



The Sarbanes-Oxley Act of 2002: Roles and Responsibilities for Compliance and Effective Corporate Governance

Tom Beirne

September 24, 2003



Introduction to Sarbanes-Oxley Act

SEC

101 - PCAOB

Laws and Regulatory Commissions

Control Environment

Management

- 302 – Certification of annual/ quarterly reports
- 304 – Forfeit of bonus/profits
- 306 – Insider trades
- 404 – Assessment of internal controls
- 406 – Code of ethics
- 409 – Real time disclosure

Board of Directors

- 301 – Auditor oversight
- 301 – AC independence
- 407 – AC financial expert
- 301 - Whistleblower program
- 301 - Separate legal and other advisors

Internal Audit

External Audit

- 201 – Scope of practice
- 203 – Auditor rotation
- 206 – Conflicts of interest

Shareholder Commitments

Industry Standards

501 – Analyst conflict of interest

307 – Attorney responsibilities

Comparing Section 404 of SOA to Sections 302 and 906

Business Risk

Technology Risk

Internal Audit

	302	404	906
<i>When is it effective?</i>	August 29, 2002	FYE on or after 6-15-04 for accelerated filers and 4-15-05 for others	July 30, 2002
<i>Who signs-off?</i>	CEO, CFO	Management Independent accountant	CEO, CFO
<i>What's it about?</i>	Executive certification issued quarterly	ICR annually Independent accountant attests to assertions in ICR	Abbreviated certification issued quarterly
<i>How often are the evaluations?</i>	Quarterly	Annual assessment Quarterly review for material change	Quarterly

Contents of the Annual Internal Control Report

The annual internal control report must articulate:

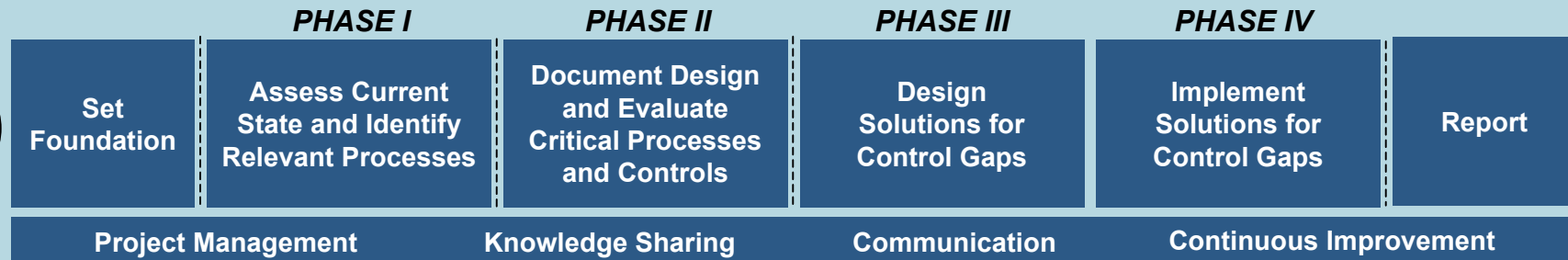
- Management's responsibility to establish and maintain internal control over financial reporting
- The framework used by management as criteria for evaluating the effectiveness of internal control (COSO)
- Management's conclusion as to the effectiveness of these internal controls at year end (point-in-time)
- Auditor has attested to and reported on management's evaluation

Relationship between Internal Control over Financial Reporting and Disclosure Controls and Procedures

- Disclosure controls and procedures addressed under Section 302
- Internal control over financial reporting is the focus of Section 404
- There is “significant overlap” between these two types of controls and procedures
- Therefore:
 - Section 404 compliance is relevant to Section 302 certifications
 - Companies need to keep their Section 404 compliance efforts on track to provide assurance to certifying officers signing 302 certifications that there aren’t any significant internal control deficiencies
 - Elements of internal control over financial reporting must be evaluated quarterly if they are a subset of disclosure controls

Our Suggested Approach to the Internal Control Reporting Process

Our Approach



Technology



Many Companies are “Staying the Course”

- **42%** of companies are continuing with their planned compliance efforts this year as if the SEC had not delayed the effective date
- Maximizes options
 - Enables “early adoption” which the SEC allows
 - Facilitates timely remediation of internal control deficiencies
 - Positions the company to send a message to the street that it is in compliance with Section 404
 - May issue an internal control report in this year’s 10-K
 - Similar to filing a statement of management's responsibility for financial reporting and internal control
 - The report would address the specific points required by the SEC (for most companies, with the exception of referring to the auditor's attestation)

Many Others are Planning Substantive Activity this Year

- Another **48%** of companies plan substantial Section 404 compliance activity this year
- Some examples:
 - Evaluate the current state and identify relevant processes this year and then reevaluate the timing for remaining phases of work
 - Evaluate control design effectiveness this year with some planning, in addition, to test controls this year
 - Evaluate control design and operating effectiveness with intention to review remediation efforts to address significant gaps first and use the available time to thoughtfully address the required improvements and minimize disruption to the organization
 - Stretch the project out over a 12 to 18 month period to increase the use of in-house resources over the course of the project
 - Focus on “high risk” processes this year and lower risk processes next year

Key Factors Driving these Choices

- The maturity of the organization and its controls
- The message management wants to communicate this year
- Existing controls documentation
- The effectiveness of entity-level analytics and monitoring
- The desire of management to identify internal control deficiencies now so they can be remedied sooner rather than later
- Increase deployment of internal resources
- Conflicting priorities

Some Companies have Deferred

- For the remaining **10%** of companies, "deferral" does not always mean "fold up the tent until next year"
 - For example, one calendar year reporting company is deferring start-up until this fall to get some other things out of the way first
- Be careful with deferring your compliance efforts
 - The clock is ticking: If starting in the spring (for a calendar year-end reporting company) was too late this year, then getting much of the project completed this summer and fall (prior to the year-end close) will avoid having to face the same situation next spring
 - Sections 302 and 906 are in force: If there are significant deficiencies in internal control not known to management, staying the course or substantial compliance activity now will help get them surfaced so they can be corrected timely
 - Don't forget: There are many elements of financial controls that are a subset of disclosure controls
 - Credibility with the street is gained by continuing compliance efforts, not by putting them off

The SEC Perspective

“If you have not yet started to prepare for the internal control evaluation, begin working on it immediately. The need to document the existing internal controls, consider whether other controls should be added, and design and perform tests of controls, indicates that a lot of time is necessary in order for management to be in a position to conclude as to the effectiveness of the company's internal control over financial reporting. Please do not use the extension of the compliance date as a reason to relax, take your eye off the ball, or otherwise not make use of the extra time you've been given. We listened to your concerns about timing, and we believe we've done our part to ensure an effective and smooth implementation of the rules, which is in the best interests of investors. If you don't take advantage of this extra time to work on the implementation, you will not have done your part for investors.”

**Scott Taub, Deputy Chief Accountant of the SEC
University of Southern California Leventhal School of Accounting
SEC and Financial Reporting Conference
Pasadena, California, May 29, 2003**

Renewed Focus on Internal Audit

- New York Stock Exchange proposed standards require an internal audit department
- Many non-public companies are also implementing internal audit programs

What should be done: Management

FOCUS ON THE CULTURE

- Ask: Does the existing culture support the CEO/CFO attestation requirement and reinforce responsible business practices?
 - If anything is broke, then get it fixed
 - If everything is working, then continue to reinforce it
- Consider conducting a comprehensive diagnostic of the company's corporate governance capabilities and the risks in complying with the new requirements
 - Assess whether there are pressures that could lead to “creative accounting”

What should be done: Management (cont'd)

FOCUS ON THE PROCESSES AND CONTROLS

- Re-evaluate internal processes and controls and fix identified weaknesses quickly
- Implement a code of conduct and a compliance program; document implementation of compliance efforts and results
- Enable necessary change and monitor compliance to ensure that reporting processes and controls are performing as intended
- Consider obtaining appropriate assurances from auditors on public reporting process deficiencies and matters
- Consider an enterprise-wide risk assessment to identify other potentially significant risks and establish capabilities to manage those risks

What should be done: Management (cont'd)

FOCUS ON THE COMMUNICATIONS

- Lead by example and with communications from the top to emphasize the importance of quality as well as ethical and responsible business behavior
 - Have the CEO strongly emphasize the important of quality financial reporting and ethical behavior
 - Communicate regularly through other channels
- Create an upward communications channel directly to the CEO
- Publish corporate governance approach and views on company Web Site

What should be done: External audit

- Must address partner rotation and scope of practice issues
 - Preapproval of non-audit services required
- Get back to basics and apply healthy skepticism in the audit process
- Provide more information to the audit committee and management beyond the present pass-fail system
 - Trends related to judgmental accounting issues
 - The quality of earnings

What should be done: Overall



Following the rules is critical; but in this environment, a passionate focus on doing the right things is more likely to hold up under scrutiny over time

The challenge is more than addressing needed changes today; the challenge is putting in place a structure that will function effectively both now and in the future



Questions?

www.protiviti.com

Tom Beirne

410-312-5032

thomas.beirne@protiviti.com