

Sarbanes-Oxley write up

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Opportunities to streamline the Sarbanes-Oxley compliance process

This briefing paper describes our approach on how to reduce costs and implement a more effective ongoing Sarbanes-Oxley (SOX) compliance process. It reflects our practical experience in optimizing and automating the SOX compliance process for a variety of public companies. All views expressed in this paper are based on practical SOX compliance work performed for our clients and have been proven successful in practice for a minimum of two consecutive financial years. These clients are SEC registrants working in different industries and the methods and tools explained in this paper were approved by their independent auditors.

Management's overall responsibility

The task of evaluating internal controls and financial reporting systems, brought about by the passage of the Sarbanes-Oxley Act (SOX) in 2002, is often seen as an investment with little or minimal return in added value. SEC registrants have already deployed annual procedures for Section 404 compliance but may be missing opportunities to streamline the compliance process.

Management is required to document and assess the effectiveness of its internal controls. It must maintain the necessary evidence to support its final assessment. In current practice, documenting controls is most commonly accomplished through the use of desktop applications such as Word, Excel, Visio and the like. These desktop applications permit free formatting in the document along with varying levels of security and template capability. However, capability varies not only among applications but also dependent

on the skill level of the document developer. More variation is introduced because documentation prepared by different individuals across the entity lacks consistency of verbiage, formatting and overall quality. Referencing across and between documents is often also an issue. These sources of variation create confusion for management, independent auditors and other project members involved in a SOX compliance assignment. It also leads to unnecessary increases in project costs with greater manhours required for the review, testing, tracking, monitoring and maintenance phases that follow the documentation.

Another required component of SOX compliance is management testing of key controls related to their significant financial statement accounts and disclosures. Internal auditors, other internal personnel or external third parties retained by management and under its direction often assist in the evaluation of operating effectiveness. The type (or

Digital testing far surpasses conventional testing in terms of accuracy and efficient use of resources

nature) of tests procedures to be performed for control activities is typically straightforward (e.g., reperformance or review of evidence).

Reperformance as a test procedure, a fully accepted auditing tool, is a very common method of validating the effectiveness of a control. Typically the test procedure is performed manually, sometimes with help of spreadsheet applications like Excel or more sophisticated analysis tools like ACL. Sampling of these controls range anywhere from 1 to

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50 items for the year, depending on the frequency of the control. However, particularly if it is IT dependent this control procedure could be processed on hundreds, thousands or even millions of transactions and manual testing raises the risk of missing key transactions.

Automate documenting the design of controls

The SEC's final rules on Section 404 indicate that it is a company's responsibility to document internal controls and that developing and maintaining such evidential matter is an inherent element of effective internal control. Documenting internal controls in a free format (in applications such as Word or Excel) introduces lack of consistency of verbiage and referencing across and between documents. Particularly in businesses with multiple operating units, this can create delays and bottle necks to further improvement of the ongoing SOX compliance process.

Ideally, key internal controls for a given organization should be standardized, using the same control activity description for the same control throughout the company. We suggest maintaining these customized control activity descriptions like a data dictionary. Any future change to a control activity requires an update to the data dictionary. This dictionary is maintained by the designated Internal Audit compliance coordinator. For SOX purposes, Managers, audit staff, other company personnel and/or third parties retained by management can only reference or select the control activity descriptions pre-defined in the data dictionary. Maintaining such a standardized data dictionary of key controls is a crucial element to improving the ongoing SOX compliance process. It allows for storage of all key control activities and their status in a central database. From the central database a variety of database applications can work with the data. Examples of

such applications are dashboards to track progress and report the status of ineffective controls to management and report builders to generate narratives, corrective action logs, control matrices etc.

In practice, we use an MS SQL database for storage of all control activity descriptions including status, risks, key/non-key, preventative/detective, fraud risk, etc. We use VB.Net applications to generate narratives, control matrices, walk through documents, corrective action logs, best practice logs, test plans, etc. These user friendly applications can be accessed from any site within the group and always work with the current data stored in the central database. The applications are

70% savings of manhours spent on documenting and maintaining internal controls

designed to be simple to use, so even temporary staff or third party retainers can assist in the SOX compliance process if needed without excessive training.

The utilization of this database and applications system results in approximately 70% savings of manhours spent on documenting internal controls and maintaining such evidential matter once the initial setup of the control data dictionary has been completed. The database application as described in this paragraph should not be confused with off the shelf Sarbanes-Oxley database applications that are installed and then randomly filled with control descriptions. The emphasis in this paper is on creating a customized internal control data dictionary and not the installation of a database application. Without the internal control data dictionary the database application itself will not create the benefits described.

100% Testing and documenting the operating effectiveness of controls

Management must also verify that key

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controls are operating effectively before they can be relied upon for SOX compliance. With most companies having completed two financial years of SOX compliance, management has necessarily arrived at a relatively final selection of which preventative and detective controls are key to the prevention of financial misstatement within their particular organization. The type (or nature) of tests to be performed for control activities is typically straightforward (e.g., select a specified number of items and re-perform the activity). In deciding how many items to test, management needs to consider that the outcome of limited testing may differ from the outcome of testing all operations of the control, thus giving them false assurance that the control environment is effective.

Running test procedures literally takes seconds and the test procedure can be repeated as many times as needed

100% testing is feasible and entirely eliminates the risk of inadequate sample selection. It is true that sample sizes of 50, 10, 3 or even 2 items is widely accepted if the controls are performed daily, weekly, monthly or quarterly, respectively. These are extremely small samples for controls that often process hundreds, thousands or millions of transactions each financial period. Reperformance of these controls in order to verify their proper operation is performed manually, sometimes with the use of spreadsheet applications or simple audit query tools. The manhours to perform such test procedures are often extensive, ranging anywhere from 1 to 4 hours or more per test procedure.

Our solution is to develop customized programmed scripts to perform the test procedure. Although the original set-up time might be longer, usually in the range of 8 to 12 hours, these programmed scripts process 100% of all transactions,

giving management an objective and conclusive test result on the effectiveness of the control. Once the script has been developed, running the automated test procedures for 100% of all transactions usually takes less than 30 seconds.

With controls standardized throughout the organization as outlined in the previous paragraph, this approach returns even greater dividends as the same script can be executed for the same control at different sites within the group. Because running the test procedure literally takes seconds, the test procedure can be repeated as many times as needed. This is extremely useful when controls are deemed ineffective and so have to be remediated and retested.

We also use this benefit to monitor controls on an ongoing basis.

The automated test procedures can be scheduled to run automatically at any frequency management requires (e.g. weekly, monthly and quarterly). SOX requires that testing must be conducted over a period of time to adequately determine operating effectiveness "as of" the end of the fiscal year. Leaving all testing until the last financial quarter leaves little time for remediation of controls which are deemed ineffective. With automated test procedures run at pre-determined intervals throughout the year, management can intervene during the course of the year to remediate ineffective controls. This permits far more efficient allocation of manpower to instigate corrective action (e.g., redesign the control, retrain individuals involved, etc.) resulting in further reduced annual SOX compliance expenses. When exceptions are found on a timely basis, management can fully consider the nature and cause of the deviations, the types of financial statement misstatement(s) that could occur and whether the misstate-

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ment(s) could result in a material misstatement in the financial statements.

Accuracy and speed are probably the most obvious benefits of using programmed scripts to perform the test procedures. With public companies often having multiple sites across the United States or around the world, programmed scripts can be executed over the company's entire network from one central location. We have used programmed scripts from one central location for clients with

We eliminate 100% of the travel expenses and discomforts that normally come with doing a SOX compliance audit

sites located in different continents of the world, eliminating 100% of the considerable travel time and expenses required to perform a SOX compliance audit in multiple locations.

Testing automated application controls

It is a general misunderstanding that application controls require minimal (one to a few items) testing. Some independent auditors assume that application controls function like a switch, where the control is "on" or "off". This is an oversimplification of how application controls work. Another false assumption that is often presented to us by independent auditors is that application controls work with "0" (zeros) and "1" (ones) and that therefore testing of one item is sufficient for a detailed applications controls review of the system. The software applications tested for purposes of SOX compliance are not written in binary code (zeros and ones) but are programmed in higher program language such as e.g. Pascal, Basic, Cobol, Fortran, etc. These programs are often written in modules. Transactions recorded by an end user are processed by one or several modules depending on the characteristics of the transaction posted. For example, when testing a three way match, transactions with a difference in quantity

received versus quantity ordered might be processed by a different set of programmed modules than transactions without any difference. Transactions with a difference in price per PO versus price per invoice might follow its own set of programmed modules within the same software application. We recommend that application controls are tested in the same manner as other controls, using programmed scripts to perform a 100% test procedure.

Testing manual controls

A common misconception is that manual controls can not be tested with customized programmed scripts. This is incorrect. We have learned that almost every control can be tested for the purpose of SOX compliance with the use of custom programmed scripts. The fact that internal controls are performed manually does not mean that the control can not be tested with programmed scripts. An example is a reconciliation where the controller uses a report from a production system to verify the correct recording of deferred revenue in the financial system. For any discrepancies, the controller posts a correction to the general ledger after investigating the difference. To digitally test such a reconciliation we utilize a programmed script that verifies that the balances in the financial system agree with the balance in the production system. The programmed test procedure also considers any adjustments posted.

Testing manual controls with automated test procedures also returns impressive dividends of accuracy and speed similar to those discussed above. Digital testing far surpasses conventional testing in terms of accuracy and efficient use of resources. Where manual testing cons-

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sumes manhours from the independent auditor as well as from local staff, automated test procedure are executed from a central location without any disturbance to the ongoing work processes at the site and without time-intensive involvement of the site's staff.

While some companies may be tempted to wait before they let go of their conventional, labor intensive SOX compliance procedures, we believe such an approach places companies at a disadvantage. The automation of internal control documentation and testing, and use of pre-scheduled automated test procedures surpasses conventional documentation and testing methods in terms of costs, accuracy and providing timely information to management to allow them to accurately assess their control environment and manage their risk. As the auditing and business world slowly gains awareness of the benefits of digital testing and realize that this will soon be commonplace, other progressive SEC registrants are already on the next step of maximizing the value of digital testing and monitoring of internal controls by using the same tools and information to optimize business performance in terms of lower operating costs, improved margins and better return on capital and equity.

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