SOX 404 IT GUIDELINES FOR THE EVALUATION OF INTERNAL FINANCIAL CONTROLS

Background

In today's information technology audit and compliance sub-industry, it is both widely and incorrectly assumed that "Big Four" external auditing companies will always have their SOX 404 IT key audit controls ready and waiting when the 404 Internal Audit Consultant shows up at the client site for the first orientation meeting. In reality, this not the case in more than 60% of the SOX IT Audit projects that have been tracked over the past 2 years.

It is for this reason, and based on my 4 years experience (which is as much SOX 404 IT background as anyone else in the entire industry) and my certifications that I have written this white paper as guide to assist in the development of "failsafe" internal business process testing structures that will facilitate the initiation of a successful SOX 404 IT Audit.

I. Examine the individual Business Processes that are significant to the company's financial reporting and secure external auditor concurrence.

a. Start by identifying the significant accounts or group of accounts at the financial applications level cross-referenced by the most recent certified financial statements. An account or group of accounts is significant if it could contain errors that either individually or collectively would have a material impact on the financial statements of the organization.

b. An account or group of accounts is also significant if other matters such as illegal acts, conflicts of interest and unauthorized management prerequisites could, even if they are not financially impacting or material, adversely affect the company's reputation and/or its relationships with customers, stockholders or the public in general if such matters remain undetected.

c. Other factors that should be considered in assessing the significance of an account include:

1. The size and composition of an account
2. Its perceived susceptibility to manipulation or loss
3. The nature or type of account,
4. The volume of activity;
5. The size, complexity and homogeneity of the individual transactions processed through the account and
6. The relative amount of subjectivity in determining the account balance (i.e., the extent to which the account may be affected by judgments rather than strict accounting principals.) For example, management and execution of delinquent accounts receivable.

II. Identify and Evaluate the Major Classes of Transactions

a. Major classes of transactions include all classes of transactions that materially affect significant accounts or groups of accounts, either directly through entries to the general ledger or indirectly through the creation of rights or obligations that may not be recorded in the general ledger.

b. The identification of major classes of transactions forms the link between significant accounts or groups of accounts and the understanding and evaluation of the supporting processes and related controls for those accounting processes. Those processes, whether accounting-oriented or business-oriented, either generate or encompass classes of transactions that can be classified as routine, non-routine, or estimation transactions. It is important to identify and distinguish between the major classes of transactions because there are differences in the components and risks related to each classification as well as the likelihood of errors of importance arising from each class.

i. Routine Transactions – frequently recurring financial data transactions that are recorded in the accounting books and records. They can also be non-financial data transactions that are used to monitor and manage the business. For example, a business unit may have the following business processes that generate routine transactions:

1. Sales and Accounts Receivable
2. Cash Receipts
3. Purchasing and Accounts Payable
4. Cash disbursements
5. Payroll
6. Inventories and Cost of Goods Sold

Some companies will use more than one process for similar transactions. For example, there may be separate accounts receivable processes for domestic sales and export sales and payroll may have separate accounts payable processes for salaried and hourly employees.

ii. Non-routine Transactions – Any major class of transactions that does not easily qualify as Routine Transactions or Estimation Transactions. This class of transactions are usually applied only periodically and are most often generated in conjunction with the preparation of financial statements. Typical Non-routine Transactions include:

1. Calculating Income Tax Expense
2. Determining accruals for goods and services received but not yet invoiced;
3. Counting and pricing Inventory and
4. Determining and calculating Prepaid Expenses

iii. Estimation Transactions – Any transactions that reflect the numerous decisions, judgments and choices that must be made in the preparation of the financial statements. These kind of transactions are required when the measurement of the valuation of some accounts or some of the dollar amounts to be allocated to those accounts is uncertain because they are dependent upon the outcome of some future events. They are also required when the relevant financial data concerning events that have already occurred cannot be accurately accumulated or calculated on both a timely and a cost-effective basis. Estimated Transactions usually include:

1. Estimating the allowance for obsolete inventory or
2. Estimating the allowance for excess inventory
3. Determining the allowance for bad debt reserves within the GAAP range;
4. Estimating the amount to be reserved against loan losses and

5. Determining the amount to be allocated for warranty reserves.

In distinguishing between the major classes of transactions, it is important to note that Routine Transactions are generally subjected to a more formalized and detailed system of controls because of the sheer volumes of the information being processed and the objectivity of this class of data that must be maintained to ensure accurate accumulations and reporting.

Conversely, because Non-routine and Estimation Transactions are more subjective (estimated) and performed less often, controls over these classes of transactions are less formal. This means that the risk of errors occurring with these transaction classes is also greater than with Routine Transactions.