Internal Control Testing

and

Section 404 of the Sarbanes-Oxley Act

HUNTER STEVENS LLC

Sarbanes-Oxley – Section 404
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1 – Preface

Why Sarbanes-Oxley Was Enacted

The Sarbanes-Oxley Act of 2002(Sarbanes-Oxley) was enacted on July 30, 2002, largely in response to a number of major corporate and accounting scandals involving some of the most prominent companies in the United States. These scandals have resulted in a great loss of public trust in corporate accounting and reporting practices.

Sarbanes-Oxley represents a major effort to prevent accounting scandals and other reporting problems from recurring, and to rebuild public trust in corporate business practices and reporting.

The Legislation of Accountability

Sarbanes-Oxley establishes new or enhanced standards for corporate accountability and penalties for corporate wrongdoing. The legislation contains 11 titles, ranging from additional responsibilities for audit committees to tougher criminal penalties for white-collar crimes such as securities fraud. Many of the legislation's provisions direct the SEC to issue implementing guidance.

Here is a summary of each of the 11 titles:

Title I – Public Company Accounting Oversight Board

- Establishes an independent, non-governmental board to oversee the audits of public companies to protect the interests of investors and further public confidence in independent audit reports.
- Defines the major responsibilities of this board.
- Requires public accounting firms to register with the board and take certain other actions in order to perform audits of public companies.

Title II – Auditor Independence

- Sets forth required actions by registered public accounting firms ("external auditors"), audit committees and companies that are intended to strengthen auditor independence.
- Legislates certain services, generally consistent with current independence rules, as unlawful if performed by the external auditor.

Title III – Corporate Responsibility

- Requires audit committees to be independent and undertake specified oversight responsibilities.
- Requires CEO's and CFO's to certify quarterly and annual reports to the SEC, including making representations about the effectiveness of specified controls.
- Provides rules of conduct for companies and their officers regarding pension blackout periods and certain other matters.
- Requires the SEC to issues rules requiring attorneys in certain roles to report violations of securities laws to a company's CEO or chief legal counsel and, if no action is taken, to the audit committee.

Title IV – Enhanced Financial Disclosures

- Requires companies to provide enhanced disclosures, including a report on the effectiveness of internal controls and procedures for financial reporting (along with external auditor attestation of that report) and disclosures covering off-balance sheet transactions and pro forma financial information.
- Requires disclosures regarding code of ethics for senior financial officers and reporting of certain waivers.
- Requires accelerated disclosures by management, directors, and principal stockholders concerning certain transactions involving company securities.

Title V – Analyst Conflicts of Interest

- Requires the SEC to adopt rules to address conflicts of interest that can arise when securities analysts recommend equity securities in research reports and public appearances.

Title VI – Commission Resources and Authority

- Provides additional funding to the SEC.
- Gives the SEC and federal courts more authority to censure and impose certain prohibitions on persons and entities.

Title VII – Studies and Reports

- Directs federal regulatory bodies to conduct studies regarding consolidation of accounting firms; credit rating agencies; violators, violations, and enforcement actions involving securities laws; certain roles of investment banks and financial advisors; and certain other matters.

Title VIII – Corporate and Criminal Fraud Accountability

- Provides tougher criminal penalties for altering documents, defrauding shareholders, and certain other forms of obstruction of justice and securities fraud.
- Makes debts non-dischargeable if incurred in violation of securities fraud laws.
- Protects employees of companies who provide evidence of fraud.

Title IX – White-Collar Crime Penalty Enhancements

- Provides that any person who attempts to commit white-collar crimes shall be treated under the law as if the person had committed the crime.
- Enhances penalties and sentencing guidelines for certain white-collar crimes such as mail and wire fraud and ERISA violations.
- Requires CEO’s and CFO’s to certify in their periodic reports to the SEC that their financial statements fully comply with the requirements of the Securities Exchange Act of 1934, and imposes penalties for certifying a misleading or fraudulent report.

Title X – Corporate Tax Returns

- Conveys the sense of the Senate that the CEO should sign a company’s federal income tax return.

Title XI – Corporate Fraud and Accountability

- Provides additional authority to regulatory bodies and courts to take various actions, including fines or imprisonment, with regard to tampering with records, impeding official proceedings, taking extraordinary payments, retaliating against corporate whistleblowers, and certain other matters involving corporate fraud.

The following effective dates have been identified for principal provisions contained in Titles III and IV of Sarbanes-Oxley and related SEC rules directly affecting public companies.

By July 30, 2002:

- Forfeiture by CEO and CFO of bonuses and profits from security sales in the event of a restatement of financial statements (§304)
- Prohibition of certain loans to directors an executive officers (§402)

By August 29, 2002:

- Required CEO and CFO certifications of quarterly and annual reports (§302 and SEC rule)
- Reporting by executives, directors, and principal stockholders within two business days of certain transactions involving company securities (§403 and SEC rule)

By October 28, 2002:

- Deadline for SEC to propose rules covering:
  - Improper influence on the conduct of an audit (§306)
  - Disclosure of material off-balance sheet transactions and arrangements (§401)
  - Presentation of pro forma financial information (§401)
  - Code of ethics for senior financial officers (§406)
  - Audit committee "financial expert" (§407)

By April 26, 2003:

- SEC to issue final rules:
  - Directing securities exchanges to prohibit a company not complying with the amended audit committee rules from listing any security (§301)
  - Improper influence on the conduct of an audit (§303)

By January 26 2004:

- SEC to complete study of extent of off-balance sheet transactions, including use of special purpose entities, and the transparency of the treatment of those transactions under generally accepted accounting principles (§401)

No Deadline Specified in Sarbanes-Oxley:

- Required internal control reports by companies (§404)
- Required "real-time" disclosure of information concerning material changes in the company's financial condition or operations (§409)

Without question, these new requirements place increased demands on some companies' executives and internal resources as well as others involved in corporate reporting. To restore the credibility of corporate accounting and reporting, Sarbanes-Oxley defines a higher level of responsibility, accountability, and financial reporting transparency – changes that ultimately are intended to return to investors the confidence they need to once again become active in the nation's financial markets.

Sarbanes-Oxley requires that company executives, boards of directors, and independent auditors take specific actions to achieve a similar goal for corporate reporting. A central theme of Sarbanes-Oxley is how these key players in the compliance chain must work together, with critical crosschecks, to achieve that goal. To carry out this theme, Sarbanes-Oxley reinforces and expands on the responsibilities of these players in the corporate reporting compliance chain:

1. Company executives

- Sarbanes-Oxley reaffirms that the CEO and CFO carry a primary responsibility for a company's reports filed with the SEC and institutes a requirement for them to report on the completeness and accuracy of the information contained in the reports as well as the effectiveness of underlying controls.
- Sarbanes-Oxley establishes a standard that is broader than GAAP, indicating that the CEO and CFO must provide financial statements and other financial information that is transparent in the way it fairly presents the company's financial condition, results of operations, and cash flows.

2. Board of Directors

- As the representative of a company's shareholders, the board of directors, through its audit committee, is responsible for overseeing the company's accounting and financial reporting processes and audits of its financial statements. Sarbanes-Oxley also imposes a new requirement to disclose whether or not at least one member of the audit committee is a "financial expert" and, if not, the reasons why. Finally, the audit committee is required to pre-approve any services provided by its external audit firm.

3. External Auditor

- An independent public accounting firm reports on the fairness of the presentation of a company's financial statements in accordance with generally accepted accounting principles. Sarbanes-Oxley reaffirms the necessity for the auditor to be independent of management, in fact and appearance, and expands the auditor's reporting responsibility to the newly required management assertions on internal controls and procedures for financial reporting.

2 – Basic Requirements

The SEC's Rule Regarding Disclosure Under Section 404 as Currently Proposed Requires Management to:

- Assess its internal controls and procedures for financial reporting each quarter;

- Provide an internal control report in its annual report; and

- Obtain an attestation on that evaluation from the independent accounting firm that audits the registrant’s financial statements.

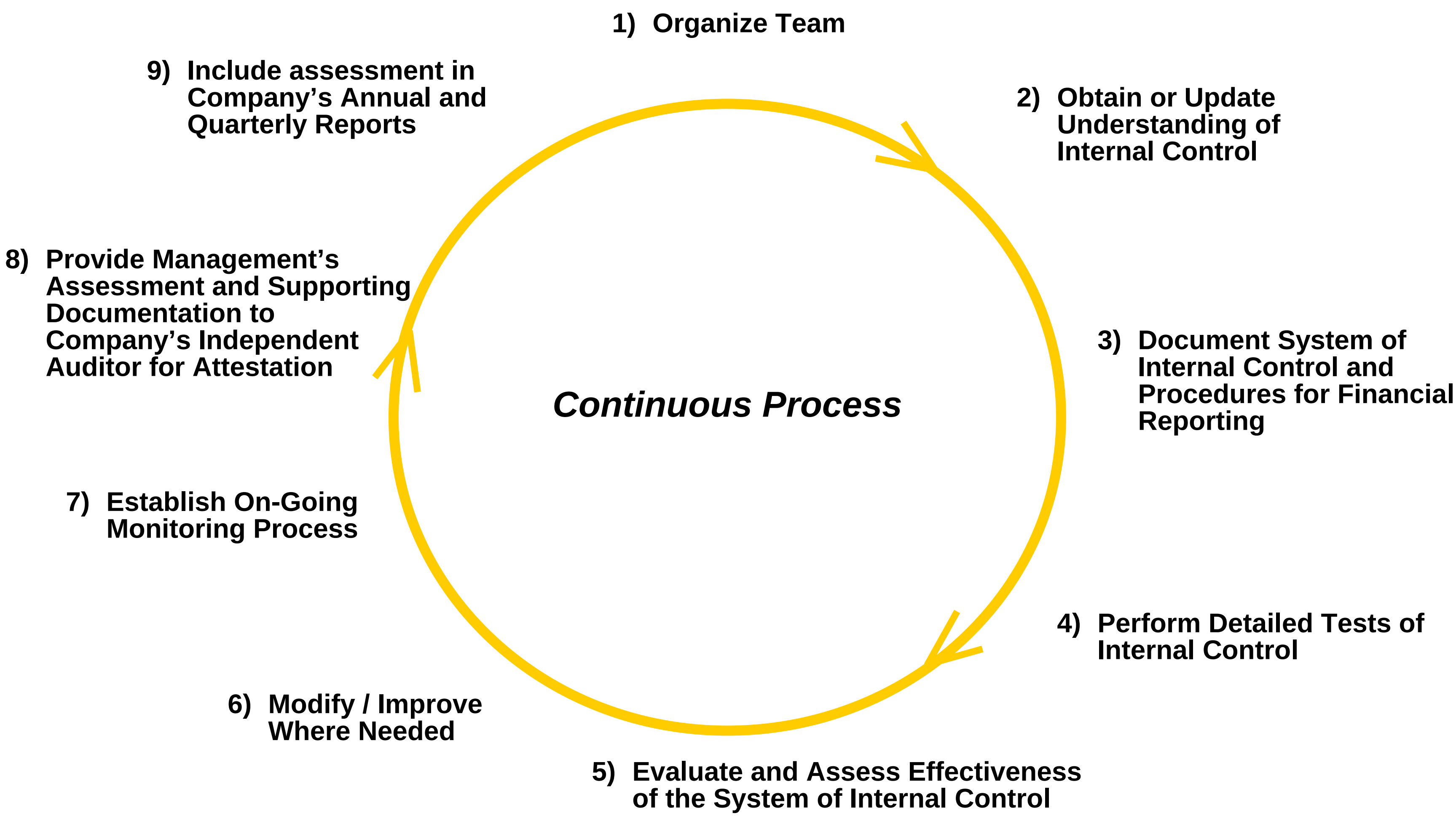
In order to accomplish this, management must:

- Document the system of internal control;
- Design and carry out sufficient tests and procedures to demonstrate that the system produces reliable financial information; and
- Establish on-going monitoring processes in order to ensure that the system of internal control continues to function effectively as changes take place in the structure, operation, or organization of the company.

Limitation On Use of Auditor

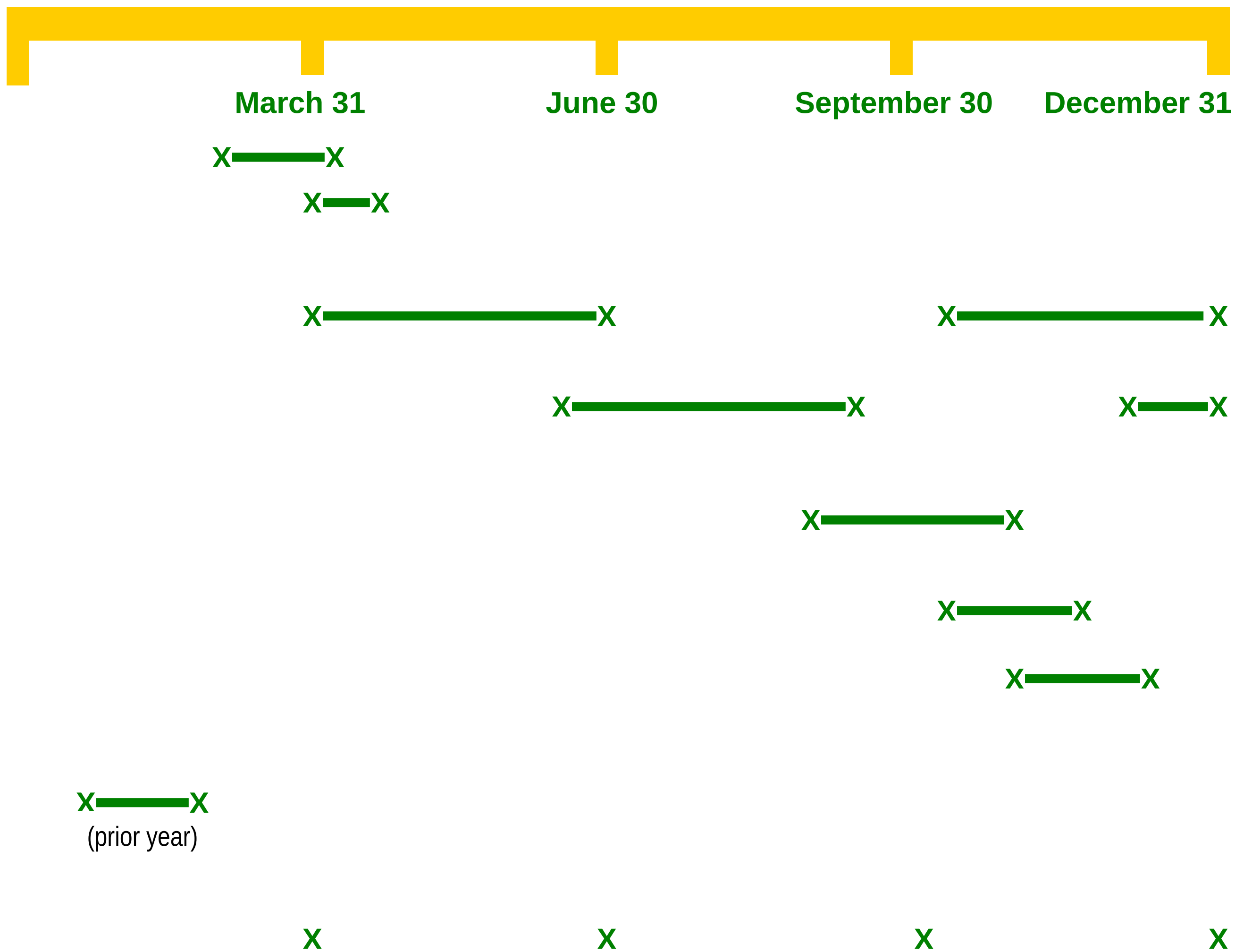
- Section 404 requires independent auditors to expand the scope of their procedures to annually attest to and report on management's assertion on the effectiveness of internal control and procedures for financial reporting.
- In order to maintain their independence, the registrant’s auditor cannot establish the procedures for evaluating internal control, prepare the required documentation, and then attest to their own work.
- While auditors may provide input to the process, the vast majority of the work required to satisfy the requirements of Section 404 <u>cannot</u> be performed by the auditing firm who subsequently must attest to the effectiveness of the underlying control and financial reporting procedures.

Section 404 Requires Evaluation of Internal Control to be a Continuous and On-Going Process



On-Going / Continuous Evaluation Process

(calendar year-end example)



TASK

1) **Organize Team**
2) **Obtain or Update Understanding of Internal Control**
3) **Document System of Internal Control and Procedures for Financial Reporting**
4) **Perform Detailed Tests of Internal Control**
5) **Evaluate and Assess Effectiveness of the System of Internal Control**
6) **Modify / Improve Where Needed**
7) **Establish On-going Monitoring Process**
8) **Provide Management's Assessment and Supporting Documentation to Company's Independent Auditor for Attestation**
9) **Include Assessment in Company's Annual and Quarterly Reports as of the Balance Sheet Date**

3 – Purpose/Objective of this Document

This document describes the concepts, approach and process utilized by Hunter Stevens to assist management (CEO's and CFO's) in assessing the effectiveness of internal controls and procedures for financial reporting under the Sarbanes-Oxley Act.

4 – Internal Control Concepts

Introduction

4.1 This section provides guidance on:

- what internal control is;
- what you need to understand;
- how you obtain an understanding;
- reporting control deficiencies;
- how you make preliminary assessments of control risk;
- preparing the Control Overview Document and other documentation.

4.2 This section is derived principally from the following:

- Internal Controls-Integrated Framework prepared by the Committee of Sponsoring Organizations of the Treadway Commission;
- U.S. SAS's included in Volume I of the AICPA Professional Standards, sections:
  - AU 316, "Consideration of Fraud in a Financial Statement Audit"
  - AU 319, "Consideration of Internal Control in a Financial Statement Audit";
- Volume II of the AICPA Professional Standards, sections:
  - AU 8006, "Risk Assessment and Internal Control"
  - AU 8006A, "Risk Assessment and Internal Control-EDP Characteristics and Considerations"
  - AU 8015, "Auditing in an EDP Environment."

4.3 Paragraphs 6.17-6.93 are based on Internal Controls-Integrated Framework.

Definition of internal control

4.4 Internal control is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in one or more of the following categories:

- effectiveness and efficiency of operations;
- reliability of financial information;
- compliance with applicable laws and regulations.

4.5 This definition implies that internal control is:

- a means by which management controls the entity's activities, being a series of actions built into, rather than being added onto, the process for managing an entity's business activities;
- accomplished by the people of an entity, by what they do and what they say;
- can provide only reasonable assurance regarding attainment of an entity's objectives.

4.6 Management seeks to monitor and mitigate the business risks that an entity's objectives will not be attained as the result of all the chiefly external factors, pressures and forces brought to bear on the entity. Internal control depends on the risks management perceives to be the greatest. Perceptions of risks and appropriate responses to the risks differ from entity to entity and from individual to individual.

4.7 Every entity develops strategies to achieve diverse objectives. By considering these objectives in three broad categories, you may distinguish what can be expected from each category. As consultants, you may then focus more specifically on what is relevant to the financial statements.

4.8 **Operations**. Unlike the other two categories, achievement of objectives relating to the entity's effective and efficient use of the entity's resources is not always within an entity's control. Internal control cannot prevent bad business judgments and decisions or external events that can cause a business to fail to attain its operating goals. For these objectives, internal control can provide reasonable assurance only that management and the board of directors are aware of the extent to which the entity is moving toward those objectives.

4.9 **Financial reporting**. Internal control, if effectively designed and operating, may be expected to provide reasonable assurance of attaining objectives relating to reliability of financial reporting. Achievement of those objectives can be measured against standards set largely by external parties and generally agreed by the business community. Moreover, there is extensive experience across many business entities in designing internal control to meet these standards.

4.10 **Compliance**. Achievement of those objectives relating to the entity's compliance with applicable laws and regulations can also be measured against standards set largely by external parties. However, laws and regulations may stem from many sources, leading to overlap or even conflict. Laws and regulations may be complex and are sometimes ambiguous. Moreover, there is less experience in designing internal control for compliance with these standards.

Components of internal control

4.11 Internal control consists of interrelated components:

- risk assessment;
- control environment;
- information and communication;

- monitoring;
- control activities.

4.12 **Risk assessment**. Management sets both entity-wide objectives and activity-level objectives, identifying and analyzing the risks that these objectives will not be achieved. All entities, regardless of size, structure, nature or industry are subject to business risks.

Business risks affect each entity's ability to survive, compete successfully within its industry, maintain its financial strength and positive public image and safeguard the overall quality of its products, services and the well-being of its people.

4.13 The decision to be in business is a decision to accept risk. There is no practical way to reduce risk to zero. Management and the board of directors decide what risks to accept and the extent and methods to be applied to monitor and mitigate the risks. Because economic, industry, regulatory and operating conditions continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

4.14 The risk assessment process is less formal and less structured in smaller entities. Smaller entities are usually more centralized and have fewer levels of authority. As a result, it may be easy and effective to communicate management’s objectives to personnel.

4.15 In smaller entities, the process of identifying and analyzing risks to the achievement of objectives often consists of management receiving information directly from outsiders and employees. Management learns about business risks from external sources through direct contact with customers, suppliers, the entity's banker, lawyer, independent auditor and others. Management is aware of risks from internal factors through continuous contact with employees. Risk assessment can be particularly effective because management has both access to appropriate information and a good understanding of its implications.

4.16 **Control environment**. The control environment consists of those factors that set the tone of an entity and thereby influence the control consciousness of people in the entity. The factors reflected in the control environment include the following:

- integrity and ethical values;
- commitment to competence;
- board of directors or audit committee activities;
- management's philosophy and operating style;
- organizational structure;
- assignment of authority and responsibility;
- human resource policies and practices.

4.17 The control environment is the foundation for the other components of internal control, providing discipline and structure. It provides an atmosphere in which people conduct their activities and carry out their control responsibilities.

4.18 The control environment of smaller and owner-managed entities is less formal than in larger entities. There is less documentation and more face-to-face communication both inside and outside the entity. As a result, the attitudes of management about integrity, ethical behavior and commitment to good business practice are carried rapidly through the entity.

4.19 **Information and communication**. Information refers to what is identified, captured and communicated in a form and time frame that enables people within the entity to carry out their responsibilities.

4.20 Communications refers to providing information down, across and up the entity as well as externally, as appropriate. Effective communication includes a clear message from management that control responsibilities are taken seriously as well as information about how each individual in the entity relates to internal control and the work of others.

4.21 An entity's information system is the collection of an entity's resources (people, expertise, facilities, processes, hardware, software and data) designed to provide information to accomplish business objectives. A financial information system is part of the entity's larger information system.

4.22 An information system provides reports containing operational, financial and compliance-related information that make it possible to operate and control the business. An information system deals not only with internally generated data, but also with information about external events, activities and conditions necessary for informed business decision-making and external reporting.

An information system may consist of one or more components such as:

- integrated financial information system
- integrated human resources system
- electronic funds transfer system computer integrated manufacturing
- retail merchandise planning and buying system

A typical financial information system consists of applications such as:

- purchasing
- accounts payable treasury
- invoicing (billing)
- accounts receivable
- financial reporting
- human resource

4.23 With today's information technology, data can be processed effectively and efficiently in most entities, regardless of size. Because the business activities in many smaller entities are less complex, there is less need for summarization and interpretation. Therefore, the information may be both more timely and more understandable. Information systems in smaller entities typically identify and report on relevant external events, activities and conditions, but their effectiveness usually depends on management's ability to monitor external events.

4.24 Smaller entities with active management involvement in the financial reporting process may not have extensive descriptions of accounting procedures, sophisticated information systems or written policies. However, when smaller entities are involved in complex transactions or are subject to legal and regulatory requirements also found in larger entities, more formal means of ensuring that internal control objectives are achieved may be present.

4.25 In a smaller entity, effective communication between management and employees is easier to achieve than in a large enterprise.

4.26 **Monitoring**. Monitoring activities are directed toward assessing the performance of the internal control system over time. Monitoring may be performed through ongoing activities, separate evaluations or a combination of the two. Effective monitoring provides for reporting of internal control deficiencies upward, with serious matters reported to management and the board of directors or its committees. Usually, some combination of ongoing monitoring and separate evaluations provide assurance that internal control maintains its effectiveness over time.

4.27 Ongoing monitoring occurs in the course of operations. It includes regular management and supervisory activities and other actions personnel take in performing their duties. The scope and frequency of separate evaluations depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures.

4.28 Ongoing monitoring activities of smaller entities are likely to be informal and to involve management directly. Monitoring of the internal control process is typically a by-product of management's personal direction of the business. Management's close involvement in operations often brings to light significant variances from expectations and inaccuracies in operating or financial data.

4.29 **Control activities**. Control activities are the policies and procedures that help provide assurance that management's directives are carried out. They help provide assurance that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the entity, at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

4.30 It is sometimes helpful to think of control activities at two levels:

- general control activities that contribute to, or support the effectiveness of, internal control for many financial statement assertions (or audit objectives if viewed from an auditor's perspective);
- control activities that apply to specific financial statement assertions.

4.31 An entity's information system contributes to the internal control process, but at the same time needs to be controlled, in part, this is accomplished by providing a stable, effective processing environment. That environment is maintained by what may broadly be referred to as computer controls. *Computer controls* consist of:

- general IT controls;
- application controls.

4.32 *General IT* controls are those control activities designed to provide reasonable assurance as to the continued proper operation of the information system. General IT controls include control activities involving:

- application systems development and maintenance;
- access controls;
- computer operations;
- system software acquisition and maintenance.

4.33 General IT controls usually are a combination of policy, guidelines, manual controls and software applications such as access control systems.

4.34 Application controls are the programmed procedures in application software and related manual procedures designed to provide reasonable assurance about the completeness, accuracy and validity of information processing.

4.35 The distinction between general IT controls and application controls is not sharp. Depending on the technical design of the information system, an entity may place relatively more emphasis on general IT controls as opposed to applications controls. General IT controls tend to apply equally to many or all applications in an entity's information system and may be relatively more efficient than equivalent controls applied at an application level.

4.36 It is often useful to distinguish control activities on the basis of the objectives of those activities. Broadly, all control activities may be grouped into preventive controls and detective controls.

4.37 *Preventive controls* are designed to prevent misstatements or other conditions resulting from some event.

For example, physical security for warehouses helps to prevent unauthorized removal of inventory items. The physical safeguards contribute to operating objectives of profitability as well as to prevent misstatements in financial statements.

4.38 Detective controls are designed to detect misstatements or other conditions after occurrence for the purpose of correcting the condition such as correcting the accounting records. Sometimes, detective controls are less costly than preventive controls. Detective controls are inappropriate if the objective is to prevent an event from occurring.

For example, comparing the results of a physical inventory to what is recorded detects misstatements due to shortages in inventory but cannot prevent the shortage from occurring.

4.39 The concepts underlying control activities in smaller entities are not likely to differ significantly from those in larger entities, but their formality varies. Some types of control activity are not always relevant because the control activities applied directly by management are effective.

Effectiveness of internal control

4.40 A judgment as to whether an entity's internal control is effective is based on considering the extent to which the components are present and operating effectively. Effective functioning of all the components provides reasonable assurance as to achievement of one or more of the three categories of objectives.

4.41 Internal control may be judged effective for each of the three categories of internal control objectives if the board of directors and management have reasonable assurance that:

- they understand the extent to which the entity's operations objectives are being achieved (operations objectives),
- published financial statements are being prepared reliably (financial reporting objectives);
- applicable laws and regulations are being complied with (compliance objectives).

4.42 Effectiveness of internal control depends on the presence of all the components of internal control working together. No two entities are likely to have the same internal control system. Nevertheless, even though entities may not respond to similar risks in the same way, the basic components contributing to an entity's being in control need to be satisfied.

4.43 For the financial reporting objective there is a more detailed criterion, namely, the material weakness concept. A material weakness is defined as follows:

A condition in which the design or operation of one or more components of internal control does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material to the financial statements may occur and not be detected and corrected within a timely period by employees in the normal course of performing their assigned duties.

What you need to understand

4.44 Financial statements are the responsibility of management. Because virtually all entities produce financial reports for a number of purposes, they all have a common set of objectives relating to financial reporting. The common set of objectives relates to representations by management (financial statement assertions) embodied in the financial statements. To plan your testing of internal control, you need to understand the internal control process as it applies to these objectives for the reliability of the financial statements.

4.45 The required understanding covers all components of internal control as they apply to the reliability of the financial statements:

- risk assessment;
- control environment;
- information and communication;
- monitoring and control activities.

How you obtain an understanding

4.46 You obtain or update an understanding of internal control by a combination of the following procedures:

- inquiries of management, supervisory and staff personnel;
- observation of an entity's activities and operations; and
- inspection of documents and records.

4.47 Obtaining or updating an understanding of internal control is not a linear process in which one step always follows another. Nevertheless, an approach likely to be efficient is as follows:

- first, complete or update your understanding of the risk assessment process and the control environment;
- second, identify how the entity's information system (part of the information and communication component) supports the entity's significant classes of transactions; and
- third, consider monitoring and control activities as they relate to the financial statements.

4.48 This cumulative level of understanding about the control components provided by these three steps ordinarily is sufficient to plan your work. The following paragraphs explain the three steps in more detail.

Risk assessment and control environment

4.49 Management's process for identifying risks, deciding the level of risks to accept and deciding the internal control mechanisms to put into place to monitor and reduce those risks, ultimately may affect the risk of material misstatements in financial statements.

4.50 Management assesses risks to the achievement of specified objectives within the control environment. Information relevant to the perceived risks is captured and communicated throughout the organization. Control activities are implemented at all levels of the organization to provide reasonable assurance that management's directives are carried out. The entire process is monitored and modified as conditions warrant.

4.51 Whether an entity has a satisfactory control environment depends more on the attitude and actions of management than on anything else. Whether the client is committed to good control requires consideration of many subjective matters and judgment at a high professional level. A satisfactory control environment encourages or supports a systems-based approach.

4.52 If the commitment to good internal control is weak, it is likely that the control environment as a whole is also weak.

4.53 When you obtain an understanding of the risk assessment process and the control environment you are likely to obtain some knowledge about information and communications within the entity as well as those monitoring activities and control activities applied by management, particularly at higher levels of the organization. Moreover, because the control environment is the foundation for the other components of internal control, you are able to modify your initial plans if your findings are significantly different from your expectations.

4.54 In assessing the risk of material misstatement of the financial statements due to fraud, you should inquire of management regarding management's understanding of the risk of fraud in the entity and whether they have knowledge of fraud that has been perpetrated on or within the entity. Examples of matters that might be discussed are whether there are particular subsidiary locations, business segments, types of transactions, account balances or financial statement categories where fraud risk factors exist or may be more likely to exist; and how management may be addressing such risks. If the entity has established a program that includes steps to prevent, deter, and detect fraud, you inquire of those persons overseeing such programs as to whether the program has identified fraud risk factors, m such circumstances, you may consider its effectiveness.

Information and communication

4.55 As a practical approach to obtaining the understanding, a first step is to identify how the entity's information system supports the significant classes of transactions. The second step is to obtain an understanding of the following for the entity's significant classes of transactions:

- how the transactions are initiated;
- how information about the transactions is processed (from initiation of transactions to inclusion in the financial statements) including how the client uses information technology to process data;
- the accounting records, supporting documents and how relevant information is reported in the financial statements.

4.56 In addition to understanding how relevant information for the significant classes of transactions is reported in the financial statements, you are also interested in understanding how the information is communicated to persons within the entity. How the information is communicated and acted upon may be important to the internal control process.

Monitoring and control activities

4.57 You should consider monitoring and control activities in two parts:

- monitoring and control activities at a general level; and
- monitoring and control activities as they apply to specific financial statement objectives.

4.58 Monitoring and control activities at a general level are those activities that are pervasive to many financial statement assertions.

For example, general IT controls contribute to the effectiveness of specific application controls.

4.59 You should consider monitoring and control activities at a general level to:

- help identify the specific activities that management uses to address the risks to the achievement of the entity's objectives;

For example, by understanding management's review of financial reporting and other operating information you may identify activities within this overall review process that may be identified with your work objectives.

- understand the extent to which these activities provide the basis for assessing control risk as low or moderate for.

For example, an internal audit function, of appropriate organizational status, staffed with competent internal auditors and operated to provide an objective viewpoint, may effectively monitor the continued effectiveness of design and operation of control activities for specific audit objectives.

4.60 A systems analysis involves identifying the monitoring and control activities specific to financial statement objectives and considering whether these activities are effective to prevent, or detect and correct, significant misstatements. The most efficient approach to identifying these specific activities is to consider management's perspective. You should work from the presumption that responsible management is likely to respond to significant risks confronting an entity by establishing policies and procedures to monitor and mitigate these risks. Therefore, you ask management, at the appropriate levels of the entity, what monitoring and control activities are established that provide the reasonable assurance that management relies on.

Reporting control deficiencies

4.61 When you obtain or update an understanding of internal control (or at any time during our work), you may become aware of deficiencies in internal control. Among other things, you may find that:

- management fails to recognize some risk of significant misstatements and fails to put effective control activities into place;
- management recognizes the risk of significant misstatements, but the design of the related control activities is ineffective;
- the control activities in place are inefficient or ineffective in operation;
- control activities that might otherwise be effective are undermined by a weak control environment.

Material weaknesses

4.62 You should report to management and the board of directors those material weaknesses that come to your attention. Because of their potential effect, it is usually important to report them promptly.

Other reportable conditions

4.63 You should also report other control deficiencies related to financial reporting that are not as serious as a material weakness but nevertheless may be important. These control deficiencies are reportable conditions, defined as follows:

Significant deficiencies in the design and/or operation of internal control which could adversely affect the entity's ability to record, process, summarize and report financial data consistent with assertions in financial statements.

4.64 You may also become aware of control deficiencies that affect the ability of the entity to attain its operating and compliance objectives. You may report them to management, as appropriate.

4.65 It is often appropriate to report at an interim date before you finish the audit.

How you make preliminary assessments of control risk

4.66 To make preliminary assessments of control risk, you should consider the components of internal control individually and together. These assessments are made for each financial statement assertion when you have obtained or updated our understanding of internal control.

4.67 You should make preliminary assessments of control risk as low or moderate if, based on your understanding, the internal control process appears to be effective for the financial statement assertions addressed by those audit objectives.

Preparing the Control Overview Document and other documentation

4.68 You should document your understanding of internal control as it relates to the reliability of the financial statements management will attest to. Minimum documentation includes the following:

- Control Overview Document;
- your understanding of how the entity's significant classes of transactions are initiated, processed and reported in the financial;
- preliminary assessments of control risk as moderate or low;
- the specific activities in the internal control process that are the basis for such preliminary assessments of control risk as moderate or low;
- planned tests of controls for the specific activities that are the basis for preliminary assessments of control risk as moderate or low.

4.69 The extent of documentation is influenced by the entity's size, complexity, and nature of its internal control process. Choice of the form of documentation depends on the availability of client documentation and preferences of our review team.

For example, documentation may combine documentation prepared by the client and by us, and it may include a combination of flowcharts, narratives, questionnaires and decision tables.

The Control Overview Document

4.70 The Control Overview Document summarizes your understanding of the components of internal control at an overview level. This summary addresses the components of internal control as they apply broadly to the financial statements. Internal control activities at this level generally have a pervasive effect over many of your review objectives rather than being specific to one or a few of them.

4.71 Your understanding of the components of internal control, as summarized in the Control Overview Document, affects the way you approach your work. Weaknesses increase your professional skepticism for some or all financial statement assertions. Your professional skepticism also increases with respect to valuation and presentation issues and other management judgment matters.

4.72 The Control Overview Document includes summaries of the components of internal control together with notes about weaknesses, suggestions for improvement or other observations. For each component, and overall, you should consider whether our understanding increases your professional skepticism and, therefore, affects your approach to the review.

4.73 The Control Overview Document includes the following:

- **the client's risk assessment process**. A description of the client's risk assessment process together with suggestions for improvement or other observations you may have.

  Consider:
  - the entity's process for identification of risks
  - the entity's identification of risks to achievement of entity-wide objectives
  - the entity's identification of risks to achievement of activity-level objectives
  - the entity's process for managing change.

- **the control environment.** A description of the control environment and a judgment of whether it appears satisfactorily supportive of preliminary assessments of control risk as low or moderate for the financial statement assertions. If the control environment is unsatisfactory, the risk of significant misstatements may be high for many financial statement assertions.

Consider:

- integrity and ethical values
- commitment to competence
- activities of the board of directors or audit committee
- management's philosophy and operating style
- the entity's organizational structure
- assignment of authority and responsibility
- human resource policies and practices.

4.74 The information and communication systems. A description of the information and communication systems together with observations you may have on their adequacy for internal and external financial reporting.

Consider:

- the adequacy, timeliness and level of detail of reports to management
- the extent to which systems are linked to strategic plans of the entity
- channels of communication within the entity and with outsiders such as customers, suppliers and regulators.

- **the monitoring and control activities:**

A description of management's review of financial reporting and other operating information and a judgment of the extent to which these reviews may contribute to preliminary assessments of control risk as low or moderate.

Consider:

- management reviews of performance compared to budgets, forecasts, prior periods and data about competitors
- tracking of major initiatives
- reviews of performance reports by managers running the appropriate function
- reconciling or integrating operating reports with the financial reporting system.

A description of general IT controls and a judgment of the extent to which general IT controls may contribute to preliminary assessments of control risk as low or moderate.

Consider:

- application systems development and maintenance
- access controls
- computer operations

- system software acquisition and maintenance.

A description of the internal audit function and a judgment of the extent to which internal audit may contribute to preliminary assessments of control risk as low or moderate.

Consider:
- internal audit in the organizational structure
- direction from management
- internal audit plan for the current year
- access to records and any restrictions on internal audit's work
- application of professional standards.

4.75 When preparing the Control Overview Document, you should also consider the following:

- the client's risk assessment process:
  - the entity's understanding of the risk of fraud.
- the control environment:
  - fraud prevention and detection
  - information risk management.
- the monitoring and control activities:
  - specific controls that mitigate the risk of material misstatement of the financial statements due to fraud.
  - the physical controls over assets, including adequate safeguards, such as secured facilities; access authorization; and periodic counting of assets and comparison with amounts shown on control records (the extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation depends on the circumstances such as when assets are highly susceptible to misappropriation).

5 – Tests of Controls

Introduction

5.1 This section provides guidance on:

- what tests of controls are;
- performing tests of controls; and
- considering the implications of our findings.

5.2 This section is derived principally from the following:

- U.S. SAS included in Volume I of the AICPA Professional Standards, AU 319, "Consideration of Internal Control in a Financial Statement Audit";

- ISA included in Volume II of the AICPA Professional Standards, AU 8006, "Risk Assessment and Internal Control."

What tests of controls are

5.3 When you plan your approach for testing one or more financial statement assertions, you should identify activities in the components of the internal control process that you judge to be effective in preventing, or detecting and correcting, significant misstatements. The identified activities are the basis for preliminary assessments of control risk as low or moderate for these financial statement assertions and the basis for modifying the nature, timing and/or extent of your procedures.

5.4 You should obtain evidence about the preliminary assessments of control risk by performing tests of controls. *Tests of controls* represent the application of procedures to obtain evidence about the effectiveness of design and operation of those activities, within the framework of the internal control process that are the basis for one or more financial statement assertions.

5.5 Tests of controls usually consist of some combination of inquiry, observation and inspection of documents but may also involve other techniques. The purpose of tests of controls is to obtain evidence about:

- design of specific activities in the internal control process;

Is design suitable to prevent, or detect and correct, significant misstatements?

- operation of specific activities in the internal control process.

Are the activities applied as designed? Evidence about effective operation relates to how activities in the internal control process are applied, the consistency with which they are applied and by whom they are applied.

5.6 Inquiry is an important technique both in understanding internal control and in performing tests of controls to obtain evidence that internal control is effective. You should recognize that inquiry is more than simply asking a person to confirm that they perform specified activities.

For example, inquiry involves:

- considering the knowledge, independence and qualifications of the individual to be interviewed;
- asking clear, concise and open questions. Open questions promote complete and detailed answers. Closed questions restrict the interviewee's response and are better used when wishing to confirm a point;
- listening actively and effectively. You should encourage information by active listening. Good listeners have a powerful appeal as they encourage people to talk. Effective listening requires an open mind;
- considering the interviewee's response and asking follow-up questions. This requires an attitude of professional skepticism. You should not accept

important answers at face value, similarly you should not reject out of hand answers. If the interviewee provides a seemingly inappropriate answer or misunderstands the point, you should follow with another question;

- concluding with a short summary of our understanding of the facts. This allows the interviewee to confirm our understanding.

5.7 *Re-performance* is a term often used to refer to a test of controls involving performing an activity a second time to ascertain that the employees assigned the responsibility to do so correctly performed the activity. Re-performance ordinarily consists of a combination of computation, comparison, inquiry, inspection and observation.

Performing tests of controls

5.8 Sufficient appropriate evidence about the effectiveness of internal control depends on the nature, timing and extent of our tests of controls.

5.9 Some control activities within the internal control process that are the basis for our final assessment of control risk as moderate or low do not change, or change very little, from one year to the next.

For example, automated control activities continue to operate consistently until the procedures are changed. You may test control activities for systems development in the period that management implements a system. In subsequent periods, you may focus on control activities relating to security and maintenance of the system.

5.10 You need assurance about the effectiveness of design and operation of internal control for each financial statement assertion. Within this constraint, you may choose to vary the nature, timing and extent of procedures applied as tests of controls.

For example, you may vary the combinations of procedures such as inquiry, observation and inspection. You may vary the dates you perform tests of controls prior to year-end. When an entity has many locations subject to the same control activities, you may often vary the locations selected for tests of controls.

Nature

5.11 The choice of procedures is influenced by the type of activity you are testing.

For example, for IT-based systems, internal control places more emphasis on general IT controls, exception reports and other monitoring activities. Tests of controls tend to involve inquiry, observation and inspection techniques.

For example, if internal control is based on control activities such as segregation of duties, re-performance of procedures by a second individual and reconciliations, tests of controls tend to involve inspection of documents and re-performance techniques.

5.12 A single procedure may not be effective.

For example:

- individuals being interviewed may provide the answers they think you want to hear rather than telling you what really happens. You may unconsciously lead the interviewee and elicit answers you expect, but that may not be correct.
- observation provides direct evidence about the observed activity only at the time of observation. In extending conclusions to time periods when the activity is not observed, you need to be aware of the possibility that the activities may not be performed or be performed with less care when you are not present.
- inspecting documents that indicate performance (by initials or signatures) does not always mean that performance actually occurred.
- the fact that you find no errors when re-performing a control activity is not conclusive if the items you test do not contain misstatements.

5.13 A combination of procedures overcomes some of the limitations of individual procedures and usually provides more persuasive evidence than one type of procedure alone.

For example, you may combine inspection of exception reports with inquiries of the person responsible for follow-up of exceptions. The inquiry provides you with information not available from the inspection of documents alone, such as impressions of the individual's skill, knowledge, judgment and motivation.

Timing

5.14 Your understanding of internal control is cumulative and is based on information obtained both in the current and prior years. Also, when making your assessments of the effectiveness of the design and operation of activities in the internal control process, you consider the evidence obtained in both the current and prior years. You build on this cumulative knowledge each year by:

- developing the overall approach to internal control;
- enhancing our understanding of internal control during planning; and
- obtaining evidence by performing tests of controls.

5.15 The factors you consider in determining the nature, timing and extent of procedures are:

- changes to the information system;
  If the information system is altered it is likely that the specific control activities also change.
- the importance of the financial statement assertions;
  The more important the financial statement assertion; the more persuasive the evidence needs to be.

- our consideration of the control environment;
  You should consider whether the control environment continues to support the effective design and operation of relevant control and monitoring activities.
- monitoring activities;
  Effective monitoring activities may provide reasonable assurance that control activities continue to be effective.

Extent

5.16 The extent of tests of controls is a matter of professional judgment. When making this judgment you should consider:

- the importance of the relevant activity to our assessment of the effectiveness of internal control for the financial statement assertion.

Considering the implications of our findings

5.17 For each of the activities that you test, you should document:

- the nature, timing and extent of the tests of controls; and
- your findings.

5.18 Our findings from the tests of controls support our preliminary assessment that internal control is effective as to design and operation.

5.19 When performing tests of controls, you may identify conditions that suggest the activities may not be designed and operating as effectively as you first thought. If so, you should investigate the nature and cause of the condition. After discussions with appropriate client staff, you may sometimes identify other activities that operate to provide the same assurance. After testing the other activities, you may be able to conclude that the preliminary assessment of the effectiveness of internal control is appropriate for specific financial statement assertions.

6 – The Hunter Stevens Process

6.1 Organize Team

- Determine the approach, scope, timing and resources needed to address certification and other disclosure requirements.
- Establish a disclosure committee. This committee should be responsible for establishing and supervising a company's entire disclosure process. Such a committee would:
  - Have overall responsibility for developing communication and action

plans and ensuring that the plans are carried out in a manner that will achieve the desired objectives.
    - Report to the CEO and CFO.
    - Include the controller, chief risk officer, and heads of compliance and/or legal, investor relations, operations, and individual business units.
- Establish a Sarbanes-Oxley project team with defined roles and responsibilities. This team should:
    - Report to the disclosure committee.
    - Include representation from the operations, finance, and compliance areas for all business and operating units.
    - Include dedicated project management resources.

6.2 Obtain or Update Understanding of Internal Control

- The Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework and U.S. auditing standards define "internal control" as a process – effected by an organization's board of directors, management, and other personnel – that provides reasonable assurance regarding achievement of objectives in the following categories:
    - **Effective and efficient operations.** Addresses a company's basic business objectives, including performance and profitability goals and the safeguarding of resources.
    - **Reliable financial reporting.** Covers the preparation of reliable financial statements and other financial information.
    - **Compliance with applicable laws and regulations.** Covers laws and regulations to which a company is subject, such as Sarbanes-Oxley and related rules, to avoid damage to a company's reputation or other negative consequences.
- COSO identifies five components of internal control that need to be in place and integrated to achieve these objectives:
    - **Control Environment.** Establishes the foundation for an internal control system by providing discipline and structure.
    - **Risk Assessment.** Involves the identification and analysis by management of relevant risks to achieving predetermined objectives, forming a basis for determining how those risks should be managed.
    - **Control Activities.** Refers to the policies and procedures to ensure that management objectives are achieved and risk mitigation strategies are carried out.
    - **Information and Communication.** Supports all other control components by communicating control responsibilities to employees and providing information in a form and time frame that enable all personnel to carry out their respective duties.
    - **Monitoring**. Covers the oversight of internal controls by management or other parties outside the process; or the application of independent methodologies, such as customized procedures or standard checklists, by employees within a process.

6.3 Document System of Internal Control and Procedures for Financial Reporting

Obtain an Understanding

- Identify the process of accumulating information reported to the SEC.
- Consider the potential types of significant misstatements that may occur as a result of routine transactions, nonroutine transactions and the use of estimates.
- Consider other factors that may affect the risk of significant misstatements.
- Identify and record the system of internal control over financial reporting, operations and compliance.

6.4 Perform Detailed Testing

Test Understanding

- Evaluate and test design of the existing control environment.
- Determine whether existing internal controls are functioning as designed.
- Determine whether transactions have been properly authorized, assets are safeguarded, and the appropriate segregation of duties exists.
- Assess whether or not the system of internal control reduces to a relatively low level the likelihood that material errors or irregularities might exist but go undetected.

6.5 Assess Effectiveness and Establish On-Going Monitoring System

- Identify matters for improvement.

- Establish monitoring system to provide for on-going, quarterly and annual assessments.

- Conclude whether internal control and procedures for financial reporting provide reasonable assurance that:

  - The company's transactions are properly authorized;
  - The company's assets are safeguarded against unauthorized or improper use; and
  - The company's transactions are properly recorded and reported so that the registrant's financial statements conform with generally accepted accounting principles.

7 – Hunter Stevens can assist in the following areas:

- Project Management.
- Documentation and Testing of Internal Control.
- Assessment of Financial Reporting Process.
- Design of Monitoring Systems for On-Going Assessments.
- Recommendations for Improvement.
- Education.

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