

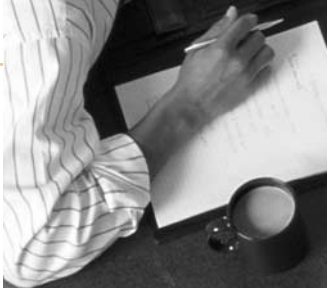
# Beyond Compliance

Leveraging Internal Control  
to Build a Better Business:  
A Response to Sarbanes-Oxley  
Sections 302 and 404



Note to Readers Regarding This First Edition – April 2003:

This document was published before the SEC had fully promulgated its Sarbanes-Oxley rules. As a result, subsequent actions by the SEC may substantially alter the accuracy and validity of the material presented herein. Contact your Deloitte & Touche advisor for more information.



The Sarbanes-Oxley Act of 2002 is, by any standard, a complex piece of legislation, one that has engendered confusion and consternation in some quarters of the business community.

If you are comfortable with the nuances of the Act and confident about its implementation in your company, congratulations! We are here to assist you in any way we can.

However, if you are proceeding with some uncertainty and trepidation, you are not alone. Deloitte & Touche has spent a great deal of time helping clients sort out the requirements and prioritize the mandates of Sarbanes-Oxley. In doing so, our partners have repeatedly encountered certain misconceptions particularly in regards to Sections 302 and 404 internal control issues. Here are a few of the erroneous statements we've heard:

- **“Sarbanes doesn’t apply to my small business; it’s meant for Fortune 500-type companies.”**

Sarbanes-Oxley applies to every public company in the United States and foreign filers, regardless of size.

- **“My last few audits have come back with clean opinions. I’m already in compliance.”**

A “clean” opinion in your last financial statement audit carries little relevance as far as Sarbanes is concerned. When your independent auditors rendered an opinion on your financial statements, they were not attesting to the effectiveness of your internal control; the testing procedures they performed were not designed to meet the requirements specified in Sarbanes-Oxley.

- **“Compliance with Sarbanes is not my concern; it’s my independent auditor’s problem.”**

In fact, Congress deliberately wrote the law to ensure that companies themselves would be held accountable for the fairness, thoroughness, and accuracy of their financial reporting and disclosure. Under Sarbanes, the primary function of your independent auditor will be to attest to your assessment of the effectiveness of your internal controls and procedures for financial reporting. In other words, you must assess, implement, monitor, and evaluate your internal control before your independent auditor can file his report. Your independent auditor can, to a limited extent, advise and assist you with the process — but *you* must accept responsibility for the work.

The benefits of a strong internal control structure can deliver business value far beyond just mandatory compliance with Sarbanes-Oxley regulations.

Deloitte & Touche believes that anything less than a vigorous response to Sarbanes-Oxley is inadvisable. Time is short. A number of certification and attestation obligations are already in place. The penalties for noncompliance are severe, and those who sign the required certifications — the CEO and CFO — are personally liable for the truthfulness and accuracy of these statements.

If your independent auditor is unable to verify your assessment of internal control, a harmful chain reaction could conceivably ensue: Your annual reports will reveal a material weakness in internal control, which will call into question the competence and credibility of your company and its management team. Such concerns may have an impact on your company's share price, and your company's market capitalization may drop accordingly.

If these issues result in regulatory scrutiny, the ramifications could be considerable.

## Understanding the Requirements of Sections 302 and 404

### SECTION 302

The requirements of Section 302 focus on management's responsibilities.

CEOs and CFOs must personally certify that they are responsible for disclosure controls and procedures. Each quarterly filing must contain an evaluation of the design and effectiveness of these controls.

The certifying executives must state that they have disclosed to their audit committee and independent auditor any significant control deficiencies, material weaknesses, and acts of fraud.

An expanded certification requirement that includes internal controls and procedures for financial reporting may also be included when the SEC issues its final rules.

### SECTION 404

Section 404 mandates an annual evaluation of internal controls and procedures for financial reporting. It also requires the company's independent auditor to issue a separate report that attests to management's assertion on the effectiveness of internal controls and procedures for financial reporting.

While the requirements of Section 404 don't come into effect until late 2003, it's necessary to put the appropriate documentation processes in place **now**. By doing so, you will have the information to support your evaluation, which will minimize the potential for a qualified opinion from your independent auditor.

Because Sarbanes-Oxley requires top executives to state for the record how well their internal control structure is functioning, you must be more attuned and better informed than ever before. Thus, establishing a link between the control activities of the organization and the governance activities of the board and senior management is crucial. The effectiveness of your internal control infrastructure and the communications within your organization regarding the internal control process are key to creating the appropriate link.

The benefits of a strong internal control structure, however, can deliver business value far beyond just mandatory compliance with Sarbanes-Oxley regulations. The same internal control infrastructure that supports Sarbanes-Oxley compliance can also be leveraged to generate greater business success. A host of benefits could result — improved flow of information permitting better business decisions, better management of resources, streamlined operations, improved investor relations, and an enhanced reputation for leadership and integrity in corporate governance and reliable financial reporting.



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## Five Steps to Developing an Effective Internal Control Infrastructure

Deloitte & Touche's multidisciplinary approach can help you address all of the factors that affect the success of your internal control program, including people, risk, accountability, communication, and monitoring, as well as other issues. In particular, we assist our clients with the change management process that must occur across the entire organization to sustain Sarbanes-Oxley compliance.

We have developed a proven approach and specialized tools to build a strong internal control framework that complies with the requirements of Sarbanes-Oxley Section 404. This five-step approach is flexible enough to be customized for your specific needs, yet sufficiently structured to address the most critical requirements of your compliance strategy.

### 1 *Step one* Start with the End in Mind

Although Section 404 does not take effect until late 2003, the mandates of both sections can be addressed through a single methodology that should be initiated right away. Separately addressing these two sections of the Act is duplicative and consequently inefficient.

### 2 *Step two* Commit and Organize

Start now to understand how Sarbanes-Oxley applies to your specific organization and its unique business characteristics. Three groups should play prominent roles.

- 1 The board of directors, which oversees the company's commitment to the process
- 2 The CEO and CFO, who acknowledge responsibility for ensuring compliance and communicating this to the rest of the organization
- 3 A specially appointed steering committee that coordinates Sarbanes-Oxley activities throughout the company

### 3 *Step three* Select a Suitable Internal Control Framework

The dominant model will most likely be the structure recommended by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

The COSO framework breaks effective internal control into five interrelated components in order to simplify management's task of administering and supervising all of the activities that go into a successful internal control structure.

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

### 4 *Step four* Empower the Disclosure Committee

The Disclosure Committee recommends parameters for disclosure, oversees the disclosure processes, and reviews control deficiencies and material weaknesses with the CEO and CFO.



### 5 *Step five* Establish an Internal Control Program

Form an internal control program management team to establish or strengthen your internal control framework based on the following five phases.

- 1 Scope and Plan the Project**  
The planning process involves defining the desired scope and outcome of your internal control program and allocating appropriate resources to accomplish the agreed-upon objectives.
- 2 Assess and Define**  
The goal of this phase is to arrive at a clear understanding of your existing control procedures and infrastructure and the degree to which existing procedures meet, or fall short of, the internal control objectives defined in Phase One.
- 3 Identify and Document Controls**  
During this phase, specific financial reporting and disclosure risks within your existing internal control structure are identified. Additionally, a central internal control repository should be built to document control objectives and activities, map activities to control objectives, and identify deficiencies on an ongoing basis.
- 4 Perform Tests and Remediate**  
In this phase, existing control procedures are tested to identify weaknesses or deficiencies, prioritize risks, and recommend strategies to remediate any control weaknesses or deficiencies uncovered in Phase Three.
- 5 Monitor, Certify and Assert**  
At this point, management, assisted as appropriate by our engagement team, establishes procedures for its ongoing internal control monitoring and remediation efforts and performs all activities necessary for compliance with Sarbanes-Oxley Sections 302 and 404.

For more details on developing an effective internal control infrastructure, please see our publication, *Moving Forward: A Guide to Improving Corporate Governance Through Effective Internal Control*.



## A Storehouse of Knowledge

In order to provide a mapping of disclosure controls and financial reporting controls, Deloitte & Touche utilizes a proprietary risk and controls knowledgebase, a central repository of industry-specific information structured according to business processes. This reliable content provides our teams with a base from which to quickly tailor process and control information for each client's unique business.

## The Power of Enabling Technology

While Sarbanes-Oxley compliance is, for the most part, a point-in-time analysis that depends primarily upon an organization's business processes and information management practices, enabling technology is a key element of a strong compliance program and infrastructure. And technology can support several components of Sarbanes-Oxley compliance.

- Documenting risks and controls
- Assessing and benchmarking risks and controls
- Reporting on control gaps for analysis and remediation
- Providing security of information stored
- Providing a means of comparison with best practices
- Increasing efficiency in review and sign-off procedures
- Providing improved management reporting and sign-off
- Integrating with other enterprise software packages

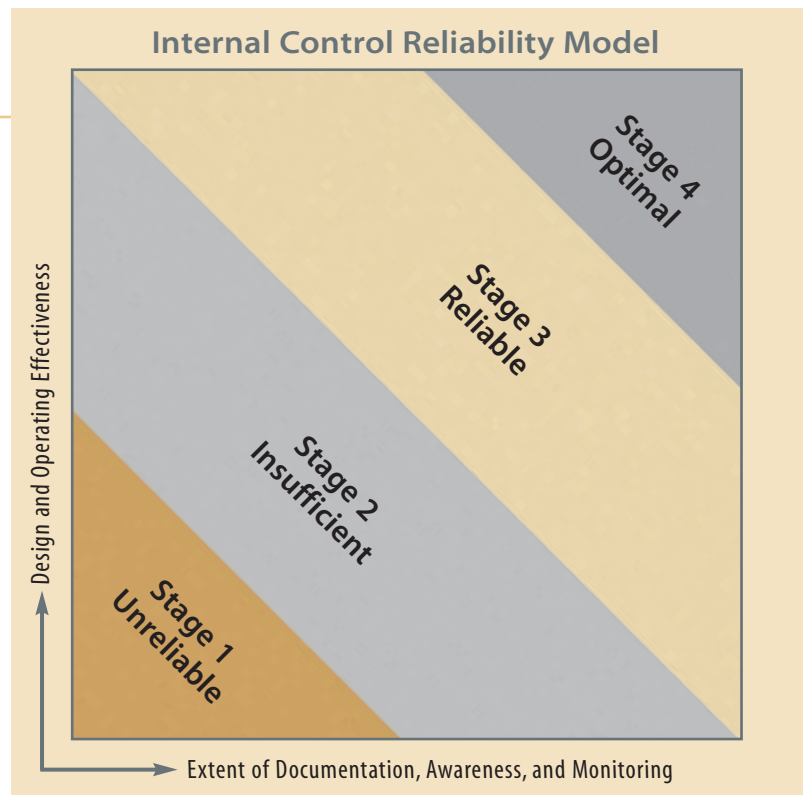
To address your specific needs, Deloitte & Touche supports numerous technology options. We do not implement a prepackaged, "shrink-wrapped" solution. Rather our team of technology specialists works closely with you to define the specific compliance processes necessary for your situation. Then we evaluate a wide range of enabling technologies and help to design a solution that best fits your internal control compliance and monitoring needs.

## Beyond Compliance

The business environment has profoundly changed, and companies must recognize that additional effort and accountability will be required. The cost of developing, enhancing and maintaining effective internal control needs to be factored into your business model. However the benefits can far outweigh the costs in streamlined operations and a closer monitoring of risks. This investment in your business can improve your investor relations and reputation as well. Deloitte & Touche can help you accomplish these goals.

## How Reliable Is Your Internal Control?

Review the model and characteristics to determine what stage you would assign to your organization's internal control. This model can also be applied to any business unit or subsidiary.



	Stage 1 – Unreliable	Stage 2 – Insufficient	Stage 3 – Reliable	Stage 4 – Optimal
Characteristics	Controls and related policies and procedures are not in place and documented.	Controls and related policies and procedures are in place but not fully documented.	Controls and related policies and procedures are in place and adequately documented.	Meets all of the characteristics of Stage 3.
	A disclosure creation process does not exist.	A disclosure creation process is in place but not fully documented.	A disclosure creation process is in place and adequately documented.	An enterprise-wide control and risk management program documents controls and procedures and continuously reevaluates them to reflect major process or organizational changes.
	Employees are not aware of their responsibility for control activities.	Employees may not be aware of their responsibility for control activities.	Employees are aware of their responsibility for control activities.	
	The operating effectiveness of control activities is not evaluated on a regular basis.	The operating effectiveness of control activities is not adequately evaluated on a regular basis and the process is not fully documented.	The operating effectiveness of control activities is evaluated on a periodic basis (e.g., quarterly) and the process is adequately documented.	A self-assessment process is used to evaluate the design and effectiveness of controls.
	Control deficiencies are not identified.	Control deficiencies may be identified but are not remediated in a timely manner.	Control deficiencies are identified and remediated in a timely manner.	Technology is leveraged to document processes, control objectives and activities, identify gaps, and evaluate the effectiveness of controls.
Implications	Insufficient documentation to support management's certification and assertion.	Insufficient documentation to support management's certification and assertion.	Sufficient documentation to support management's certification and assertion.	Meets all of the implications of Stage 3.
	Level of effort to document, test, and remediate controls is significant.	Level of effort to document, test, and remediate controls is significant.	Level of effort to document, test, and remediate controls may be significant depending on the company's circumstances.	Improved decision-making because of high-quality, timely information.  Efficient use of internal resources.  Real-time monitoring.





“Beyond Compliance” is a publication of Deloitte & Touche’s Corporate Governance Services designed to help you clearly understand the fast-evolving requirements of the new regulatory and stock market rules, while keeping your response aligned with your broader corporate goals and strategies. These services focus around four specific areas – board roles and responsibilities, ethics and corporate compliance, risk management and controls, and transparency and disclosure.

For more information, visit us at [www.deloitte.com/us/corpgov](http://www.deloitte.com/us/corpgov)

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