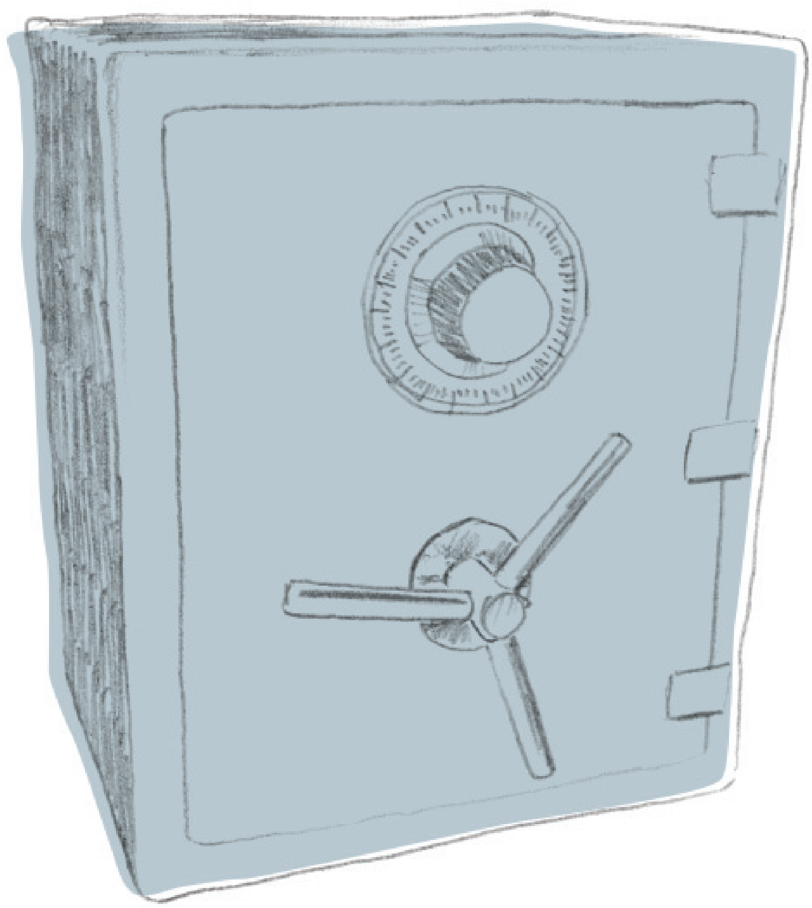
Monitoring the system of internal control

The audit committee guide series



"Effective audit committees are critical to the quality of financial reporting and the proper conduct of business. This guide is one of a series that is meant to help audit committees meet their oversight and fiduciary responsibilities."

– Trent Gazzaway, National Managing Partner of Audit Services

Contents

The audit committee guide series has been adapted from *The Audit Committee Handbook, Fifth Edition*, published by John Wiley & Sons and available for purchase at www.GrantThornton.com/ACHandbook and through major online booksellers and bookstores nationwide.

Laws passed in recent years requiring management and others to report on the effectiveness of internal control over financial reporting (ICFR) are rooted in the expectation that good business practices are in place. They do not specifically require the establishment of new, large compliance departments. An organization that had good internal control — including good monitoring procedures — before the passage of these laws should be able to comply with the existing reporting requirements without a dramatic, long-term increase in cost or effort.

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COSO guidance

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) 2009 *Guidance on Monitoring Internal Control Systems*[1] was designed to help management better utilize its organization's existing internal control monitoring procedures to support its assertions, rather than building a separate and often inefficient process to comply with Section 404 of the U.S. Sarbanes-Oxley Act of 2002 (SOX).

The various forms of international guidance on internal control (e.g., COSO Framework, CoCo and the Turnbull Guidance) are indistinguishable in most respects. Of all the guidance, COSO's Framework has been vetted most extensively[2] and is the framework used by most U.S.-listed public companies. The following discussion about internal control and monitoring draws heavily from both the COSO Framework and COSO's 2009 monitoring guidance.

Organizations should have effective internal control systems, and should monitor those systems to ensure that they remain effective.

[1] Available at http://www.coso.org/IC.htm.

[2] COSO's *Internal Control—Integrated Framework* was the first major framework published in 1992. Its *Guidance on Monitoring Internal Control Systems* (published in 2009) was developed over a two-year period that included two public comment periods.

Internal control objectives

The COSO Framework says, "Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

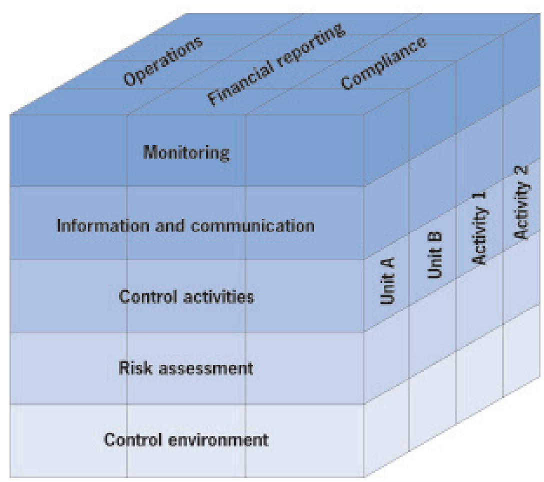
- Effectiveness and efficiency of operations,
- Reliability of financial reporting,
- Compliance with applicable laws and regulations."

Organizations meet these objectives through a process that includes five primary components:[3]

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

The interrelationship between the three objectives and the five components, operating across organizational boundary lines, is often depicted in the graphic shown in Exhibit 1.

Exhibit 1 The COSO Framework Cube

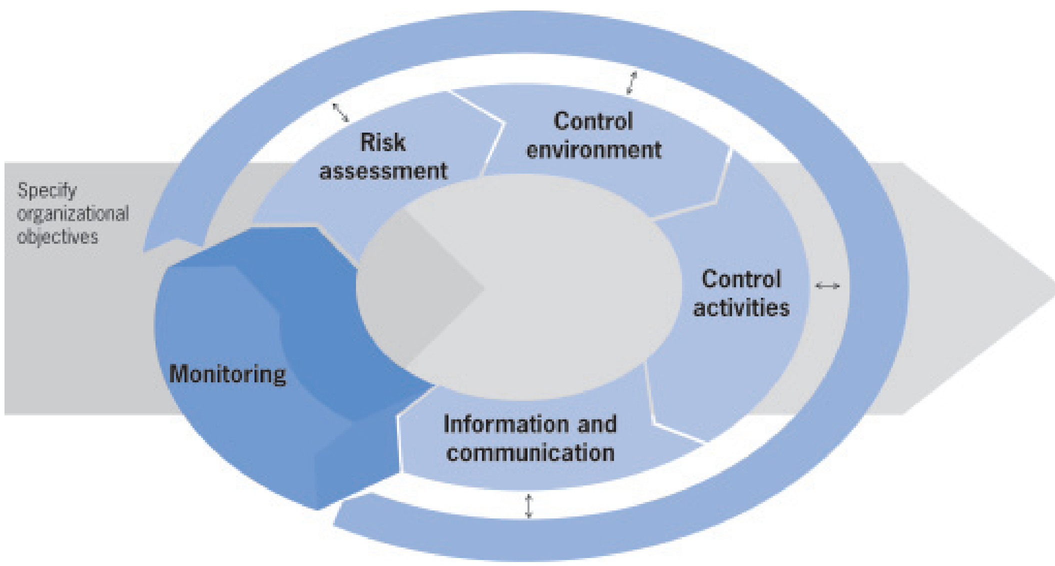


[3] See COSO Framework, Ch. 1.

Monitoring internal control

COSO's 2009 monitoring guidance shows how these components fit together as an overall process, and how monitoring covers all five components (Exhibit 2).

Exhibit 2 Monitoring Applied to the Internal Control Process



The COSO Framework states that "monitoring ensures that internal control continues to operate effectively."[4] Monitoring should evaluate (1) whether management reconsiders the design of controls when risks change, and (2) whether controls that have been designed to reduce risks to an acceptable level continue to operate effectively.

[4] COSO Framework, 69.

When monitoring is effective, it provides the necessary support for management — and others who are charged with governance — to be confident that internal control is operating effectively at any given point in time, including at the end of the year when formal assertions by management may be required.

Audit committee members should note that large, fourth-quarter efforts, designed solely to comply with Section 404 of SOX or similar reporting requirements, likely are indicative of:

1. inadequate monitoring procedures earlier in the year,
2. a weak internal control system that needs correction, and
3. a duplication of effort already addressed by the organization's effective monitoring procedures.

Organizations perform their most effective monitoring when they focus on gathering and evaluating *persuasive information* about the operation of *key controls* that address *meaningful risks* to their objectives.[5] This process includes the following:[6]

1. Understanding and prioritizing risks to organizational objectives
2. Identifying key controls across the internal control system that address those prioritized risks
3. Identifying information that will persuasively indicate whether those controls are operating effectively
4. Developing and implementing cost-effective, ongoing or periodic evaluations that evaluate that persuasive information

[5] See COSO's *Guidance on Monitoring Internal Control Systems*, vol. I, par. 26.

[6] Ibid., par. 27-47.

Effective monitoring expends minimal time or effort on risks that are not meaningful or on controls whose evaluation is not necessary to support a conclusion about internal control effectiveness. It is important, then, to understand the definition of "key controls."

COSO's monitoring guidance defines key controls as having one or both of the following characteristics:

- Their failure could materially affect the objectives for which the evaluator is responsible, but might not be detected in a timely manner by other controls.
- Their operation may prevent other control failures or detect such failures before they have an opportunity to become material to the organization's objectives.[7]

The intent of identifying key controls is to help organizations devote monitoring resources where they can provide the most value. If a given control's failure is likely to be immaterial to the financial statements, or to be detected and corrected in a timely manner by other controls, then perhaps monitoring should focus on those other controls. Understanding this dynamic can help the audit committee ensure that management, the internal auditor and the external auditor have an appropriate internal control evaluation scope.

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[7] Ibid., par. 30-33.

Roles and responsibilities

Everyone in an organization shares some responsibility for internal control. Their roles and responsibilities can be characterized as follows:

Management

The chief executive officer ultimately is responsible for and should assume "ownership" of the system. The chief executive, above others, sets the tone at the top that affects integrity, ethics and other attributes of a positive control environment. Large-company CEOs fulfill this duty by providing leadership and direction to senior managers, and reviewing the way they control their units' business. In smaller organizations, the influence of the chief executive (often an owner-manager) is usually more direct.

Board of directors

Management is accountable to the board of directors, which provides governance, guidance and oversight. Effective board members are objective, capable and inquisitive. They also have knowledge of the entity's activities and environment, and commit the time necessary to fulfill their board responsibilities. The board can be particularly effective when sound upward communications channels and capable financial, legal and internal audit functions are in place.

Audit committee

Audit committee member responsibilities are separate and apart from those of conventional board members. The audit committee generally is responsible for overseeing the accounting and financial reporting processes of an organization, and for the appointment, compensation and oversight of the external auditor.[8]

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[8] This is especially true under the Sarbanes-Oxley requirements for audit committees of U.S.-listed public companies.

In addition, audit committees of companies listed on the New York Stock Exchange are obligated to review their organization's risk management practices.[9] The New York Stock Exchange went further by specifying additional audit committee oversight expectations through a modification to Section 303A of its Corporate Governance Standards.[10] Regardless of the audit committee's area of focus, its role is one of oversight, not execution. Audit committee procedures should be focused on (1) understanding the risks, and (2) verifying that management, the auditors and others are focused appropriately on those risks. To that end, an effective internal audit function is a valuable tool to the audit committee.

Internal auditors

Internal auditors play an important role in evaluating the effectiveness of control systems and contribute to ongoing effectiveness. Because of its organizational position and authority in an entity, an internal audit function often plays a significant monitoring role.

Other personnel

Virtually all employees are responsible either for producing information used in the internal control system or for taking other actions needed to effect control. A responsibility shared by all personnel is that of upward communication of operations problems, code of conduct noncompliance, and other policy violations or illegal actions.

External parties

External parties often contribute to an entity's achieving its objectives. External auditors, in bringing an independent and objective view, contribute directly and indirectly — directly through the financial statement audit and indirectly via information that is useful to management and the board in executing their responsibilities. Moreover, auditing standards require external auditors to communicate to the audit committee any identified significant deficiencies or material weaknesses in internal control over financial reporting.[11] Legislators and regulators, customers and others transacting business with the enterprise, financial analysts, bond raters and the news media all provide information that is useful to the entity's effecting internal control. External parties, however, are not responsible for, nor are they a part of, the internal control system.

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[9] See NYSE Rule 303A.07(c)(iii)(D).

[10] Securities and Exchange Commission, Release No. 34-50298 (Washington, DC: SEC, August 31, 2004 (www.sec.gov/rules/sro/nyse/34-50298.pdf)), Section 303A(7)(c)(iii)(H), 23–24.

[11] See SAS No. 115, par. 1; and ISA 265, par. 9.

Reporting requirements

Because of the great volume and complexity of U.S. reporting requirements regarding controls for public companies, only the most common requirements are summarized here. Audit committee members should work with internal audit, external audit and management to stay abreast of changes by the SEC.

Quarterly certifications and annual assertions

Section 302 of SOX requires CEOs and CFOs of U.S.-listed companies to file quarterly certifications as to their responsibility for internal control and the accuracy of the financial statements. The SEC's required certification language can be found at http://www.sec.gov/rules/final/33-8238.htm and in Exhibit 3.

Exhibit 3: SEC's required quarterly certification

The SEC expects the wording of these reports, which should be filed as exhibits to the Form 10-Q, to appear *exactly* as written in Exhibit 3.

I, [identify the certifying individual], certify that:

1. I have reviewed this [specify report] of [identify registrant];
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a–15(e) and 15d–15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a–15(f) and 15d–15(f)) for the registrant and have:
   a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
   b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
   c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
   d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
   a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
   b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date

[Signature] **[Title]**

Note: Reproduced from 17 CFR 229.601(b)(31)(i). Note that asset-backed issuers (as defined in 17 CFR 229.1101) have different certification language. See 17 CFR 229.601(b)(31)(ii) for the required text.

In addition to the quarterly certification requirements, management also must file on an annual basis an assertion about the effectiveness of ICFR. That report must contain the following:[12]

1. A statement of management's responsibility for establishing and maintaining adequate ICFR
2. A statement identifying the framework used by management to evaluate the effectiveness of ICFR (typically the COSO Framework)
3. Management's assessment of the effectiveness of ICFR as of the end of the most recent fiscal year, including disclosure of any material weakness in ICFR identified by management[13]
4. A statement that the external auditor's opinion includes a report on ICFR

For U.S.-listed accelerated filers,[14] the annual report also must include the external auditor's opinion on ICFR and disclose any material changes in ICFR that occurred during the registrant's last fiscal quarter. Exhibit 4 contains an example of a typical annual management assertion regarding ICFR.

Exhibit 4: Sample management assertion under Sarbanes-Oxley Section 404

Management's Report on Internal Control Over Financial Reporting

Management of XYZ Corp. is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) of the Securities Exchange Act of 1934 as amended (the Exchange Act). The Corporation's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. XYZ Corp.'s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and disposition of the Corporation's assets; (2) provide reasonable assurance that transactions are recorded as necessary to permit the preparation of the financial statements in accordance with generally accepted accounting principles and that receipts and expenditures of the Corporation are being made only in accordance with the authorizations of XYZ Corp.'s management and directors; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Corporation's assets that could have a material impact on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate due to changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

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[12] See 17 CFR 229.308.

[13] Management is not permitted to conclude that ICFR is effective if one or more material weaknesses are present.

[14] Accelerated filers have more than $75 million in public float as of the end of their second fiscal quarter.

Under the supervision and with the participation of management, including the Chief Executive Officer and the Chief Financial Officer, the Corporation conducted an evaluation of the effectiveness of the internal control over financial reporting based on the framework in "Internal Control — Integrated Framework" promulgated by the Committee of Sponsoring Organizations of the Treadway Commission, commonly referred to as the "COSO" criteria. Based on this evaluation under the "COSO" criteria, management concluded that the internal control over financial reporting was effective as of December 31, 20XY.

There was no change in the Corporation's internal control over financial reporting that occurred during the fourth quarter of 20XY that has materially affected or is likely to materially affect, the Corporation's internal control over financial reporting.

The effectiveness of the internal control structure over financial reporting, as of December 31, 20XY, has been audited by ABC Auditors LLP, an independent registered public accounting firm, as stated in their report included herein, which expresses an unqualified opinion on the effectiveness of the Corporation's internal control over financial reporting as of December 31, 20XY.

Disclosure controls and procedures versus ICFR

Audit committee members may hear the terms "disclosure controls and procedures" and "internal control over financial reporting." It is important to understand the differences and similarities.

- **Disclosure controls and procedures** include the processes and controls used to prepare *all* of an organization's filings under the Securities Exchange Act of 1934.[15] They cover all of the information required to be part of a filing, including management's discussion and analysis (MD&A), risk disclosures, the financial statements, and so on.
- **Internal control over financial reporting (ICFR)** is a subset of disclosure controls and procedures that is more narrowly focused on (1) the financial statements, (2) the financial reporting processes, and (3) controls over the safeguarding of assets.

When management issues its quarterly certification under Section 302 of SOX, its certification covers the disclosure controls and procedures. Management certifies that controls and other procedures are designed to ensure that information required to be disclosed in the quarterly report is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

[15] The term "disclosure controls and procedures" was first used in connection with U.S. filings under the Securities Exchange Act of 1934. It is now incorporated into other countries' securities laws. For example, beginning in 2005, Canadian securities laws require CEOs and CFOs to file certificates attesting to their disclosure controls and procedures.

Management also is certifying that controls and procedures are in place to ensure that necessary information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.[16]

When management issues an annual assertion regarding ICFR under SOX Section 404, it is asserting to the controls that provide reasonable assurance regarding the reliability of *financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles*. As such the ICFR assertion does not cover MD&A and other disclosures not related to the financial statements. The ICFR assertion covers those policies and procedures that:

1. pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
2. provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
3. provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.[17]

[16] See 17 CFR 240.13a-15(e).
[17] See 17 CFR 240.13a-15(f).

Audit committee expectations

Following is a list of reasonable expectations the audit committee may have of management with respect to the controls and procedures discussed:

1. Understanding of objectives
2. Risk assessment
3. Involvement of appropriate personnel
4. Proper focus on control
5. Effective monitoring procedures

Grant Thornton's internal audit services

Solid internal control monitoring can mitigate risks now, but it can also save resources and bolster the bottom line later. Grant Thornton's experienced team helps organizations better monitor their internal control systems to achieve both of those objectives.

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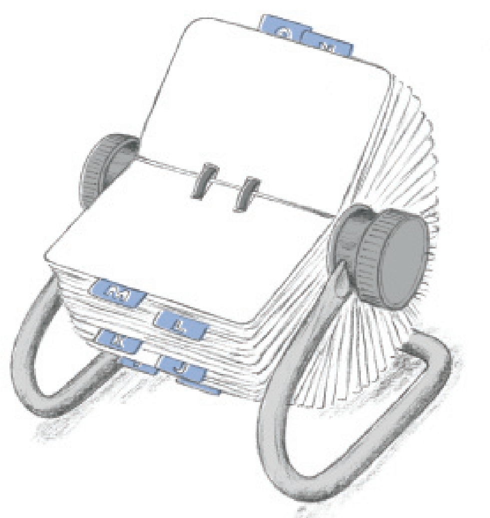
Contacts

Trent Gazzaway
National Managing Partner
of Audit Services
T 312.602.8034
E Trent.Gazzaway@gt.com

Warren Stippich
Partner and National Governance,
Risk and Compliance Solution Leader
T 312.602.8499
E Warren.Stippich@gt.com



Grant Thornton led the development of COSO's 2009 *Guidance on Monitoring Internal Control Systems*, designed to help organizations identify and use existing effective monitoring, and identify and improve less effective monitoring. To learn more, visit Grant Thornton's COSO Resource Center at www.GrantThornton.com/COSO and COSO's website at www.coso.org.

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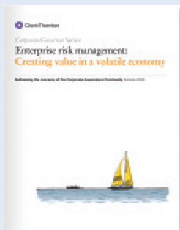

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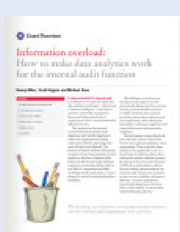

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Suggested reading

***The Audit Committee Handbook, Fifth Edition* (Wiley, 2010, ISBN: 978-0-470-56048-8, U.S. $95.00).**
The Audit Committee Handbook is co-authored by Grant Thornton LLP audit committee experts R. Trent Gazzaway, national managing partner of Audit Services, and Robert H. Colson, retired partner in Public Policy and External Affairs, along with Louis Braiotta Jr., professor of accounting at SUNY — Binghamton's School of Management, and Sridhar Ramamoorti, principal at Infogix Advisory Services. *The Audit Committee Handbook* provides practical, in-depth guidance on all audit committee functions, duties and responsibilities. This latest edition features regulatory updates, new chapters on audit planning and oversight, heightened focus on fraud risk, and broad international coverage. *The Audit Committee Handbook* is available at www.GrantThornton.com/ACHandbook and through major online booksellers and bookstores nationwide.

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Today's demanding marketplace expects CFOs, auditors, compliance officers and forensic accountants to take responsibility for fraud detection. These expectations are buoyed by such legislation as the Foreign Corrupt Practices Act, which makes it a crime for any U.S. entity or individual to obtain or retain business by paying bribes to foreign government officials. Written by William P. Olsen, the national practice leader of Forensics, Litigation and Investigation Services at Grant Thornton LLP, *The Anti-Corruption Handbook* provides guidelines addressing the challenges of maintaining business integrity in the global marketplace.

Grant Thornton LLP offices

National Office
175 West Jackson Boulevard
Chicago, IL 60604
312.856.0200

National Tax Office
1900 M Street, NW, Suite 300
Washington, DC 20036
202.296.7800

Arizona

Phoenix	602.474.3400

California

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