

 **ERNST & YOUNG**  
*Quality In Everything We Do*

# Internal Control over Financial Reporting



**INTEGRITY**  
**CONSISTENCY**

**EAGLE**  
North Carolina  
Office of the State Controller

*Enhancing Accountability in Government through Leadership and Education*

# Agenda

- Introduction to Ernst & Young
- What Happened and Why Invest in a Better Internal Control System
- What is Internal Control
- Approach: Top-Down, Risk-Based Methodology
- Phased Roll-Out: Steps and Timing of EAGLE
- Next Steps – A Balanced Approach
- Appendix



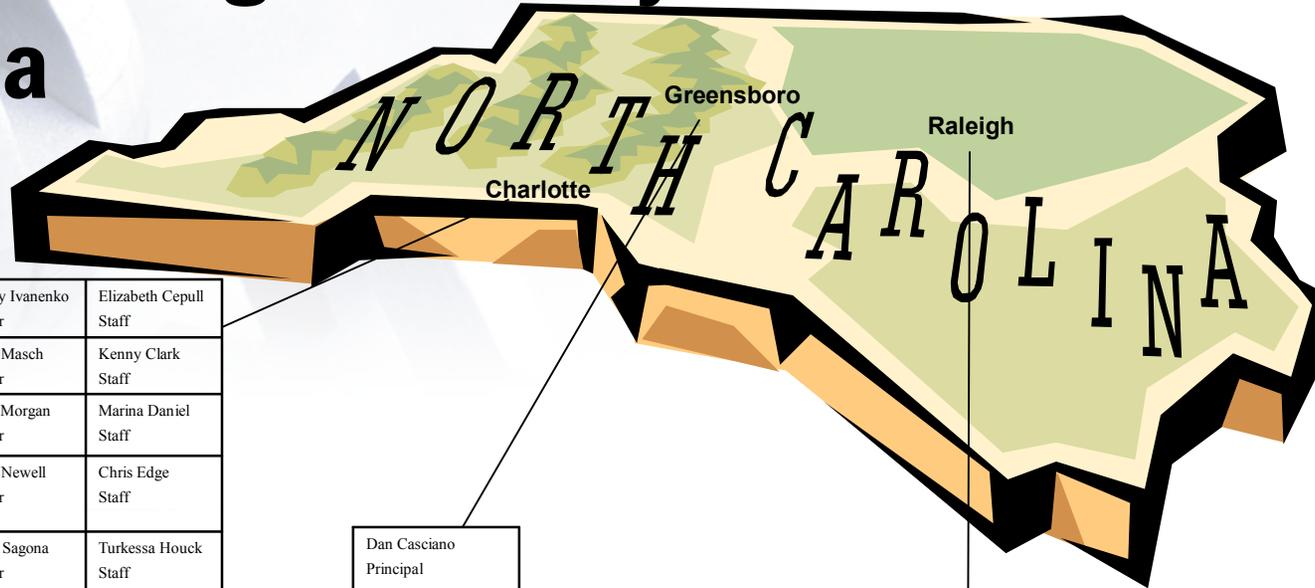
# Introduction to Ernst & Young

# Introduction to Ernst & Young

- **Our Raleigh Practice**
- **Internal Controls Experience**
  - Implementing Internal Controls Over Financial Reporting under SOX 404
  - Process Improvements; Driving Effectiveness and Efficiency – Success Stories
  - Training – We have led Internal Control Training and Technical Accounting Seminars with more than 10 companies in the Triangle
- **Core E&Y Team**

**We look forward to supporting the OSC with the EAGLE Program and are excited about the opportunity to work with the State of North Carolina!**

# Ernst & Young's Advisory Practice in North Carolina



Frank Faist Principal	Jenny Ponstein Manager	Sergey Ivanenko Senior	Elizabeth Cepull Staff
Larry Herlong Partner	Paul Price Manager	Brian Masch Senior	Kenny Clark Staff
Paul Stein Partner	George Snyder Manager	Chris Morgan Senior	Marina Daniel Staff
Jon Billington Partner	Catherine Wallace Manager	Anna Newell Senior	Chris Edge Staff
Tony Blackman Senior Manager	Ukachi Asogu Senior	Andy Sagona Senior	Turkessa Houck Staff
Kimberly Buck Senior Manager	Leah Battiste Senior	Patrick Simmons Senior	Robert Markham Staff
AJ Desai Senior Manager	Aaron Cornelison Senior	Mark Stille Senior	Gaurav Mithani Staff
Steve Stillitano Senior Manager	R.J. Crane Senior	Tarly Talatala Senior	Bryce Ressler Staff
Mike Walters Senior Manager	Dhaval Gandhi Senior	Andy Allen Staff	Heather Smith Staff
Suzy Allen Manager	Stephanie Gordon Senior	Brandon Bailey Staff	Zach Taylor Staff
Alex Crenshaw Manager	Sharad Gupta Senior	Dwayne Baker Staff	Greg Topolski Staff
Dillon Dieffenbach Manager	Chris Haskins Senior	Trisha Bolton Staff	

Dan Casciano Principal
Rick Wimmer Partner
Jenya Comfort Senior
Stephanie Moore Senior
Brian Stowe Senior
John Alexander Staff
Francis Chan Staff
Vickie Papapetrou Staff

Keith Feuz Partner	Christopher DeVito Manager	Matt Anderson Senior	Matt Sulkey Senior	Jay Overcash Staff
Bob Thorburn Partner	Ashlie Holt Manager	Kenan Barnes Senior	Julie Tingen Senior	Nathan Reynolds Staff
Grant Blachly Senior Manager	Sandi McDowell Manager	Whitney Freeman Senior	Steve Weintraub Senior	Hunter Rooker Staff
Karen Gring Senior Manager	Tim Penrose Manager	Ryan Lenz Senior	Ranim Abou-Chacra Staff	Alison Scalvini Staff
Bryan Petrequin Senior Manager	Katie Schottmiller Manager	Ronnie Moshkowitz Senior	Elizabeth Bernisderfer Staff	Erika Scholl Staff
Timur Uckun Senior Manager	Michael Stanziale Manager	Rebecca Short Senior	Katherine Bisogno Staff	Wade Sutton Staff
Swati Amin Manager	Lisa Wurtzbacher Manager	Aisha Sims Senior	Brian Coleman Staff	Michael Vollmer Staff



**What Happened  
and**

**Why Invest in a Better Internal Control  
System**

# What Happened?

WorldCom

Enron

Arthur Andersen

Martha Stewart

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# Why are Internal Controls on the Radar Screen in the Government and Not-for-Profit Sectors

- Inquiries by stakeholders including the Federal Government, Compliance and Internal Audit function and bond rating agencies (North Carolina currently has a AAA Bond Rating)
- Enhanced Public Accountability to Key Stakeholders – Taxpayers of the State of North Carolina
- Competitive advantage of some for-profits for federal dollar and foundations
- GAO's comments and belief that government should be as good or better as those it regulates
- Office of Management and Budget Circular A-123 on Management's Responsibility for Internal Control
- Office of Management and Budget Circular A-133 on Audits of Institutions of Higher Education and Other Non-Profit Organizations
- Agencies and Component Units with Board Members who recognize the importance of Sarbanes-Oxley in the public sector

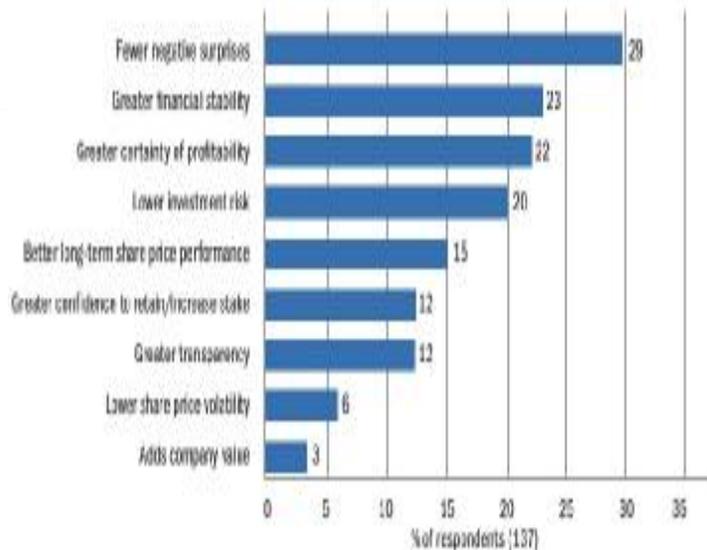
# GAO View of Sarbanes-Oxley

- **GAO strongly supports Strong Internal Controls**
  - At the same time efficiencies can be gained in the process through
    - Streamlining
    - Better integration of the State Auditors' audit plans and the internal control audit
    - Adopting a risk-based approach using reasoned risk and experienced based State Agency's judgments in areas such as rotation of testing and additional flexibility in using the work of others
    - Use of common sense strategies in large and small environments

# What are the Organizational Advantages?

## Benefits for stakeholders:

- Recent surveys now point to the value the financial markets and investment analysts ascribe to those companies that can demonstrate good risk management.



Q: What do you see as the key benefits - for investors - of a company having a focused and reliable approach to risk management?

## Benefits for the organization:

- **Avoid Surprises**
  - A routine “baked in” process to identify and manage potential issues before they become serious business problems
- **Better Governance**
  - Clear risk roles and responsibilities
  - Clear risk communication and language
  - Clear risk reporting and escalation
- **Better Decision Making**
  - Considering the business impact of a broader range of scenarios and “what ifs” improves the quality of decisions
- **Efficiencies**
  - More effective risk functions
  - Better coordination between them
  - Less overlap in risk coverage
  - Fewer gaps in risk coverage

# Good Corporate Governance Creates Value

## GOOD BEHAVIOR

Companies ranked highly for corporate governance outperformed businesses with weak governance during the past three years. A study of stock returns of 1,600 major global firms by GovernanceMetrics International shows that corporations with bad governance cost investors money.

GOVERNANCE RATING	STOCK PERFORMANCE*
Well above average	+5.37%
Above average	+1.7%
Average	-0.18%
Below average	-6.23%
Well below average	-13.27%
Global universe average	-1.76%

\*Annualized return figures for the three-year period ended Aug. 12.

- Corporate governance has been linked to financial performance:
  - Over three years, the global companies with the worst governance rating lost an average of 13% a year compared with a loss of 1.8% for all companies
- Good governance is a long-term investment

Source: Ken Brown, "Weak Boardrooms and Weak Stocks Go Hand-in-Hand," The Wall Street Journal, 9 September 2003.



# What is Internal Control

# What is Internal Control?

**Definition - Internal control is a process, effected by an entity's governing body, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories (four levels of COSO):**

## Four Levels of COSO

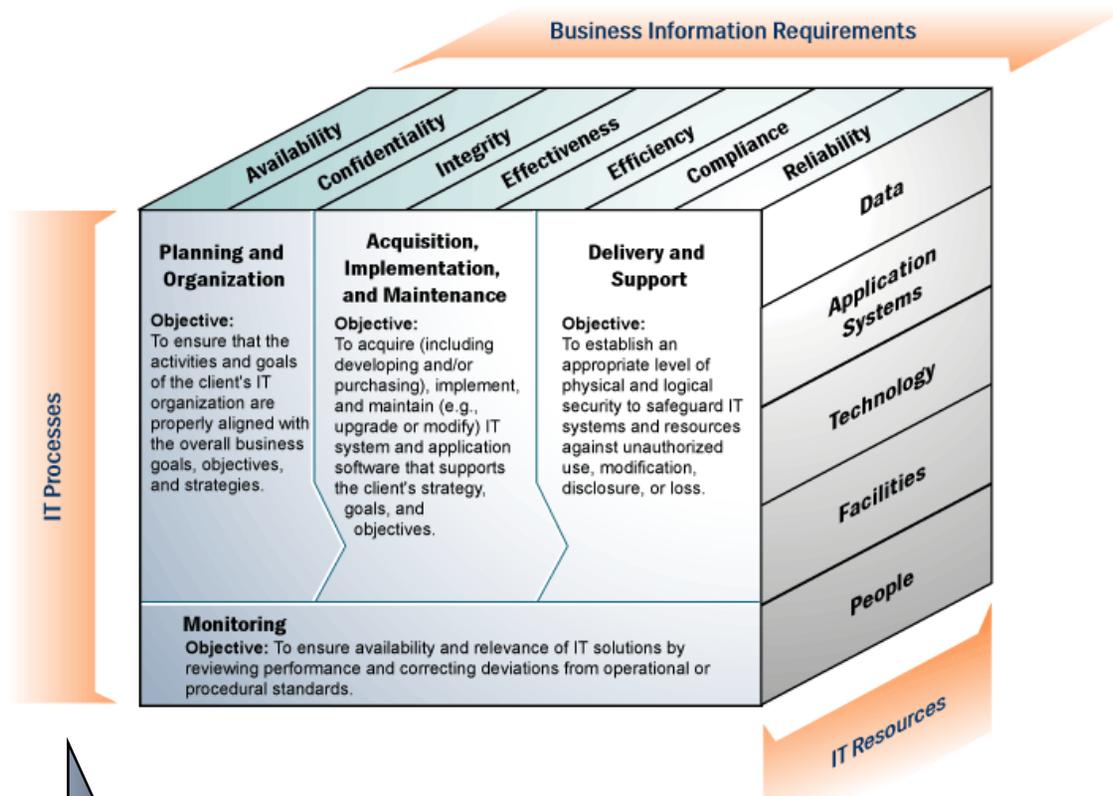
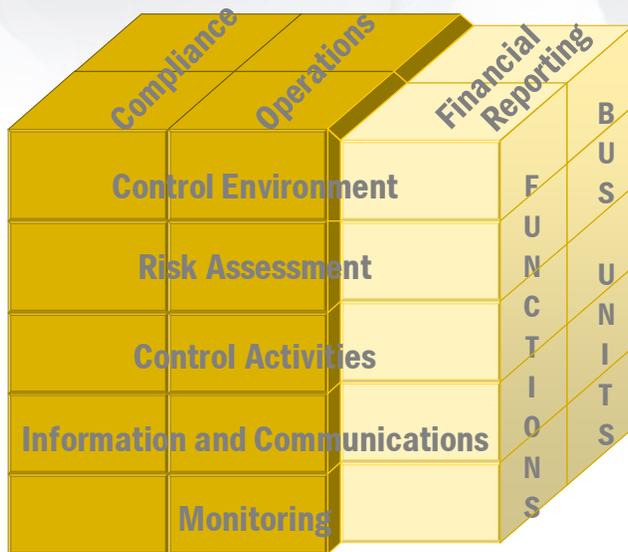
- Alignment of high-level goals with overall mission and supporting strategy
- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Achievement of those objectives requires competency in all five layers of COSO's Framework :

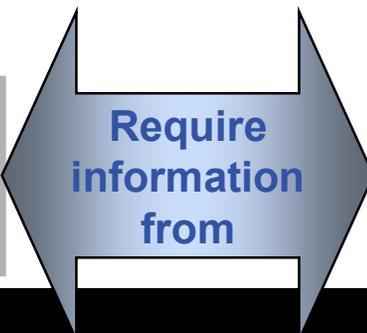
- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

# Relevant Frameworks Chosen by the State of North Carolina

## IT (CoBIT) Framework aligns with COSO Internal Controls Framework



**Enterprise Activities**

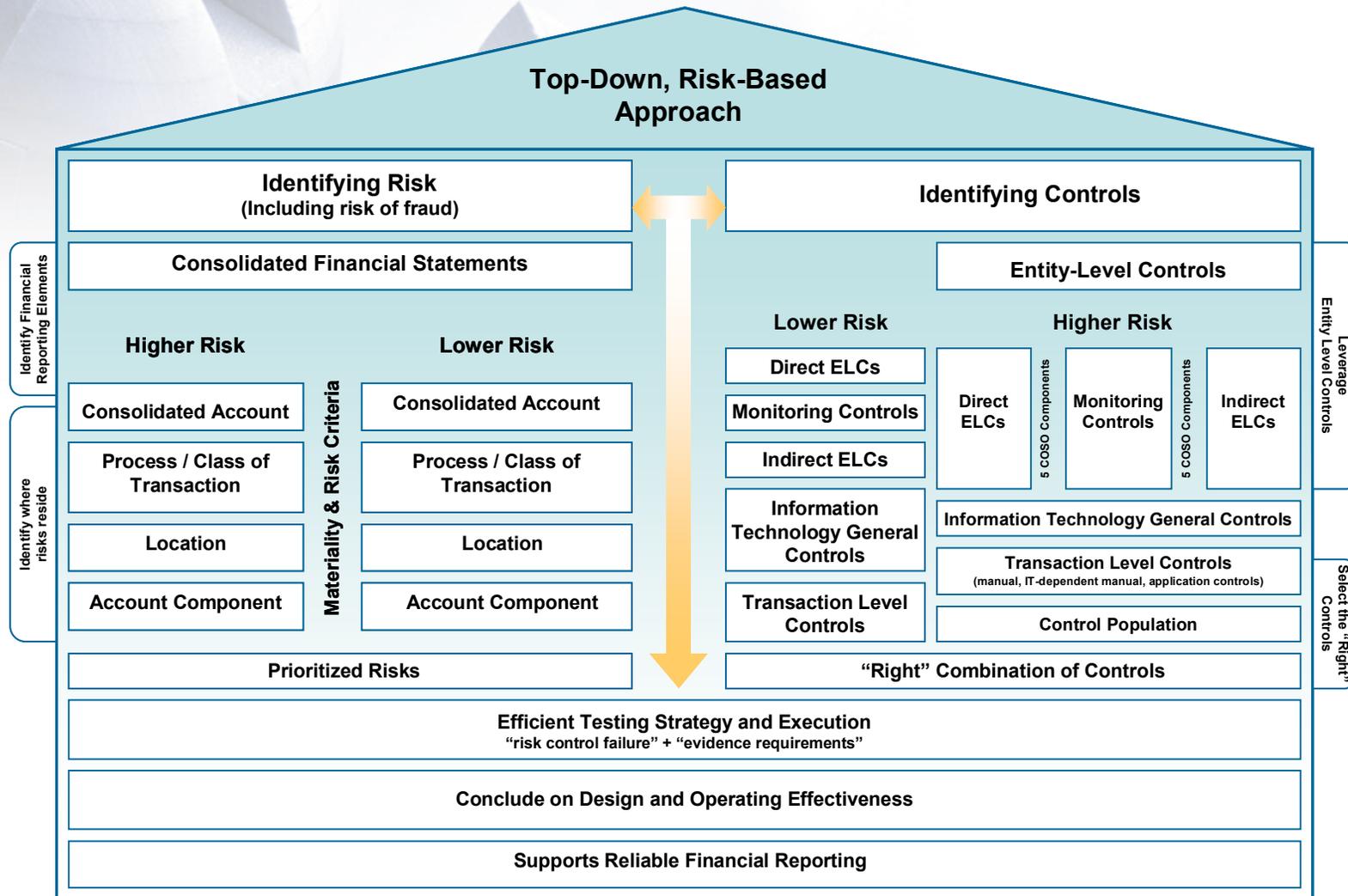


**Information Technology Activities**

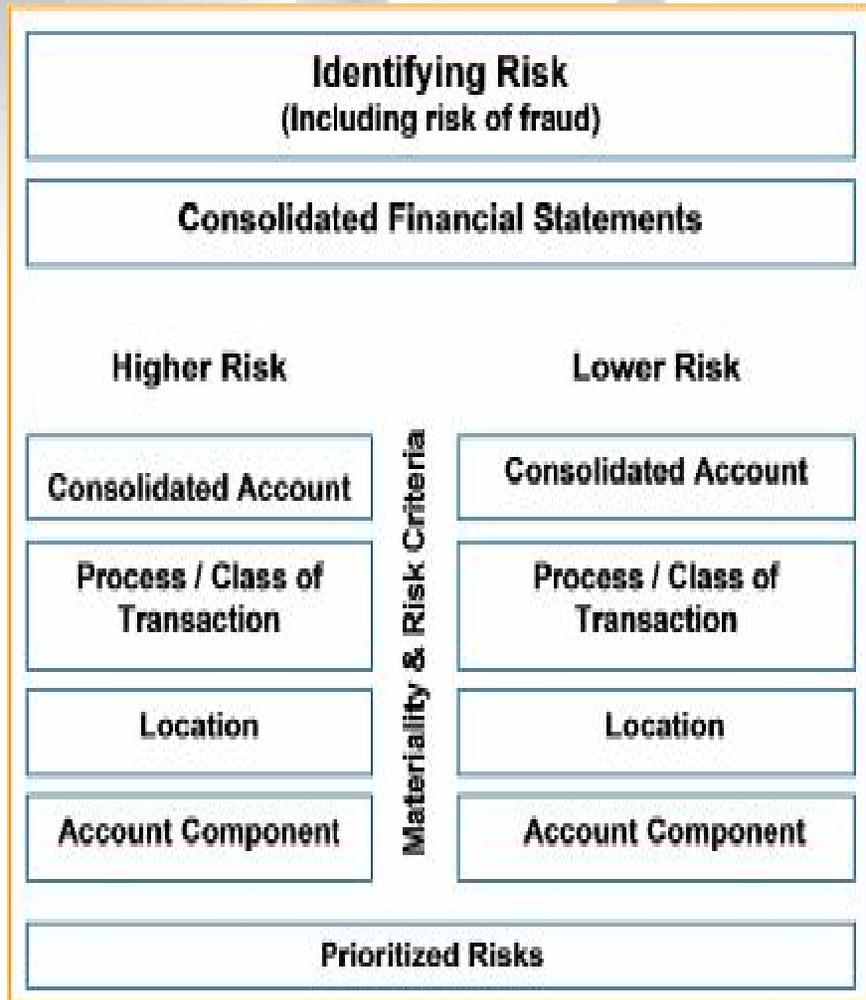


**Approach:**  
**Top-Down, Risk-Based  
Methodology**

# Top-Down, Risk-Based Approach – Overview



# Top-Down, Risk-Based Approach: Risk Assessment



- In a top-down approach, the State Agency begins by identifying, understanding, and evaluating the risk at a financial statement level.
- At the financial statement and process level, the State Agency will identify those accounts and processes that possess the quantitative (i.e. Materiality) and qualitative factors for higher or lower risk to determine the final scope.

## Advantages of a Top-Down, Risk-Based Approach:

By using a Top-Down, Risk-Based Approach, the State Agency will focus the majority of the internal control efforts on those highest risk areas and avoid performing excess work on the lowest risk areas.

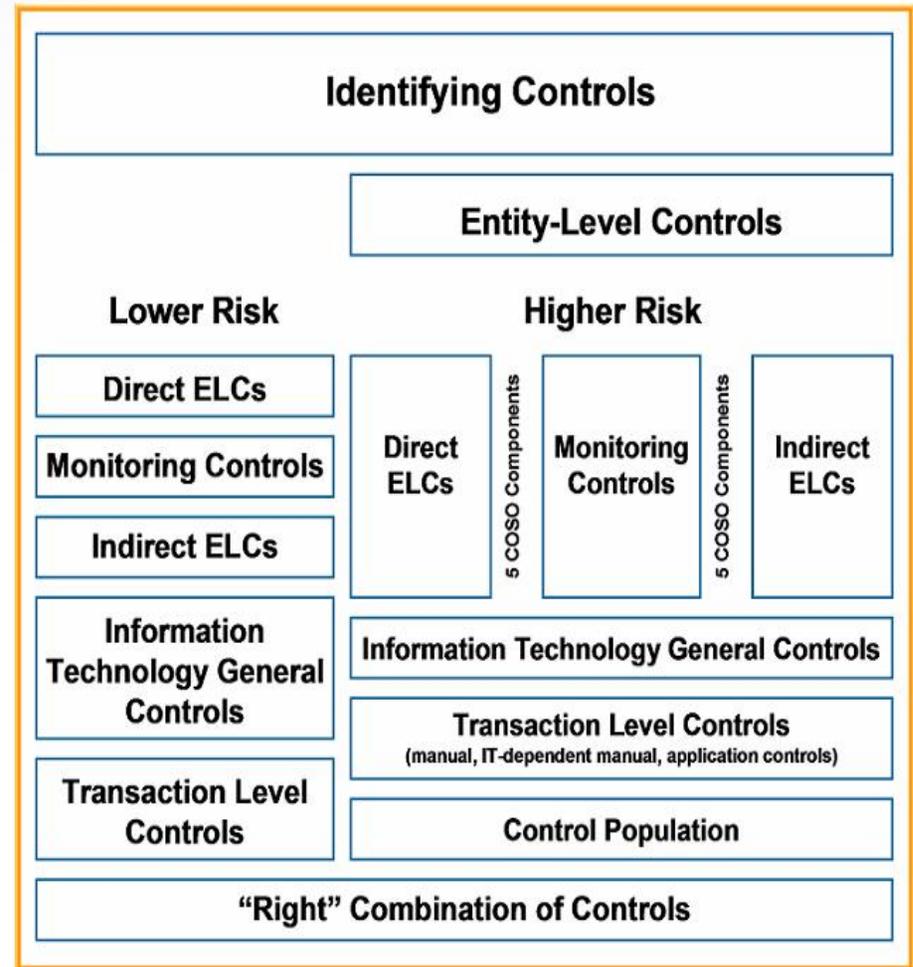
# Top-Down, Risk-Based Approach: Design Effectiveness - Controls Identification

- After the State Agency has completed the risk assessment and identified those processes in scope, the flow of transactions will be documented to gain an understanding of the highest risks in those processes.
- For those risks that exist in the transaction processing, the State Agency will identify those internal controls that would either prevent or detect an error from occurring.

## Advantages of a Top-Down, Risk-Based Approach:

By using a Top-Down, Risk-Based Approach, the State Agency will focus the internal control efforts to identifying those controls over the highest risk processes.

In applying this approach at another client, E&Y was able to reduce the overall number of controls from nearly 900 to approximately 250, allowing the Company to focus their efforts on those areas that posed the highest risks.



# A Word On Entity-Level Controls

- Entity-level controls have traditionally been undervalued but their importance is critical to an effective control environment as it sets the overall “TONE” of control consciousness throughout the State of North Carolina
- Entity-level controls can provide additional coverage to the Agencies and many of the controls are traditionally in place

Tone and the Top	Financial Statement Close	Internal Audit	Fraud Prevention
<ul style="list-style-type: none"> <li>•Policies &amp; Procedures</li> <li>•Code of conduct</li> <li>•Audit Committee involvement</li> </ul>	<ul style="list-style-type: none"> <li>•Account reconciliations</li> <li>•Flux analysis</li> <li>•Margin analysis</li> </ul>	<ul style="list-style-type: none"> <li>•Rotational audits (audits of low risk areas)</li> <li>•Validation (audits of moderate risk areas)</li> <li>•Annual audit focus (e.g., purchasing, payroll, reimbursement expenses, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>•Segregation of duties</li> <li>•Analytic procedures</li> <li>•Authorization limits</li> </ul>

# Top-Down, Risk-Based Approach: Operating Effectiveness – Execution and Evaluation

- After the State Agency has completed the documentation of the processes and identified the “right” combination of controls, a testing strategy will be designed to focus the efforts on those controls that have been designed to prevent or detect errors of the highest risk processes.

## Advantages of a Top-Down, Risk-Based Approach:

By using a Top-Down, Risk-Based Approach, the State Agency will focus the testing and self-assessment effort to controls that provide the greatest coverage over the highest risk areas. Further, using this risk based approach will allow the agency the ability to better time and schedule the testing over the course of the entire reporting period by testing the lower risk controls earlier in the year and the highest risk controls closer to year-end.

Efficient Testing Strategy and Execution “risk control failure” + “evidence requirements”
Conclude on Design and Operating Effectiveness
Supports Reliable Financial Reporting



# **Phased Roll-Out: Steps and Timing of EAGLE**

# EAGLE Program - Steps and Timeline

## Development of the Guidance Manual, Training Program and Assessment Process

February 22, 2008 through March 15, 2008

- Definitive guide for internal control and the assessment process for use by all State agencies
- Based on top-down, risk-based approach – risks, entity level controls, IT controls, transaction level controls, assessment and evaluation
- Design Effectiveness
  - Process narratives
  - Risk and Control Matrices
  - Flowcharts
- Operating Effectiveness
  - Test grids
  - Issue tracking report templates
- Assessment templates

## Training and Implementation

March 31, 2008 through July 31, 2009

- Statewide CEO and CFO Kick-off Meeting (Feb 2008)
- Agencies to implement approach based on guidance manual, assessment tools, and training
- Select Agencies' assessments complete by July 31, 2008
- Training Session - March 2008
- Training Session – Fall 2008
- Training Session - Spring 2009
- Remaining Agencies' assessments complete by July 31, 2009

# Training Program Session Example

<b>Tentative Time</b>	<b>Module</b>
8:30 – 9:00	Introduction
9:00 – 9:30	Overview of Internal Control over Financial Reporting
9:30 – 10:00	Risk and Control Theory
10:00 – 10:15	<i>Break</i>
10:15 – 11:00	Methodology
	- COSO
	- COBIT
11:00 – 11:30	Introduction to Processes
11:30 – 1:00	<i>Lunch</i>
1:00 – 1:30	Basic Documentation
1:30 – 2:00	Documentation of Processes and Controls
2:00 – 2:45	Testing Theory and Strategy
2:45 – 3:00	<i>Break</i>
3:00 – 3:30	Fraud Concepts
3:30 – 4:00	Assessment
4:00 – 4:15	Questions and Answers
4:15 – 4:30	Conclusion

# Training Timeline

	<u>Date</u>	<u>EY Participants</u>
1. Preparation of Material for CEO/CFO meeting	February 25, 2008	
2. CEO/CFO Kick-Off	February 26, 2008	6
3. Preparation of Guidance Manual	February 22 - March 15, 2008	
4. Preparation of Training Manual	February 22 - March 15, 2008	
5. Train the Trainer	March 2008	10-12
6. Preparation of Assessment Templates	March 2008	
7. Spring 2008 Session (200 - 250 Participants)	March 2008	6 - 8
8. Fall 2008 Session (350 - 400 Participants)	Fall 2008	8 - 10
9. Spring 2009 Session (500 - 600 Participants)	Spring 2009	10-12



# **Next Steps: A Balanced Approach**

# A Balanced Approach

## Keep Us Out of Trouble

Inaccurate Financial Reporting

State Auditor Findings

Larger Fines and Settlements

HIPAA Requirements

Expanded Regulation

Catastrophic Reputational Consequences

Federal and State Budget Constraints

All too confusing and overdone... **Except when we get in trouble**

## Make Our Organization Better

Enhanced and Coordinate Risk Management Activities

Standardizing Contracts Across State Agencies

Improved Risk Reporting and Disclosure

Reduced Total Operating Expenses

Enhanced Technologies

Ability to Deliver Efficient and Cost Effective Services

Must do it...  
**But how do we do it better?**



# Appendix

# Ernst & Young Differentiators

- Our People First culture has earned Ernst & Young:
  - *Fortune* “100 Best Companies to Work For” list for ten years in a row
  - *Working Mother* magazine’s “100 Best Companies for Working Mothers” list for nine years in a row
  - *Training* magazine’s list of top “100 businesses that excel initiatives for its people development” for six years in a row
  - Catalyst Award in 2003
  - Most Admired Knowledge Enterprise (MAKE) Award for nine consecutive years.
- Ernst & Young is a great organization because of our exceptional people. To attract and retain high-caliber people, we need to be an outstanding place to work. Each year, we renew our commitment to helping our people achieve both their professional and personal goals, through an environment that fosters flexibility and provides continual opportunities to develop new skills and knowledge.
- **Tone From the Top**—Ernst & Young’s senior management communicates, regularly enforces the firm’s expectations and the importance of performing quality work and complying with the firm’s policies and procedures. Our internal message has consistently been that no single client is more important than our professional reputation— the firm’s reputation and the reputation of each of our professionals.
- **Office of Quality**—Our firm has created an office of quality led by a senior partner who reports directly to the chairman. Our initiatives include expanded training, increased self-assessments, and an enhanced focus on client acceptance and continuance processes.
- **National Professional Practice Group**—This practice includes regionally based subject matter professionals and other seasoned technical professionals. A senior client service partner is assigned in each business unit to act as a sounding board.
- **Consultative Culture**—Underlying our quality processes is a culture that emphasizes the importance of taking full advantage of experienced professionals when reaching conclusions on challenging accounting matters.

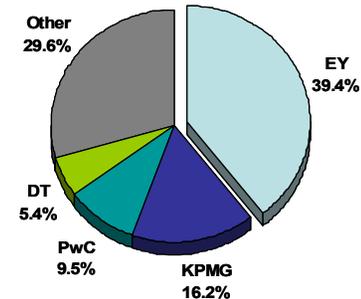
# Ernst & Young's Internal Controls Experience

- Ernst & Young has been at the forefront of understanding the Sarbanes-Oxley Act of 2002 and its implications and has been sharing our point-of-view with clients since August 2002. Our teams utilize a proven methodology, which is top-down and risk-based, that has been proven time-and-time again on the numerous client engagements where we have successfully advised clients on their Section 404 compliance efforts.
- Our experience advising clients on the implementation of Section 404 is second to none. Specific to *Section 404 of the legislation, Ernst & Young has helped more BusinessWeek Global 1200 companies with their Section 404 compliance than any of our competitors.* Through our hands-on experience we have developed structured processes and working templates which have been “road-tested,” through numerous Section 404 engagements.
- As many of our clients have communicated to us, Ernst & Young has been the most responsive and thorough public accounting firm when it comes to providing public companies with guidance and thought leadership around the requirements of Sarbanes-Oxley and best practices on how companies ought to be implementing related compliance programs.
- With the first several years of operating within Sarbanes-Oxley regulations and implementing Section 404 completed, companies are now looking at how to better approach their professional service relationships in this new environment. We have assisted many companies with their initial Section 404 efforts as well as ongoing engagements where we work together with clients to assess how to maintain a sustainable and cost-effective process around Sarbanes-Oxley and Section 404 on a continual basis.

# Market Leadership in Government and Not-for-Profit

- Ernst & Young has one of the largest public sector practices in the profession. Our public sector practice is comprised of professionals who possess the skills that today's government clients need, including auditing, accounting, budgeting methods, systems, and controls.
- Nationally, we serve more than 2,500 public sector and not-for-profit clients. Our professionals have decades of experience with the systems, programs, and issues facing the public sector. Our public sector practice comprises professionals skilled in the auditing, accounting, and budgeting methods, systems, and controls that today's government clients need. Several of our professionals are former policy makers or senior executives or served as department heads within the government sector.
- This group of professionals keeps close tabs on the industry they serve through a variety of professional networks, to make sure that they deliver current, relevant advice to our clients. They also work closely with standard-setting and professional organizations, including the following:
  - Governmental Accounting Standards Board
  - Government Finance Officers' Association (GFOA)
  - National Association of State Auditors, Comptrollers, and Treasurers
  - Council of State Governments
  - Association of Government Accountants
  - Intergovernmental Audit Forum
  - Joint Financial Management Improvement Program

The Ames Research Group's Leading Database  
EY Sector: Gov't, Public Sector & NFP  
% of Sales Audited



Auditors current as of January 2008

- Ernst & Young serves some of the most complex and prestigious public sector organizations in the world. We have conducted audits for one-half of the states having audits of their activities performed by independent auditors. At the federal level, we have performed one or more services for nearly every major agency.