Preparing to publicize financial controls
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TRENDS

IN FINANCIAL MANAGEMENT

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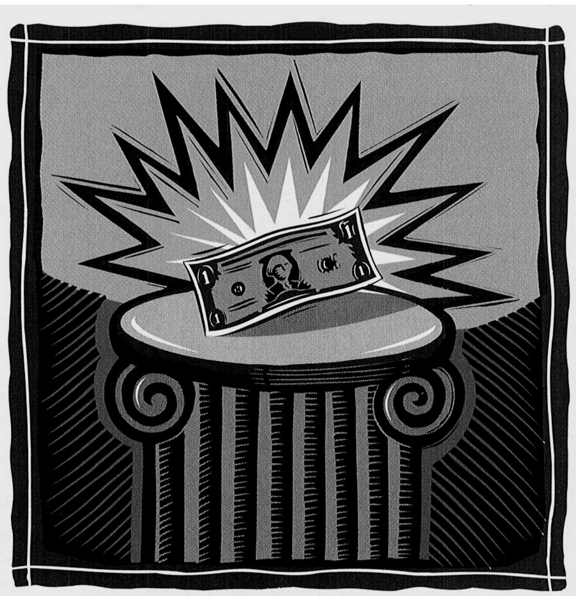
Preparing to Publicize Financial Controls

➤ **UNDER FINAL RULES ENACTED** by the Securities & Exchange Commission in late May 2003, most senior managers of public companies will have to report and certify the adequacy of their companies' internal financial controls and financial reporting procedures to prevent financial abuse and fraud. These new certifications must be included in annual reports for fiscal years ending on or after June 15, 2004. U.S. public companies with market capitalizations under $75 million and foreign private issuers must comply with the new requirements when their fiscal year ends on or after April 15, 2005.

The new rules are essentially what the SEC had initially proposed in compliance with Section 404 of the Sarbanes-Oxley Act, except the effective date was moved back nine months. Under the final rules, management's annual internal control report must contain a statement of management's responsibility to set up and maintain adequate internal controls. Senior managers must also assess the effectiveness of their company's internal control structure and financial reporting procedures. They'll also have to say what framework they used to evaluate their internal controls. In addition, Section 404 requires a company's independent auditors to issue an attestation report on management's assessments of its controls and financial reporting procedures. It will be up to the new Public Company Accounting Oversight Board (PCAOB) to set the standards by which external auditors gauge the effectiveness of a company's controls and reporting. The PCAOB is expected to set those standards by year-end.



According to the new rules, internal controls must include assurances of accurate records maintenance as well as financial reporting that complies with generally accepted accounting principles. The rules also stipulate that managers and directors sign off on receipts and expenditures and that companies maintain adequate systems to prevent or detect unauthorized

ILLUSTRATION: STEPHANIE CARTER/ARTVILLE

material transactions. Management must disclose any material weakness in a company's internal controls structure. If there are material weaknesses in the controls, senior executives "will be unable to conclude that the company's internal control over financial reporting is effective," the Commission said.

The framework that management uses to assess the effectiveness of internal controls must also be set up by a group that has followed due-process procedures, including broad distribution of the framework for public comment. The SEC recommends but doesn't require the so-called COSO framework yet assumes most companies will use it. This framework is named after the Committee of Sponsoring Organizations of the Treadway Commission,[1] which published "Internal Control—Integrated Framework" in 1992. Key portions of it are summarized in a PricewaterhouseCoopers White Paper, "The Sarbanes-Oxley Act of 2002," and on COSO's website noted below.

According to the PwC paper, COSO identifies the following five components that must be in place for a system of internal control to be effective:

- Discipline and structure of a control environment,
- Risk assessment of achieving control objectives,
- Policies and procedures of control activities,
- Information and communication of control responsibilities to employees, and
- Monitoring by management to ensure proper application of control methodologies and procedures.

In a seminar presentation, Lynn Edelson of PricewaterhouseCoopers advised executives to ask the following questions to determine the adequacy of their company's financial controls:

- What does our control structure look like, and how does it operate?
- Who is accountable?
- How does it deal with change?
- What are the critical control activities?
- Are they monitored?
- Is all of this documented?
- How will I demonstrate that I have reviewed the controls every quarter?

Clearly, this will cost some money. The SEC staff said they expect companies to spend an average of 383 hours in the first year trying to meet requirements associated with the rule. But in an informal survey of its members, Financial Executives International said managers expect implementation of Section 404 to take an average of 6,700 hours the first year (including internal and external resources and attestation time) and cost, on average, an additional $480,000 in software and IT consulting. Those surveyed said they expect their annual audit fees to increase more than 35% to cover the auditor attestation.

So is this what officials at Enron, WorldCom, Adelphia, Tyco, HealthSouth, Waste Management, Sunbeam, and more—with a little help from friends on Wall Street—have helped bring about? ■

HELPFUL WEBSITES

Sarbanes-Oxley Act:
www.pcaobus.org/rules/Sarbanes_Oxley_Act_of_2002.pdf

SEC Section 404 final rules:
www.sec.gov/rules/final/33-8238.htm

SEC Section 404 summary:
www.sec.gov/news/press/2003-66.htm

Committee of Sponsoring Organizations of the Treadway Commission: www.coso.org

PricewaterhouseCoopers "White Paper," The Sarbanes-Oxley Act of 2002," at www.cfodirect.com

PricewaterhouseCoopers Webcast: "What Companies Should Be Doing Now," at www.cfodirect.com

[1] COSO's sponsoring organizations are the American Institute of Certified Public Accountants, the American Accounting Association, Financial Executives International, the Institute of Internal Auditors, and the Institute of Management Accountants.