Sarbanes-Oxley Update:
Impact on Public Companies,
Management,
and Audit Committees

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Dynamic and Defining Times

- The Sarbanes-Oxley Act of 2002 (the “Act”)
- Unprecedented rule-making by the SEC to implement the Act
- Changes impact all participants in the marketplace
- Implementation phase now in full swing…and doing so within
  - a changed regulatory environment
  - an uncertain economy
Overview of Recent SEC Rule-Making

Final Rules Include:

- CEO/CFO Certifications
- Code of Ethics
- Financial Experts
- Retention of Records
- Standards for Attorneys
- Audit Committee Responsibilities
- Non-GAAP Measures
- Form 8-K Requirements
- MD&A Disclosures
- Accelerated Filing Deadlines
- Trades in Blackout Periods
- Accelerated Reporting of Insider Transactions
Overview of Recent SEC Rule-Making

- **Auditor independence**
  - Hiring former auditors
  - Non-audit services
  - Audit committee pre-approval
  - Disclosure of professional fees
  - Audit partner compensation
  - Audit partner rotation
  - Auditor communications

- **Proposed rules open for comment or yet to be final include:**
  - “Noisy withdrawal” provision of attorney conduct rule
  - Management’s assessment of internal control
Key Points for Audit Committees

- Definition of audit committee independence
- Disclosure of audit committee financial expert
- Basic elements of auditor relationship shift to the audit committee
- Pre-approval of audit and non-audit services
- Additional requirements for auditor communications
- Procedures for handling whistle-blowers and complaints
Audit Committee Independence

Section 301

- Sets minimum independence standards for audit committee members
- Requires exchanges to reconcile listing standards with the rule and provides flexibility for exchanges to go beyond requirements
- Audit committee members, to be independent, can not
  - Accept any consulting, advisory, or other compensation (other than board fees) from the company
  - Be an ‘affiliated person’ of the company or its subsidiaries
- Effective date:
  - Exchanges to submit proposed amendments by July 15, 2003
  - Listed issuers to comply by the earlier of:
    - First annual shareholders meeting after January 15, 2004, or
    - October 31, 2004
  - Foreign private issuers and small business issuers: July 31, 2005
Audit Committee Financial Experts

Section 407

- Definition of audit committee financial expert revised in final rule

- Rule requires disclosure of:
  - Whether audit committee includes at least one audit committee financial expert
  - If not, why not
  - Name of the audit committee financial expert and whether independent from management

- Discretion to disclose additional audit committee financial experts

- Disclosures required in annual reports for FYE on or after July 15, 2003 (small businesses: December 15, 2003)
Basic Elements of Auditor Relationship

Section 301

- Rule requires audit committees
  - Appoint, compensate, retain, and oversee independent auditor
  - Be given appropriate funding, as determined by the audit committee, by the company for external auditors and advisors

- For some, may be a formality – however
  - Will impact timing and frequency of communications between auditors and audit committees
  - Consider implications for effective communication among auditors, audit committees, and management

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Pre-Approval by the Audit Committee

Section 202

- Audit committees required to pre-approve all audit and non-audit services

- Two alternatives for pre-approval (both equally acceptable by the SEC):
  - Services may be specifically pre-approved by the audit committee, or
  - Services may be entered into pursuant to pre-approval policies and procedures established by the audit committee

- Inadvertent lapses of pre-approval permitted in certain situations

- Effective May 6, 2003
Auditor Communications with Audit Committees
Section 204

- Adds to the list of required auditor communications
  - Discussion of critical accounting policies
    - Those most important to company’s financial condition and results of operations
    - Require management’s most difficult, subjective, or complex judgments
    - To include an assessment of management’s disclosures and any proposed modifications by the accountant not included
      - Alternative accounting treatment for material items that have been discussed with management
      - Other material communications
- Effective May 6, 2003
Procedures for Handling Complaints

Section 301

- Audit committees required to establish procedures for
  - Receipt, retention, and treatment of complaints regarding accounting, internal controls, or auditing matters
  - Confidential anonymous submissions by employees of concerns regarding questionable accounting or auditing matters

- Effective date:
  - Exchanges to submit proposed amendments by July 15, 2003
  - Listed issuers to comply by the earlier of:
    - First annual shareholders meeting after January 15, 2004,
    - October 31, 2004
  - Foreign private issuers and small business issuers: July 31, 2005
Key Points for Management

- New certification requirements
- Plan to comply with accelerated filing deadlines
- Prepare for new disclosure requirements
  - MD&A
  - Non-GAAP Measures
  - Disclosure of professional fees paid
- Enhanced code of ethics for senior officers
- Understanding key elements of auditor independence
  - Hiring Former Auditors
  - Audit Partner Rotation
  - Non-audit services
  - Incorporating pre-approval requirements
New Certification Requirements

Section 302

- CEO and CFO to make specific certifications in each quarterly and annual report including:
  - Report contains no untrue statements
  - Report is fairly presented in all material respects
  - Responsibility for design and maintenance of disclosure controls and procedures
  - Requires disclosure controls and procedures to be evaluated by CEO and CFO

- Effective dates:
  - August 29, 2002, except for certifications related to disclosure controls and procedures
    - Certifications related to disclosure controls and procedures: effective for periods ending after August 29, 2002
Accelerated Filing Deadlines

- To be implemented over three years

<table>
<thead>
<tr>
<th>For Fiscal Years Ending After</th>
<th>Form 10-K Deadline</th>
<th>Form 10-Q Deadline</th>
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<tbody>
<tr>
<td>December 15, 2002</td>
<td>90 days after FYE</td>
<td>45 days after FQE</td>
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<tr>
<td>December 15, 2003</td>
<td>75 days after FYE</td>
<td>45 days after FQE</td>
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<tr>
<td>December 15, 2004</td>
<td>60 days after FYE</td>
<td>40 days after FQE</td>
</tr>
<tr>
<td>December 15, 2005</td>
<td>60 days after FYE</td>
<td>35 days after FQE</td>
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</tbody>
</table>
Management’s Discussion and Analysis
Section 401a

- Requires MD&A disclosure of
  - Off-balance sheet arrangements
    - Documents containing financial statements for fiscal years ending on or after June 15, 2003.
  - Known contractual obligations must be shown in table
    - Documents required to include financial statements for the fiscal years ending on or after December 15, 2003.
Non-GAAP Financial Measures

Section 401b

- If non-GAAP measure presented must also
  - Reconcile to the most directly comparable GAAP financial measure
  - Disclose why the non-GAAP measure is useful

- SEC dealing with implementation issues - interpretations evolving
  - Q&A expected to be issued by SEC
Disclosure of Professional Fees Paid

- Fees billed by the auditor for two fiscal years

- Four categories:
  - Audit fees
  - Audit-related fees
  - Tax fees
  - All other fees

- Additional disclosures
  - Description of the types of services provided
  - Pre-approval policies and procedures adopted by audit committee
  - Percentage of fees paid subject to de minimis exception

- Effective for periodic annual filings for the first fiscal year ending after December 15, 2003
  - Early adoption encouraged
  - Pre-approval by audit committee - effective May 6, 2003
Code of Ethics

Section 406

- Disclosure of
  - Existence of code of ethics
    - Applicable to principal executive officer, principal financial officer, principal accounting officer or controller, or equivalents
    - If one does not exist, why not
  - Must be publicly available
    - Exhibit to annual report
    - Website
    - Provide copies at request, no charge
- Changes or waivers reported within 5 business days
- New disclosures required in annual reports for fiscal years ending on or after July 15, 2003
Hiring Former Auditors

Section 206

- Required 12-month cooling-off period for
  - Former audit engagement team members hired in financial reporting oversight role
  - 12 months commences from the date prior year annual report was filed with the SEC
  - Example:
    - Calendar year end company
    - 12/31/03 annual report is filed on March 15, 2004
    - For ’03 engagement team, 12-month cooling-off period would begin March 16, 2004

- Effective May 6, 2003
  - Existing employment relationships will be grandfathered
Audit Partner Rotation

Section 203

- Final rule focuses on
  - Responsibility for final decisions on accounting, auditing, and reporting matters or
  - The level of relationship with management and the audit committee

- Applies to lead, concurring, corporate-level and significant subsidiary audit partners.

- Lead partner and concurring partner: 5 on/5 off

- Other partners subject to rotation: 7 on/2 off
Non-Audit Services

Section 201

- Permitted if:
  - Pre-approved by audit committee, and
  - Not one of nine prohibited services

- Major changes:
  - Financial information systems design and implementation
  - Internal audit outsourcing
  - Expert services

- Tax services are specifically permitted with pre-approval

- Effective May 6, 2003
  - Transition period for exiting existing contracts is 12 months after the effective date of the rule
Section 404

Requires the CEO and CFO to annually:

- State their responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting
- Conduct an assessment of the effectiveness of the company’s internal controls and procedures for financial reporting

Requires the external auditor to:

- Issue a separate report attesting to management’s assertion on the effectiveness of internal controls and procedures for financial reporting (requires a framework such as COSO)

The proposed rules go into effect for years ending on or after September 15, 2003
Choosing A Framework

- Section 404 requires the evaluation of internal control in the context of an established framework
- Many companies build their internal control structures around the Committee of Sponsoring Organizations’ *Internal Control – Integrated Framework* (“COSO”)
- Though other frameworks for internal control exist, D&T believes that COSO will become the dominant model and recommends its adoption
- COSO can be viewed as the GAAP equivalent for internal control evaluation
Applying the COSO Framework

COSO is a principles-based internal control framework that requires subjective judgment (i.e., there are no bright-line tests) with respect to the following:

- Defining the appropriate scope for internal control assessment
- Pinpointing the specific risks, control objectives, and control activities most relevant to a company
- Defining an internal control deficiency and evaluating its significance
- Determining the overall effectiveness of internal controls
Definition of Internal Control

COSO defines internal control as a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of business objectives in three areas:

- **Operations**
  - Effective and Efficient Use of Resources

- **Financial Reporting**
  - Preparation of Reliable Published Financial Statements

- **Compliance**
  - Compliance with Laws and Regulations

404 Scope
COSO Components/Criteria

COSO recommends the evaluation of internal controls under five interrelated components/criteria:

- **Control Environment** – the foundation for all other elements of internal control; includes the ethical values and competence of a company’s employees
- **Risk Assessment** – the identification and analysis of relevant risks that can hinder the achievement of business objectives
- **Control Activities** – specific tasks to mitigate each of the risks identified by the company
- **Information and Communication** – information pathways from management to employees and vice versa
- **Monitoring** – external and internal assessments of internal control
Required Evaluation of Tax Internal Controls

- COSO requires the evaluation of a company’s internal controls at both the entity and process levels.
- Because the tax process has a material impact on the accuracy of financial reporting, tax department operations are now subject to senior management and external auditor scrutiny.
- Most tax directors have limited experience with the concept of internal controls.
Auditors have historically relied on substantive testing of calculations, rather than internal controls, when evaluating tax–specific line items and disclosures in financial reports.

The policies, procedures, and processes that make up the tax function’s internal controls must now be auditable.

Nonexistent or informal tax internal controls could constitute a material weakness that results in an audit report qualification.
Approach to Evaluating Tax Internal Control

Identify financial reporting and disclosure risks related to key tax sub-processes and tax types

Define tax control objectives necessary to mitigate identified risks

Identify relevant control activities

Perform tests of control to assess the design and operating effectiveness of controls as unreliable, insufficient, reliable, or optimal

Document Results
The results of the dependent, integrated tax planning, tax reporting, tax controversy, and tax management sub-processes impact the accuracy of financial reporting for the overall tax process. Thus, all four sub-processes should be addressed by tax function internal controls.
## Tax Management and Tax Reporting

<table>
<thead>
<tr>
<th>Tax Management</th>
<th>Tax Reporting</th>
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<tr>
<td>• Set and align tax strategy</td>
<td>• Gather and evaluate data</td>
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<tr>
<td>• Support tax competencies</td>
<td>• Complete FAS 109 process</td>
</tr>
<tr>
<td>• Leverage and integrate technology</td>
<td>• Develop disclosures</td>
</tr>
<tr>
<td>• Establish monitoring procedures</td>
<td>• Prepare and review tax returns</td>
</tr>
<tr>
<td></td>
<td>• File tax returns and remit payments</td>
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## Tax Planning and Tax Controversy

<table>
<thead>
<tr>
<th>Tax Planning</th>
<th>Tax Controversy</th>
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</thead>
<tbody>
<tr>
<td>• Monitor and assess tax laws and regulations</td>
<td>• Maintain tax records</td>
</tr>
<tr>
<td>• Monitor and assess business environment</td>
<td>• Respond to information requests</td>
</tr>
<tr>
<td>• Perform tax research and conclude on positions</td>
<td>• Resolve tax adjustments</td>
</tr>
<tr>
<td>• Coordinate planning with controversy requirements</td>
<td>• Integrate with future tax planning</td>
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Key Tax Types/Accounts

The following tax types could be material to a company’s financial reports:

- US Income and Excise Tax
- Multi-state Income and Franchise Tax
- Non-US Income Tax
- Non-US Indirect Tax
- Employee Benefits
- Sales and Use Tax
- Real and Personal Property Tax
- Unclaimed Property Reporting
Example

COSO Element: Control environment

Control Objective: The tax department organizational structure supports the competent performance of the tax management function

Control Activity: The tax department maintains an updated, accurate organizational chart that has been approved by upper-level management

Test of Control: Request and review the organizational chart for the tax function; determine when chart was last updated; determine level of management review

Related Tax Sub-processes: ALL – tax reporting, tax planning, tax controversy, and tax management
**Example**

**COSO Element: Risk assessment**

**Control Objective:** The tax function monitors and addresses changes in the tax regulatory environment.

**Control Activity:** The tax department performs periodic risk assessments on the likelihood and implications of taxing authorities challenging current or previous tax positions taken by the company.

**Test of Control:** Request and review documentation of a recent risk assessment; determine who in upper-level management reviews risk assessments.

**Related Tax Sub-processes:** Tax reporting and tax controversy.
Example

**COSO Element: Control activities**

**Control Objective:** General ledger postings for tax accounts are authorized and approved by appropriate tax personnel prior to posting and periodically reviewed.

**Control Activity:** The head of tax reviews the FAS 109 calculations and authorizes accounting to book the necessary entries to the general ledger; tax personnel periodically review the tax accounts for reasonableness.

**Test of Control:** Confirm the authorization process for general ledger postings to tax accounts; determine who in the tax department reviews the tax accounts and how frequently.

**Related Tax Sub-process:** Tax reporting.
Example

COSO Element: Information and communication

Control Objective: The tax function ensures the retention of electronic and hard copy tax source data for open tax years

Control Activity: The tax department maintains an updated record retention policy that meets the source data requirements of all tax jurisdictions

Test of Control: Confirm that an updated, adequate record retention policy exists

Related Tax Sub-process: Tax controversy
Example

COSO Element: Monitoring

Control Objective: An external party periodically assesses the performance of tax internal control

Control Activity: Internal audit regularly assesses the tax function and provides a separate evaluation of the effectiveness of the design and operation of tax internal controls

Test of Control: Obtain and review a copy of the most recent tax internal control assessment

Related Tax Sub-process: ALL – tax reporting, tax planning, tax controversy, and tax management
Things to Remember

- Tax function readiness is a part of a much larger organization-wide effort around internal controls
- Expect some scope to be applied
- Begin with the end in mind … coordination with the rest of management and the external auditor is key
- This is a financial reporting requirement, not a tax issue
- Each situation is different, requiring some level of internal control customization
- Expect considerable attention to be paid to documentation of the controls around the tax accounts and disclosures in the financial statements
Breadth and volume of the new requirements seems daunting at first

Comprehensive plan and deliberate approach are key to effective implementation
  – Consult with appropriate advisors when issues and questions arise
  – Gain perspectives on best practices
  – Adopt a plan of continuous improvement
  – Acknowledge that improvement and changes will come as experience is gained

Many challenges over the next year, but need to remember the desired outcome …

To improve financial reporting and restore investor confidence
Questions and Answers