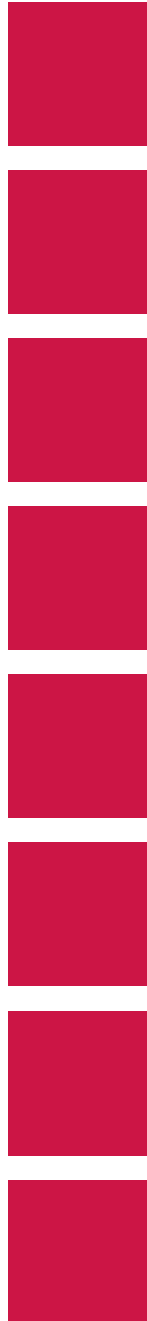


SARBANES - OXLEY Year Three Accelerated Filers' Management Guide



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SARBANES – OXLEY YEAR THREE ACCELERATED FILERS’ MANAGEMENT GUIDE

► CHANGES FOR ACCELERATED FILERS

The Sarbanes-Oxley Act of 2002 and, in particular, Section 404 have had far-reaching effects on the business community. Some accelerated filers adopted a conservative approach to 404 compliance in Year 1, and much has already been written about the high cost of compliance. This was not surprising given the minimal level of available guidance and the high level of uncertainty surrounding the consequences of reporting material weaknesses. As a result, many companies spent more on their first year assessment than will be required on an ongoing basis.

This guide has been developed to highlight some ways to better manage Section 404 compliance for “Year Three” for accelerated filers. The areas of focus for this guide are as follows:

- Focusing on Enterprise-wide Risk Management
- Using a Top Down Risk Approach for Section 404 Compliance
- Revising Testing Strategies to Reduce Compliance Costs
- Continuous Training of Key Personnel
- ROI and Sarbanes Oxley

► ENTERPRISE-WIDE RISK MANAGEMENT

A strong, enterprise-wide, executive-driven internal control management program is essential to achieving Section 404 compliance. Section 404 encompasses a company’s overall control environment as well as every key process related to financial reporting throughout the organization in all business units, divisions and functions.

The lack of a strong enterprise-wide internal controls management program threatens compliance with Section 404. A lack of strong enterprise-wide internal controls can cast serious doubt on executives’ commitment to effective internal control; a company may fail to detect control weaknesses, which could result in adverse opinions; and it can lead to inappropriate disclosures regarding changes to internal control over financial reporting as required by Section 302 of the Sarbanes-Oxley Act of 2002.

Implementing a formal risk assessment process can help sustain Section 404 compliance. First, the existence of a formal process for identifying and assessing risk demonstrates that management is making every effort to apply the company’s compliance efforts to the appropriate business areas; second, a solid understanding of the organization’s risk profile allows executives and board members to allocate their compliance resources more effectively, devoting the most attention to areas that represent the greatest risk. A formal risk assessment process also helps a company satisfy the New York Stock Exchange (NYSE) requirement that the audit committee discuss its assessment of risk with management.

An effective risk management program includes the following:

- Identifying specific financial reporting risks that might arise as a consequence of the organization’s business model, strategy and operations
- Assessing the potential impact of each identified risk on the integrity of financial reporting
- Aligning each specific risk with one or more business processes or control environment areas in which that risk may occur
- Including activities to monitor and report on changing risk conditions
- Establishing formal communication protocols regarding control performance and changes to the organization’s risk profile

Companies should perform a risk assessment at least once a year to keep the organization’s financial reporting risk profile in line with the evolution of the business. This assessment should occur early enough each year for the company to make appropriate changes before year-end. In addition, a company should re-evaluate its financial reporting risk profile every time it undergoes a significant business event. This helps management guard against unpleasant surprises at year-end, when overlooked risk can loom large in an independent auditor’s Section 404 assessment.

► TOP DOWN RISK MANAGEMENT APPROACH

In a top down approach, management identifies the controls to test in a sequential manner, starting with company-level controls, then drilling down to significant accounts at the financial statement level and then to relevant individual controls at the process, transaction or application levels. This top down approach enables management to focus early in the process on matters that may have an effect on later decisions about scope and testing strategy, such as company-level controls.

The top down approach comprises the following sequence of actions:

- Company-level controls. Identify, understand and evaluate the design effectiveness of company-level controls.
- Accounts. Identify significant accounts, beginning at the financial statement or disclosure level. Identify the assertions relevant to each significant account.
- Processes. Identify significant processes and major classes of transactions that are related to these accounts and disclosures; link the accounts to the processes.
- Risks. Identify the points in each process at which errors or fraud could occur. This occurs during the identification of significant accounts, relevant assertions and related processes, and is confirmed by performing self-assessments.
- Controls. Identify controls that are designed to prevent or detect errors or fraud on a timely basis; clearly link individual controls with the significant accounts and assertions to which they relate.

The top down approach is both effective and efficient. The identification of significant accounts at the financial statement level is driving the process “down” to the individual controls level. In this manner, management is more likely to identify the controls to be tested that address relevant assertions for significant accounts. The process prevents an auditor from spending unnecessary time and

effort understanding a process or control that ultimately is not relevant to whether the financial statements could be materially misstated.

The top down risk-based approach allows management to reduce the scope of the internal control audit and the amount of testing being performed, thus improving the focus and efficiency of the audit and, over time, the amount of hours and cost associated with SOX compliance.

► REVISING TESTING STRATEGIES TO REDUCE COMPLIANCE COSTS

For accelerated filers, the greatest cost of ongoing compliance with SOX stems from the need to test controls each year, and many will rethink their testing strategy in Year 3. The number of controls management plans to test is a strong indicator of the ongoing cost of management's annual assessment. The experience of accelerated filers shows that even with a rationalized set of controls, there remains a large number to be tested each year. Management can significantly reduce the cost for the current year and the ongoing costs of its assessment process by developing efficient testing strategies.

To have an effective testing strategy, the following will need to be addressed:

A. Leveraging Entity-Level Controls

- Effectively capitalizing on entity-level controls to reduce the amount of transaction control testing
- Only testing entity-level controls that are relevant to the assessment process
- Considering the effect of entity-level controls when assessing the nature and extent of testing of lower-level controls

B. Leveraging Supervisory Activities

- Management conducts ongoing reviews of key processes
- Management's review is part of the annual assessment process
- The independent auditor or internal auditor can follow management's testing methodology
- Exceptions are remedied in a timely manner

C. Employing a Risk-Based Approach

- Develop a plan to test controls
- Have test plans/scripts reviewed to ensure that strategies used are responsive to the type of controls and the underlying risks
- Evaluate timing of testing to gain the maximum efficiency with which testing resources are employed
- Periodically evaluate changes in controls to ensure that proper testing can be conducted at year-end
- Have the independent auditors review the testing methodology to avoid surprises

D. Deploying the Most Efficient Testing Resources

- Assigning the right responsibilities for testing of internal controls
- Using a control self-assessment process to support the annual assessment of internal controls
- Maintaining objectivity when performing testing given the nature of the controls and the underlying level of risk
- Ensuring that testers have sufficient skill and experience
- Allowing internal audit and other competent objective parties to review the results of any self-assessment of controls

- Including the independent auditor in all discussions concerning who will perform testing

E. Balancing the Cost of the Independent Auditor's 404 Assessment with the In-House Effort

- Discussing the independent auditor's strategy for reliance on work done as part of management's assessment
- Increasing the objectivity and competence of testing in lower risk areas to increase auditor reliance on internal work

F. Considering Opportunities for Process Improvement

- Incorporate reviews of process and control efficiencies into testing strategies and plans
- Evaluate control efficiency as well as effectiveness
- Benchmark and standardize control sets across similar processes
- Centralize controls by centralizing business processes
- Automate manual controls by leveraging ERP and IT systems

By accomplishing the steps noted above, there is an opportunity for management to reduce the overall cost of maintaining compliance with Section 404 now and in the future.

► TRAINING KEY PERSONNEL

Over the past two years, companies have developed various training programs on Sarbanes-Oxley and internal control. To keep pace with potential modifications and revisions to both the regulations and the interpretive guidance that follows, management needs to develop new training programs and modify existing ones. Each program then needs to be integrated with other employee training.

Tailoring training programs to an audience is the surest way to get results, but when it comes to compliance training, the correct accountability structure must first be in place. Once accountabilities are understood and accepted, training can effectively reinforce them.

Remembering that skilled, competent and objective personnel are required to perform testing, a robust skills-training program should be on every company's priority list for ongoing compliance. This program typically includes:

- Periodic workshops for the Board, Audit Committee, Disclosure Committee and other responsible parties
- Sarbanes-Oxley training as part of new-hire orientation
- Certification training for process owners or risk and control specialists in internal control

Mandated training sends a very clear message that upholding the effectiveness of internal control is imperative.

While some training programs can be very technical, a well-rounded training program should also include seminars on the sharing of best practices in the business – from optimal control design to streamlining and standardizing of financial and operational processes. This is an opportunity for business units to learn from one another and for the business to benefit from the collective understanding and ideas of its employees.

► ROI AND SARBANES-OXLEY

With added internal controls compliance from Sarbanes-Oxley now firmly ingrained in corporate processes, here are some insights on why it's smart to shift from a "let's just comply" mindset to one that is focused on reaping substantial benefits.

As with implementation of most laws impacting the corporate sector, compliance with Section 404, the internal controls provision of the Sarbanes-Oxley Act of 2002, has generated substantial frustration and complaints from corporations concerning its high costs. Many smaller companies, in particular, view compliance expenditures as diverting substantial corporate resources from more productive uses.

While it is true that Section 404 compliance has increased most companies' expenditures for internal controls, it is widely accepted that the higher costs, in significant part, represent: 1) a "catching up" process for companies that previously devoted insufficient resources to their internal controls infrastructure; 2) a learning curve for external auditors in understanding how to comply with the Public Company Accounting Oversight Board's Auditing Standard No. 2 (AS2).

To the extent that companies have now installed the proper systems and processes to monitor internal controls and external auditors now have experience auditing in the AS2 environment, compliance expenditures have already begun to plateau and are expected to decline in the coming years.

The underlying reason that companies are so concerned about Sarbanes-Oxley compliance costs is that they have adopted a "let's just comply" attitude – one in which they view the required expenditures as simply one more annual cost imposed by government regulations. At the same time, it is becoming increasingly clear that compliance activities can generate substantial benefits.

Among many improvements, the benefits can: enhance operational efficiency and productivity; foster better management decision-making; improve customer service and enhance relationships with vendors and customers. To unlock this potential, however, companies must shift away from a "let's just comply" mindset and implement return on investment (ROI) opportunities.

► THE SOURCES OF SARBANES-OXLEY ROI

ROI is, of course, the ratio of the benefits or improvements achieved by an investment, divided by the investment expenditure or cost. The ROI from Sarbanes-Oxley compliance can generate substantial benefits throughout a company's operations. Here are just a few of the ways in which improved internal controls can pay off:

- Greater use of automation in internal controls processes can achieve:
 - reduced error rates
 - more effective and reliable financial reporting
 - lower personnel costs
 - lower cost to test Sarbanes-Oxley compliance

- Extensive analysis of a company's customer interactions, including key "touch points" and error rates, plus improvement of key controls over these areas, can reduce errors in customer interactions, improve

customer satisfaction, enhance company reputation and raise employee morale.

- ▶ Sarbanes-Oxley compliance can be a springboard to improved overall company performance. Upgraded controls that include real-time monitoring of appropriate metrics can help identify problem areas before they “hit the numbers.” For example, a system that monitors key revenue recognition metrics, when combined with an appropriate business intelligence platform, can monitor revenue recognition in far-flung operational units and identify control breakdowns before they become a problem.

In conclusion, companies need to look at Sarbanes-Oxley compliance as an opportunity to improve organizational performance. Compliance helps identify areas for improvement – eliminating unnecessary and/or redundant controls; implementing more preventive and automated controls; and putting power behind the concept of “zero defects” at every level of the company – from the boardroom to the cubicle.

Improved financial controls can help management understand – and streamline – both its process costs and its organizational structure costs. It has been estimated that a significant percent of organizational activity is wasteful or redundant; so there appears to be plenty of room to cut back in all areas.

Each company can view Sarbanes-Oxley as a cost or as an opportunity. If seen strictly as a cost, it will always remain a cost. But those that view Sarbanes-Oxley compliance as an opportunity will find a wealth of areas for potential ROI that will offset the costs and make the company a better performer with improved profitability.

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