Impact of Sarbanes-Oxley (SOX) on Equipment Management

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Compliance with SOX for Your Organization

This presentation is designed solely to provide a general overview and awareness of the Sarbanes-Oxley Act and its impact for information purposes only. Specific rules and practices for ensuring compliance to the Act should arise from and be guided by your respective Organizations’ Program or Policy Office.
SOX Penalties

- Establishes severe penalties for corporate level management (CEO, CFO) of public companies
  - $5 million and/or up to 20 years of imprisonment
- The Act sets the obligation of accurate and reliable financial reporting and disclosures with the CEO and CFO….no excuses for being uninformed!
Key Objective of SOX

- To protect investors by improving the accuracy and reliability of financial reporting and disclosures
- Reinvigorate investor confidence in the financial markets
  - Most significant reform that the US financial markets have had since SEC Act of 1933 and 1934
Why does SOX Exist?

1970s – Foreign Corrupt Practices Act
- Prevent bribery and fraud

1987 – Treadway Commission formed
- Define internal control

1992 – Internal Control – Integrated Framework (COSO) issued
- Recognized framework for evaluating internal control

Proved insufficient to prevent accounting scandals and unethical practices of the late 1990s and early 2000s
- Enron
- WorldCom
- Adelphia
- And others

Governmental reaction to the uproar and frustration in the financial markets and the lack of investor confidence in the financial reporting of public companies

2002 – Sarbanes-Oxley Act of 2002
Formation of the PCAOB
(Public Company Accounting Oversight Board)

- The Act resulted in the SEC appointment of the PCAOB
- Duties of the PCAOB:
  - Establish auditing standards regarding publicly traded entities
  - Conduct inspections of registered public accounting firms
  - Enforcement of the Act
Structure of the Act

- Rules Affecting Registered Public Accounting Firms and Audit Services
  - Auditor Independence - Sec. 201-209
- Rules Affecting Corporate Responsibility
  - Corporate disclosure/representations – Sec 301-308
  - Corporate governance and oversight – Sec 401-409
- Rules Affecting Corporate Fraud
  - Various sections: 501, 601-604, 701-705, 801-807, 901-906, 1001, 1101-1107
What is 404?

- **404 (a) – Internal Control System**
  - Management is responsible for the development and monitoring the effectiveness of an adequate internal control structure
    - CEO and CFO provide an annual certification

- **404 (b) – Independent Auditor**
  - External auditor provides attestation to management’s assessment of its controls over financial reporting
Reasonable assurance that the Company’s processes will ensure that:

- Transactions are properly authorized
- Assets are safeguarded against unauthorized or improper use
- Transactions are completely, accurately, and properly recorded and disclosed
- Records are accurately maintained and safeguarded

Financial Statements in Conformity with GAAP
External Auditor Opinion

- **Pre-SOX**
  - Opinion on the financial statements alone

- **Post-SOX**
  - Opinion on the financial statements alone
  - Opinion on management’s assessment process
  - Opinion on the effectiveness of internal controls over financial reporting
What is Involved in the 404 Process?

- Identification of significant accounts and disclosures
- Identification of key processes and classes of transactions that feed into the significant accounts

Identification and documentation of the objectives, risks and controls related to these key areas impacting financial reporting:
  - Not just Accounting!

Testing and evaluation of the controls over financial reporting:
  - For adequacy of the design
  - For effectiveness in operation

Identification and remediation of control deficiencies:
  - Retesting to ensure effectiveness

Adequacy of documentation is Critical
COSO – 5 Components of Internal Control

- Control Environment
- Risk Assessment
- Control Activities
- Information & Communication
- Monitoring
5 Financial Statement Assertions

- Existence or Occurrence
- Completeness
- Rights and Obligations
- Valuation or Allocation
- Presentation and Disclosure
Processes Impacting Equipment/Portfolio Management

- Establishment of residual values
- Monitoring of residual values
- Pricing using approved residual values
- FAS 13 Capital versus operating lease
- Remarketing valuations of equipment
- Collateral valuations impacting reserves
- Booking accuracy in lease accounting system
Other Key Considerations

- **Use of service organizations (3rd parties)**
  - SAS 70 Type II (or other control assurance)

- **Identification and testing of IT controls**
  - Application controls (edit checks, calculations, segregation of duties)
  - General controls (system access, data safeguarding)

- **Identification and testing of anti-fraud controls**
  - Practices that prevent and detect fraud by:
    - Employees
    - Suppliers
    - Customers
Success Factors

Those Organizations that find innovative ways to embrace the intent of the Act into their ongoing business practices such that their system of internal controls is continually monitored, measured, and improved will succeed in the long-run.
Daily Workflow Impact

- **Forecasting (Pre Booking)**
  - Methods (metrics management review)
  - Drivers of asset (S Curve, oil/energy, etc.)
  - Valuation used for proper residual accretion in lieu of “supporting” a transaction (Treasury document)

- **New Transactions (Booking)**
  - Capital v Operating lease classification (Income recognition)
    - Restructures
    - Renewals
  - Reserves upfront v specific allocation (i.e. aircraft)
  - Residual accretion (Pricing/income recognition)
  - Useful life test (50% of model is retired from industry)
Daily Workflow Impact

- **Portfolio Management (FAS 13)**
  - Monitoring of residual values
    - Internal v external and/or combination
    - Budgeting
    - Reserves (Basel II, etc.)
  - Residual v Inventory valuation
    - % of Inventory portfolio
    - Inventory Static
    - Portfolio – monthly accrual income
      - Financial reporting
      - Income recognition

- **Inventory**
  - Valuation process
  - Arm’s length
Impact on overall department

- Working with outside third parties
- Internal v external resources
- Budget (valuations going forward)
- Understand drivers of industry/asset – not bluebook static snapshot
- Auditors are focusing more in these area’s based on the perceived/actual risk with income recognition
Questions ?