

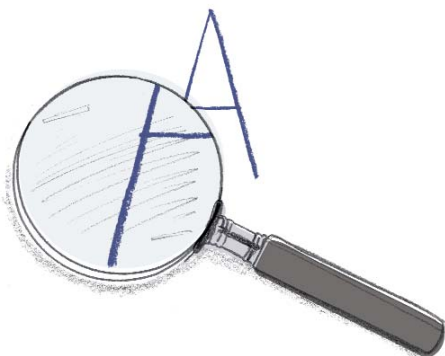
# CorporateGovernor

Providing vision and advice for management, boards of directors and audit committees Vol. 4, No. 4

## Risky business: Strong supervisory and internal controls are the best defense

By Steven Goldberg, principal,  
Business Advisory Services

One need look no further than the recent and much-publicized rogue trading scandal at a major investment bank to see what can happen when supervisory and internal controls fail. Over the course of months, a junior-level trader allegedly managed to make enormous unauthorized trades totaling upward of \$73 billion that ultimately resulted in a loss of \$7.2 billion for the bank. The effects may have even radiated to the markets, creating volatility as the bank tried to unwind the trades.



Although the ultimate story and facts will take many months or years to come to light, early indications and reports indicate the alleged rogue trader was able to bypass controls because he worked in the “back office” and had intimate knowledge of how trades were processed. According to published reports, he worked late to disable controls in the bank’s computer system to hide his massive trades. The trader also used colleagues’ logins and passwords, and employed simple tricks like falsifying emails to thwart his supervisors.

The purpose of having supervisory and internal controls in place is to detect and respond to such actions early. However, a firm must be diligent in its implementation and follow-through of these controls.

Financial institutions should let situations like these serve as the impetus to re-examine their own risk management models and systems and inspire renewed diligence in enforcing internal and supervisory controls. In the United States, legislation is in place to ensure companies

take these protective measures. For the securities industry, the Financial Industry Regulatory Authority (FINRA) requires that the CEO certify that supervisory controls are in place. The Securities and Exchange Commission (SEC) has stated that it will be examining risk management procedures at most broker-dealers.

### Steps toward compliance

The first steps toward confirming that the appropriate internal controls are in place are to complete an assessment and test of risk management procedures and supervisory controls. This process includes:

- Completing annual FINRA testing of supervisory procedures and remediating identified issues.
- Reviewing and documenting internal controls and procedures for managing risk, as required by FINRA and recommended by the SEC.

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# Risky business: Strong supervisory and internal controls are the best defense (continued)

- Assessing market risk relating to trading activities and firm inventory, including value-at-risk models, stress testing and economic models.
- Continuing to maintain current records documenting systems of internal risk management controls as required by regulators.

In addition, broker-dealers should:

- Identify new businesses or new regulations that would impact testing. Has a previously existing business become more important or risky as a result of financial or regulatory changes?
- Identify ineffective or inadequate supervisory procedures that will require remediation.
- Address the New York Stock Exchange's (NYSE) Rule 342, "Offices—Approval, Supervision and Control," internal controls requirements.
- Plan and schedule testing within the various areas.

## Taking responsibility

With so many areas falling under the umbrella of supervisory controls and risk management, it is imperative that specific roles be designated to carry out these tasks. The risk management process begins with senior management. In environments in which there are mounting pressures for staff to perform, the tone must be set from the top that compliance is the main priority, even when there is a decision to be made between supervisory responsibilities and financial gain. Managers and supervisors must understand that they are expected to make the right decision and not put the

firm at risk. In a smaller firm, these roles will often overlap and exemptions may be made for the independent supervisory testing requirements of FINRA 3012. This makes the development of clear written policies and procedures even more vital for those firms.

An independent internal audit function is essential; the SEC has stated that an effective internal audit function is a key element in managing risk within a firm. The internal audit group should be expected to present a thorough risk assessment to the audit committee, which should also provide independent oversight throughout the audit process. The risk assessment should focus on operational risk, regulatory risk and market risk. An operational risk assessment may detect areas of weakness in IT security and internal controls relating to systems access.

Additionally, the chief compliance officer must meet regularly with the CEO to discuss the supervisory control systems, as required by FINRA 3013. The heart of the supervisory control system is the written supervisory procedures (WSPs), which become the basis for the supervisory responsibilities for each business unit within the firm. The WSPs must be updated as business conditions change and should be independently tested as part of the FINRA 3012 and NYSE 342 reporting requirements.

Written supervisory procedures are the guiding force for the firm's behavior when it comes to internal controls, operations, technology and financial areas. The procedures should also address market risk and the use of pricing models. The use of pricing models should be fully documented along with clear limits, lines

of authority and escalation procedures. Any new business should undergo assessment for market- and operations-related risks. Effective surveillance and monitoring is critical — in today's fast electronic markets, automated surveillance systems, electronic alerts, integration with internal trading systems and outside counterparties should be considered.

The level of required supervisory controls can be driven by the importance of a particular business to a firm's revenues. U.S. firms are required to provide a heightened level of scrutiny in cases where a supervisor is responsible for a desk generating a high percentage of the revenue in a particular business area. While the alleged rogue trader was a relatively low-level one, it is reported that he managed to make sizable gains with his risky bets. Institutions should expand their scope to monitor any uncharacteristic spikes in performance.

As evidenced by the case of the major investment bank, risk management has been thrust into the limelight and will not be leaving the stage in the foreseeable future. In this environment, firms must create a culture of compliance, instill supervisory and internal controls, and conduct regular testing and risk assessment. When it comes to risk management, the lesson here is to be proactive. •

# A clearer picture: Proxy disclosures and executive compensation

By Henry Oehmann, director, National Executive Compensation Services

While conversations about salary are typically taboo, executive compensation is anything but hush-hush for investors, shareholders and boards of governance. Companies are increasingly charged with providing more transparency and clearer explanations about how and why executive compensation decisions are made. Upon reviewing the first round of disclosures after the new proxy rules became effective on Nov. 7, 2006, for the 2007 proxy season, the Securities and Exchange Commission (SEC) outlined areas for improvement and encouraged clearer disclosures. However, it can be a daunting task to determine how to best present this complex information in “plain English.” Companies need a compensation philosophy and a process designed to carve through proxy disclosure requirements to ensure compliance.



**A well-defined compensation philosophy serves two purposes: It acts as a roadmap for executive pay decisions and provides support for the CD&A.**

## **Compensation philosophy: The foundation**

The requirement to file proxy disclosures with the SEC raises the stakes for companies. Instead of merely providing an informational disclosure, the act of filing the compensation discussion and analysis (CD&A) with the SEC not only provides shareholders with executive pay information, it also can pose added risks to the company. For instance, if shareholders discover that disclosures about severance pay were inaccurately valued, those filings could be the source of a shareholder lawsuit. Similarly, evidence of non-compliance in the filings could result in hefty SEC fines and other potential enforcement actions.

A well-defined compensation philosophy serves two purposes: It acts as a roadmap for executive pay decisions and provides support for the CD&A. The philosophy means that the board has a plan for how to pay executives and how the pay relates to company performance.

It also articulates the board’s policy on the mix of cash and non-cash forms of compensation, provides clarification on how to manage compensation in the event of a change in control and allows the board to implement policies regarding ownership guidelines, supplemental retirement programs and employment agreements. Without such a philosophy, executive pay could become a series of ad hoc decisions that result in an inconsistent patchwork of programs and plans.

## **How and why?**

The SEC commented that disclosures failed to focus on the “how” and “why” of compensation decisions. To improve clarity, companies need to link their pay decisions to the required tables instead of overemphasizing program mechanics. Companies are also advised to use “plain English” and stay away from technical lingo that would not be easily understood by the average reader.

The CD&A is the vehicle for companies to clearly explain compensation decisions. It is important to note that a well-defined philosophy simplifies preparation of the CD&A. While companies are not required to disclose performance-related factors that involve trade secrets, the CD&A must answer:

- What are the objectives of the company's compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company pay each element?
- How does the company determine the amount (and where applicable, the formula) for each element?
- How does each element and the company's decision regarding that element fit into the company's overall compensation objectives?

### The path to improvement

The basis of the proxy disclosure process is a system of disclosure controls and procedures. Before such a system can be put in place, the relationship between internal controls over financial reporting and controls for disclosures must be understood. For example, internal controls for financial reporting might require that all numbers disclosed are traced back to supporting documentation. Or, a disclosure control checklist might be employed to ensure that all information required by the SEC is appropriately disclosed. These procedures must be clear and applicable. Training should be part of the ongoing process of monitoring compliance.



## A favorable proxy disclosure outcome occurs when you are able to report on a well-organized plan to achieve executive pay objectives.

When building a process, start with the end in mind. A favorable proxy disclosure outcome occurs when you are able to report on a well-organized plan to achieve executive pay objectives. This plan includes:

- Beginning the year with a year-end tally sheet. Preview tally sheets with the compensation committee.
- Confirming the compensation plan objectives and charter at the beginning of the year.
- Setting the compensation committee meeting dates a year in advance.
- Linking meetings to key decisions related to salary adjustments, bonus targets and awards, stock grants and perquisites.
- Conducting peer benchmarking as soon as possible, projecting year-end targets and setting targets accordingly.

Make the process a collective effort. Loop in internal and external experts with management and the compensation committee. From start to finish, the process should be checked and verified by multiple parties. The final document should be tested against the company's driving principles. Then fill in the gaps to ensure a clear and accurate description of the compensation program.

The amount of time and resources required is substantially more than expected. To prepare for next year's proxy, companies should review named executive officers and board members' compensation philosophy to provide the basis for the CD&A. Performance plan opportunities, pay mix and target-setting procedures may need to be reassessed to ensure consistency with the philosophy.

### On the horizon

The new proxy rules will paint a clearer picture of the board's policies and practices regarding executive pay. In fact, the disclosures will shed light on not only the cash and stock-based compensation, it will also illuminate the impact of termination and change-in-control plans that may impact future compensation. It's these more subtle arrangements and programs that most often shock shareholders and the public. To maintain the trust of shareholders and comply with the new rules, a well-defined compensation philosophy pays off. •

# What you need to know: Auditing Standard No. 6 and Section 404 delay

By Jay Brietz, senior manager, National Corporate Governance group

Transparency is the name of the game when it comes to Auditing Standard No. 6 (AS 6). The Public Company Accounting Oversight Board (PCAOB) recently approved AS 6, *Evaluating Consistency of Financial Statements*, and certain other amendments to their interim auditing standards. This standard allows auditors to indicate why a company has restated its financial results, whether because of an error or a change in accounting rules.

For the most part, AS 6 and the amendments are designed to:

- Align the auditor's responsibilities to evaluate and report on consistency with the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standard 154 (FAS 154), *Accounting Changes and Error Corrections*. FAS 154 requires that companies restate current and previous financial reports in the event of an accounting rule change or a voluntary change of accounting method.
- Remove the hierarchy of generally accepted accounting principles (GAAP) from the PCAOB's interim auditing standards due to the pending issuance of a proposed FASB statement, *The Hierarchy of Generally Accepted Accounting Principles*. The hierarchy identifies the sources of GAAP and the framework for selecting principles to prepare financial statements. The FASB's proposed statement would make this GAAP hierarchy directly applicable to the preparers of financial statements — not just to the auditors. Auditors will be required to report on consistency issues.

AS 6 and the amendments will become effective 60 days after approval by the Securities and Exchange Commission (SEC). The FASB intends to make the effective date of its proposed GAAP hierarchy standard coincide with that of AS 6.

## Section 404 delay

For small companies, time is on their side. Section 404 of the Sarbanes-Oxley Act of 2002, and the timeliness and cost of its implementation, have been at the center of much debate among regulatory agencies, industry professionals and the companies it affects. Section 404(a) requires management to assess the effectiveness of its company's internal control over financial reporting, while Section 404(b) requires the auditor to make an attestation on the company's internal control over financial reporting. Larger companies have been required to comply with both provisions since 2004.

In February 2008, the SEC proposed a one-year extension of the Section 404(b) auditor attestation requirement for non-accelerated filers (those with less than \$75 million in public market capitalization). If the delay is adopted, the effective date would move from fiscal years ending on or after Dec. 15, 2008 to fiscal years ending on or after Dec. 15, 2009 — five years after the original effective date.

This extra year would allow the SEC to conduct a study analyzing the "real world" cost and benefit data from companies that are already complying with Section 404(b) under newly issued guidance by both the SEC and the PCAOB. The study will focus on small companies complying with Section 404(b) for the first time.



This extension is the latest measure to help manage the cost of compliance while balancing investor protection. Even with a possible delay of Section 404(b) on the horizon, small companies should take steps to ensure they have an effective assessment process in place, not simply for compliance, but for the sake of investors and stakeholders. Companies should:

- Analyze risks that could cause a misstatement in financial statements.
- Identify controls to mitigate those risks.
- Prioritize and correct identified control weaknesses.
- Prepare documentation supporting the evaluation.

Grant Thornton is working with the Committee of Sponsoring Organizations (COSO) to develop guidance that will help companies more effectively and efficiently monitor their internal control systems. A document discussing effective internal control monitoring is available at [www.coso.org](http://www.coso.org).

Companies would be prudent to evaluate the benefit of making preparations for Section 404(b) part of their own corporate governance procedures. Companies that build strong internal controls not only protect themselves, but also bolster investor confidence and assume a position ahead of the regulatory curve. •

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### **Contact information**

**Trent Gazzaway**  
National Managing Partner  
Corporate Governance  
[Trent.Gazzaway@gt.com](mailto:Trent.Gazzaway@gt.com)

Editor: Emily Ford  
[editors@gt.com](mailto:editors@gt.com)

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Grant Thornton LLP  
175 West Jackson Blvd.  
Chicago, IL 60604

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