



# Sarbanes-Oxley (SOX)

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## The Migration from Project to Process

### *Practical Actions for Getting Started*

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November 7, 2006

## The Results So Far?

|  | Opinions<br>Filed | Adverse<br>Opinions | Restated<br>Opinions | Effective to<br>Non-Effective              |
|--|-------------------|---------------------|----------------------|--|
| Year 1<br>(period ending<br>prior to 11/15/05)   | 3,710             | 591 (15.9%)         | 90 (2.4%)            | 59 (10%)                                   |
|  |                   |                     | Pending<br>& Late    | Total Estimated<br>Failure Rate for Year 2 |
| Year 2<br>(period ending<br>11/15/05 to 1/31/06) | 2,895             | 194 (6.7%)          | 89                   | 283 (9.5%)                                 |

Source: AuditAnalytics.com – May 2006

## SEC's Internal Control Weaknesses Remain

By a WALL STREET JOURNAL Staff Reporter  
April 25, 2006; Page C3



WASHINGTON -- ...The Government Accountability Office said **three material weaknesses in the SEC's internal controls**, which were found in an audit of the **SEC's 2004 financial statement**, **remained in place** when the government-watchdog agency did its audit of the **SEC's 2005 results**.

...identified problems with **computer security**, **tracking of fines and penalties**, and **preparation of financial results**.

.... for some SEC line items, detailed information supporting the balances and underlying transactions weren't readily available and were hard to retrieve.

It recommended the agency beef up its financial-management office and procedures.

SEC Chairman Christopher Cox said his goal is to fully resolve material weaknesses involving financial-statement preparation and penalty tracking in fiscal year 2006, which ends Sept. 30.

## Overview - Early Compliance Cost Estimates

- First-year costs of Section 404 compliance were significant, ranging from **.06%** of revenues for companies in excess of **\$10 billion** to **2.65%** of revenues for companies with revenues of under **\$100 million**.
- Over **12%** of first adopters reported material weaknesses, with an impact on shareholder value of generally less than **3%**.
- Approximately **70%** of material weaknesses were related to financial accounting issues; another **14%** of the issues pertained to personnel matters relating to poor segregation of duties, inadequate staffing; remaining disclosures related to IT controls, control environment or other matters.
- First-year Section 404 compliance was not a model of efficiency.
  - Some adopters waited too long to begin
  - Standard-setters issued guidance during Q3
  - Interpretations of standards differed among all parties involved

## Calendar Years 2001–2005 Restatements

|                                    | Total Restatements | Restatement Issues (percentages based on total restatements) |   |                                    |  |                            |   |
|------------------------------------|--------------------|--|---|------------------------------------|--|----------------------------|---|
|                                    |                    | Unique filers  | Debt, quasi debt, warrants, equity (BCF) issues | Deferred, stock-based, comp issues | Lease, legal, FAS 5 contingency issues | Revenue recognition issues | FAS 109 tax expense, benefit, deferral issues |
| <b>2005</b>                        | 1541               | 1385   | 319   | 179                                | 288                                    | 210                        | 193   |
| % of Year's Total                  |                    |  | 20.7%   | 11.6%                              | 18.7%                                  | 13.6%                      | 12.5%   |
| % of Category Total                | 42.6%              | 42.0%  | 51.8%   | 44.4%                              | 66.4%                                  | 31.5%                      | 47.7%   |
| <b>2004</b>                        | 763                | 698  | 123   | 81                                 | 61                                     | 153                        | 85  |
| % of Year's Total                  |                    |  | 16.1%   | 10.6%                              | 8.0%                                   | 20.1%                      | 11.1%   |
| % of Category Total                | 21.1%              | 21.2%  | 20.0%   | 20.1%                              | 14.1%                                  | 23.0%                      | 21.0%   |
| <b>2003</b>                        | 587                | 546  | 67  | 65                                 | 51                                     | 129                        | 77  |
| % of Year's Total                  |                    |  | 11.4%   | 11.1%                              | 8.7%                                   | 22.0%                      | 13.1%   |
| % of Category Total                | 16.2%              | 16.5%  | 10.9%   | 16.1%                              | 11.8%                                  | 19.4%                      | 19.0%   |
| <b>2002</b>                        | 412                | 378  | 51  | 41                                 | 25                                     | 93                         | 27  |
| % of Year's Total                  |                    |  | 12.4%   | 10.0%                              | 6%                                     | 23%                        | 7%  |
| % of Category Total                | 11.4%              | 11.5%  | 8.3%  | 10.2%                              | 6%                                     | 14%                        | 7%  |
| <b>2001</b>                        | 316                | 293  | 56  | 37                                 | 9                                      | 81                         | 23  |
| % of Year's Total                  |                    |  | 17.7%   | 11.7%                              | 2.8%                                   | 25.6%                      | 7.3%  |
| % of Category Total                | 8.7%               | 8.9%   | 9.1%  | 9.2%                               | 2.1%                                   | 12.2%                      | 5.7%  |
| <b>Totals</b>                      | 3619               | 3300   | 616   | 403                                | 434                                    | 666                        | 405   |
| <b>% Total of all Restatements</b> |                    |  | 17.0%   | 11.1%                              | 12.0%                                  | 18.4%                      | 11.2%   |

Source: AuditAnalytics.com – as of April 25, 2006

## Calendar Year 2006 Restatements to Date

|                   |                    | Restatement Issues (percentages based on total restatements) |                            |   |                                    |                            |   |
|-------------------|--------------------|--|----------------------------|---|------------------------------------|----------------------------|---|
|                   | Total Restatements | Unique filers  | Cash flow statement issues | Debt, quasi debt, warrants, equity (BCF) issues | Deferred, stock-based, comp issues | Revenue recognition issues | FAS 109 tax expense, benefit, deferral issues |
| 2006 YTD          | 844                | 752  | 93                         | 203   | 112                                | 113                        | 97  |
| % of Year's Total |                    |  | 11.0%                      | 24.1%   | 13.3%                              | 13.4%                      | 11.5%   |
| 2006 Forecasted   | 1925               | 1718   | 212                        | 463   | 258                                | 258                        | 221   |
| % of Year's Total |                    |  | 11.0%                      | 24.1%   | 13.3%                              | 13.4%                      | 11.5%   |

Total number of Financial Restatements could increase by as much as 25% from 2005 to 2006 if this pace (year to date) continues

Source: AuditAnalytics.com – as of June 9, 2006

## Preliminary Securities Class Action Litigation Analysis for First Year 404 Filers

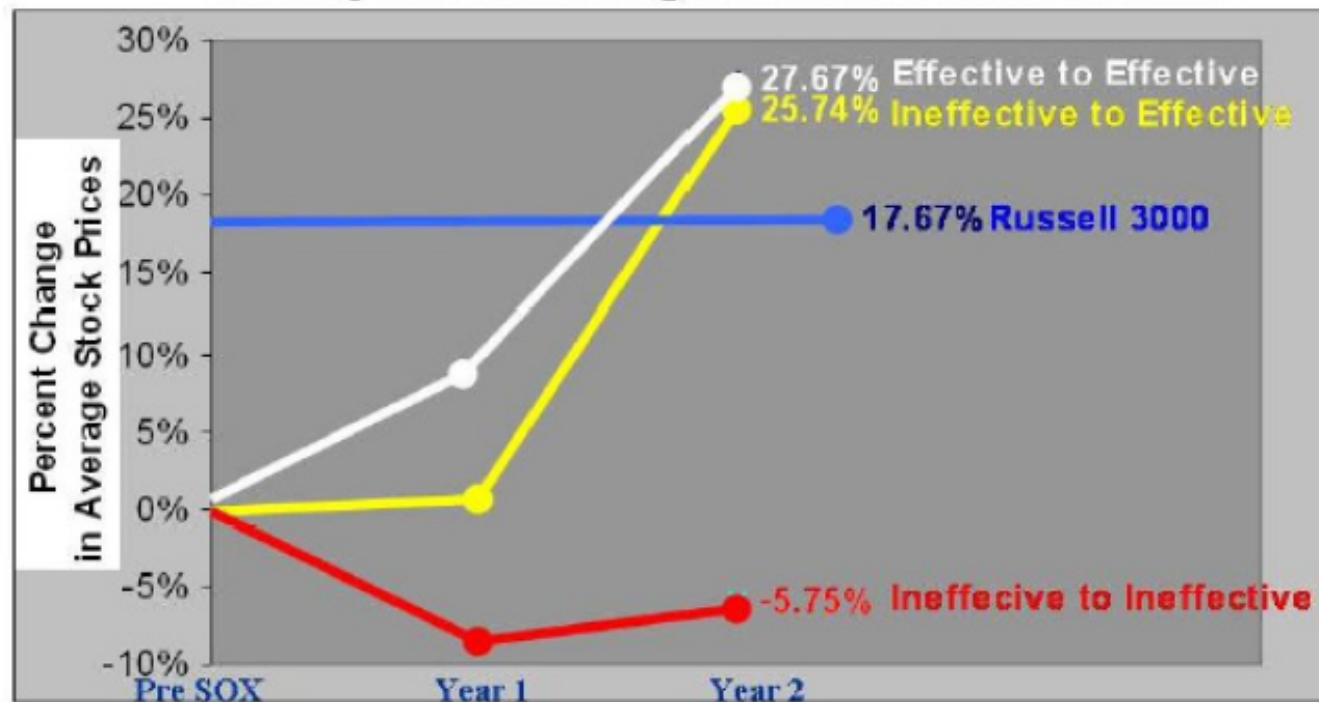
| <b>First Year 404 Filers - Restatements and Litigation</b> |   |   |                                  |   |   |
|--|---|---|----------------------------------|---|---|
| <b>Adverse 404s ( 582 total )</b>                          |   |   | <b>Clean 404s ( 3015 total )</b> |   |   |
| <b>Restatements</b>  | <b>Securities Class<br/>Action Litigation</b> | <b>% Litigation of<br/>Restatements</b> | <b>Restatements</b>              | <b>Securities Class<br/>Action Litigation</b> | <b>% Litigation of<br/>Restatements</b> |
| 280  | 52  | 19%                                     | 192                              | 103   | 54%                                     |

For companies who filed a financial restatement and had a clean 404 opinion from their auditors, there was a 184% greater likelihood that they would also be involved in securities class action litigation, as compared to those who had an adverse 404 opinion.

Source: AuditAnalytics.com – as of May 30, 2006

## So, Where's the Good News in all of This?

### Good Sarbanes-Oxley Section 404 Internal Controls Corresponded with Higher Share Price Movement



Source: Lord & Benoit "Do the Benefits of 404 Exceed the Cost? May 8, 2006



## SOX Year 2 Efforts Didn't Get the Job Done

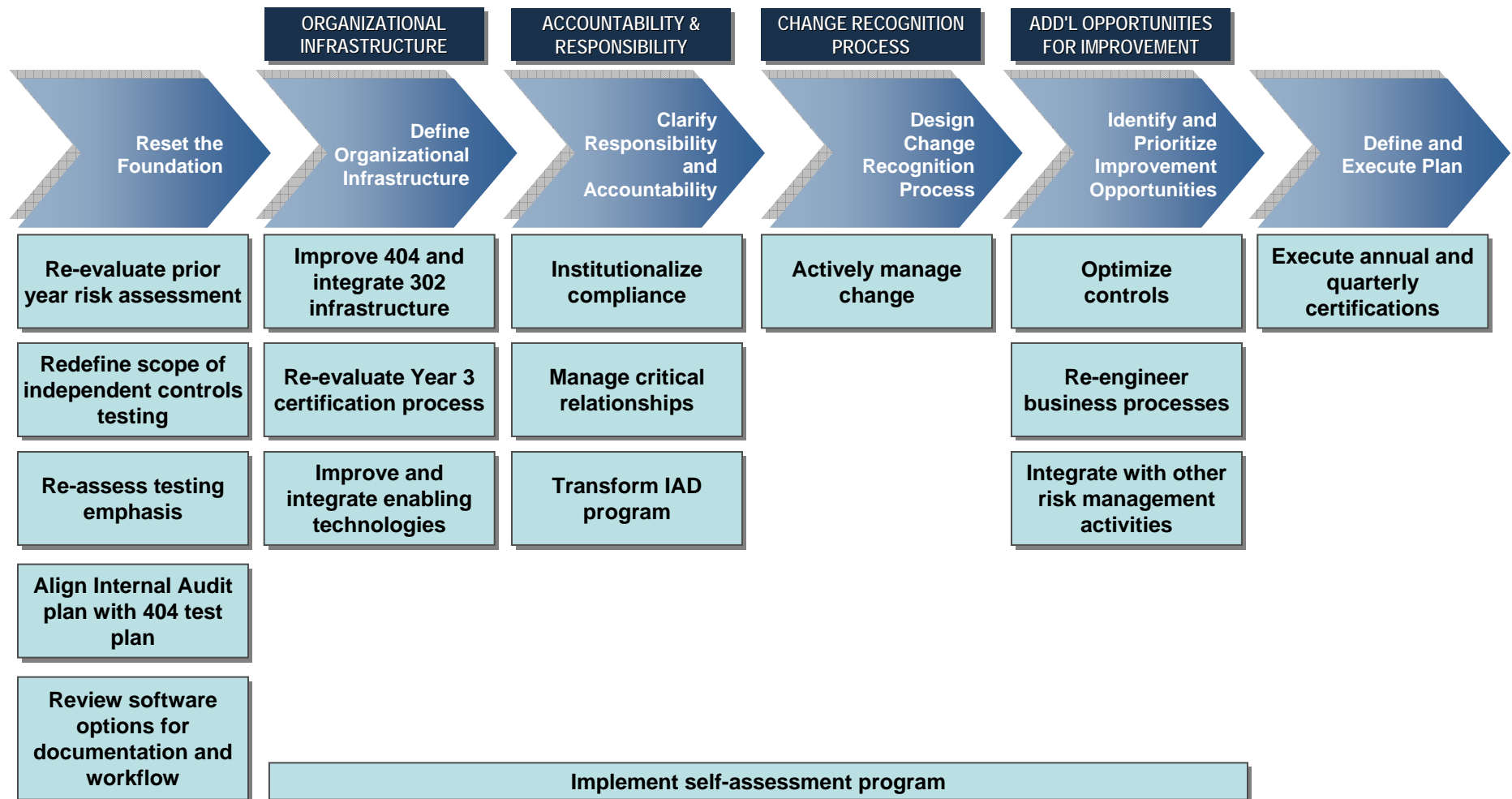
### What We Know:

- Costs still exceed benefits
- Personnel are tired
- "Catch up" on important things was a priority
- Resource shortages continue to be acute
- Angst in the auditor relationship – auditors are tightening their approach
- It still takes longer than anticipated
- # of key controls is still **THE** cost driver
- Sole reliance on independent tests of controls remains **THE** "high cost" approach

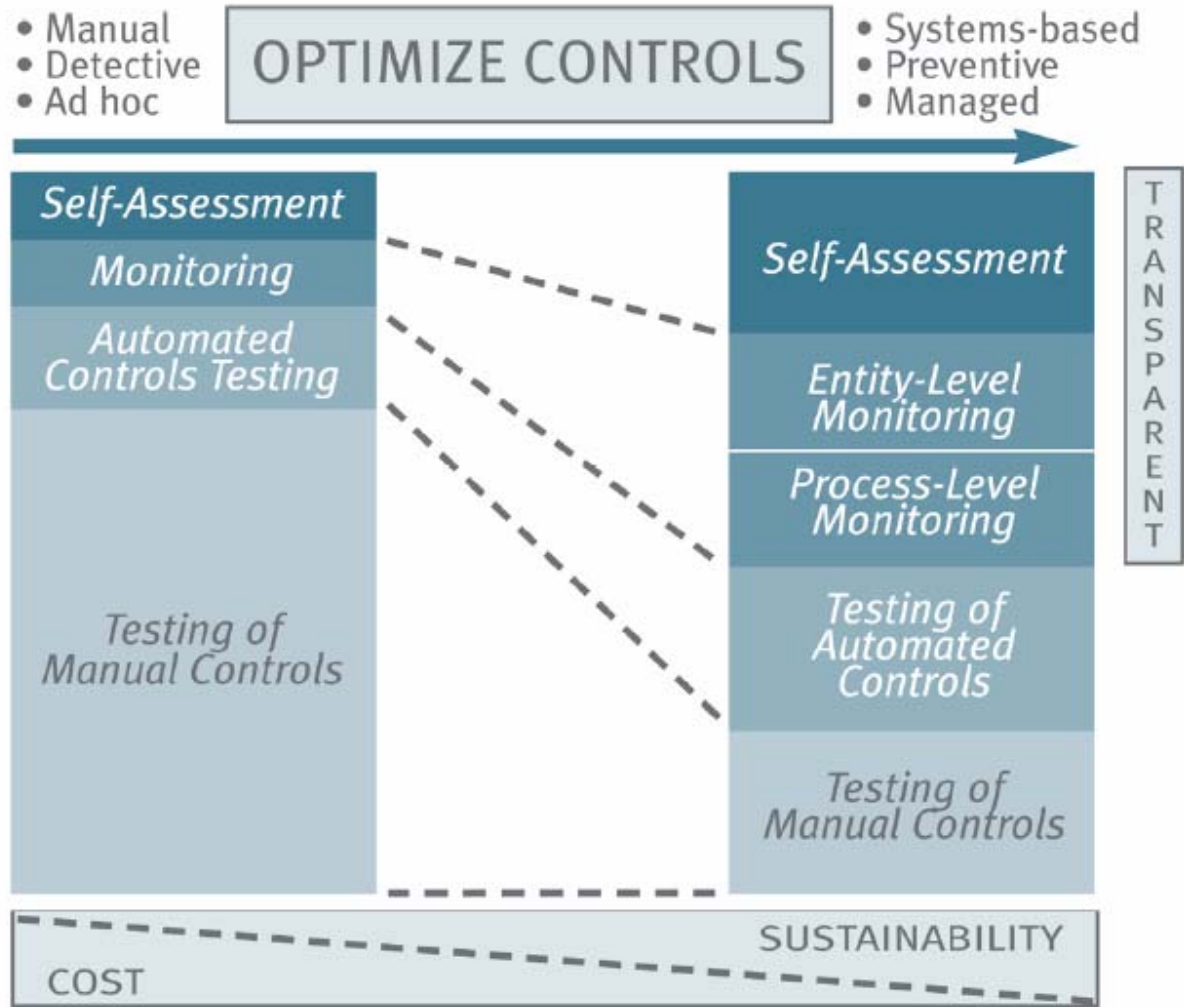
## SOX "Project to Process" – What are we talking about?

- SOX "Project to Process" is about the transition from an ad hoc project, which most first adopters experienced in Year 1, to a sustainable, cost-effective and value-added process over time
- How do companies make "Project to Process" happen?
  - **Think longer term giving consideration to the following:**
    - Will the internal control structure continue to perform as significant changes occurs?
    - Given the increased level of transparency within the financial reporting processes, do value-add opportunities exist?
    - Is the organization confident it is aligning the compliance process with a risk-based approach?
  - **Make the right choice**
  - **Create value while improving sustainability**

# Create Value While Improving Sustainability – Overview



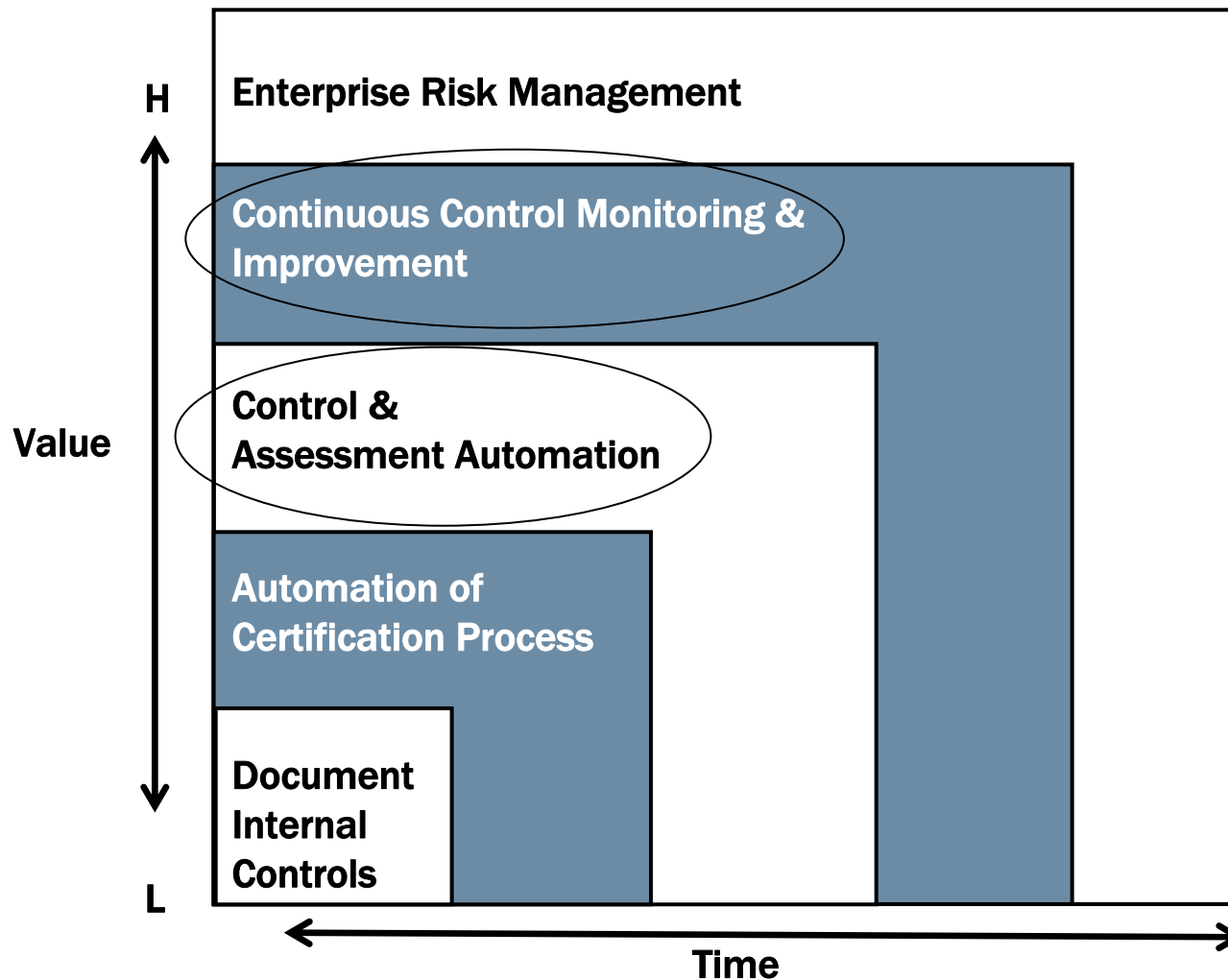
# Key to Cost-Effectiveness: Balancing the Sources of Evidence



## Application and Technology's Role

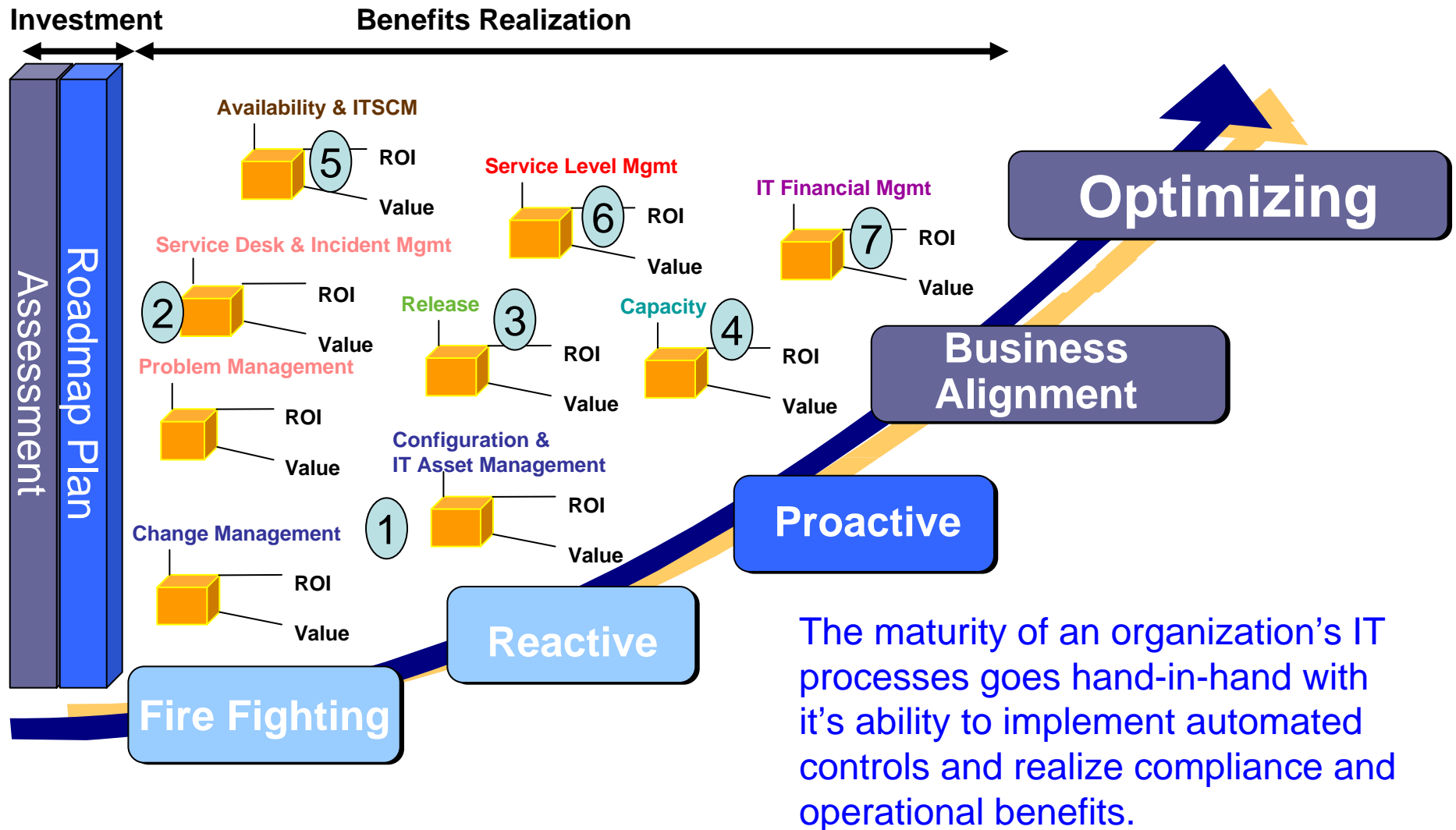
- The role of technology or automation in regulatory compliance can be broken down into two parallel tracts:
  - Automation of the internal control environment
  - Automation of the compliance process
- Sustainability, reduction in costs, and improved value to the organization require advances in **both**.
- Significant advances can be made for many companies through better leverage of already acquired applications and tools.

# The Evolution of Compliance Technology



- Integration of compliance frameworks, tools and data
- Portal access to personalized risk management information
- Proactive risk identification and evaluation

## Standardizing/Automating IT Processes



# ITGC Example – Standardize and Consolidate

## Critical Applications Supporting Financial Reporting

- Application 1
- Application 2
- Application 3
- Application 4
- Application 5
- Application 6
- Application 7
- Application 8
- Application 9
- Application 10
- Application 11
- Application 12
- Application 13
- Application 14
- Application 15

## IT General Control Processes

- 4.1 Define IT Strategy and Organization
  - 4.1.1 Develop and Maintain the IT Strategy
  - 4.1.2 Define and Manage the IT Organization
  - 4.1.3 Develop and Maintain the IT Governance Structure
- 4.2 Manage Security and Privacy
  - 4.2.1 Security / Privacy Strategy and Communication
  - 4.2.2 Administer Security (Add, Change, Delete Users)
  - 4.2.3 Manage Security Incidents
  - 4.2.4 Monitor Regulatory Compliance
- 4.3 Deploy and Maintain Solutions
  - 4.3.1 Manage Systems Development Life Cycle (SDLC)
  - 4.3.2 Develop and Maintain Application Interfaces
  - 4.3.3 Manage Application Changes
- 4.4 Manage IT Infrastructure
  - 4.4.1 Manage Data Center Operations
  - 4.4.2 Manage Technical Infrastructure
  - 4.4.3 Performance Planning and Monitoring
- 4.5 Manage IT Assets
  - 4.5.1 Manage IT Asset Requests
  - 4.5.2 Manage IT Asset Procurement
  - 4.5.3 Accounting for IT Asset Management
  - 4.5.4 Manage IT Asset Deployment
  - 4.5.5 Monitor IT Assets
  - 4.5.6 Manage Software Licensing and Compliance
  - 4.5.7 Manage Hardware Maintenance Agreements
  - 4.5.8 Manage Third-Party Agreements
  - 4.5.9 Manage IT Asset Retirement
- 4.6 Support End Users
  - 4.6.1 Manage Incidents
  - 4.6.2 Manage Problems
  - 4.6.3 Manage Service

## Assessment of Design and Operational Effectiveness

**Number Processes for Documentation and Risk / Control Analysis:**  
**240 Processes**

**Controls to Test:**  
**1,920 Controls**

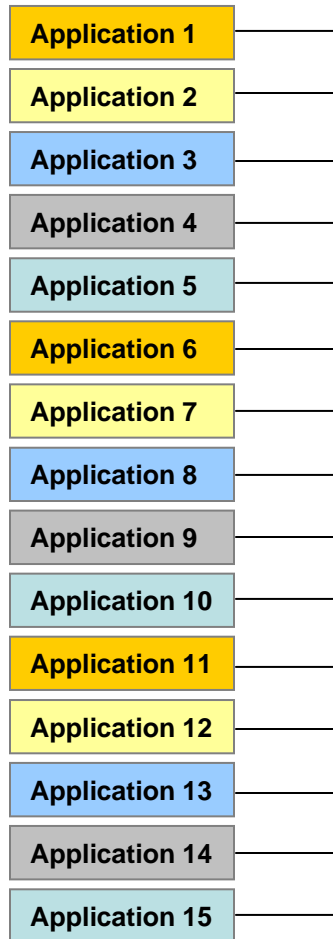
**Level of Effort:**  
**15,360 Hours**

**Note:** Assumed 8 controls per process, 8 hours per control test for purposes of illustration.

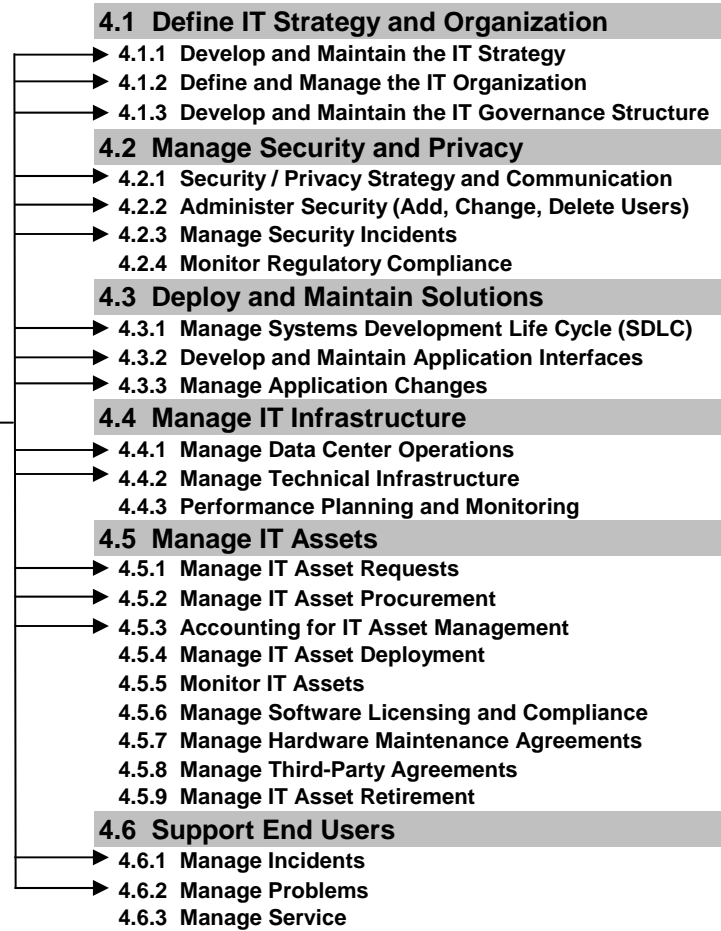


# ITGC Example – Standardize and Consolidate

## Critical Applications Supporting Financial Reporting



## IT General Control Processes



## Assessment of Design and Operational Effectiveness

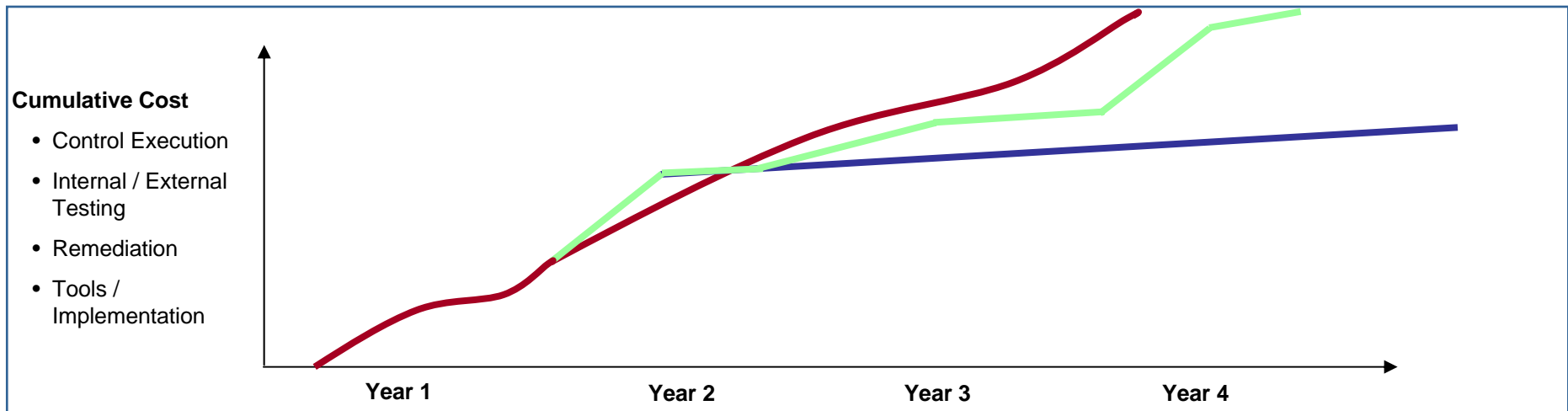
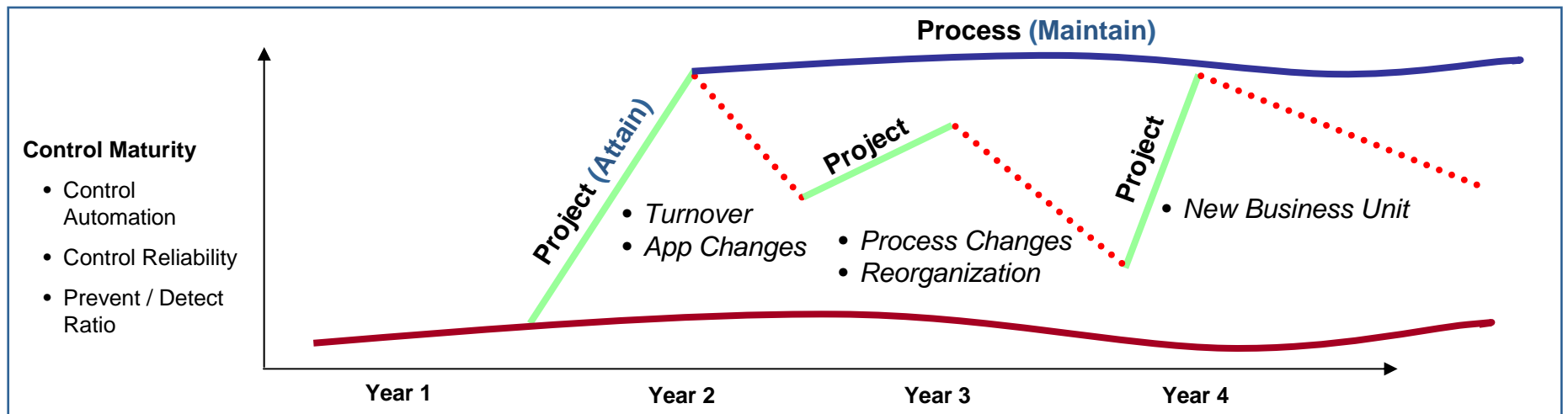
**Number Processes for Documentation and Risk / Control Analysis:**  
**16 Processes**

**Controls to Test:**  
**128 Controls**

**Level of Effort:**  
**1,024 Hours**

**Note:** Assumed 8 controls per process, 8 hours per control test for purposes of illustration.

# Attain and Maintain



## In Summary - - It's Time to Shift the Dialogue

### Institutionalize the Existing Internal Control Structure

- Leave financial reporting processes as is
- Apply manual “find and fix” controls with unacceptable error rates
- Underutilize configurable controls
- Design and implement test plans around EXISTING controls
- Apply a quantitative, coverage approach to scoping
- Test most of the controls tested last year
- Apply detailed testing almost exclusively to validate effectiveness
- Focus risk assessment on financial reporting risks



### Improve the Quality of the Internal Control Structure

- Improve process quality, time and cost performance
- Improve the processes upstream to eliminate defects at the source
- Optimize configurable controls
- Design and implement test plans around IMPROVED controls
- Apply a risk-based approach to scoping
- Optimize key controls and rotate independent tests in low risk areas
- Also apply self-assessment and entity- and process-level monitoring
- Focus risk assessment more broadly on business risks (ERA)

**“PASS/FAIL”**

**“PROCESS CAPABILITY”**

## Questions/Open Discussion

At Protiviti, we believe the companies that most effectively understand and manage their risk are the companies that most often succeed. Or as we like to say...

**Know Risk. Know Reward.<sup>TM</sup>**