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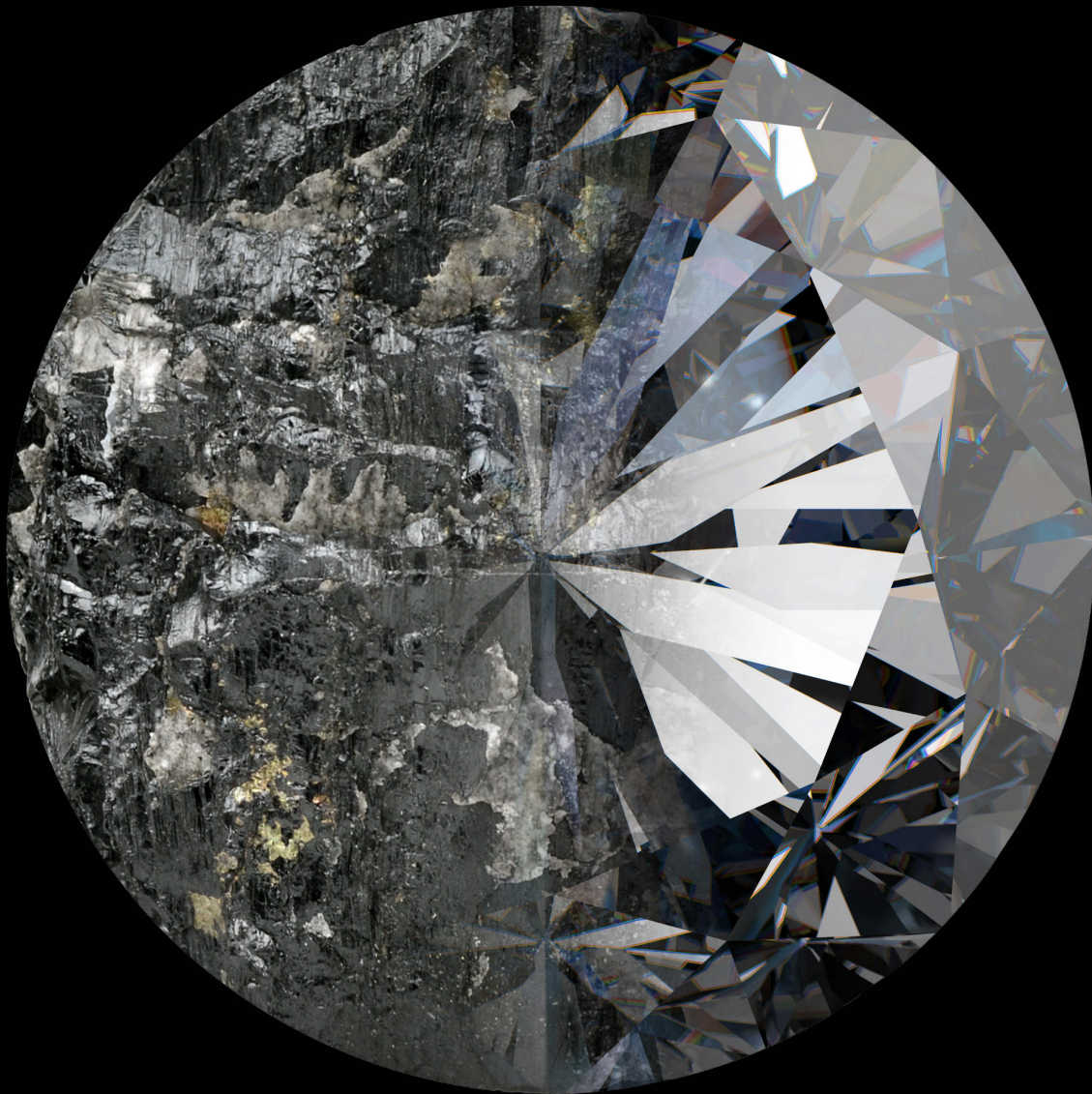
**Refocus your management
review control lens**
Improve your ICFR program by
resolving common challenges

Refocus your management review control lens

Improve your ICFR program by resolving common challenges to management review controls

While anniversaries are usually an opportunity to celebrate and reflect on accomplishments, the Sarbanes-Oxley (SOX) 15-year anniversary this past July did not follow that trend. Instead of celebration, the 15-year reflection was met by several observations from management:

- The cost of compliance is too high

- Internal Control over Financial Reporting (ICFR) programs lack modernization

- Regulators continue to focus in ICFR

We believe that one driver of the high cost of compliance is the continued challenges related to management review controls (MRCs). MRCs have been cited by the Public Company Accounting Oversight Board (PCAOB) as an auditor area of focus each year since the release of the October 24, 2013 Staff Audit Practice Alert No. 11. Management is also challenged by MRCs, spending time and resources to address continued control deficiencies, significant deficiencies or material weaknesses and answer questions from auditors to meet regulatory expectations.

We believe that the solution is in management's hands and involves refocusing the lens by modernizing the ICFR program through implementation of leading practices, innovation, and technology to increase the level of precision of the MRCs control performance and enhance the testing approach. Ultimately, these actions may serve to reduce the cost of compliance and increase the reliability of financial reporting.

Effective internal controls are also good for business. As Wesley R. Bricker, SEC chief accountant, stated in his December 4, 2017, speech at the 2017 American Institute of Certified Public Accountants (AICPA) Conference on Current SEC and PCAOB Developments:

> "Well-run public companies have effective internal controls not just because internal controls are a first line of defense against preventing or detecting material errors or fraud in financial reporting, but also because strong internal controls are good for business and can have an impact on costs of capital. It is important for audit committees, auditors, and management to continue to have appropriately detailed discussions of ICFR in all areas—from risk assessment to design and testing of controls, as well as the appropriate level of documentation. If left unidentified or unaddressed, internal control deficiencies can lead to lower-quality financial reporting which can ultimately lead to higher financial reporting restatement rates and higher cost of capital."

In this point of view, we will explore how management can refocus their internal control lens related to MRCs by providing insights regarding select pillars of success, common challenges, and how world-class organizations are modernizing and renewing their focus into the ICFR program. We believe these insights can provide a roadmap for management that may increase the reliability of financial reporting while decreasing the related cost of compliance.

What are MRCs?

Examples of MRCs include, but are not limited to, reviews of:

Any analysis involving an estimate or judgment.

Comparisons of budget to actual.

Financial results for components of a group.

Fair value estimates.

Transactional activity processed by a company's IT system.

The impact of adoption of new accounting standards (e.g., revenue recognition or lease accounting) or new legislation (e.g., 2017 Tax Cuts and Jobs Act).

Accounting for infrequent transactions or events.

"Management review controls are the reviews conducted by management of estimates and other kinds of information for reasonableness. They require significant judgment, knowledge, and experience. These reviews typically involve comparing recorded amounts with expectations of the reviewers based on their knowledge and experience. The reviewer's knowledge is, in part, based on history and, in part, may depend upon examining reports and underlying documents."

– John Fogarty, Retired Partner, Deloitte & Touche LLP

What is so challenging about MRCs?

There are multiple challenges associated with MRCs, most of which are interconnected. This interconnectedness provides a challenge, because like a domino, if one falls, the others are sure to follow. It's the same concept with MRCs: if one of the select pillars fail, the other pillars will be impacted.

We believe the select pillars that can serve to increase the level of precision of MRCs and enhance the testing approach are people, data quality, risk identification, documentation, and control design. Below is a summary of each pillar as well as the common root causes that challenge the integrity of each pillar and leading practices.

People

People perform the review of key assumptions and judgments utilizing data and information. Therefore, the foundational pillar is ensuring ICFR responsibilities are assigned to individuals with the appropriate competency, authority, and knowledge for the MRC area and that those responsibilities, as well as MRC complexities and challenges, are well understood. Common root causes that challenge the integrity of the people pillar include:

- Lack of a documented baseline for the MRC activity in sufficient detail to establish a baseline understanding for those who perform the control and those who test the control (e.g., internal audit, SOX testers, and external audit; the "control testers").

- Insufficient succession planning, training, and cross-training considerations as people frequently change roles and responsibilities. Succession activities establish the necessary expectations to onboard those who may not have sufficient knowledge and competency for the specific ICFR role. In order for succession to be effective, the baseline understanding of the MRC, established through documentation, is required

- Insufficient number of resources who are stretched too thin, resulting in control performance issues.

Why are people important?

"Accounting personnel resources and competency/training" were cited as contributing factors in material weaknesses in 72 percent of adverse opinions, or 26 percent of internal control issues in those adverse opinions, for 2017 integrated filers. While allocation to MRCs is not specified, the point is, insufficient competency, training, and resource levels are an underlying root cause of material weaknesses. While a professional may have impressive qualifications, the critical aspect is knowledge, experience, and competency in regard to their specific ICFR role.

Data is based on a download from the Audit Analytics website (www.auditanalytics.com) as of January 5, 2018 (Source Dates through December 28, 2017). Data is limited to annual reports issued during 2017 (based on Source Date of annual report).

Leading practice solutions utilized by world class organizations include training and documentation policies as described below.

Data quality

MRCs rely on information, such as data and reports, with reports either being system generated or non-system generated (e.g., spreadsheets and end-user computing (EUC)). For these reasons, controls over the completeness and accuracy of the data or reports used in the performance of the control need to be identified and incorporated into the control activity documentation and tested. As the saying goes, garbage in, garbage out (e.g., if bad data is reviewed, the reviewer conclusion is ineffective and may cause a misstatement).

Common root causes that challenge the integrity of the data quality pillar include:

- Data and reports used in the MRC are not identified and are therefore not considered in control documentation or testing.

- Lack of understanding regarding who owns the controls over the data and reports used in the MRCs, resulting in those controls not being considered in testing.

- Resource limitations due to the time spent to extract, aggregate, and manipulate data for analysis, resulting in less time being spent on confirming the completeness and accuracy of that data.

- EUCs are often used for the most complex controls, and the size, scale, and complexity of such spreadsheets often grow exponentially, becoming monstrous and unmanageable, resulting in ineffective or insufficient spreadsheet controls.

Leading practice solutions utilized by world-class organizations include documentation, spreadsheet integrity checks (SIC), and robotic process automation (RPA), as described below.

Risk identification

Robust risk assessment procedures are necessary to identify, analyze, and respond to financial reporting risks. Sufficient analysis should be performed, especially for areas that include subjective judgment related to estimates, key assumptions, and complex accounting for transactions, accounts, and disclosures to identify the risk of material misstatement ("RoMM") for the area. Once the RoMM is identified, management can design MRCs to respond.

Common root causes that challenge the integrity of the risk identification pillar include:

- RoMMs are not identified at the level of granularity that specifies what the specific subjective judgments, estimates, key assumptions, or complex accounting areas are and what can go wrong.

- RoMM is identified, but the right control isn't selected to mitigate the RoMM.

- A lack of revisiting risk assessments as changes occur.

Leading practice solutions utilized by world-class organizations include: a robust risk assessment, documentation policies and data analytics, and visualization as described below.

Documentation

Documentation falls into two general categories:

1) Documentation of the control activity details.

2) Documentation to support execution of the control activity.

Documentation of control activity

Documentation of the control activity details is needed to establish a baseline understanding for those who perform the control and for control testers. Sufficiency of documentation is often undervalued and overlooked with significant upside benefits that may result in increased reliability of financial reporting and ICFR program efficiencies that include:

- Establishing a baseline understanding of the control activity details, which serves as the single source of truth.

- Utilizing the baseline understanding to:
  – Support succession planning, training, and cross-training of control performers.

– Enforce accountability and responsibility of the control performers for executing procedures consistently and in line with expectations.

– Effectively inform the control selection process when identifying controls to mitigate RoMMs.

– Evaluate the level of precision of the control, a necessary assessment in concluding on risk mitigation.

Common root causes that challenge the integrity of the documentation of a control activity details pillar include:

- Lack of a documented baseline of the MRC control activity. We often observe the absence of important control activity details, such as:
  – Inputs used in the control (e.g., data, reports, external benchmark information).

  – Identification of the key assumptions or judgments that are subject to review.

  – The criteria requiring further investigation (e.g., dollars and percentages).

– The steps the reviewer is expected to perform, including steps to confirm completeness and accuracy of inputs, steps to challenge the reasonableness of the key assumptions or judgments, and steps for investigation and resolution.

– The outputs of the control, including what constitutes evidence of control performance.

– Management does not view documentation as a value-added activity and therefore does not allocate resources for documentation efforts.

– Management does not have governance policies requiring that MRC documentation reflect current processes—as a result, it is difficult to enforce accountability.

Documentation of control execution

Document the execution of the control, including evidence to support challenges raised in the review, contradictory evidence considered, and the level of precision of such procedures.

Common root causes that challenge the integrity of the documentation of the execution of the control pillar include:

• Lack of control performer's understanding of what constitutes evidence of execution of the control; therefore, evidence is not proactively documented and retained.

• Availability of auditable evidence. When evidence supporting the steps of the control is not available, control testers may conclude the operating effectiveness of the control is deficient.

MRCs are especially challenging because reviews often happen in real-time, involving multiple inputs and more than one reviewer in a meeting setting. Management needs to retain evidence to support the steps performed by the control performer(s), that is, the inputs and the outputs of the control. Oftentimes, this evidence is in the form of meeting minutes summarizing key items challenged and resolution, iterative versions of analysis through final version, and emails or notes for follow-up procedures. It is nearly impossible to recreate such evidence several months after the fact.

Leading practice solutions utilized by world-class organizations include documentation policies as noted below.

Control design

It is important to design controls to operate at a level of precision that would prevent or detect a RoMM.

Common root causes challenging the control design pillar include:

• Not designing specific steps to mitigate the identified RoMM. We have observed instances where control design is limited to "management reviews key assumptions." In this case, the potential for a material weakness exists (e.g., ICFR isn't effective), as the RoMM may not be addressed. A well-designed control will consider the RoMM and define specific steps to be performed. For example, consider a RoMM where "revenue projection assumptions may include management bias and be inflated to hide potential impairments." Designing control steps to address the RoMM would include activities that challenge the reasonableness of key assumptions and consider contradictory evidence. Example steps may include:

– Comparing the projected revenue for the discrete five-year period to historical results and trends achieved, as well as approved budgets and forecasts for the reporting unit.

– Comparing the discrete and long-term growth rates to industry publications to assess if the projections are more aggressive than the broader market.

– Evaluating company and industry analyst reports to identify anomalies that would contradict plans to achieve forecasted growth.

– Performing a retrospective lookback comparing prior-year(s) projections to actual results to identify contradictory evidence and the potential for management bias in estimates.

– Documenting the results and the conclusions regarding the reasonableness or the assumptions and the contradictory evidence considered.

In this example, the detailed steps increase the level of precision, resulting in an effectively designed control that mitigates the RoMM and avoids a material weakness.

• Not identifying, considering, and evaluating the design factors that contribute to understanding the level of precision of the control.

• Not considering, as part of design, whether the selected MRC addresses the RoMM individually or in combination with other controls. For example:

– A MRC, relating to a comparison of actuals to budget, would also rely on the budget control.

– A MRC, relying on data and reports, would also rely on the controls over the completeness and accuracy of such information.

Leading practice solutions utilized by world-class organizations include documentation policies and the tools and techniques as noted below.

How world-class organizations utilize leading practice solutions

Change is in the air. We are observing world-class organizations refocusing their lens to employ modernization around people, processes, tools, and techniques that are serving to increase the reliability of financial reporting and reduce the cost of compliance, specifically in the area of MRCs. While some of the modernization techniques may include an initial investment, the payback is considered worth the effort and often results in efficiencies and effectiveness in regard to control execution.

People

• Assessing the sufficiency and competency of resources to meet the needs for ICFR.

• **Training** and cross-training to educate on the common MRC challenges and leading practices to produce an informed mindset and enforce accountability. Training has taken on a new "edgy" approach by using various techniques and interactive methods, such as gaming, simulations, or case studies.

• Assignment of responsibilities, utilizing an automated quarterly 302 certification to enforce accountability, requiring the control owners to certify that control documentation reflects current state, the control continues to operate as designed, or changes have been reported.

Processes

• A **robust risk assessment** that integrates the right people, processes, tools, and techniques serves to identify the relevant RoMMs. The risk assessment also includes the selection of controls and the evaluation of design of control in regard to the RoMM.

Please refer to our point-of-view "Refocus your risk assessment lens" for more information on leading practices associate with the risk assessment process. **(See first ICFR series paper, "Refocus your risk assessment lens: Scale your ICFR program to focus on risks not benchmarks")[1]**

• Establishing **documentation policies** to support sufficient detail of the MRC control activity, including the inputs, steps of the review, and the outputs that serve as the single source of truth, which support the following:

– Establishing a baseline understanding for control owners, which serves to enforce accountability for responsibilities, drives consistency in the performance, and provides a foundation for succession when roles and responsibilities change.

"It is important to maintain competent and adequate accounting staff to accurately reflect the company's transactions and to augment internal resources with qualified external resources, as necessary. Qualified accounting resources and appropriate processes and controls will be of vital importance in connection with the adoption of the new accounting standards."

– As stated by Marc Panucci, deputy chief accountant, in his December 5, 2016, speech at the 2016 AICPA Conference on Current SEC and PCAOB Developments

[1] Refocus your risk assessment lens: Scale your ICFR program to focus on risks not benchmarks (www.deloitte.com/us/icfrseries)

– Establishing a baseline understanding for control testers, which includes the basis to evaluate the design of the control in regard to mitigating the RoMM, and considering whether the control is designed at a sufficient level of precision to mitigate the RoMM.

• Establishing **documentation policies** for retention to support control performance, including:

– Centralized repository to store control documentation (e.g., control activity descriptions, process flow diagrams, risk control matrices, etc.)

– Governance policies and processes around the data and reports that are used in controls.

Tools and techniques

World-class organizations are utilizing tools and techniques to make the **complex simple**. While these tools and techniques can not remove the complexities associated with key assumptions and judgments, they serve as opportunities to automate, simplify, and stress-test areas that have been historically challenging:

• **Data analytics and visualization** are powerful tools that can be used in the MRC by reviewing and challenging the analysis using visualization of trends and relationships. **(See Appendix)**

• Utilizing **SIC tools** to identify integrity issues with complex spreadsheets that are used as key input in the performance of MRCs. Integrity issues are evaluated and addressed, with new controls established over the data extraction and manipulation, serving as a new baseline for the spreadsheet moving forward. **(See Appendix)**

• Automating time consuming repetitive, human activities through **RPA**, which frees up human resources to work on higher value areas. For example, more time can then be spent reviewing data rather than on aggregating, extracting, and manipulating the data in preparation for the review. **(See Appendix)**

• Employing the **Deloitte Management Review Control Simulation** (Deloitte MRC SIM), which is an innovative, interactive technique of stress-testing controls under realistic conditions to determine if the MRCs are designed at an appropriate level of precision and are operating as designed. This is achieved by introducing and monitoring predefined test variables throughout the execution of the management review control. These variables can be introduced in a test environment or can be the foundation for a simulation workshop designed to assess the level of precision of management's review of key assumptions and complex judgments.

• Using a simplistic example, revenue forecast assumptions used in goodwill impairment tests are often subject to MRCs, which may investigate growth rates above a predetermined threshold, say 10 percent. Deloitte, working with management, inserts a growth rate into the test environment that exceeds this threshold, say 15 percent, and observe if the test variable is detected through the execution of management's review. If the 15 percent growth rate is not detected and investigated, then management has obtained objective evidence that the MRC is either not designed properly, or not operating effectively. The root cause for the control failure is assessed, and a remediation plan is developed.

What can management do to refresh their lens?

If management sets their sights on SOX's upcoming sixteenth birthday, with the objective of addressing and minimizing the MRC challenges, and employs the identified pillars to enhance the level of precision of MRCs and testing approach, there may certainly be cause for celebration!

It's time to consider utilizing some of the modernization tools and techniques that lend themselves to increasing the reliability of financial reporting while reducing the cost of compliance.

MRCs can be the success story for the upcoming year. It's time to refocus your internal control lens on these efforts.

Contact us

We want to hear from you. If you have questions or comments or would like to learn more about how to modernize your controls and refresh your MRC lens, contact one of our team members.

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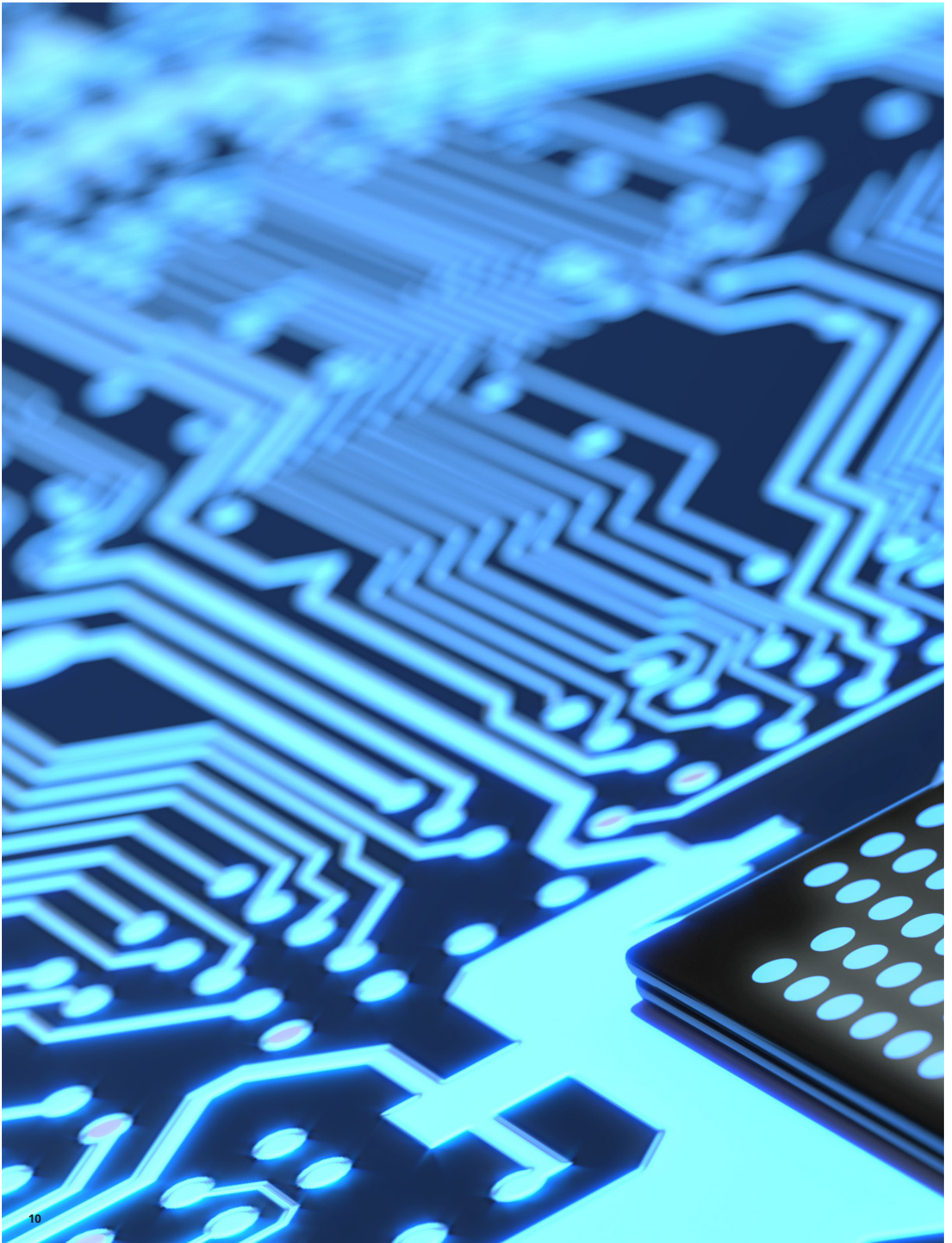Senior Manager | Deloitte Risk and Financial Advisory
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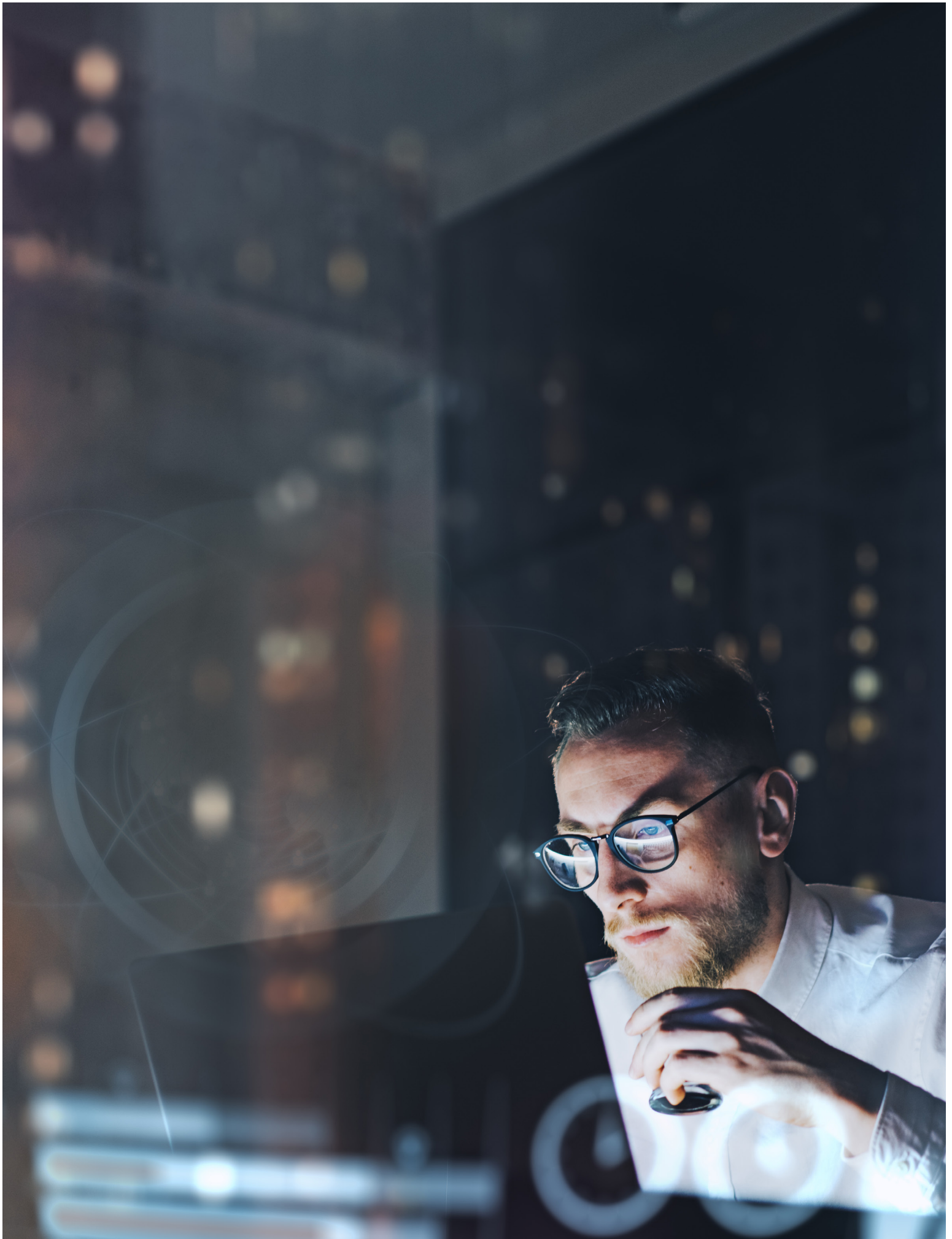
Appendix

Table 1: Data analytics and visualization tools used in MRCs

The use of data analytics and visualization tools in MRCs serves to improve the understanding of the population and enables the identification of relationships and trends through user-friendly dashboards that can quickly identify fluctuations and provide drill-down options for further detail. Unexpected relationships and trends would be further challenged to determine if recorded account balance is fairly stated, in all material respects.

Example 1: Accounts receivable (AR) and allowance for doubtful accounts

The account analysis is designed to visualize and analyze relevant ratios in AR and allowance for doubtful accounts population showing period-over-period trends, including:

AR and allowance trend: visualizes the trend of total AR and Allowance amount period over period and shows the allowance as a % of total AR.
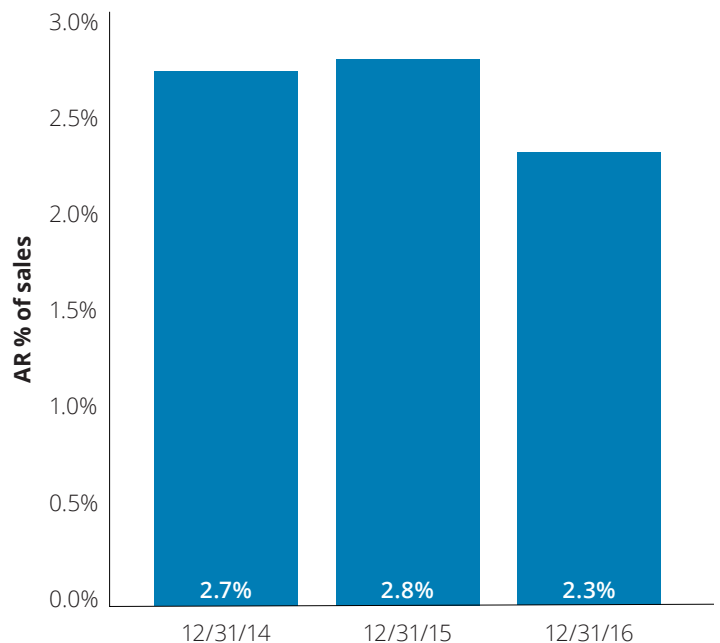
AR % of sales trend: visualizes the trend of the AR as a percentage of Sales period over period, showing the relationship between unpaid sales and total sales.

Figure 1: AR and allowance trend analysis

AR and allowance trend
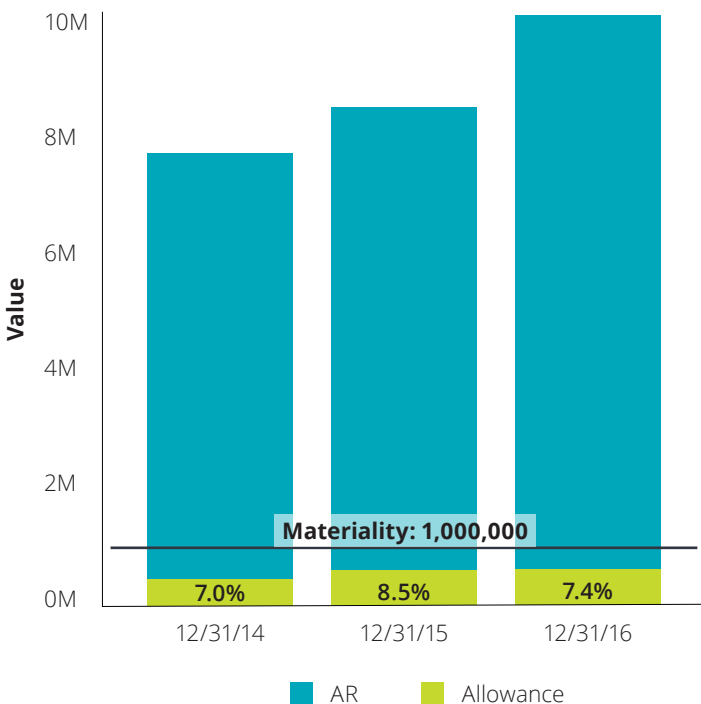
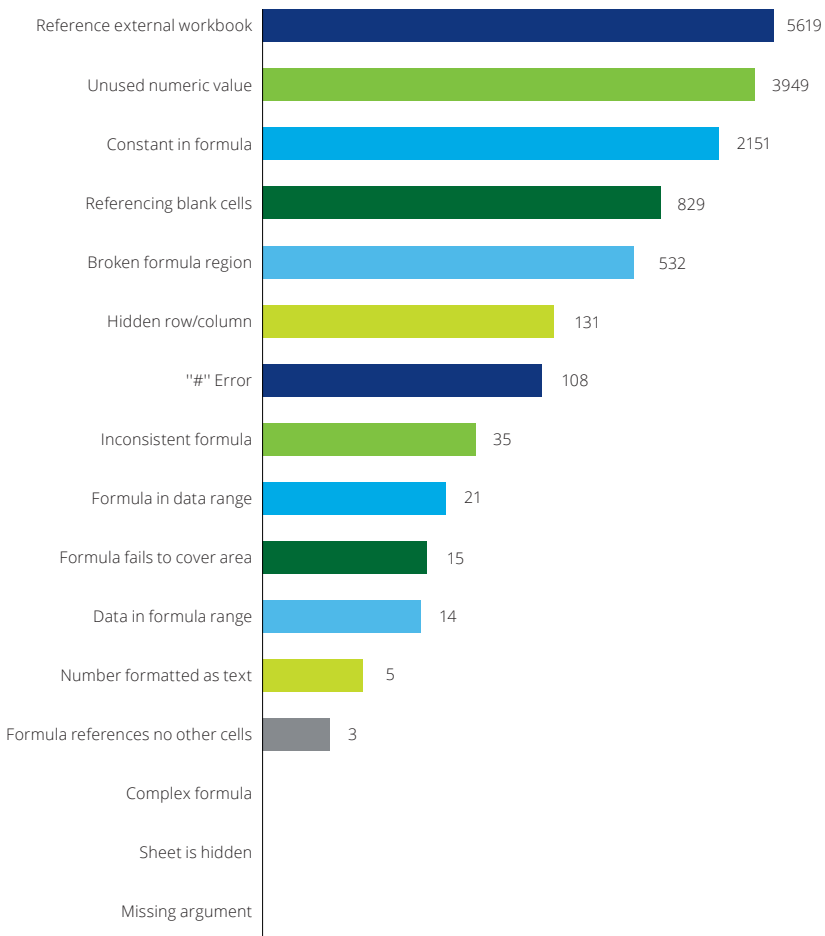**AR % of sales (trailing 12 months) trend**

Table 2: SIC tools used in MRCs

Many organizations face difficult decisions when using EUC tools. On the one hand, EUC tools provide great convenience by enabling users to directly manage, control, and manipulate data and processing. This flexibility is generally and intentionally not available in the major Enterprise Resource Planning (ERP) applications. Additionally, EUC tools can be modified quickly, and with the growing availability of tools and functionality (built-in formulas and easy-access macro design), their ability to meet complex business requirements is growing. Convenience, versatility, and low cost to modify EUC tools has entrenched them into modern organizational culture, and their use has become pervasive across all business processes.

The SIC tool enables users to perform a detailed cell-by-cell analysis of EUCs. This analytical assessment evaluates the integrity of every formula throughout the spreadsheet and reports the results back in a meaningful, easy-to-read format that facilitates focused remediation of potential errors (see figure 2). Additionally, this analysis can be used to conduct a tree relationship assessment, quickly enabling management to determine source files that are feeding key data into EUCs, in order to assess the need to identify controls over the completeness and accuracy of the source data.

Figure 2. SIC summary results

Number of instances

Reference external workbook	5619
Unused numeric value	3949
Constant in formula	2151
Referencing blank cells	829
Broken formula region	532
Hidden row/column	131
"#" Error	108
Inconsistent formula	35
Formula in data range	21
Formula fails to cover area	15
Data in formula range	14
Number formatted as text	5
Formula references no other cells	3
Complex formula	
Sheet is hidden	
Missing argument	

Attribute	Comments
Referencing external workbook	Finds formulas which reference cells in external workbooks
Unused numeric value	Finds cells that contain numeric values that are not referenced in any calculations
Constant in formula	Finds formulas which contain hard-coded constants in them (constants embedded in formulas are often difficult to update)
Referencing blank cells	Finds formulas which contain references to blank cells (references may be unintended)
Broken formula region	Finds formula regions that are inconsistently sized compared to nearby formula regions
Hidden row/column	Shows cells hidden by the range's 'hidden' property
"#" Error	Finds error cells including: #REF!, #VALUE!, #N/A, #NULL!, #NAME?, #DIV/0!
Inconsistent formula	Finds formulas that are unexpectedly different than those in neighboring cells
Formula in data range	Finds formulas within ranges of data
Formula fails to cover area	Finds formulas which reference part, but not all, of a group of similar cells (references are usually unintended)
Data in formula range	Finds data cells that may have overwritten formulas
Number formatted as text	Identifies data cells which contain numbers formatted as text (numbers formatted as text may or may not be included in the formula calculations)
Formula references no other cells	Finds cells that contain formulas that doe not reference any other cells
Complex formula	Considers simplifying these complex formulas
Sheet is hidden	Finds hidden sheets
Missing argument	Checks formulas for arguments that are missing in functions causing non-default behavior

Table 3: RPA used in MRCs

RPA is a rules-based system that mimics human behavior to automate parts of repeatable processes (e.g., control checks, regulatory reporting). As it relates to MRCs, leading practice organizations are utilizing RPA in the preparation of the analysis that is subject to review by reducing the manual and time-consuming process of compiling information (e.g., control inputs) and automating initial follow-up procedures to allow reviewers to appropriately focus on the strategic risks and exposure areas after the RPA process is employed.
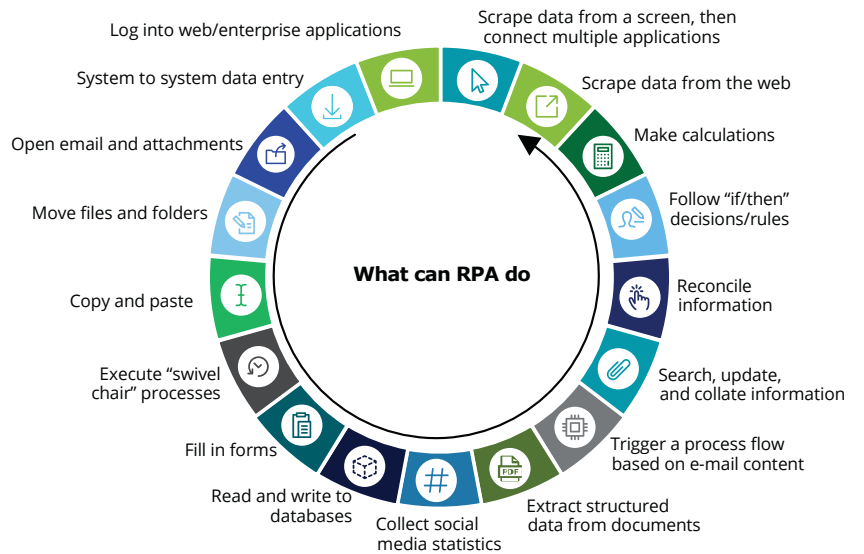
RPA is delivered through software that can be configured to undertake rules-based tasks.

RPA is...

✓ Computer-coded software
✓ Programs that perform repetitive rules-based tasks
✓ Cross-functional and cross-application macros

RPA is not...

× Walking, talking robots
× Physically existing machines processing paper
× Artificial intelligence or voice recognition and reply software

What can RPA do

- Log into web/enterprise applications
- System to system data entry
- Open email and attachments
- Move files and folders
- Copy and paste
- Execute "swivel chair" processes
- Fill in forms
- Read and write to databases
- Collect social media statistics
- Extract structured data from documents
- Trigger a process flow based on e-mail content
- Search, update, and collate information
- Reconcile information
- Follow "if/then" decisions/rules
- Make calculations
- Scrape data from the web
- Scrape data from a screen, then connect multiple applications

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