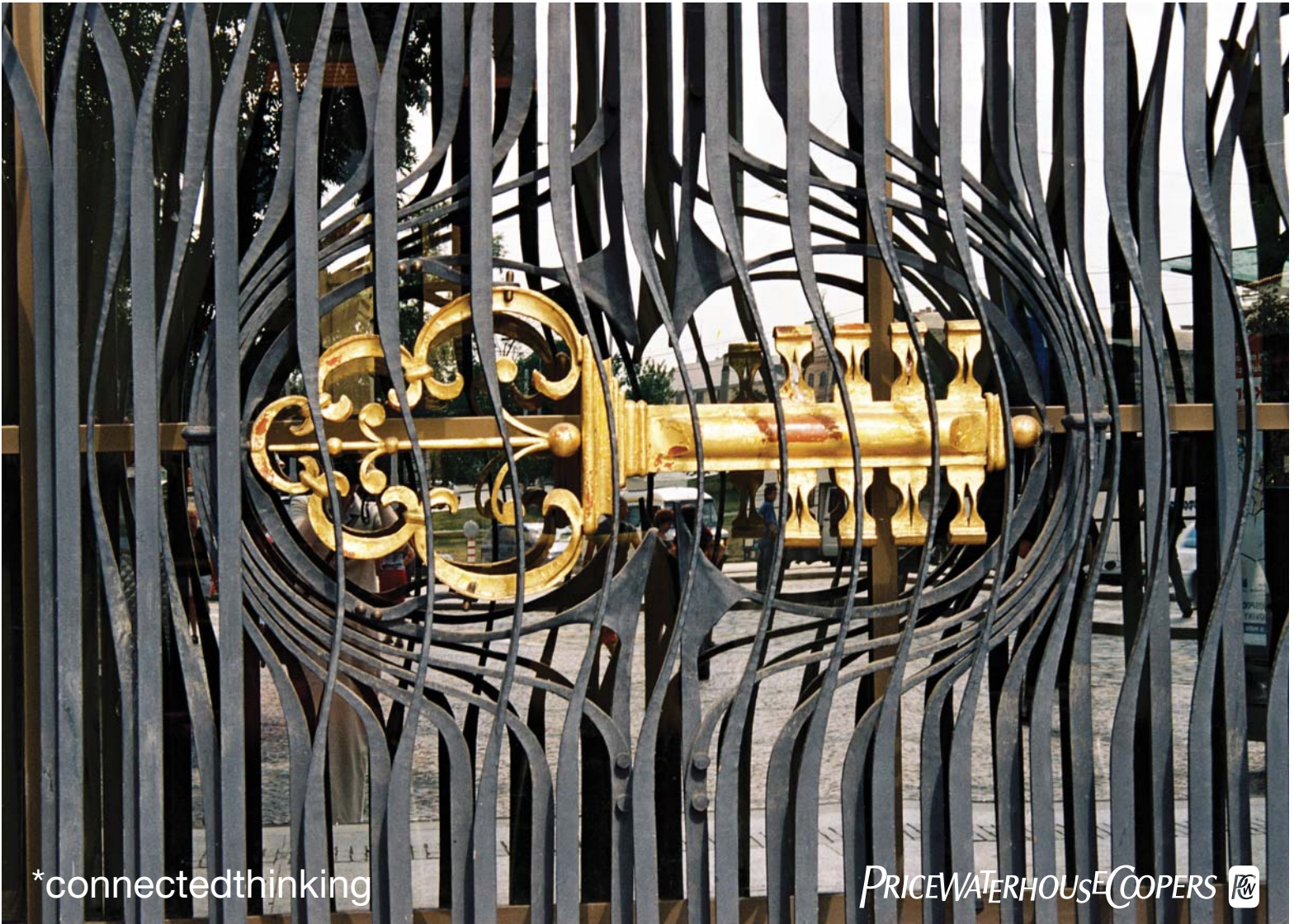


Utilities


Sarbanes-Oxley 404 Best Practices Executive Forum

Better, faster and more efficient*

Shared perspectives



*connectedthinking

PRICEWATERHOUSECOOPERS 

PwC hosts Sarbanes-Oxley 404 compliance best practices series for utility company executives

More than a hundred executives representing 47 utility companies recently engaged in a series of open-forum discussions to explore ideas and opportunities that could make compliance with Section 404 of Sarbanes-Oxley “better, faster and more efficient.”

The forums, sponsored by PricewaterhouseCoopers’ (“PwC”) Utilities Practice, were held just before and after the May 24 adoption of new management guidance for Sarbanes-Oxley 404 compliance by the Securities and Exchange Commission (“SEC”) and new integrated audit guidance by the Public Company Accounting Oversight Board (“PCAOB”). These discussions provided a timely opportunity for utility company executives to share best practices and exchange ideas on how the SEC’s Interpretive Guidance for Management (“SEC Guidance”) and PCAOB Auditing Standard No. 5 (“AS 5”) will affect compliance with Section 404 of the Sarbanes-Oxley Act of 2002 (SOX 404).

PwC’s objective for sponsoring these forums was to encourage collaboration between companies and provide a forum for our clients to share best practices and help each other meet the challenges of implementing and executing SOX 404. Most of all, we were interested in your insights into how the new guidance will provide opportunities for improvements.

The discussions were thoughtful and dynamic, with participants openly sharing ideas and methodologies. This paper provides a recap of the valuable information you shared with your industry peers on SOX 404 best practices, as well as the insightful thoughts you contributed on ways to adopt the new guidance.

To kick off the discussions, we suggested that the SEC and PCAOB guidance offers strategic and tactical opportunities to revisit prior scoping decisions and apply a top-down, risk-based approach, such as relying more heavily on entity-level controls, reducing the number of locations at which to perform controls testing, and other approaches for adjusting the nature and extent of testing internal control effectiveness.

What percent “coverage” was attained by your scoping of financially significant locations at which controls will be evaluated for all significant accounts (prior to new SEC Guidance and AS 5)?

Answer: Half of you said over 90 percent and another 46 percent said between 70 and 90 percent.

Honing in on tactics

While there was some interest in exploring strategic implementation opportunities, participants tended to view tactical options as the quickest way to gain immediate efficiencies for 404 compliance. The tactical option that sparked the most interest involved “right-sizing” the number of key controls needing to be tested.

You were vocal in saying real and significant opportunities exist to reduce the cost of compliance by focusing on essential controls that address the risk of misstatement. There was general agreement that the idea is not to reduce the degree of internal control built into business processes and systems, but rather to rationalize the number and type of controls that require evaluation and testing. We agree with this observation.

PwC observation

We believe the SEC Guidance and AS 5 significantly enhance the ability for management and auditors, respectively, to tailor their assessment of ICFR to the facts and circumstances of each company using a risk-based approach.

Entity-level controls

Companies that successfully define and document their use of entity-level controls to a precise level can achieve efficiencies in the nature, timing and extent of other controls testing. Entity-level controls that operate at a level of precision to prevent or to timely detect a material misstatement in the financial statements may exist at one or multiple levels: corporate, shared service centers, divisions, business units, and so forth. Controls that monitor operations or evaluate results at the account level, such as robust budget-to-actual analyses, may serve to address the risk of material misstatement for certain accounts sufficient to justify reducing or even eliminate the testing of process or transaction-level key controls. This concept led to discussion on the use of a company's segment and departmental budgets.

As a heavily regulated industry, utilities submit frequent financial filings that are often subject to regulatory review. In addition, utilities also depend on accurate historic and projected financial data, and typically have in place a robust budget function to support rate cases. Companies that are able to demonstrate a budget-to-actual monitoring process that is robust and contains appropriate substance and precision can potentially rely on it as a key control. Documentation of the findings and any follow-up actions taken by management resulting from budget monitoring can contribute valuable evidence about the control's effectiveness.

When using the budget as part of a key control, it can be just as important to document the manner in which budget is prepared and used, as to provide documentation supporting the execution of the process. Management also needs to assure itself (and the auditor) that the budget preparation and use is consistent and timely in its intent to prevent or detect errors. Periodic budget monitoring might include the following attributes (including documentation thereof) when it is used as a control:

- Who reviews and approves the budgets
- What the approach is for locking and/or adjusting budgets over time
- The manner in which the budget is used to manage the business
- Historical evidence that the budget is reasonably accurate and effective in its purpose
- Who executes and who reviews the monitoring and budget-to-actual analyses
- What data is included in the analysis and how it is derived
- How timely and consistently the analyses are applied
- Establishment of a reasonable precision level
- Historical evidence that the monitoring is effective in identifying potential misstatements at the level of precision defined

Payroll expense is a good example of an area where a budget analysis might be effective as a key control. Payroll often has a high dollar value, but is generally regarded as an inherently low-risk account. Consistent, periodic analysis of payroll costs pursuant to pre-determined protocols and thresholds for investigating differences between budgeted and actual results may result in the opportunity to reduce or eliminate extensive transaction or process-level controls testing within the payroll cycle, because potential misstatements to payroll expense would be identified through departmental budget analysis.

Reliance on the work of others

Throughout the forum discussions, you expressed a desire for your external auditors to rely more on the work completed by management.

The factors that determine the level of reliance auditors place on management testing do not change with the adoption of AS 5. Auditors will still evaluate the objectivity and competency of the tester(s), as well as the level of risk associated with the controls being tested.

From a testing standpoint, there are a wide range of philosophies and approaches regarding the personnel or functions that are best suited in an organization to perform management's testing. Several companies noted that they successfully use reasonably objective resources other than internal audit to test key controls, including third party outsourcers or internal SOX teams. Others delegate the authority and responsibility for testing key controls to business unit personnel, as they believe responsibility for controls is taken more seriously if the assessment of effectiveness is done by the business unit itself, rather than internal audit or a separate SOX department.

What is your organization's philosophy regarding the interplay of management's approach and the auditor's work?

Answer: Most of you – 67 percent – said you do everything you can internally to help the auditor minimize their efforts by making maximum use of your efforts.

Areas of high risk, for example, areas of accounting that require significant judgment or those that are highly complex, such as derivative contracts, are good candidates for continued evaluation by a qualified independent tester. In contrast, self-assessment may be a sufficient technique for testing controls in lower risk areas of accounting, such as capital additions or payroll.

The SEC Guidance provides management with significant flexibility to vary the nature and extent of their controls evaluation procedures, whether from direct testing of controls or on-going monitoring activities or both. During the forum discussions, many of you indicated at least some desire to evolve your current evidence gathering techniques to be more naturally embedded into day-to-day monitoring activities, rather than separate and discrete testing activities. The potential impact on auditor reliance from such a shift in approach will depend heavily on the overall quality and effectiveness of those monitoring activities.

No single best practice exists to maximize auditor reliance on management's work. However, advance communication with the auditors is a good start for exploring alternatives that could maximize efficiencies. The auditor will perform an analysis based on the risk associated with the control being tested and the competence and objectivity of the tester when determining the areas for which they will rely upon management's testing. Each situation is different, but it is important to remember that the external auditor can rely on work that is performed by sufficiently competent and objective personnel who are not necessarily internal auditors.

PwC observation

We support a principles-based framework for auditors to evaluate the competence and objectivity of company personnel when considering the extent of reliance on the work of others.

Information Technology

Participants noted there are still opportunities for them to modify their entity's approach to IT controls testing. Companies represented at the forums said 20 percent of their controls are automated and 50 percent are otherwise IT-dependent (i.e., they use information from the system). This confirms that IT general controls remain important at some level, but many participants believe there could be more streamlined focus on only those controls that are important to addressing the risk of material misstatement of the financial statements.

An important point of discussion was the significant benefits that tend to be derived when there is regular communication and collaboration between the finance and IT functions about IT-related controls. Several companies acknowledged that their IT personnel probably tend to identify risk more from an operational perspective than from a financial reporting perspective and, consequently, may identify more controls for testing and test more extensively than is needed from a SOX 404 compliance standpoint. When finance and IT work together, the result tends to be a more cost-effective approach to evaluating IT controls, but also enhanced opportunity to leverage more automated controls and develop better reports and information flow in support of internal controls over financial reporting.

Coverage

Another way to possibly revise control assessment efforts is to reassess the approach to scoping work at locations. Under the previous guidance, companies tended to achieve compliance by performing detailed controls testing at all locations considered financially significant, which often resulted in a high percentage of coverage (often 70 percent or more). Under the new guidance, the testing approach can be risk-based rather than based on specified coverage levels. When identifying locations at risk for financial misstatement, companies can use a top-down risk-based approach starting at the financial statement level, rather than basing the tests on a location's size.

In previous years, some immaterial accounts were scoped into the testing to achieve certain coverage of the balance sheet or the income statement. Under the new guidance, an approach of attaining "coverage" without regard to risk of material misstatement is neither required nor recommended.

Strategically speaking

While many of you thought that any significant strategic changes to your controls assessment approach will likely carry through to the next fiscal year, we also heard you say that a number of new strategic approaches are already being considered, especially in the area of risk assessment and applying materiality.

What you indicated is that utility companies have spent considerable time over the past few years refining their risk assessment process and view the new guidance as providing an opportunity to use these processes. However, because the internally developed risk assessment process for most companies is more focused on business risk rather than on financial statement risk, the challenge is how to reach a level of refinement that translates into a more effective and efficient SOX 404 compliance process.

Which aspect of the SEC Guidance to management do you find most beneficial?

Answer: Close to half, or 46 percent cite the emphasis on the risk assessment to drive effort.

PwC observation

We believe a top-down risk assessment approach, combined with awareness that management has the best sense for where savings can be attained, can result in reduced compliance costs. While these savings may be incremental rather than dramatic — they are real.

The new guidance stresses a top-down approach for risk assessments. Starting with the financial statement balances and assertions, management can identify the likely areas for misstatements and determine what controls are in place to prevent them from occurring.

Risk assessments evaluated at the appropriate level within the company are most effective. Some primary inputs for identifying risks of material misstatement are the financial statements, an understanding of relevant assertions, consideration of the COSO components (risk assessment, control environment, information and communication, control activities and monitoring of controls), and knowledge of past history and current and pending business and organizational changes. An important message in the SEC Guidance is that management is closer to day-to-day activities and has a better sense of the proper functioning of controls and the pervasiveness of risks. Because management is generally in a better position to understand its organization's risks and controls, it may be appropriate for management's approach to testing controls to differ from that of the auditor.

Some of the more successful implementations of a risk-based approach cited during the forums seemed to involve the process owners at the control level as well as management's use of monitoring and other entity-level controls. It is the process owners and the individuals performing the day-to-day controls that often identify where risks reside and which controls they rely on to address those risks. Management's business process reviews sometimes offer the best way to identify misstatements. With insight obtained from the process owners, management can more effectively tailor its monitoring controls. With this broad and varied perspective on risk come the best assessments of risk and the most effective and efficient testing approach.

An auditor's view of risk is through relevant financial statement assertions. Companies may find it beneficial to use assertions in their approach to assessing risks as it can facilitate their ability to consider how and where things might go wrong in their financial reporting processes. The risk of material misstatement often varies significantly from account to account and from assertion to assertion within accounts. For example, asset existence in the utility industry is not, in most cases, considered to be a high-risk area. The key controls designed around the existence of assets are less extensive than key controls over the valuation of the assets (for which the costs incurred may be recoverable in rates). Appropriately assessing the risks associated with the key assertions over a particular account balance will allow companies to effectively focus efforts and tailor the approach.

After rethinking the risk assessment process, companies may need to better link it to established materiality thresholds. Management should not focus solely on identifying areas and accounts that are quantitatively material, but should also consider qualitative risk factors. Companies may do less extensive testing in areas where there is a low-risk assessment and a material weakness is not expected to arise, and expend higher efforts on those key controls that address higher risks.

Using goodwill as an example, the “existence” assertion will often be considered irrelevant or at least low risk, particularly in years subsequent to the event that gives rise to the goodwill — so controls addressing the existence of goodwill are not likely going to be as important to test. However, the “valuation” assertion is often relevant and a higher risk, so the company’s annual impairment assessment may be an important key control that warrants more extensive testing.

Plant construction was another area of discussion. Capital expenditures are both ongoing and common in the utility industry and do not necessarily equate to high risk just because they are of high volume and quantitatively large. Instead, when determining the scope of testing, management might consider targeting large or unusual projects for process-level control testing, while perhaps testing only entity-level controls (such as budget-to-actual analysis, assuming they are effective) for those classes of expenditures that are for expected, budgeted, routine improvements or expansions.

PwC observation

We believe that the SEC interpretive guidance, along with COSO's project to develop guidance designed to help organizations monitor the quality of their internal control systems, will contribute to improving the effectiveness and efficiency of management's evaluation of ICFR.

Management should keep in mind that any change in the controls evaluation process should be directed to improving the overall effectiveness and efficiency of the company's approach to internal control over financial reporting. Executing on a well-designed system of controls is important, regardless of the nature and extent of testing such controls for SOX 404 compliance purposes.

Takeaways

Significant opportunities exist to improve the SOX 404 process by making it faster, better and more efficient in the upcoming fiscal year. Although there is no all-encompassing solution for every company, consideration of risk as the basis for the assessment can lead management to a more defined path for testing.

The intent is not to merely reduce controls, but to streamline management's SOX 404 process to identify and test only those key controls that prevent or timely detect material misstatement. Improvements can be achieved strategically as well as tactically, with tactical changes bringing more immediate benefits.

It's clear from the forum discussions that your next cycle of SOX 404 assessment will focus on a practical approach to "better, faster, more efficient" compliance. Whether your approach to change is tactical or strategic, communicating with your external auditors is important, and we hope these forums serve as an integral part of a continuing productive dialogue.

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