

# Sarbanes-Oxley Compliance: Ready or Not Here it Comes

Moderator — *Darin Zimmerman*

History and Background — *James Miles*

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Responsibilities and Challenges for the External Auditors

— *Brad Irick*

Society of Actuaries Spring Meeting  
San Antonio, Texas, June 14 – 15, 2004

# Sarbanes-Oxley Compliance: History and Background

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Society of Actuaries Spring Meeting  
San Antonio, Texas, June 14 – 15, 2004

## The Players



Senator Paul S. Sarbanes  
(D-Maryland)



Congressman Michael G.  
Oxley  
(R-Ohio)

## Counterpoint



Senator Phil Gramm  
(R-Texas)

*“..., I want to make it clear that this bill could have been a lot worse. In the environment we’re in, virtually anything could have passed the Congress.”*

*Senator Phil Gramm, Washington Post,  
July 28, 2002*

# Sarbanes-Oxley

## The Public Company Accounting Reform and Investor Protection Act

July 30, 2002

*“To protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes.”*

## How to speak Sarbanes-Oxley

- SEC
- PCAOB
- Section 302
- Section 404
- Control deficiency
- Significant deficiency
- Material weakness
- COSO

## SEC

- United States Securities and Exchange Commission
  - Required to promulgate rules and regulations to implement and further the Act
  - Appoints members of the PCAOB

## PCAOB

- Public Company Accounting Oversight Board
  - A private-sector, non-profit corporation
  - Created by Sarbanes-Oxley Act
  - Oversees the auditors of public companies
    - To protect the interests of investors; and
    - To further public interest in the preparation of informative, fair, and independent audit reports

## PCAOB

- Board comprised of five financially literate members
  - Appointed for five-year terms
  - Two must be or have been CPAs
  - Three must not be or cannot have been CPAs
- FY04 Budget: 284 employees and \$103 million

## PCAOB



William J.  
McDonough



Kayla J. Gillian



Daniel L. Goelzer



Bill Gradison



Charles D.  
Niemeier

## PCAOB

- SEC
  - Has oversight and enforcement authority over the PCAOB
  - Can give the PCAOB additional responsibilities
  - Can censure or impose limitations upon the PCAOB

## Section 302

- The CEO and CFO shall each certify:  
*‘[The] appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the insurer.’*
- Effective August 27, 2002

## Section 404

- Requires each annual report to contain an internal control report.
  - State the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting
  - Contain an assessment of the effectiveness
- Auditor must attest to and report on assessment
- Effective for fiscal years ending on or after November 15, 2004

## Control Deficiency

“A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.”

PCAOB Release 2004-002

## Significant Deficiency

“A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be prevented or detected.”

PCAOB Release 2004-002

## Significant Deficiency

“A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company’s annual or interim financial statements that is more than inconsequential will not be prevented or detected.”

PCAOB Release 2004-002

## Material Weakness

“A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.”

PCAOB Release 2004-002

## COSO

- The National Commission on Fraudulent Financial Reporting (1985)
- Committee of Sponsoring Organizations of the Treadway Commission:
  - The American Institute of Certified Public Accountants
  - The American Accounting Association
  - The Institute of Internal Auditors
  - The Institute of Management Accountants
  - The Financial Executives Institute

## COSO Internal Control

- Task force formed to review internal control literature
- Task force recommended a project to provide practical, broadly accepted criteria for establishing internal control and evaluating its effectiveness.
- Internal Control – Integrated Framework (1991)

## COSO Model

Components for evaluating effectiveness:

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

## Other Dialects

- States
  - Cascade effect
  - *A Reasoned Approach to Reform* (2003)
- NAIC
  - Working Group is currently drafting:  
‘Model Regulation Requiring Annual Audited  
Financial Reports’
  - 2006 - earliest implementation

## Sources of Information

- AICPA website: [www.aicpa.org](http://www.aicpa.org)
- PCAOB website: [www.pcaobus.org](http://www.pcaobus.org)
- COSO website: [www.coso.org](http://www.coso.org)
- SEC website: [www.sec.gov](http://www.sec.gov)
- Your auditor

# Sarbanes-Oxley Compliance: Process Overview and Implementation Issues

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Society of Actuaries Spring Meeting  
San Antonio, Texas, June 14 – 15, 2004

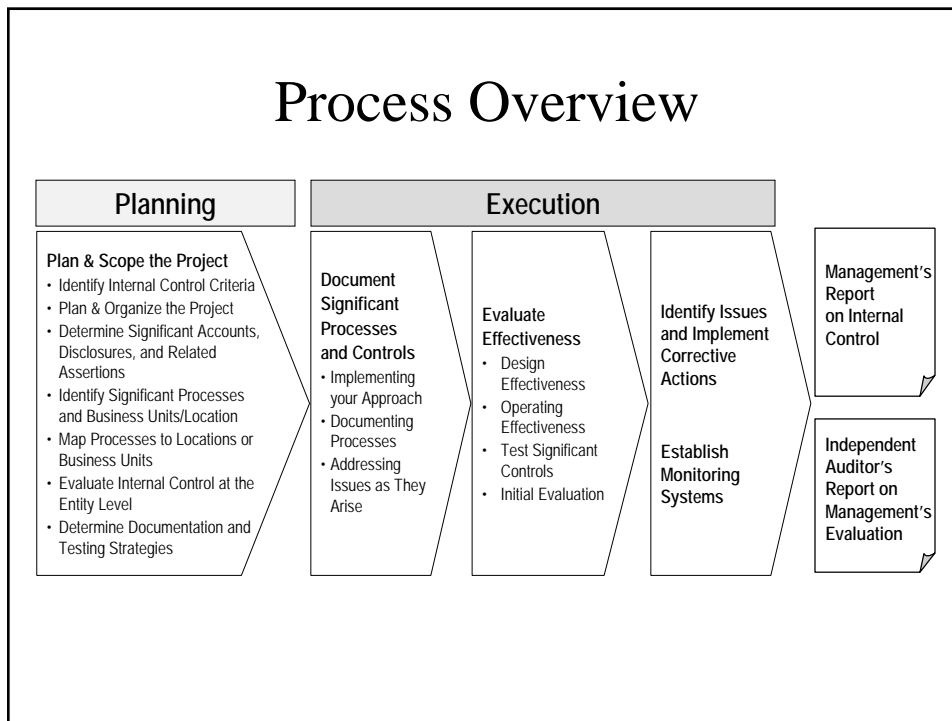
## Management's Responsibilities The PCAOB Standard

- Accept responsibility for effectiveness of internal control
- Evaluate the effectiveness of internal control using suitable criteria
  - COSO is cited, but other suitable criteria can be used
- Support its evaluation with sufficient evidence and documentation
  - Rigorous process – must test design and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures
- Present a written assessment as of end of year

## Management's Responsibilities The PCAOB Standard (cont'd)

- Sufficient documentation is important and integral to the assessment
  - Inadequate documentation is considered a control deficiency – could require the auditor to disclaim an opinion
- Scope of evaluation should include entities acquired on or before year-end and entities accounted for as discontinued operations at year-end
  - There may be situations where the SEC allows management to limit its assessment by excluding certain entities (e.g., certain variable interest entities)

## Process Overview



# What is Internal Control?

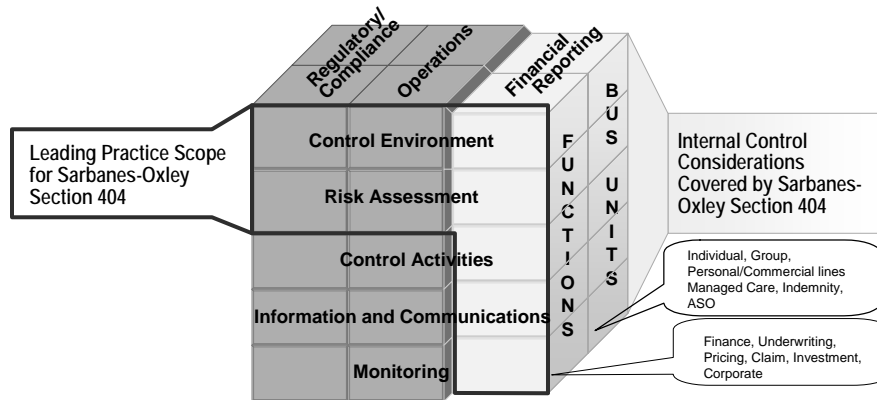


Diagram Based Upon AICPA Auditing Standards AU319, Definition of Internal Control (Paragraph .13)

## Key Insight

- Leading companies are using Section 404 compliance as a catalyst to review their entire risk framework

# Organize Section 404 Project Team

- Ensure right project sponsorship (e.g. CEO or CFO)
  - Must own the project
  - Must communicate importance of Section 404 to the organization
- Identify project manager (e.g., CFO, Controller or Internal Audit Director)
  - Must develop and oversee execution of project plan
  - Must coordinate internal audit, external audit and management
- Select 404 advisor
  - Must have substantial relevant resources and industry experience

## Key Insight

- Companies may underestimate the time and effort involved in meeting requirements for management's evaluation and the auditor's attestation of their system of internal control

## Section 404 Roles & Responsibilities

	Management	404 Advisor	External Auditor
▪ Sponsor Project	X		
▪ Lead Project Team	X	X	
▪ Participate as Project Team Member/ Advisor	X	X	X
▪ Prepare Documentation	X	X	X
▪ Evaluate Controls/ Correct Deficiencies	X	Assist	
▪ Test Controls to Support Management Assertion	X	X	
▪ Provide Management Assertion	X		
▪ Test Controls and Provide Attestation Report			X

## Develop Project Plan and Scope Project

- Determine overall strategy and approach
- Determine resources, roles and responsibilities
- Establish timelines
- Establish communication and reporting protocols
- Evaluate supporting tools and techniques
- Inventory existing internal control documentation
- Determine extent of documentation and testing

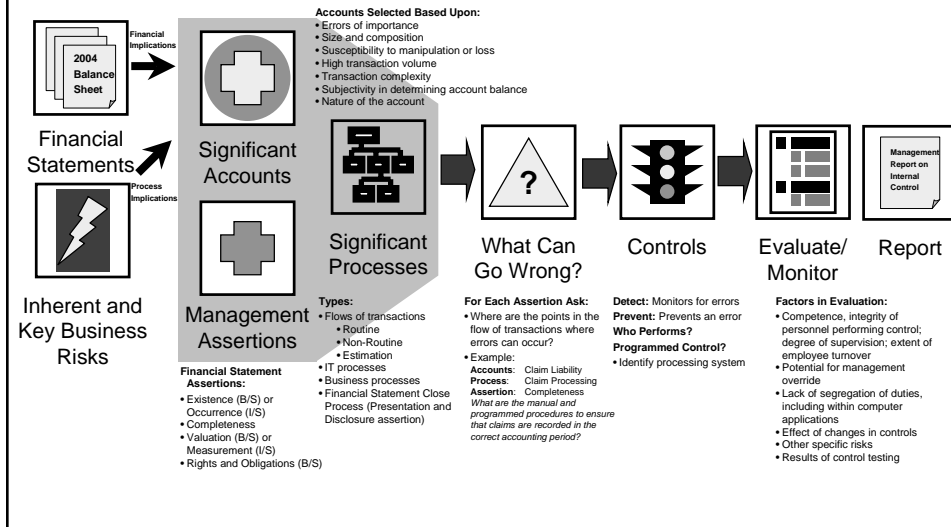
## Develop Required Documentation for Evaluation of Internal Controls

- Internal controls over financial reporting must be evaluated at both the entity and at a significant account level
  - Entity level controls are at the corporate-wide level or sometimes business unit level that have a pervasive effect on the organization such as setting the tone from the top and policies and procedures
  - Process, transaction or application level control documentation is required for all significant accounts and the related processes and transactions that could contain errors of importance

## Evaluation of Internal Controls at the Entity Level

- Entity level controls at the corporate or business unit level include the following components:
  - **Control environment** reflects the tone set by top management and the overall attitude, awareness and actions of the board of directors and management concerning the importance of internal control
  - **Risk assessment** is the entity's identification and analysis of relevant risks to the achievement of its objectives
  - **Information and communication** supports the identification, capture, and exchange of timely information that enable management and personnel to carry out their responsibilities
  - **Control activities** are the policies and procedures that help ensure that management's directives are carried out
  - **Monitoring** is the process that assesses the quality of internal control performance over time

# Process, Transaction or Application Level Control Evaluations



## Identify Significant Accounts

Example Significant Accounts	Documentation Points			
	Locations/Entities			
	A	B	C	D
<b>Balance Sheet Accounts</b>				
Debt and Equity Security Investments	X			X
Mortgage Loans	X			X
Policy Loans	X			
Short-term Investments	X			X
Accrued Investment Income	X			X
Premiums Receivable	X	X	X	
Reinsurance Receivables	X			X
DPAC	X			
Value of Business Acquired	X			
Goodwill	X			
Separate Account Assets and Liabilities	X	X	X	
Future Policy Benefits and Claims	X	X	X	X
Unearned Premiums	X			X
Policyholder Account Balances	X	X	X	
Claim Reserves	X			X
Current and Deferred Income Taxes Payable	X			
Long-term Debt	X			
Shareholders Equity	X			
<b>Income Statement Accounts</b>				
Net Premium Revenues	X	X	X	X
Net Investment Income	X			
Realized Investment Gains/Losses	X			
Benefit Expenses	X	X	X	X
DPAC Amortization	X			
Other Operating Expenses	X	X	X	X
Current and Deferred Income Taxes	X			

# Identify Significant Processes

## Routine Processes

- Cash receipts
- Cash disbursements
- Premium and commission processing
- Benefits and claims processing
- Investment purchases, sales, and maturities
- Investment income recognition
- Maintenance of policy masterfiles

## Non-Routine Processes

- Calculation of reserve balances
- Identification and amortization of deferred costs
- Calculation of accrued expenses

## Non-Routine (continued)

- Changed in unearned premiums
- Suspense clearing
- Investment valuation
- Calculation of accrued investment income

## Estimation Processes

- Development and monitoring of reserve estimates
- Development and monitoring of amortization assumptions
- Recoverability/loss recognition
- Valuation of reinsurance recoverables
- Investment valuation allowances

The activity in the significant accounts, Benefits/Claims Reserves and Related Expense accounts, traverses the following significant processes, Cash Disbursements, Benefits/Claims Payments, Development and Monitoring of Reserves. The following is an example of the Benefits/Claims Reserves and Related Expense significant accounts with the applicable financial statement assertions, what could go wrong statements and mitigating controls for each what could go wrong statement.

### Benefits/Claims Reserves and Related Expense Accounts

#### Completeness Assertion

##### *What Could Go Wrong*

##### **Benefits/claims are recorded in the wrong period**

- |         |   |
|---------|---|
| Control | Claims pending reconciled weekly/monthly to subledgers and G/L      |
| Control | Denials are reviewed by authorized personnel                        |
| Control | Claims date and amount overrides are reviewed                       |
| Control | Claim processing backlogs are continually monitored                 |
| Control | Benefit systems are reconciled to G/L daily, weekly and monthly     |
| Control | Benefit/claim payments are reconciled to cash and suspense accounts |

##### *What Could Go Wrong*

##### **Claim reserve estimates exclude valid inforce policies**

- |         |   |
|---------|---|
| Control | Inforce data per masterfile reconciled to details of reserve calculations |
| Control | Key analytical relationships monitored                                    |

##### *What Could Go Wrong*

##### **Claim file not prepared and accruals not recorded for submitted notices**

- |         |   |
|---------|---|
| Control | Claimants complain about not receiving payments     |
| Control | Claim processing backlogs are continually monitored |

##### *What Could Go Wrong*

##### **Coding of claim/benefit is incorrect**

- |         |   |
|---------|---|
| Control | Validity and amount of claims/benefits is selectively tested    |
| Control | Daily claims transaction reports are reviewed                   |
| Control | System prompts adjuster to review case reserves                 |
| Control | Benefit systems are reconciled to G/L daily, weekly and monthly |

## Benefits/Claims Reserves and Related Expense Accounts

### Existence/Occurrence Assertions

<b>What Could Go Wrong</b>	<b>Claim reserves are not adjusted for claims payments</b>
Control	Current year reserves compared to prior year amounts for reasonableness
Control	Inforce data per masterfile reconciled to details of reserve calculations
Control	Key analytical relationships monitored
Control	System automatically codes claims payments against reserve balances
<b>What Could Go Wrong</b>	<b>Fictitious/duplicate claims/benefits are recorded</b>
Control	Edits reports identify possible errors in benefit and claims transactions
Control	Validity and amount of claims/benefits is selectively tested
Control	Supervisors review open claims without activity for 90 days
Control	Evidence of loss (death, disability, etc) is reviewed
Control	Confirmations of policy changes are mailed to policyholders
Control	Access to modify payee information is restricted
Control	System verifies coverage with policy masterfile before paying claims
Control	System prohibits negative reserve positions
Control	Changes made to the masterfile are independently reviewed
<b>What Could Go Wrong</b>	<b>Claims/benefits are not recorded</b>
Control	Claims pending are reconciled weekly/monthly to subledgers and G/L
Control	Denials are reviewed by authorized personnel
Control	Claimants complain about not receiving payments
Control	Premiums/profits compared by line of business to budget/forecast

## Benefits/Claims Reserves and Related Expense Accounts

### Valuation/ Measurement Assertions

<b>What Could Go Wrong</b>	<b>Loss reserves exclude relevant factors</b>
Control	Actual mortality/morbidity compared to assumptions
Control	Actual loss experience compared to assumptions
Control	Company monitors actuarial standards and evaluates impact of new standards
Control	Reserves on large policies (> \$XXX,XXX) are individually evaluated
Control	Reserve assumptions and valuation practices are reviewed
Control	Reserving methodology reviewed and approved by management
Control	Independent reserve projections performed by outside consultants
<b>What Could Go Wrong</b>	<b>Claims/benefits are miscalculated</b>
Control	Claims/benefits compared by line of business to budget/forecast
Control	System calculates claims/benefits based on data in policy masterfile
Control	Access to change claim/benefits calculation tables is restricted
Control	Validity and amount of claims/benefits is selectively tested
Control	Claim date and amount overrides are reviewed
<b>What Could Go Wrong</b>	<b>Claim reserves are based on inaccurate contractual obligations</b>
Control	Inforce data per masterfile reconciled to details of reserve calculations
Control	Key analytical relationships monitored
Control	Projections are adjusted for other-than-normal processing backlogs

## Benefits/Claims Reserves and Related Expense Accounts

### Valuation/ Measurement Assertions (continued)

<i>What Could Go Wrong</i>	<b>Assumptions used in loss reserve estimates are not appropriate</b>
Control	Prior period estimates of select ultimates are retrospectively reviewed
Control	Assumptions to compute policy reserves compared to statutory guidelines
Control	Reserves on large policies (> \$XXX,XXX) are individually evaluated
Control	Loss modeling techniques and validation tests are reviewed
Control	Periodic ratio analysis verifies reserves are trending as expected.

<i>What Could Go Wrong</i>	<b>Losses are not valid obligations of the Company and are not supported by coverage that is inforce</b>
Control	Inforce status of policy is verified before claim is processed
Control	Claim/loss payments are reviewed for propriety
Control	Claim system verifies coverage and information with policy system

## Managing the Effort: Key Lessons Learned

- You can't determine resource needs until the work plan, scope, level of documentation and timelines are finalized
- Pilot project can validate effort/approach—revisit resource needs after completion
- Decentralized approach needs establishment of clear, required minimum standards for documentation, evaluation
- Involve independent auditors throughout the project
- Build in monitoring mechanisms and anticipate likely business changes
- Embed computer controls into the approach

## Establishing a Core Project Management Office (PMO)

The most common structure has control over the project centralized within a PMO:

- Provides a consistent view of the significant accounts, processes, and locations to maximize approach efficiency
- Supports decentralized approach as to business unit responsibility for documentation
- Established the parameters for testing and evaluation, which generally is done by project team members, often qualified auditors assigned to each region or country
- Allows for better management and assessment of pilot exercises during the planning stage

## Making it Happen: Centralized Projects

### Challenges

- Inconsistent approach and deliverables
- Business Units fail to deliver
- (Poor quality, time slippage, suffering from initiative overload, patchy / inconsistent support at local level, etc.)
- Lots of noise, but no action from the center can erode buy-in
- Inefficiencies from work being performed without a consistent, common plan
- Lack of external auditor clarity across all locations – differing views on materiality impacts the size of the project

Managed  
Through

### Critical Success Factors

- A flexible approach that can be responsive to different business needs – test using pilots
- Early communication of clearly defined key definitions and required minimum standards
- Engage business units in providing details of work already done, identifying hot spots
- Early identification of business units unlikely to be included in program scope (materiality)
- Early agreement of roles at initial steering committee meeting
- Engage with external auditors early but not before ready
- Consistent communication of "why" as well as "what" has to be done to maintain buy-in
- Maximum use of common templates and project guidelines to support business units
- Foster an environment of honesty about capability and availability of business unit resources

## Findings: What is the Level of Effort on Initial Implementation and Compliance?

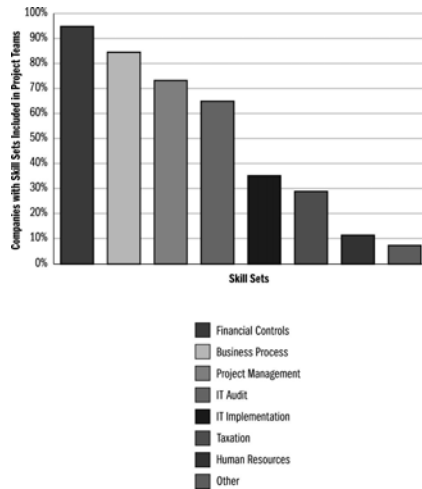
### **The effort is larger than initially envisioned!**

- 70% of companies > 10,000 hours
- 36% plan to incur > 25,000 hours
- 40% of companies exceeding \$100 billion in sales plan to incur >100,000 hours

## Project Management: Key Lessons Learned

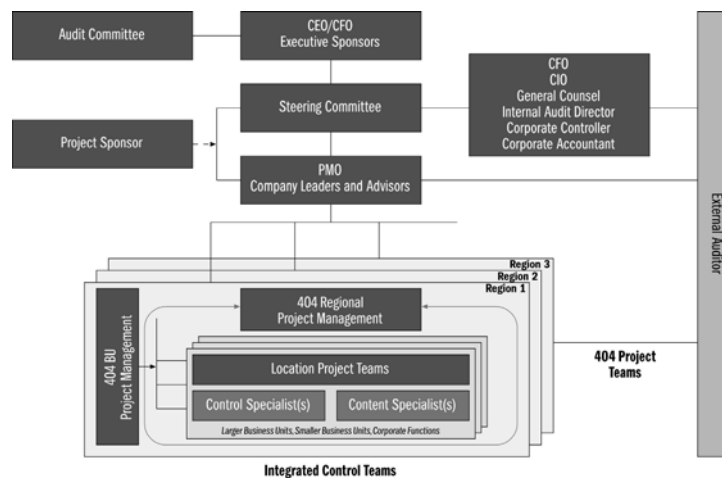
- Project Management competencies are critical
- Use risk assessment to determine higher risk, complex areas—flex work plan accordingly
- 404 is not only a documentation exercise—focus on important risks and controls
- Design the project to extract value
  - Process improvements
  - Consistent policies and controls
  - Reduction of duplicate controls

# Key Issue: Who Should be Part of the Project Team?



Successful project completion requires the right combination of skill sets.

# Sample Project Team Structure

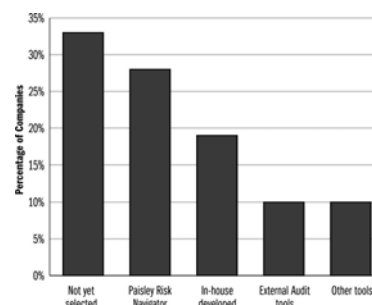


## People: Key Lessons Learned

- Required skills are not always resident to the degree required and located where needed (internal, external, technical, industry, or process)
- Management should be clear and explicit in determining the skill requirements needed at the outset
- Executive time is critical and greater than most expect—educate finance and operational stakeholders on Section 404
- Executive sponsorship is key to ensuring that the right resources are made available at the right time

## Key Issue: What Technology Enablers are Being Used?

- Of companies that have selected a vendor
  - Risk Navigator was most often selected
  - Other tools included On Project, Open Pages, Handy Soft, and Movaris
- Some companies have built or converted in-house systems



## Technology Enablers:Key Lessons Learned

- **Be clear on approach and methodology before selecting the enabling tool**
- **Understand and incorporate the implementation costs and timelines in advance**
- **Allow for slippage—it always occurs**
- **Keep customization to a minimum in the early stages**
- **Ensure all costs are disclosed in vendor discussions**
- **Involve your IT department early**
- **Technologies for Section 404 continue to evolve**

## Best-in-Class Approach to Controls at Third Parties

For Companies

- Catalog all third-party relationships
- Risk rate outsourced operations
- Analyze the number and size of transactions being processed
- Determine what information the outsourcer provides over its internal controls
- Challenge service providers regarding scope and timing of SAS 70 reports
- If necessary, request more timely or thorough information

For Outsourcers

- Manage companies' expectations by soliciting their feedback and that of their external auditors
- Establish plans for addressing the most common needs

## Keys to Project Success

- Senior Management Support
- Business Department Ownership
- Required Cultural Changes
- Consistent Approach and Documentation Everywhere
- Early Identification and Remediation of Control and Testing Issues
- Ongoing Monitoring and Testing Effectively Embedded in Processes

## Focus on Trouble Spots

- Documentation of non-routine and estimation processes, particularly actuarial and top-level adjustments
- Interfaces between administration systems and general ledger, including timely clearance of reconciling and suspense items
- General IT controls including excessive access to systems and program change controls
- Distributed IT system controls, particularly spreadsheets
- Information from service bureaus, companies from which business is assumed and other outside transaction originators

# Sarbanes-Oxley Compliance: Responsibilities and Challenges for the External Auditor

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Society of Actuaries Spring Meeting  
San Antonio, Texas, June 14 – 15, 2004

## Sarbanes-Oxley Sections 302 and 404: Responsibilities and Challenges for the External Auditor

- The PCAOB Standard
- Management's Responsibilities
- The Auditor's Responsibilities
- Significant Audit Issues - Planning and Performance
- Particular Areas of Concern

## Public Company Accounting Oversight Board (PCAOB) Standard

- Standard issued March 9, 2004. Proposed standard was issued October 7, 2003.
- Effective after approval from the SEC following an expected 30 day comment period.
- Effective date:
  - Accelerated filers (a seasoned US company with float exceeding \$75 million) under Exchange Act Rule 12b-2 – required compliance for fiscal years ending on or after November 15, 2004.
  - All others--fiscal years ending on or after July 15, 2005. All others include foreign private issuers filing Forms 20-F and 40-F.

## PCAOB Standard (cont.)

- Reinforces the concept that an audit of the financial statements and an audit on internal control over financial reporting is now integrated and inseparable.
- Recognizes that internal control is not a “one-size-fits-all” concept and that companies will implement controls in different ways based on their size and complexity.
- Outlines management’s:
  - Responsibilities.
  - Documentation requirements.
- Outlines the auditor’s responsibilities and required communications.
- Establishes criteria for evaluating deficiencies.
- Outlines the auditor’s responsibilities for management’s quarterly internal control reporting under Section 302.
- Provides reminders on auditor independence.

## PCAOB Standard: Key Points

- Two opinions in report on internal control over financial reporting – one on management’s assessment process and one directly on the effectiveness of internal control.
- Evaluation of Audit Committee
- Use of Work of Others, including Service Organizations
- Multiple Business Units and Locations
- No Rotation of Testing of Controls
- Material Weakness = Adverse Opinion on Effectiveness
- Relating significant accounts to relevant financial statement assertions.
- Mandatory auditor walkthroughs.
- Definitions of significant deficiency and material weakness
- Evaluation of Fraud
- Quarterly Procedures

## Management’s Responsibilities

- Accept responsibility for the effectiveness of the company’s internal control over financial reporting.
- Evaluate the effectiveness of the company’s internal control over financial reporting using suitable control criteria (like COSO).
- Support its evaluation with sufficient evidence, including documentation.
- Present a written assessment about the effectiveness of the company’s internal control over financial reporting as of the end of the company’s most recent fiscal year.
- **If responsibilities are not fulfilled, the auditor should communicate in writing to the Audit Committee and disclaim an opinion or withdraw.**

## Management's Documentation Requirements

- The design of controls over *all relevant* assertions related to *all* significant accounts and disclosures in the financial statement –all five components, including the control environment and company-level controls.
- Information about how significant transactions are initiated, authorized, recorded, processed and reported.
- Sufficient information about the flow of transactions to identify where material misstatements due to error or fraud could occur.
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties.
- Controls over the period-end financial reporting process.
- Controls over safeguarding of assets.
- The results of management's testing and evaluation.

## Auditor's Responsibilities

- Plan the audit.
- Evaluate management's assessment process.
- Obtain an understanding of the internal control over financial reporting.
- Evaluate design effectiveness.
- Test and evaluate operating effectiveness of controls.
- Use of work of others.
- Evaluating deficiencies and forming an opinion on the effectiveness of internal control over financial reporting
- Quarterly Procedures

## Significant Audit Issues

- Scoping and Coordination with Management's Process
- Evaluating Management's Process – Form and Extent of Documentation
- Testing – How Much and Reliance on Work of Others
- Evaluating Deficiencies
- Evaluating the Audit Committee's Effectiveness
- Evaluating Controls Over Fraud Risks

## Evaluating Management's Assessment Process

- The auditor must evaluate management's process for assessing the effectiveness of the company's internal control over financial reporting by determining whether management has addressed the following elements:
  - Determining which controls should be tested.
  - Evaluating the likelihood that failure could result in a misstatement and if so, its magnitude.
  - Determining locations or business units to include.
  - Evaluating design effectiveness.
  - Evaluating operating effectiveness.
  - Determining deficiencies in internal control over financial reporting.
  - Communicating findings to the auditor and others.
  - Evaluating reasonableness of findings and whether they support management's assessment.

## Testing and Evaluating Operating Effectiveness of Controls

- Must obtain evidence (either by performing tests of controls himself or herself or by using the work of others) about effectiveness of controls for all relevant assertions related to all significant accounts and disclosures each year.
- Should vary nature, timing, and extent of testing year to year.
- High level of assurance needed.
- Consider nature of control (manual vs automated; frequency of operation; importance)
- Multiple Locations and/or Business Units – Extent of Testing

## Using the Work of Others

- “Others” includes internal auditors, other company personnel, and third parties working under the direction of management or the audit committee.
- Extent to which auditor may use the work of others depends on:
  - The nature of the controls.
  - The competence and objectivity of others who performed the work.
  - Tests of the work performed by others to evaluate its quality.
- Service Auditors vs. Experts
- ***The extent to which auditor may use the work of others is still subject to the requirement that the auditor’s own work must provide the principal evidence for the auditor’s opinion.***

## Evaluating Deficiencies

- Must evaluate all identified deficiencies in internal control over financial reporting for significance based on:
  - **Likelihood** that a deficiency, or combination of deficiencies, could result in a misstatement of an account balance or disclosure.
  - **Magnitude** of the potential misstatement resulting from the deficiency or deficiencies.
  - Evaluation of significance includes both quantitative and qualitative factors.
  - Requires aggregation – **all** locations reporting.

## Automatic Significant Deficiencies/ Potential Material Weaknesses

### **Circumstances which result in a significant deficiency and are strong indicators of a material weakness:**

- Restatement of previously issued financial statements.
- Identification by the auditor of a material misstatement in the financial statements.
- Ineffective oversight by the company's Audit Committee.
- Ineffective internal audit or risk assessment function, for more complex entities.
- Ineffective regulatory compliance function for complex entities in highly regulated industries.
- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies communicated to management and the audit committee which remain uncorrected after some reasonable period of time.
- An ineffective control environment.

## Deficiencies in these Areas are at Least Considered Significant Deficiencies

- Controls over the selection and application of accounting policies that are in conformity with GAAP.
- Antifraud programs and controls.
- Controls over non-routine and nonsystematic transactions.
- Controls over the period-end financial reporting process.

## Particular Areas of Concern

- Remediation of Control Issues
- Financial Reporting Process (i.e., Closing the Books and Periodic Reporting)
- Spreadsheets
- Areas not Traditionally Audited for Controls – Actuarial and Tax
- Non-standard Journal Entries
- Acquisitions close to year-end
- Reporting/Disclosure of Identified Weaknesses
- TIME - It's not on our side!