $1 Billion	19%	2%	58%	21%
$1-5 Billion	25%	3%	59%	13%
$5-20 Billion	18%	3%	47%	32%
$20 Billion +	45%	5%	29%	21%

* For many companies, a significant amount of testing has been or will be performed by third parties reporting to these groups.

KEY QUESTION

Has the self-assessment/testing approach been designed to be both sustainable and reliable?

KEY QUESTION

Are resources with requisite skills available within the organization?

Findings

In Year 1, most companies are relying upon Internal Audit and dedicated Section 404 project resources to perform the majority (75% +) of Section 404-related testing. Third-party resources typically support these groups, often to a significant extent. Among the largest companies (those with greater than $20 billion in annual revenue), process and control owners are performing a somewhat larger portion of Section 404-related testing than are their smaller counterparts. With that portion projected to increase further in Year 2, companies should carefully weigh potential resource and efficiency benefits with the challenges of achieving the objectivity and competence the external auditor will require in order to place reliance upon the results.

In Year 2, companies anticipate that Internal Audit will continue to play a significant role in Section 404-related testing, especially among smaller companies. Dedicated Section 404 project resources also will continue to play a key role, with some anticipating a shift to more of an oversight role. For both groups, obtaining necessary testing resources and expertise, especially during periods of high demand, will be an ongoing challenge and is expected to be addressed through the use of third-party resources.

Observations

Companies, mindful of the unanticipated cost of compliance with the Act, are seeking to make Section 404 activities as much a part of everyday business activity as possible. For many, this means delegating more responsibility for the process to business unit management. However, many companies recognize the need for objective testing in order to achieve a basis upon which external audit may rely.

Internal auditors are set to play an important role in the ongoing compliance efforts. For many companies, this role will require additional resources and training in financial auditing techniques and tools.

Nevertheless, there appears to be a need to retain some of the project resource pool to test areas such as company-wide controls.

Considerations

- Have the resources and expertise required to sustain ongoing Section 404 compliance and testing been identified and secured?
- To what extent will the external auditor be able to rely upon current or proposed control self-assessment and self-testing techniques?
- What portion of testing in Year 2 will be conducted by new resources, and what transition and training activities are in place to support the process?

Testing and Remediation

KEY ISSUE: WHERE ARE THE HOT SPOTS?

With most companies more than halfway through their testing efforts, a picture of remediation is beginning to emerge. Given that the majority of remediation activities are occurring in the final quarter, companies must carefully track scope, resource requirements, and progress to allow sufficient time for re-testing.

Findings

The largest group of controls identified to date requiring remediation is those preventing or detecting errors in routine data processes. However, the likelihood of greater risk exists within estimation and non-routine processes, given their lower frequency.

Typical areas of remediation in each of the three process types include the following:

- **Routine**–Systems conversions and/or enhancements; availability of specialized resources; IT remediation in a distributed environment; large number of IT general controls requiring remediation
- **Non-Routine**–Maintaining a "tone at the top" within international subsidiaries that is consistent with corporate; inefficient reconciliation and financial statement close processes
- **Estimation**–Segregation of duties, especially in smaller companies

Observations

Some project teams are facing real issues tracking their remediation progress, particularly with foreign subsidiaries, and in creating and maintaining an overall sense of urgency.

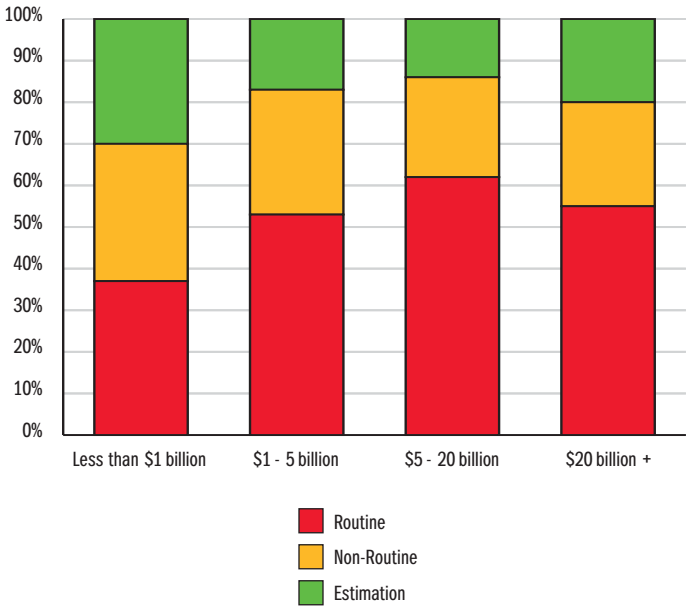
Considerations

- Are remediation activities being centrally tracked?
- Are sufficient resources in place to address remediation challenges in an effective and timely manner?
- Will there be an effort to track and revisit key remediation areas in Year 2 for a more thorough review?

Average Number of Controls Identified for Remediation (by Process Type)

	Routine	Non-Routine	Estimation	Total
Less than $1 Billion	42	37	34	113
$1-5 Billion	82	47	26	155
$5-20 Billion	172	65	39	276
$20 Billion +	181	82	64	327

Process Type for Controls Identified for Remediation



Testing and Remediation

KEY ISSUE: WHAT ARE THE INITIALLY IDENTIFIED REMEDIATION AREAS FOR IT GENERAL CONTROLS?

Companies are finding that a large number of IT general controls require remediation. This is an important area, given the pervasive nature of these controls.

Findings

Nearly three-fourths of surveyed companies identified either "program change" or "logical security" controls as key areas for remediation. Logical security controls were the most prevalent type of IT general controls requiring significant (30 days or longer to complete) remediation at 48%. However, this type of remediation was closely followed by program change controls at 43%.

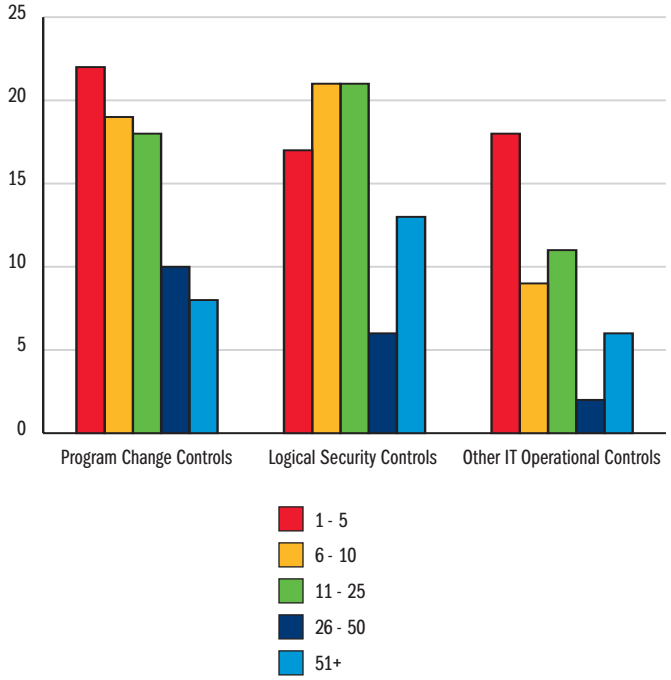
Observations

The nature and scope of IT general controls requiring remediation vary, depending upon the complexity and diversity of the company's IT environment. Within some companies, this effort has provided the impetus and opportunity to refine and enhance application configuration, leading some to consider ERP and other enterprise solutions to capitalize on leading practice and standardize aspects of control across the entire organization. Although companies recognize the need for and benefits of controls, lack of resources, expertise, and time continues to create challenges and reinforces the need for close tracking of progress and coordination of effort.

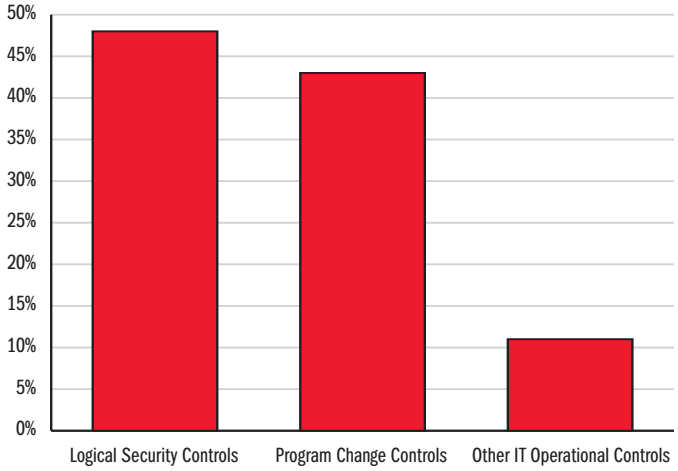
Considerations

- What is your company's approach to assessing IT general controls?
- Is there an opportunity to improve this approach for ongoing work?

Number of IT General Controls Identified for Remediation (by Type)



IT General Controls Requiring Significant Remediation (% of Companies by Control Type)



Testing and Remediation

KEY ISSUE: HOW ARE COMPANIES TRACKING REMEDIATION EFFORTS?

Tracking remediation efforts at a consolidated corporate level is a critical activity of the Section 404 program management team. Without an effective approach in place, the potential for critical challenges or last-minute surprises increases significantly. Technology can play an important enabling role in the process.

Findings

Our survey indicates that nearly 60% of companies are using Excel spreadsheets or an Access database to track their remediation activities. Version control and availability of consolidated reporting are noted as key challenges. Many companies that have selected and implemented a specialized Section 404 technology platform are leveraging these systems to manage and track remediation efforts.

Observations

Robust and appropriate coordination and tracking of remediation issues and activities is critical, given:

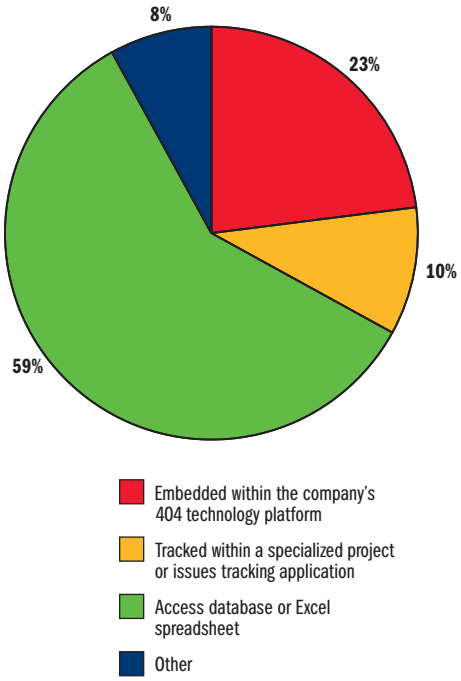
- The need to coordinate remediation, testing, and re-testing by both internal resources and the external auditor
- Approaching deadlines and the consequences for failure to complete
- Limited access to required resources and skill sets

Companies that now are finding their approach or technology lacking in the capability and functionality necessary to support their Section 404 remediation activities must act quickly to develop an effective work-around.

Considerations

- Can your company track the status of remediation activities across the organization on a real-time basis?
- Does your remediation management process include agreed-upon milestones, resources required, estimates to complete, and warning flags and indicators?

Technology Used to Support Coordination and Tracking of Remediation Activities

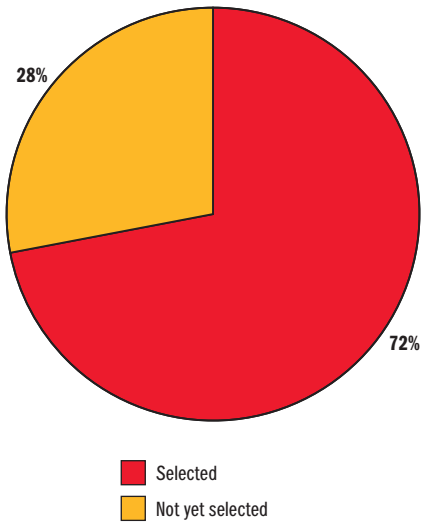


Technology

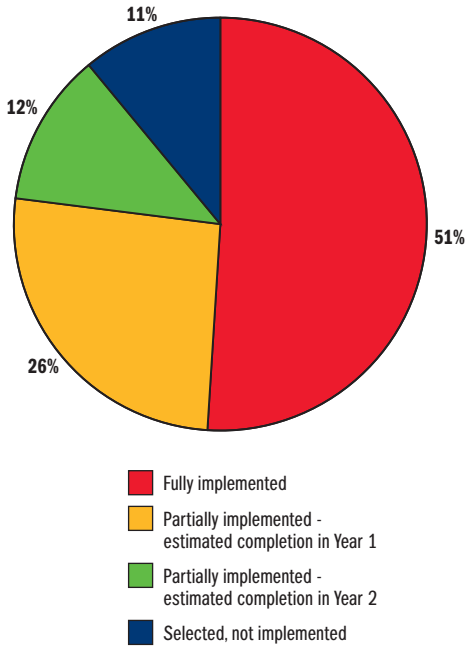
KEY ISSUE: WHAT TECHNOLOGY ENABLERS ARE BEING USED?

Selection of the appropriate Section 404 tool and timely implementation were early concerns for many management teams. While the market continues to evolve and mature, some companies are still implementing or have not yet selected a long-term technology solution.

404 Technology Platform



404 Technology Implementation Status



Findings

Over two-thirds of companies surveyed have selected a technology platform to assist them with Section 404 implementation. Of those that have selected a technology, only half have fully implemented the platform, while another quarter plan on full implementation in Year 1. However, nearly 30% of companies have not yet made their technology selection, and in some cases are noting a desire to let the Section 404 technology market mature further before making a decision.

Observations

Those that have selected and successfully implemented supporting technology for Section 404 compliance may now be in a position to reap the benefits, as they are better able to strategize testing, evaluate trends in results, and quickly and effectively manage remediation activities. Those that have not selected technology should weigh the benefits of the available tools with the promise of future technologies as the market matures.

Many companies will first define their future state compliance with Sections 404 and 302 more closely before choosing a technology platform. This will create a second wave of interest in technology during the first half of the new year. Adding to this trend, a significant number of companies are switching from sub-optimal tools to more robust applications.

Considerations

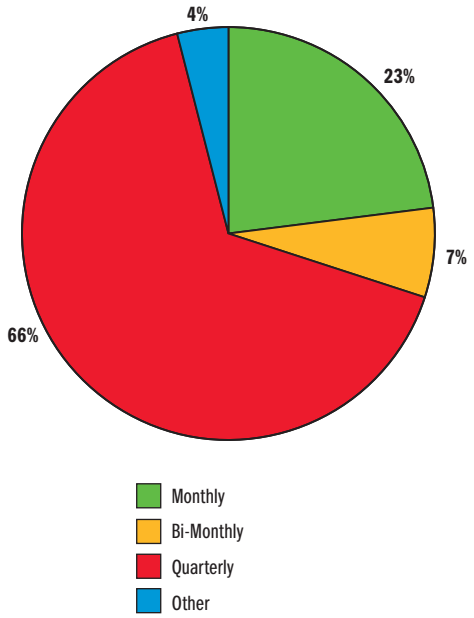
- Is technology being used appropriately to increase the efficiency of the Section 404 project?
- For those without supporting technology today, is the company's IT department thinking ahead to the second year of compliance and beyond and laying the groundwork for a decision in the new year?
- Is the company's existing technology platform adequate for planned future state compliance?

Leadership and Oversight

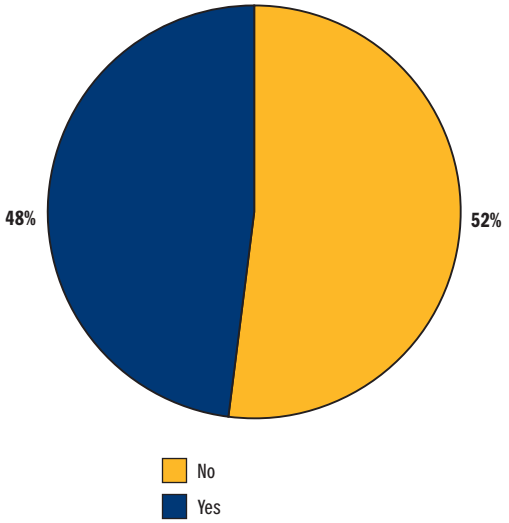
KEY ISSUE: WHAT IS THE LEVEL OF EXECUTIVE AND AUDIT COMMITTEE OVERSIGHT AND COMMUNICATIONS?

The need for effective executive oversight and communications is especially critical for companies now in their final few months of implementation. How much time and effort are senior executives, the board of directors, and the audit committee devoting to this area of corporate governance?

Frequency of 404 Updates to the Audit Committee



CEO/CFO Has Provided Specific Input on Information Needed to Support Year-End 404 Assertions



Findings

As of the date of our survey, two-thirds of audit committees were receiving only quarterly updates on progress with Section 404 compliance. The frequency of updates and dialogue should increase as testing and remediation activities increase and deadlines approach.

Most CEOs and CFOs currently require sign-offs from lower to upper management, culminating in their quarterly Section 302 certification. However, only 48% have provided specific input to the Section 404 project leader about the nature of the information they need to make their Section 404 assertion.

Observations

Although most audit committees and executive management have provided some input and oversight to companies' Section 404-related activities, the frequency and depth of involvement should increase in the quarter preceding the fiscal year end. In support, Section 404 project teams can play an active role in promoting timely communication and requesting input.

The cascading sign-off process that most CEOs and CFOs will require to support their Section 404 assertions might resemble the process used to support their quarterly Section 302 certification. For Year 2, many companies likely will identify opportunities to align and leverage these processes better with normal business activities, such as with planning and reporting cycles.

Considerations

Key questions audit committees should be asking:

- What has been completed and what remains to be done?
- Are we getting the right information at the right time?
- What are the results from testing? If significant deficiencies and material weaknesses are identified, what actions are being taken?
- Do the results of preliminary evaluations warrant disclosure under Section 302 prior to the end of the year?
- What if we cannot complete the assessment? What is management's plan?

Leadership and Oversight

KEY ISSUE: WHO WILL LEAD COMPLIANCE ACTIVITIES AFTER YEAR 1?

Leadership is critical to successful transition from the first year of implementation of the requirements of the Act to the ongoing post-implementation period. As companies begin to think about Year 2 and beyond, what are the key trends?

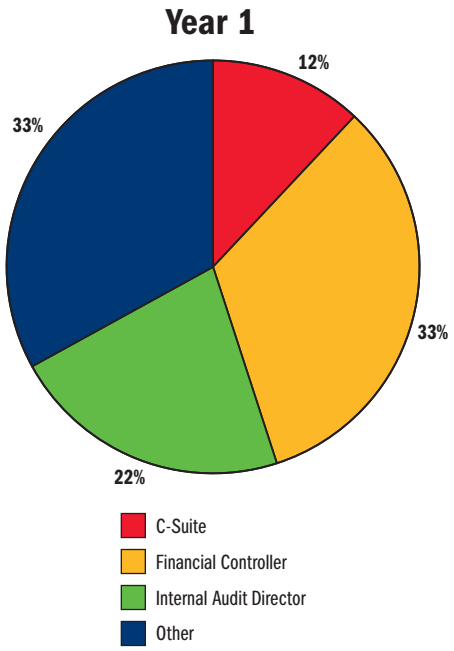
Findings

For Year 1, our surveys indicated that financial controllers and "others" are each leading one-third of Section 404 programs overall. "Others" were most often described as a project managers or specialists pulled from other areas of the business or from external sources. C-level executives led 12% of the efforts; Internal Audit led 22%.

In Year 2, nearly half of the companies we surveyed plan to place responsibility with the financial controller. Although the number of companies choosing "others" has decreased from 33% to 22%, the characteristics of those companies have changed significantly.

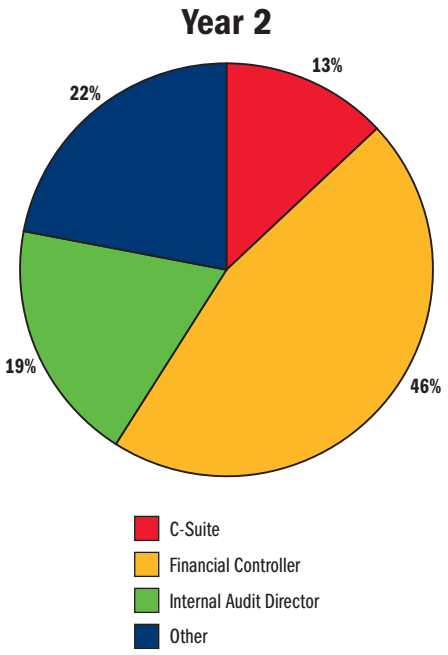
Many companies are creating new permanent positions, variously described as "Vice President of Internal Controls" or "Director of Controls Compliance." These new posts indicate recognition of the fact that ongoing compliance with the Act will remain a significant management responsibility.

A significant portion of the companies we surveyed has placed responsibility for project operations and for ongoing compliance with the Internal Audit director. This trend is even more pronounced at smaller companies, where approximately 45% of those with less than $1 billion in revenue had projects being led by Internal Audit.



Observations

Our first survey showed that, although companies looked for a number of potential skill sets in their Section 404 project leader, most important was a solid understanding of financial controls. Also important was a level of respect within the organization and commitment to setting the "tone at the top." These attributes should be taken into account when selecting leadership for Year 2.



Considerations

- Does the person responsible for ongoing compliance have adequate time, resources, and skills?
- How will companies "hand over" the Section 404 controls by migrating knowledge and infrastructure to the financial controller or VP of Internal Controls?

Leadership and Oversight

KEY ISSUE: WHAT IS THE LIKELY LONG-TERM IMPACT OF SARBANES-OXLEY ON INTERNAL AUDIT FUNCTIONS?

Internal Audit will play a significant role in the ongoing compliance process. While many companies have yet to define the precise nature of that role, what impact is it likely to have on the size and focus of Internal Audit going forward?

Findings

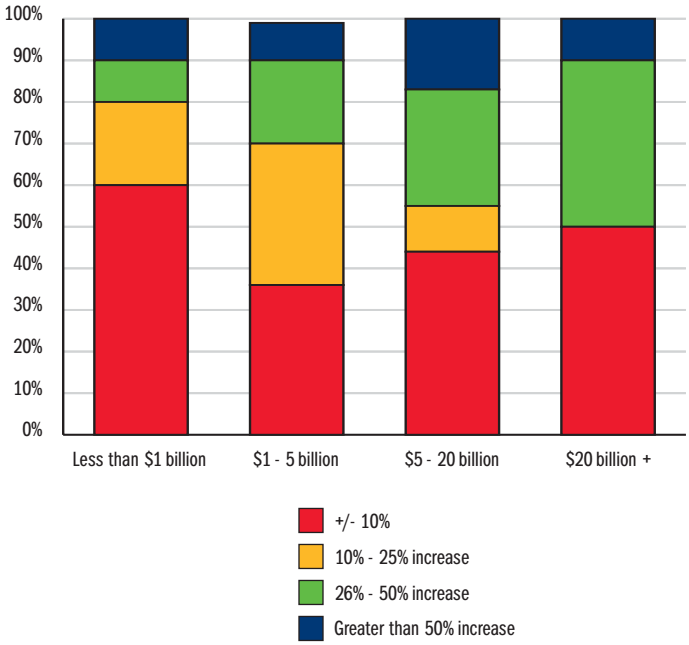
We found that nearly half of companies with more than $5 billion in annual revenue anticipate increasing their Internal Audit staff by 25% or more over the next 12 months. A significant portion of this growth is anticipated to support Section 404 activities.

Observations

The role of Internal Audit continues to evolve and vary across companies. Some functions provide objective assurance to senior management over the entire Section 404 program, while others provide resources to assist management with documentation and testing efforts. In many cases, Internal Audit encompasses both roles, acting in different capacities within different geographies and organizational units. Whatever the outcome of the current debate about the right role for Internal Audit, there seems to be agreement that it needs increased resources.

This poses some significant challenges. Timing the annual testing cycle for maximum leverage for the year-end investment of internal control means a peak in demand during the second and third fiscal quarters of every year. This has led some companies to consider the need to retain third-party resources through teaming and co-sourcing arrangements.

Anticipated Change in Internal Audit Function Staff Size Over the Next 12 Months



Considerations

- What specific skill sets are necessary to support the growing Internal Audit function?
- Does the company have a compelling career path for Internal Audit's new hires?
- If Internal Audit's responsibilities are refocused, how can the company address other risks and other planned or ad hoc audit activities?
- Does Internal Audit have the experience and skills needed to design and review a control self-assessment (CSA) approach or management self-testing techniques?
- Does Internal Audit have the capability to apply the latest techniques, including analytics and continuous monitoring?

Leadership and Oversight

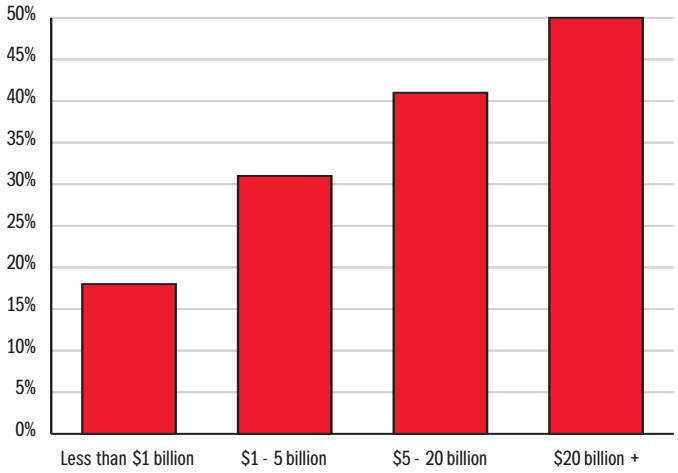
KEY ISSUE: ARE COMPANIES CONSIDERING THE FORMATION OF A NEW INTERNAL CONTROLS FUNCTION?

An internal controls function that focuses on activities and issues related to Section 404 may provide a natural transition for the existing Project Management Office (PMO).

Findings

Nearly half of companies with more than $20 billion in annual revenue are contemplating or will form a new function or group dedicated to the oversight of internal controls and Section 404-related activities. In most cases, this function would serve primarily in a PMO capacity and provide program oversight.

Percentage of Companies Planning to Form a New Internal Controls Function



Observations

Typical 404-related activities for which the internal controls functions may have oversight responsibilities include:

- Confirming and updating documentation
- Validating design effectiveness
- Performing testing
- Carrying out remediation
- Ongoing training
- Annual Section 404 reporting
- Identifying and assessing significant changes in the system of internal control for quarterly Section 302 disclosures

Staffing and supporting this new function may be a challenge. Many companies have not yet fully focused on how to drive sustainability or anticipated how they will obtain necessary resources.

Considerations

- Has management implemented a plan to migrate existing PMO and project team knowledge effectively into a new internal controls function?
- Has management begun to focus on resources and migration of testing activities to these new functions?

Sustained Compliance

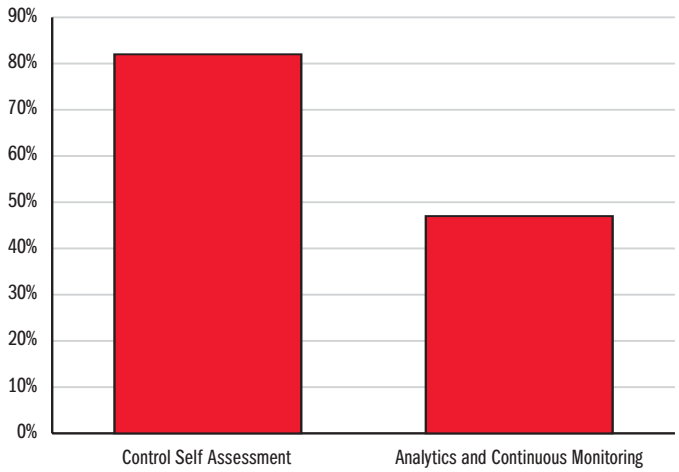
KEY ISSUE: HOW MANY COMPANIES ARE TAKING ADVANTAGE OF EVALUATION AND/OR MONITORING TECHNIQUES?

In the future, continuous monitoring techniques, control self-assessment frameworks, and dashboard reporting tools may be integrated to offer companies cost-effective, comprehensive control management and monitoring systems. What techniques are being considered?

Findings

Over 80% of companies anticipate using some form of control self-assessment (CSA) to help them embed ongoing evaluation and testing. Nearly half are anticipating using analytics and continuous monitoring techniques and some are beginning to explore opportunities for integration into CSA and/or Section 404 technology platforms.

Anticipated Use of Control Evaluation and/or Monitoring Techniques (Year 2 and beyond)



Observations

We find that large companies, in particular, are looking to apply CSA techniques in hopes of increasing efficiencies and driving down Section 404 costs. Many companies are considering such techniques for the first time, and many underestimate the amount of work both to create the environment for successful self-assessment programs and sustain them long term. Companies need to consider whether these control self-assessment or management self-testing techniques can be practically designed to address the objectivity and competence criteria the external auditor will require to be able to rely upon the results. If they cannot, the value of the effort must be carefully considered and alternative strategies explored. Also, while both self-assessment and continuous controls monitoring may be attractive ways of driving ongoing compliance, the time necessary to implement them fully may delay their impact until the later months of Year 2.

Considerations

- Does the company have the appropriate technology to support CSA?
- Is its methodology aligned to other risk-based activities (e.g., internal audit, risk management)?
- Does it have common documentation and assessment criteria?
- Can continuous monitoring techniques be applied to replace manual controls and/or reduce the need for testing within certain processes?

Sustained Compliance

KEY ISSUE: HAVE SECTION 404 IMPLEMENTATION EFFORTS PROVIDED ANY ADDED VALUE TO COMPANIES AND THEIR PROCESSES?

Most companies have realized from their activities added value beyond Section 404 compliance. Leading companies will continue to leverage their investments in Section 404 implementation.

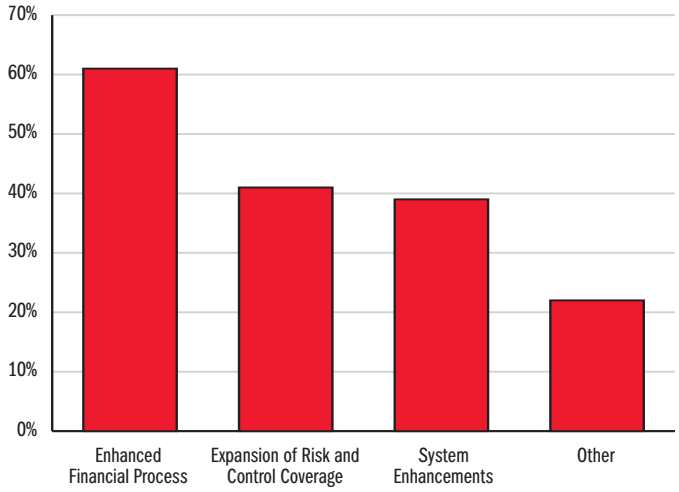
Findings

According to our survey participants, nearly two-thirds of companies expect to benefit from improved financial processes. Approximately 40% expect to extend risk coverage beyond financial reporting, in many cases through the expanded use of control self-assessment. More than one-third are anticipating benefits stemming from systems enhancements. Nearly 20% have noted "other ancillary benefits," predominantly through increased process standardization and consistency.

Observations

While it is still too early to quantify, added value is expected to increase in Year 2 and beyond as companies increase their control consciousness and integrate activities across operational, compliance, and strategic risk areas.

Other Anticipated Benefits



Considerations

- What is the company's point of view about Section 404 activities (e.g., compliance vs. value added)?
- Can the Section 404 effort be leveraged to lower the cost of control over time?

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

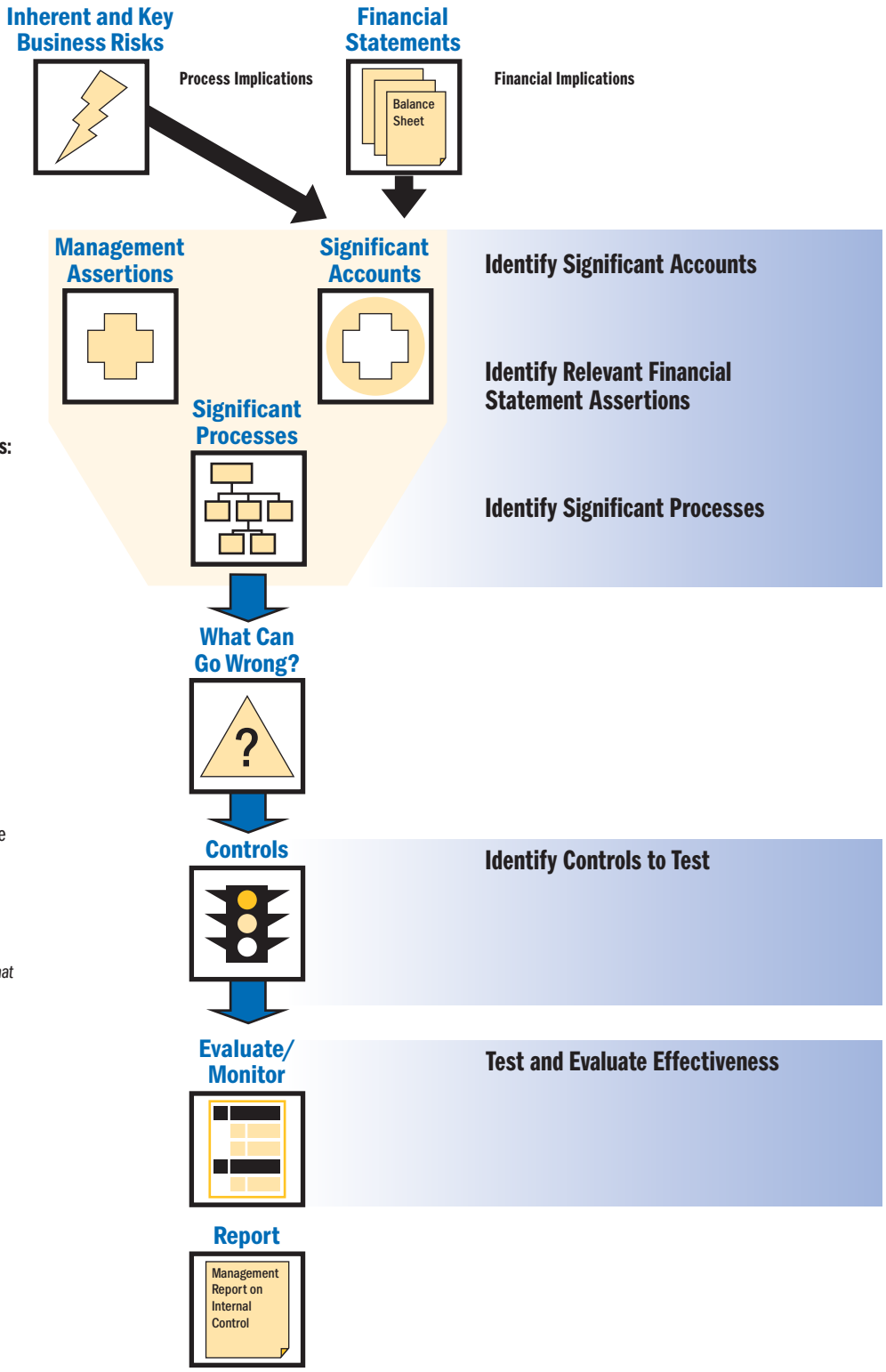
Processes That Influence the Significant Accounts:
- Flows of transactions
  - Routine
  - Non-routine
  - Estimation
- IT processes
- Financial statement close process

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

To obtain copies of our complete *Emerging Trends in Internal Controls* series, or our follow-on publication, *Section 404 Post-Implementation—What You Should Be Thinking About Now*, contact Tom Bussa, global director of Business Risk Services at Thomas.Bussa@ey.com.

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