

Director's Role Related to Effective Internal Controls

NACD – Capital Area Chapter
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Objectives

- Discuss the audit committees responsibilities regarding internal controls
- Equip the audit committee with an understanding of the COSO Framework
- Offer suggested action items to assist in execution of related responsibilities
- Highlight areas of typical risk
- Provide an update of the regulatory environment

The audit committee's charge

SOX Section 205

Sarbanes-Oxley defines the audit committee as:

*"a committee (or equivalent body) established by and amongst the board of directors of an issuer **for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements** of the issuer"*

The audit committee's charge

SOX Section 301

The audit committee is responsible for:

- **Appointment, compensation** and **oversight** of auditor
- **Resolution of disagreements** between management and the auditor regarding financial reporting

The audit committee's charge SOX Section 301 (cont'd)

The audit committee is responsible for:

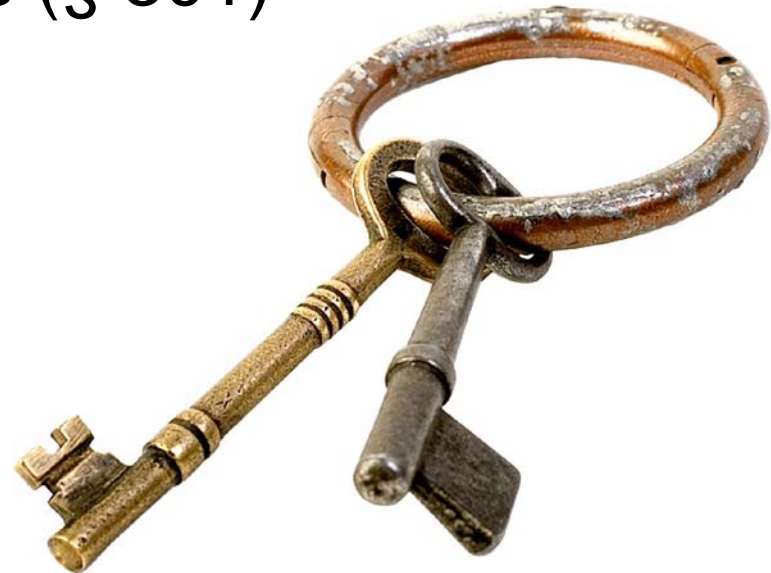
- The **receipt, retention and treatment of complaints** received regarding accounting, internal accounting controls, or auditing matters; and
- The confidential, anonymous submission by employees of the issuer of **concerns regarding questionable accounting or auditing matters.**

Question: Is today's audit committee fully prepared to execute these duties?

The audit committee's charge

Three ways to prepare and/or improve:

- Train existing board and audit committee members
- Find new members with specific skills
- Engage independent advisors (§ 301)



What are good internal controls?

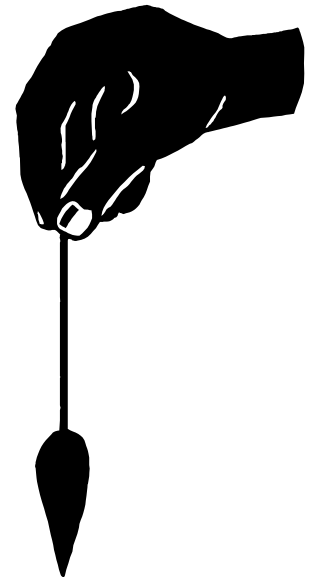
Overview of the COSO framework

- Introduction to COSO
- The five components
- Evaluation methods

A "Framework" for evaluation COSO

What does the "framework" accomplish?

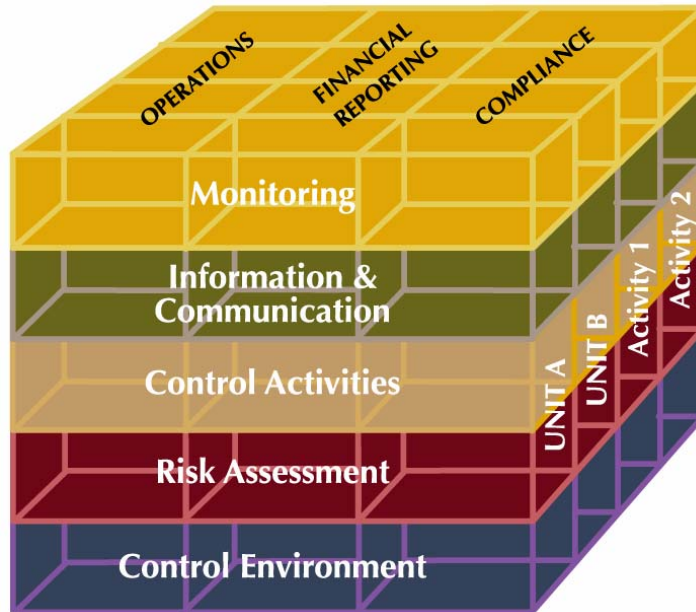
- Establishes a common language
- Establishes a generic benchmark of acceptable internal controls



A "Framework" for evaluation COSO Components

"Internal control consists of five interrelated components. These are derived from the way management runs a business and are integrated with the management process."

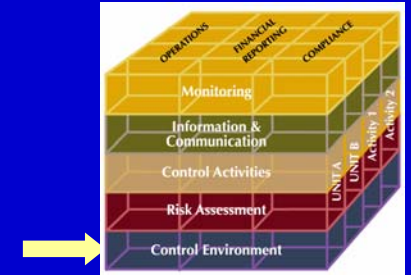
-- Committee of Sponsoring Organizations
of the Treadway Commission; 1987



1. Control Environment
2. Risk Assessment
3. Control Activities
4. Information and Communication
5. Monitoring

COSO Components

1. Control environment



- **Tone of the organization**
- Attributes of people employed
 - Level of Integrity
 - Ethical values
 - Competence
- Combination creates the foundation of the control environment

COSO Components

1. Control environment – Tone at the top!!

Foreword

As officers and employees of [REDACTED] Corp., its subsidiaries, and its affiliated companies, we are responsible for conducting the business affairs of the companies in accordance with all applicable laws and in a moral and honest manner.

To be sure that we understand what is expected of us, [REDACTED] has adopted certain policies, with the approval of the Board of Directors, which are set forth in this booklet. I ask that you read them carefully and completely and that, as you do, you reflect on your past actions to make certain that you have complied with the policies. It is absolutely essential that you fully comply with these policies in the future. If you have any questions, talk them over with your supervisor, manager, or [REDACTED] legal counsel.

We want to be proud of [REDACTED] and to know that it enjoys a reputation for fairness and honesty and that it is respected. Gaining such respect is one aim of our advertising and public relations activities, but no matter how effective they may be, [REDACTED] reputation finally depends on its people, on you and me. Let's keep that reputation high.

July 1, 2000

[REDACTED]
Chairman and Chief Executive Officer

COSO Components

1. Control environment – Tone at the top!!

BACKUP THE WORDS WITH ACTION

Foreword

As officers and employees of **Enron** Corp., its subsidiaries, and its affiliated companies, we are responsible for conducting the business affairs of the companies in accordance with all applicable laws and in a moral and honest manner.

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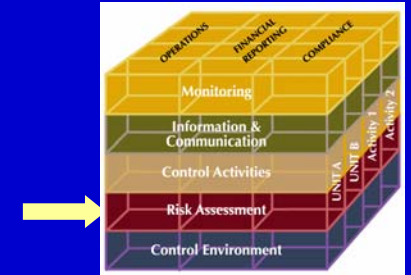
July 1, 2000

Kenneth L. Lay

Chairman and Chief Executive Officer

COSO Components

2. Risk assessment



- Risk awareness and prevention
- Setting objectives
 - Mission or value statements
 - Overall strategy
 - Integrated with sales, production, marketing, financial, etc. to operate in concert
- Establishing mechanisms to identify, analyze and manage risks

COSO Components

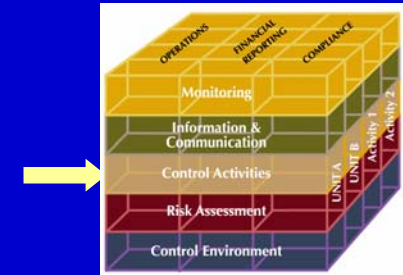
2. Risk assessment – as it relates to SOX

Both the SEC and the PCAOB have encouraged a top-down, risk-based approach to evaluating internal controls over financial reporting



COSO Components

3. Control activities



- Establishing and implementing policies and procedures
 - Carry out the entity's objectives
 - Addresses the risk to achievement of objectives
- Occurs throughout the organization, at all levels and in all functions
- Approvals, authorizations, verifications, reconciliations, segregation of duties, etc.

COSO Components

3. Control activities – control purpose

Preventive controls are generally preferred over **Detective** controls

- **Preventive Controls** focus on preventing errors or exceptions
 - Standard policies and procedures
 - Proper segregation of duties
 - Authorization levels/approvals
- **Detective Controls** are designed to identify an error or exception after it has occurred
 - Exception reports
 - Reconciliations
 - Reviews of operating performance

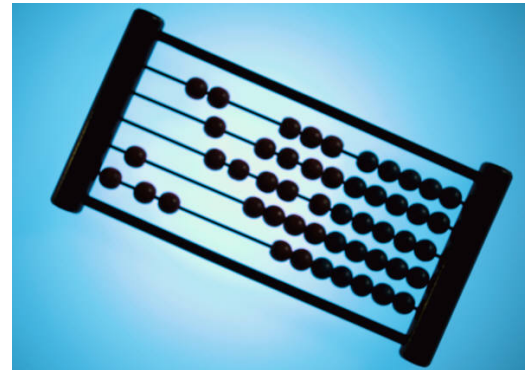


COSO Components

3. Control activities – control type

Automated
controls are
generally
preferred over
Manual
controls

- **Automated Controls** operate through and within the information technology systems. They function systematically and work with a high degree of consistency.
- **Manual Controls** operate through human intervention. They are the most flexible but are also subject to human error.



COSO Components

4. Information and communication

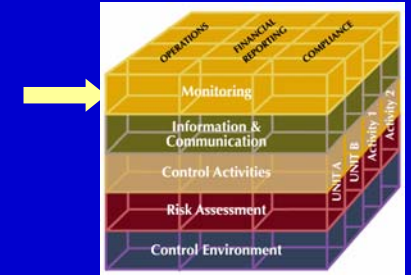


- Systems of communications
 - How information is identified, captured, exchanged and used on a timely basis
- Information systems
 - How reports are designed, produced, disseminated and used on a timely basis

Are the **right people** getting the **right information** at the **right time**?

COSO Components

5. Monitoring



- Assessing the quality of the system
 - Ensures controls continue to operate effectively
 - Adjusts for changing environment
- Ongoing monitoring activities
 - Built into the normal, recurring activities
 - Performed on a real-time basis
- Separate evaluations
 - Periodically tested based on circumstances

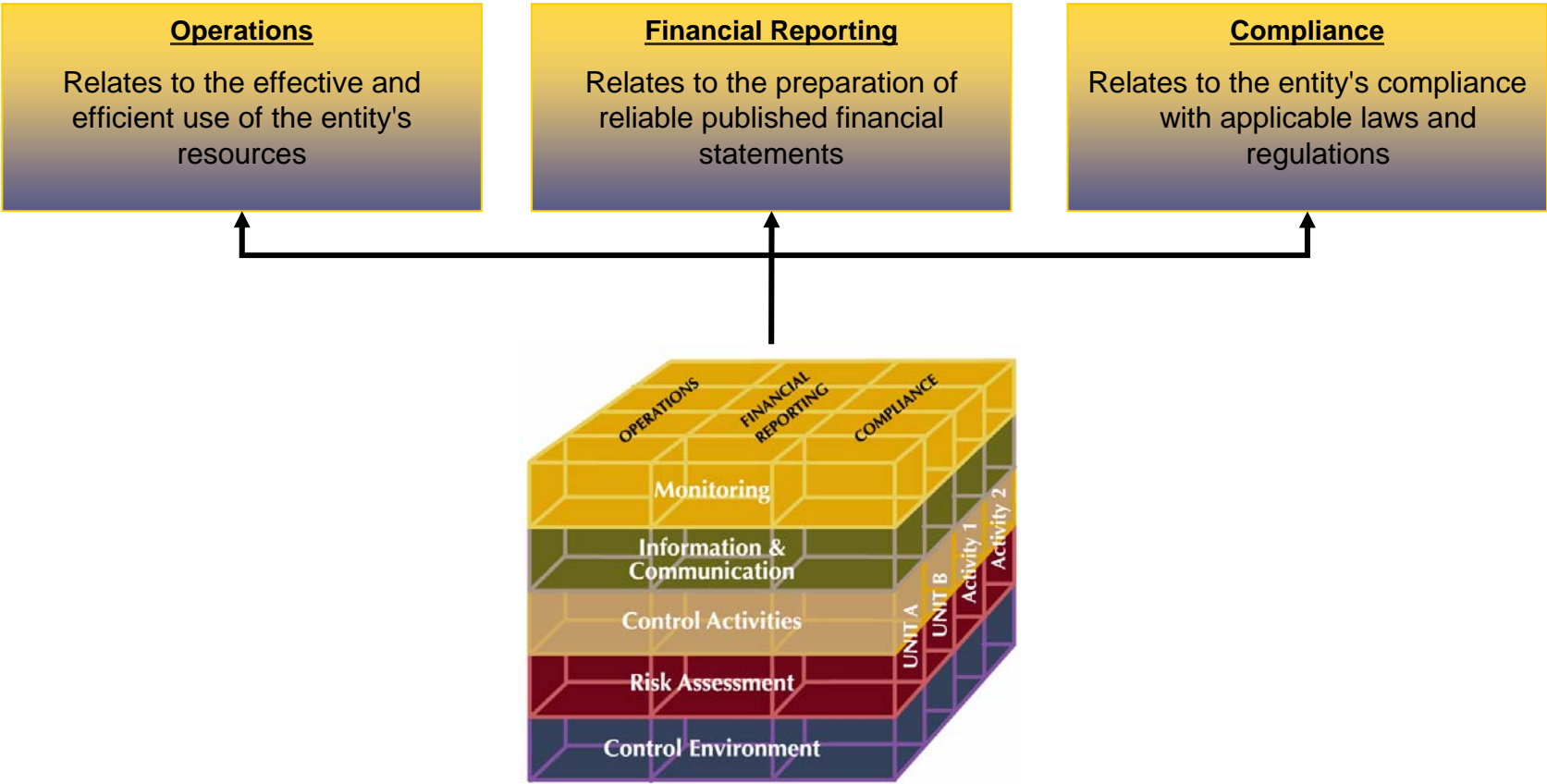
COSO Objectives

The COSO “Cube” looks at each component of internal control by objectives. The Cube further indicates that internal control is relevant to the entire enterprise, or to any of its units or activities.



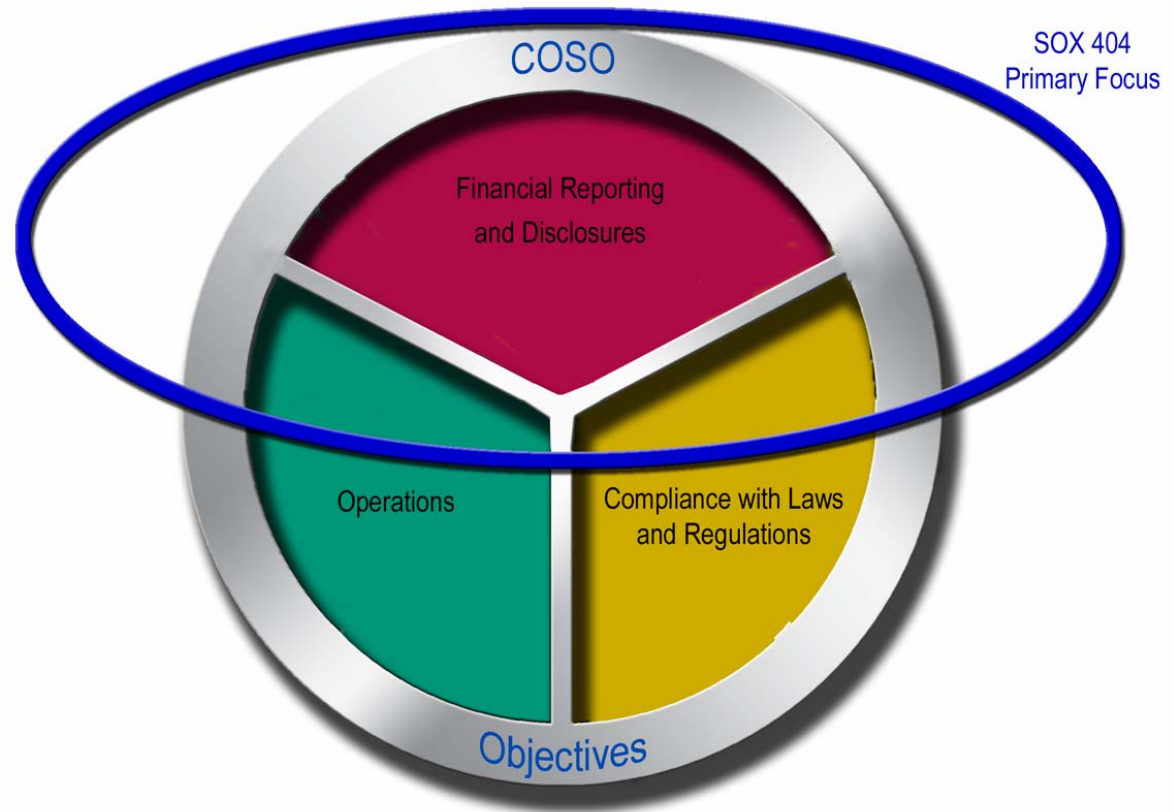
1. Operations
2. Financial Reporting
3. Compliance

COSO Objectives



COSO Objectives

The COSO Framework objectives are broader than those of SOX Section 404



Evaluation methods

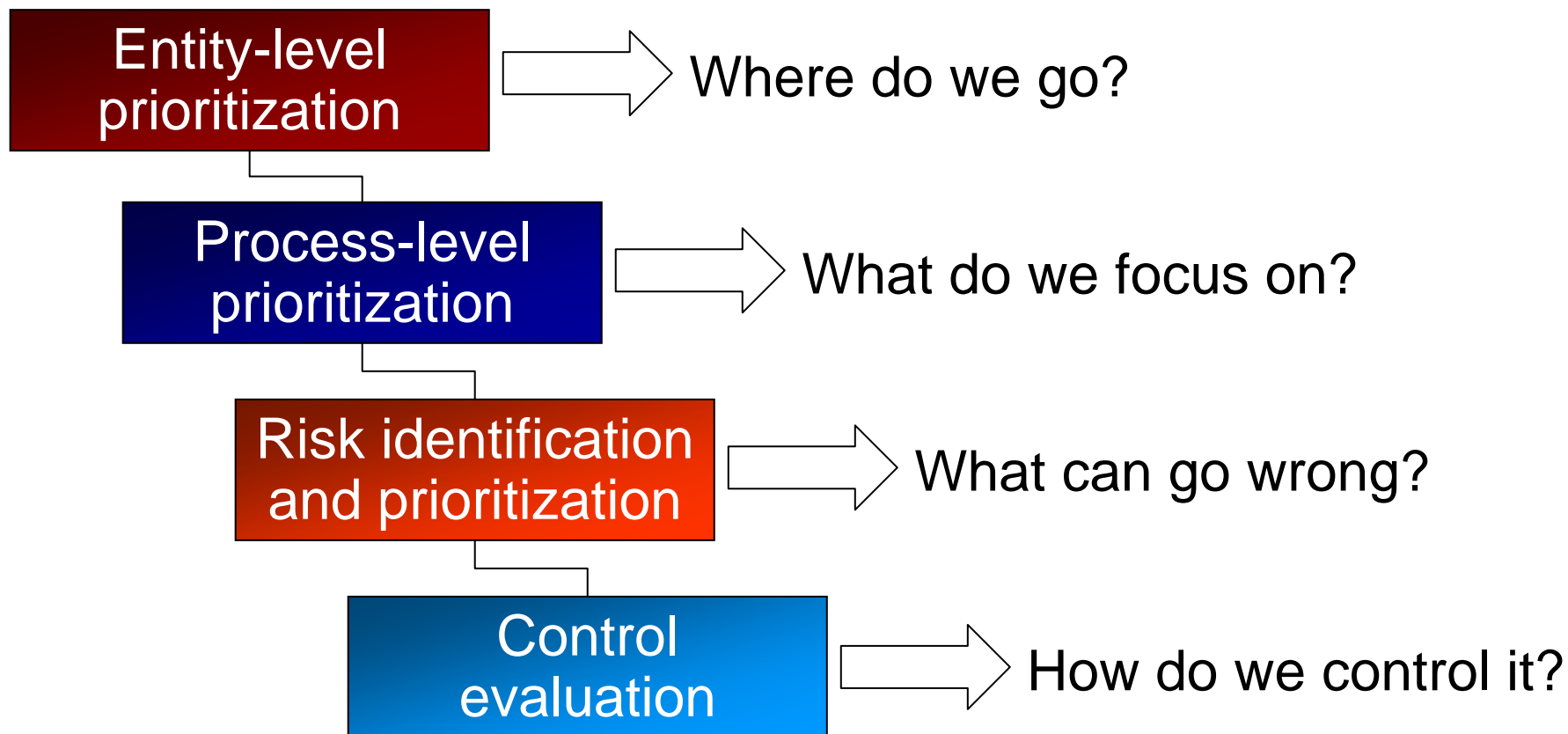
- SEC did not prescribe a single method
- Appropriate testing will largely depend on the circumstances of the company and the characteristics of the related control(s)
- Inquiry, alone, will not provide an adequate basis for assessment
- Non-management personnel may be used, if supervised

Evaluation methods (cont'd)

- SEC did identify four areas that must be examined:
 1. Processing routine transactions
 2. Processing non-routine and non-systematic transactions
 3. Selecting and applying appropriate accounting policies, and
 4. Identifying, preventing, and detecting fraud

First steps to compliance

Drill down to find and address significant risks



Audit committee considerations: Ongoing involvement

Consider asking for progress reports that include:

- Compliance approach taken including entities or units selected, processes selected and risks identified
- Documentation gaps identified and corrective action taken and/or proposed
- Weaknesses in internal controls identified and corrective action taken and/or proposed
- The external auditors expectations and involvement to date

Audit committee considerations: Ongoing involvement

Consider asking for progress reports from both management and the external auditor that include:

- How the project is being staffed (e.g., permanent staff, temporary staff, and/or consultants)
- Total hours spent to date and estimated hours to complete
- Total costs of compliance to date and estimated cost to complete
- Estimated completion date

Audit committee considerations: Ongoing involvement

Ask both management and the external auditors to keep the audit committee up-to-date

- Internal controls should be an agenda item for every audit committee meeting

Ask for the appropriate amount of detail

- Get enough information to understand and judge the effectiveness of the approach

Make it clear that you don't want surprises

- If significant concerns are identified ask both management and the external auditor to consider calling an emergency audit committee meeting

Audit committee considerations: What if we get an adverse opinion?

Understand the details behind the opinion

- What is the severity of the material weakness?
- What is the potential financial statement impact – both annually and quarterly?
- How has management/auditor adjusted their closing/audit to make certain the financial statements are correct?

Audit committee considerations: What if we get an adverse opinion?

What is management's remediation plan?

- How long will the remediation take?
- How will management/auditor update the audit committee?

How will the material weakness be disclosed?

- Anticipate the needs of the shareholders, analysts, lenders, etc.
- Transparent disclosure includes a full discussion (i.e., complete description; severity; remediation plan and timeframe; impact on the financials)

Areas of focus/risk – A brief look at the GAO restatement study

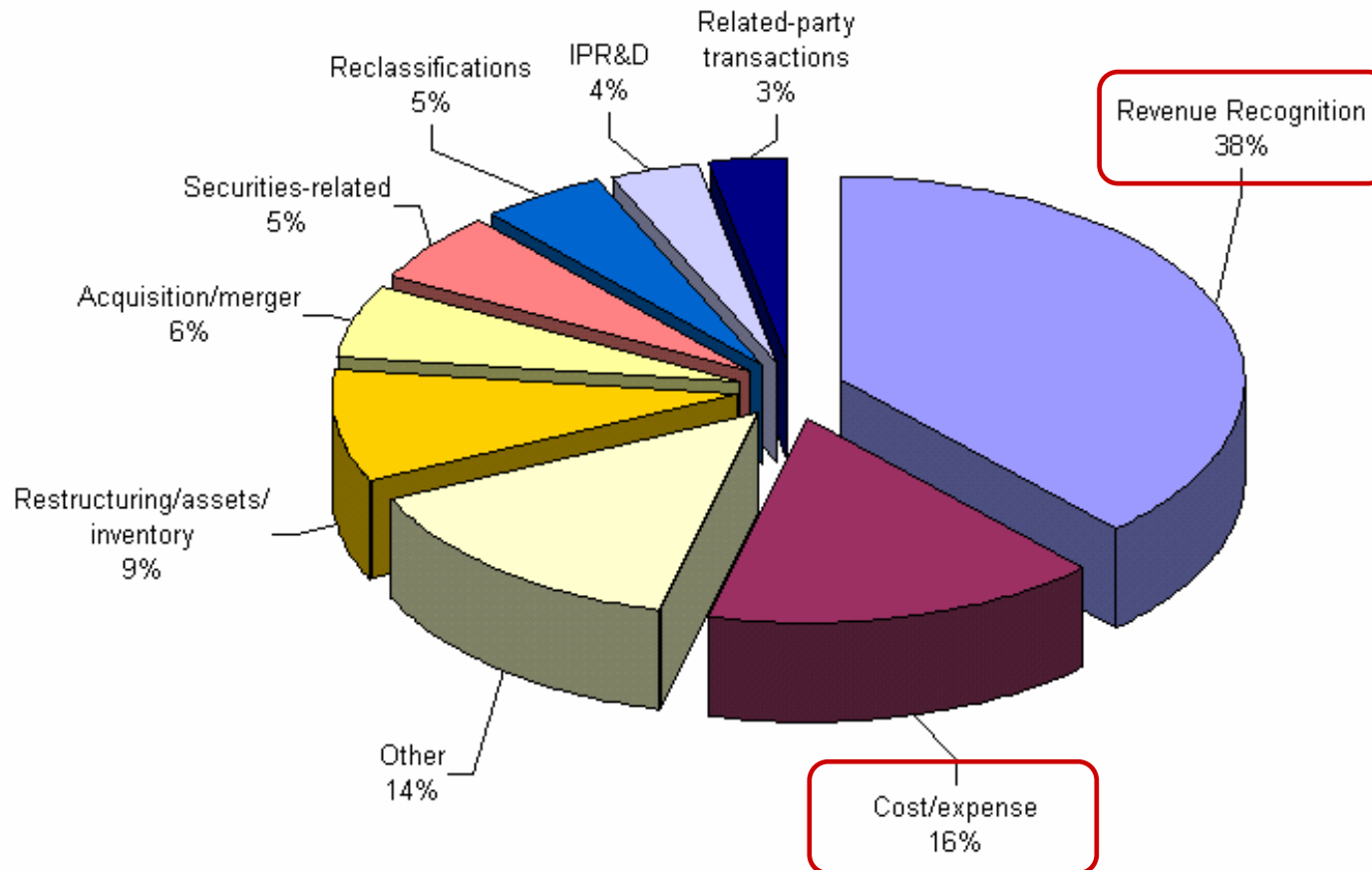
- In October of 2002, the GAO released a study mandated by Sarbanes-Oxley regarding financial statement restatements since 1997
- The study reviewed 919 restatements by 845 companies that resulted from material errors or fraud between January 1997 and June 2002

(<http://www.gao.gov/new.items/d03138.pdf>)

GAO restatement study

Analysis of restatement causes

(January 1997 – June 2002)



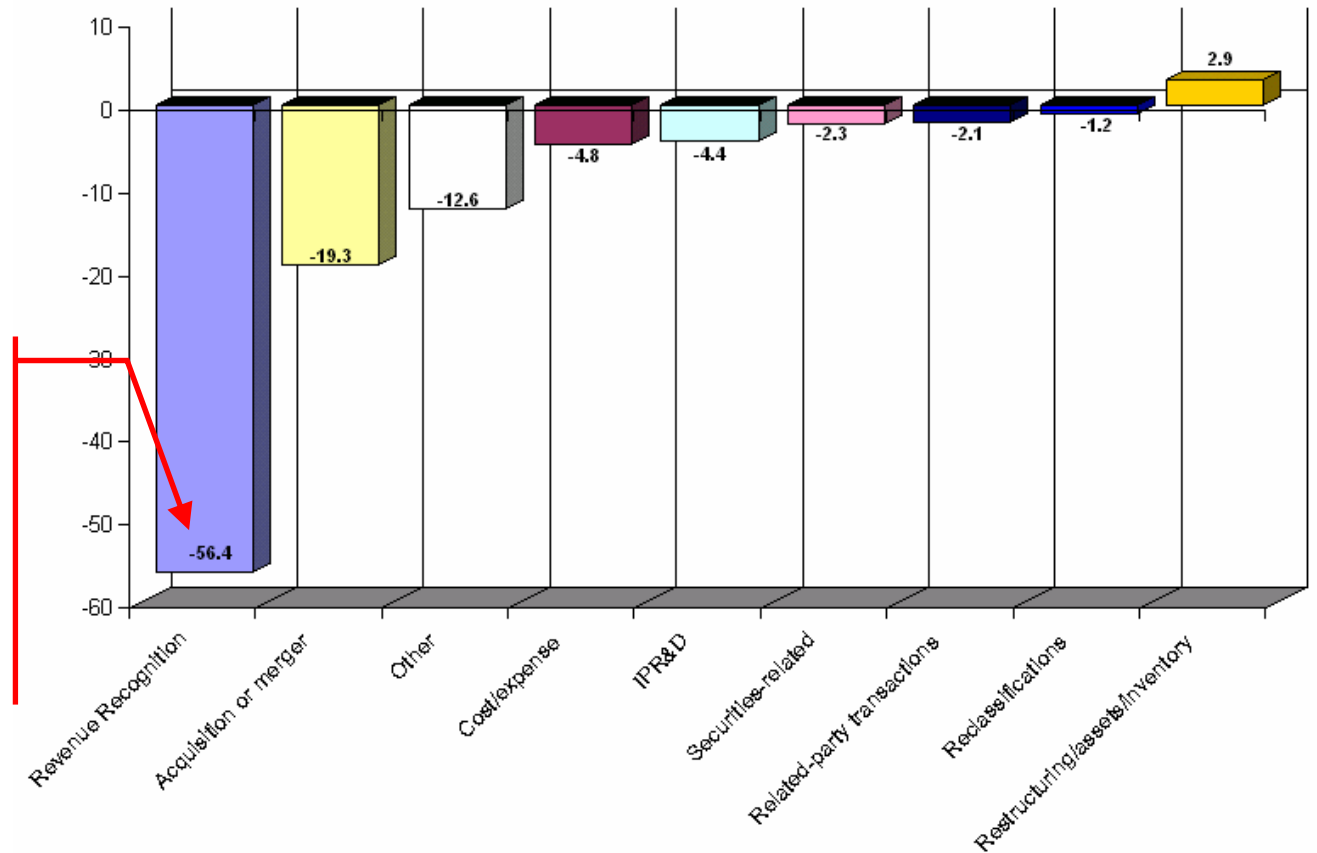
Source: October 2002 GAO study, *Financial Statement Restatements*.

\$100 billion is a whole lot of money . . .



GAO restatement study

Analysis of restatement impacts



Revenue recognition issues accounted for 56% of the \$100 billion market cap loss

Source: October 2002 GAO study, *Financial Statement Restatements*.

SEC & PCAOB May 16, 2005 guidance Summary

Encouraged the:

- **integration of audits** of internal control with audits of the client's financial statements
- **exercise judgment** to tailor their audit plans to the risks facing individual audit clients
- use of a **top-down approach**
- use by the auditor of the **work of others** more effectively; and
- **direct and timely communication** between auditors and management