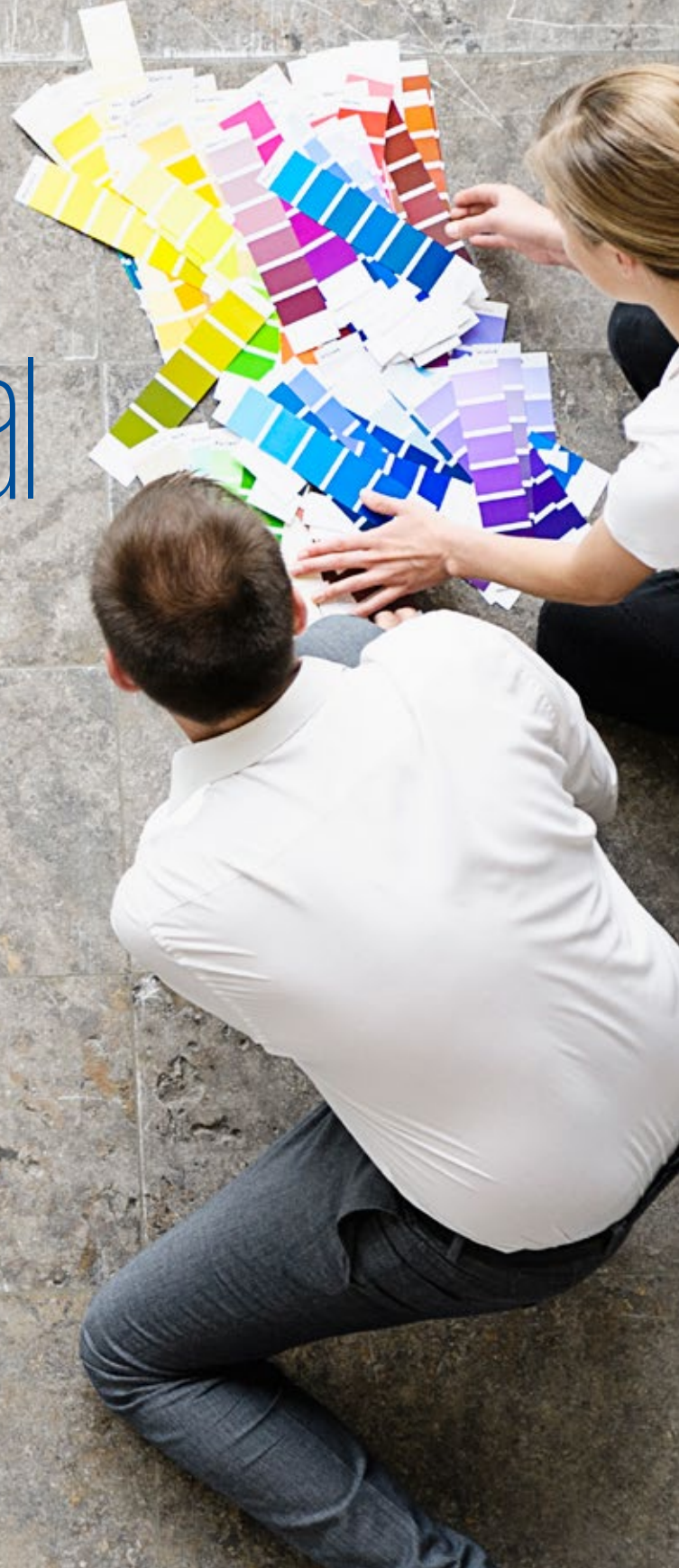




Internal controls over financial reporting

Designing a healthy program that evolves to meet changing needs





In this series of white papers, KPMG's Risk Consulting practice looks at how companies can design a "healthier" internal controls over financial reporting (ICOFR) approach to better manage risks, reduce costs, and find opportunities to improve operational performance.

Responsible individuals, even if they have not had serious health issues in recent years, still have regular medical checkups. Similarly, companies whose ICOFR programs appear to be running smoothly should still periodically evaluate the health of their ICOFR program and controls portfolio. In addition to identifying and correcting potentially unhealthy aspects of the programs or control problems before they occur, a well-designed evaluation (health check) can provide significant insights:

- **Assessing the total cost of controls**, including an understanding of costs that are often hidden (such as the costs to perform the control activities), may identify opportunities for cost savings and better allocation of resources. These opportunities are growing as documentation requirements, particularly around completeness and accuracy, increase.
- **An effective ICOFR program assessment** may identify specific areas that are less mature than others. A common example is ICOFR program governance, where there may be disconnects between who owns the overall program, who designs the controls, who performs the controls and who tests the controls. The result is often inefficiencies and/or omissions.
- **Defining an ICOFR strategy** may reduce financial reporting risks without increasing spend by helping identify a company's most critical areas. A strong, effective financial statement risk assessment process helps establish and support the ICOFR strategy, control selection, testing approach, and other program decisions. Companies can then focus both their control performance and testing efforts on the most critical areas.
- **A more strategic and focused ICOFR program** allows internal audit resources to focus more on the broader risk assessment, process improvement and value-creation audits, leading to better organizational performance.

Future papers in this series will look at these points in detail. The rest of this paper will delve into how the evolution of Sarbanes-Oxley 404 (SOX) has impacted ICOFR programs and offer insights on how to evaluate whether your company's ICOFR program is providing value as a mature, "healthy" program should.

Understanding themes in material weaknesses

No company expects to discover costly and damaging weaknesses in its ICFR program, but failures happen, even in companies that devote extensive and expensive resources to performing and testing controls. Several consecutive years without material weaknesses or significant deficiencies is no guarantee that a control issue is not looming, particularly if the company does not have a healthy ICFR program.

The seven primary themes for material weaknesses are as follows.¹

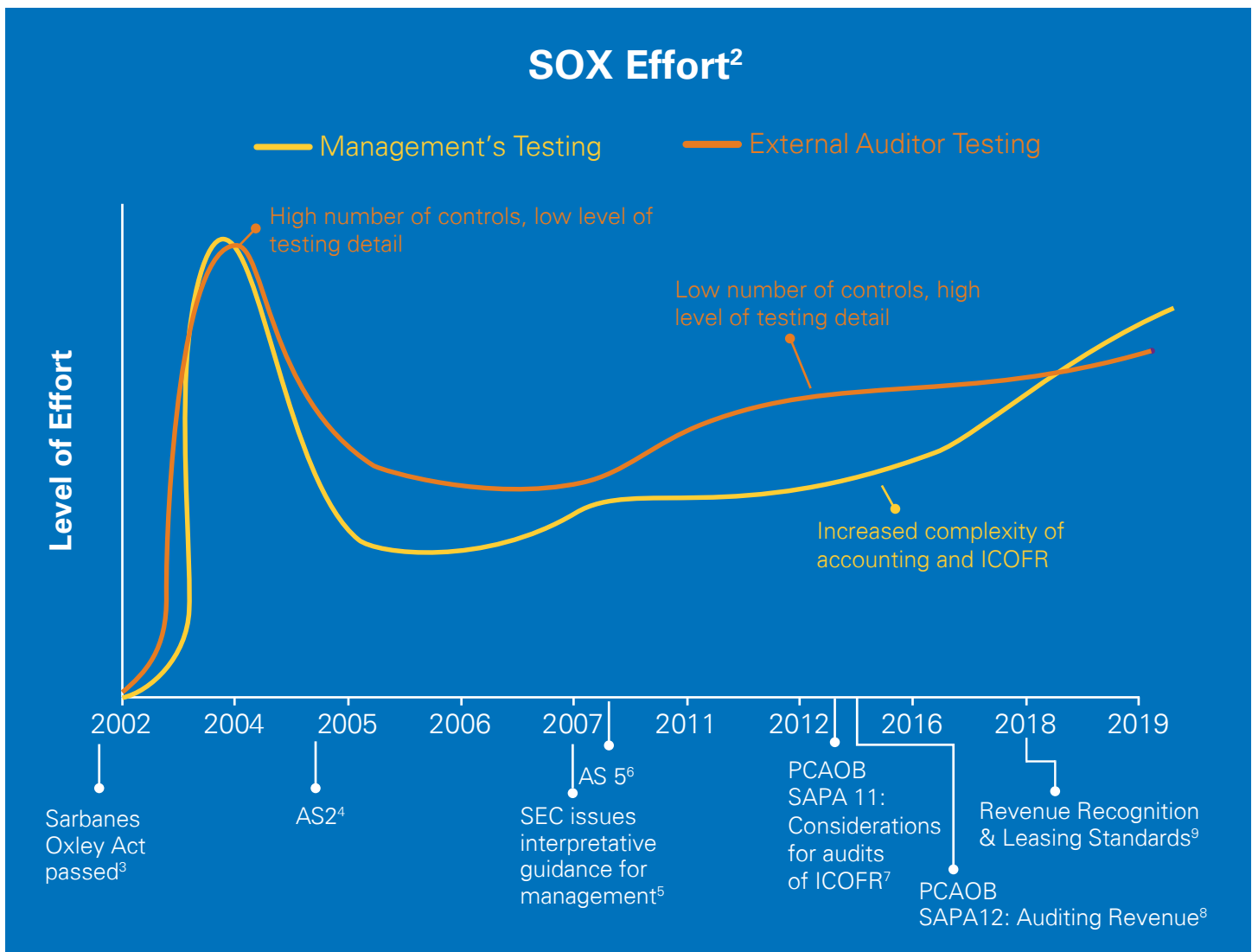
Theme	Example
Lack of documentation, policies and procedures	"...a deficiency in the effectiveness of a control intended to properly document and review relevant facts and apply the appropriate tax accounting under accounting standards..."
Lack of accounting resources/expertise	"The Company did not maintain a sufficient complement of personnel with an appropriate level of knowledge of accounting, experience, and training commensurate with its financial reporting requirements..."
Material and/or numerous auditor year-end adjustments	"...we identified a material weakness in our internal control over financial reporting with respect to the application of complex technical accounting standards..."
IT, software, security, and access issues	"Insufficient information technology controls and documentation"
Issues around the segregation of duties	"The Company has not appropriately restricted access to the accounting applications to appropriate users and does not have processes in place that ensure that appropriate segregation of duties is maintained."
Inadequate control design or a lack of controls	"...The internal audit department did not develop its functions to comply with the analysis of the controls during the year, consequently, this limited the functions of the Audit Committee..."
Non-routine/complex transactions	"Management has identified a material weakness in internal control over financial reporting relating to the accounting for significant and complex transactions..."

¹ Based on a KPMG study of annual filings released by all SEC-registered public companies between November 2014 and June 2017.

Understanding these themes can help companies take continuing measures to reduce the risk of future errors. As an added benefit, these measures can also reduce the total cost of ICFR and improve efficiency throughout the company.

The evolution of Sarbanes-Oxley

Since the Sarbanes-Oxley (SOX) Act was passed in 2002, the related demands on companies and external auditors have evolved, as seen in the graphic below:



² Based on trends observed by KPMG professionals

³ Source: U.S. Securities and Exchange Commission Web site; Laws SOA 2002

⁴ Source: Public Company Accounting Oversight Board (PCAOB) Web site; Docket 008: Auditing Standard No. 2 (March 9, 2004)

⁵ Source: U.S. Securities and Exchange Commission Web site; 17 CFR Part 241 (Release No. 33-8810), Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934

⁶ Source: PCAOB Web site; Rulemaking Docket section; Docket 021: Auditing

Standard No. 5 – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements (June 12, 2007)

⁷ Source: PCAOB Web site; PCAOB Staff Audit Practice Alert (SAPA) No. 11 – Considerations for Audits of Internal Control Over Financial Reporting (October 2013)

⁸ Source: PCAOB Web site; Standards section; Guidance section; Matters Related to Auditing Revenue in an Audit of Financial Statements (September 9, 2014)

⁹ Source: Revenue Recognition & Leasing Standards – Accounting Standards Codification (ASC) 606, Revenue from Contracts with Customers; ASC 842, Leases

Without entering into too much detail on each phase in the ICFR evolution, it is still possible to identify several broad trends:

- **SOX continues to evolve** from a high number of controls with a low level of testing detail to a lower number of controls with more in-depth testing. Companies that have not recently updated their programs, especially if they also lack a focus on aligning with the PCAOB and SEC focus areas, may have SOX programs that are out of alignment with leading practices.
- **The type of effort** required from process and control owners to execute and document controls has changed. Management must now provide more detailed documentation, especially around management review controls, and appropriately consider completeness and accuracy for key reports. Creating and maintaining documentation in a timely and efficient manner is critical to an efficient program.
- **The SEC and the PCAOB** are both messaging that management and auditors have not yet finished the controls journey, and we expect a continued trend of increasing requirements for the external auditor and therefore, indirectly, for companies. In particular, companies that strive to increase external auditor reliance may see internal testing efforts increase to meet PCAOB expectations.
- **The balance of cost and reliance** should be a deliberate consideration in establishing a company's ICFR program strategy. Currently, many ICFR programs are focused on maximizing external auditor reliance on the company's internal testing. That could mean the company's internal testing efforts are focused on the lower-risk controls instead of on those areas that pose greater financial reporting risks.
- **The new accounting standards** around revenue recognition and leases bring new internal control challenges. Companies need to design controls around the new processes, systems, and governance required to implement these standards as well as around the calculation of the transition amounts. These standards also require new types of data and estimates, which rely on historical details and trends (e.g., average length for leases, how many extensions are usually entered into, etc.) that have not previously required controls to be in place.
- **The increasingly complex** nature of business transactions also has an impact on internal control considerations, as acquisitions, divestitures, restructurings, and refinancings are all "significant unusual transactions" that need extra attention from a controls perspective. These are also focus areas for the SEC and PCAOB.

ICFR can be costly, and many companies are looking for opportunities to reduce expenditures while maintaining compliance. But if companies do not continue to examine and evaluate their ICFR programs, the natural tendency is for rising complexity and requirements to lead to rising effort and cost. Better strategy, governance, and performance can meet higher demands without a higher budget.

Assessing the health of an ICOFR program

A thorough health check can identify the potential for a more effective and efficient ICOFR program. Answering the following questions will provide perspective on where your company's ICOFR program currently stands:

1

Is the ICOFR program's value clear to senior management and the board of directors?

If your ICOFR program is merely seen as a necessary cost, then it is not demonstrably fulfilling its role of ensuring the reliability of financial statements and avoiding costly errors. An ICOFR program should serve management and the board by providing insight beyond compliance to enable and support process improvement, thereby decreasing risk and adding value to the business.

2

Does your organizational culture support the ICOFR program?

Even the best set of controls will not function well if key personnel are not collaborating fully. This culture should start at the top. Companies with significant control issues often end up identifying the root cause as senior management's failure to place appropriate emphasis on controls and not allocating sufficient resources to fully remediate control failures with sustainable processes.

3

Have you identified the 10–20 most critical internal controls and directed efforts toward them?

Not all key controls are created equal. Some are far more likely to catch errors. The program as a whole should show a visible difference in approach for the most critical controls. ICOFR programs often allocate the same amount of time and effort to all key controls, rather than designing, operating, and testing controls with a greater focus on the most critical areas.

4

Do those critical internal controls include a strong set of direct entity level controls (ELCs)?

Well-designed direct ELCs operating at the right level of precision can function as an "insurance policy" to mitigate lower level control failures and keep them from becoming material to the company. These direct ELCs are often the key operational controls that management relies on to run the business. Since they are complex and time consuming to document and test, ICOFR programs often do not include them, but they are important to a well-balanced ICOFR program.

5

Are you confident that your controls are effective, even without testing them each year?

If you cannot answer yes to this question, or are concerned with testing your controls before the external auditor does, it is a sign you are worried the controls are not operating effectively. In that case, you should consider the cause of this uncertainty, which may be incorrectly designed controls, problems in the control environment, or cultural issues.

6

Do you have KPIs to identify potential issues?

Defining control-related KPIs is one of the best ways to measure and monitor ICOFR program and control performance. Monitoring controls can assess whether controls are failing elsewhere in the company. For example, how many terminated users are identified during a periodic user access review should be used to identify and address shortcomings in the regular employee termination process where access for those users should have been revoked.

I have not had an issue, why should I check the health of my ICFR program?



Need for a strong 404a process, irrespective of PCAOB or external auditor perspective



The external auditor cost is high once you end up with a material weakness



Focus on total cost of control



In extreme circumstances, the external auditor may resign



Even if you do not think you have a problem, you should have a "check up"



It is expensive to remediate once something has gone wrong



Drive continuous improvement and efficiencies



Potential impact on management compensation related to material weaknesses



A link between stronger controls and greater predictability of earnings/overall valuation of a company



Potential loss of Audit Committee trust



You have had a significant deficiency or some "close calls"



Impact on share price/total cost of the business



Final thoughts

Like any other important program, ICOFR is vulnerable to mission creep, rising costs and inefficiencies, especially if the program has gone for years without a thorough “health check” of its activities. In the case of ICOFR, an unhealthy program can be expensive and increase the risk of a material weakness.

But beneath these risks are opportunities, as the journey to continuously improve and mature ICOFR programs can reduce risk, cut costs, and increase efficiency. A healthy ICOFR program can drive value through a positive impact on business processes and risk management and therefore on business performance.

Future papers will further explore these opportunities.

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