

A high-angle, top-down photograph of a person diving into clear, vibrant blue water. The person is in the center of the frame, with their arms and legs spread wide in a classic diving posture. The water's surface is rippled, and the overall scene is bright and clear, suggesting a sunny day at a swimming pool or beach. The background is a deep, uniform blue, with some darker, shadowed areas near the edges of the frame.

Deloitte.

Lean and Balanced

How to Cut Costs

Without Compromising Compliance

Deloitte's Control Rationalization Approach

Audit • Tax • Consulting • Financial Advisory.

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Lean and Balanced

How to Cut Costs Without Compromising Compliance

Deloitte's Control Rationalization Approach

Under Pressure

Poll any random sampling of public company CFOs, and a probable majority will tell you that Sarbanes-Oxley¹ has placed enormous pressure on their organizations. Many of these executives will also divulge a corollary fact: Much of the stress falls directly on their shoulders.

As a result of the Act, financial reporting executives today face occupational risks unheard of even just a few years ago, from regulators, from their own boards, and even, in extreme cases, from the legal establishment.

Exacerbating the problem are the realities of today's business environment and the expectations on CFOs to achieve lean operations through aggressive structural cost cutting. Compliance costs, in general, are seen by many as placing U.S. companies at a competitive disadvantage; therefore Sarbanes-Oxley-related costs are on the radar screens of most CEOs. The message is clear: *Achieving compliance was too expensive!* And the mandate is unambiguous: *Reduce the cost of compliance!*

Thus, CFOs may find themselves in a quandary so severe it seems a "lose-lose" proposition: Slash costs and they may jeopardize compliance, upset their audit committee, or even experience a material breakdown in controls. Ignore costs and they may displease their boss, worry stakeholders and analysts, and miss an opportunity to enhance competitiveness.

Considering the above, one can appreciate the palpable urgency among CFOs to reconcile these seemingly contradictory mandates: Compliance *must* be maintained; and costs *must* be cut.

In this context, high stress levels make perfect sense. Are CFOs being asked to attain the unattainable?

Second-Year Efforts

Companies started paying more attention to cost as they entered their second year under the Act. This made sense: After all, in most cases, year one work had been completed and compliance had been attained. And many companies found that project costs had far exceeded expectations.

Unfortunately, despite the good faith, diligent effort, and professional judgment that went into the cost-cutting effort, in some cases, the results didn't turn out as well as hoped. Based on anecdotal reports from Deloitte practitioners involved in Sarbanes-Oxley-related engagements, the following factors often came into play:

- In the absence of any other guidance, companies decided to tackle cost by reducing the number of key controls tested.
- Companies focused initial efforts at the process level, instead of applying a top-down, risk-based method.
- Programs lacked a consistent, methodical approach.
- No benchmarking effort took place to capture leading practices.
- Companies focused on achieving short-term results instead of adopting a long-term strategy to address flaws in control design and to drive continuous improvement.
- Executives failed to reinvest cost savings in higher risk areas.

Without a risk-based approach, some companies may have inadvertently cut too many controls or the wrong controls. As a result, in the worst cases, compliance was put at risk. But even in the best cases, abundant opportunities for reducing cost while maintaining compliance were not fully exploited.

¹ For purposes of this document, the terms "Sarbanes-Oxley," "the Act," and "SOX" all refer to the Sarbanes-Oxley Act of 2002 in its entirety, including all sections of the law enacted by Congress, all associated rules promulgated by the Securities and Exchange Commission, and all related standards issued by the Public Company Accounting Oversight Board.

Deloitte's Control Rationalization Approach

One key to reconciling the seemingly irreconcilable – to cut costs and maintain compliance – can be found in this concept: Deloitte's Control Rationalization Approach.

Control Rationalization is a continuous, programmatic approach driven in a top-down, risk-based manner. Applied in steps, it starts with identifying the most effective and efficient controls needed to achieve compliance and streamline efforts. For these controls, risk-based considerations are used to drive efficiency in testing.

Early steps in a Control Rationalization program include considerations for eliminating unnecessary controls. Equally important, opportunities for improving overall control design are targeted. Such improvements are realized through the streamlining and consolidating of processes, and through the automating of controls. All of these activities are prioritized and developed into the overall control enhancement plan.

This plan is aligned with the organization's priorities and integrated with planned initiatives to drive control implementation efficiency. In this manner, Control Rationalization not only results in immediate compliance cost reductions but also positions the organization to enhance its compliance risk profile and achieve longer term compliance efficiencies through the application of a continuous program that cost effectively integrates control design improvements into the organization's future initiatives in a cost-effective manner.

Key Principles

Deloitte's Control Rationalization program is based on two principles: a top-down, risk-based approach and a lean and balanced control design.

Top-Down, Risk-Based Approach

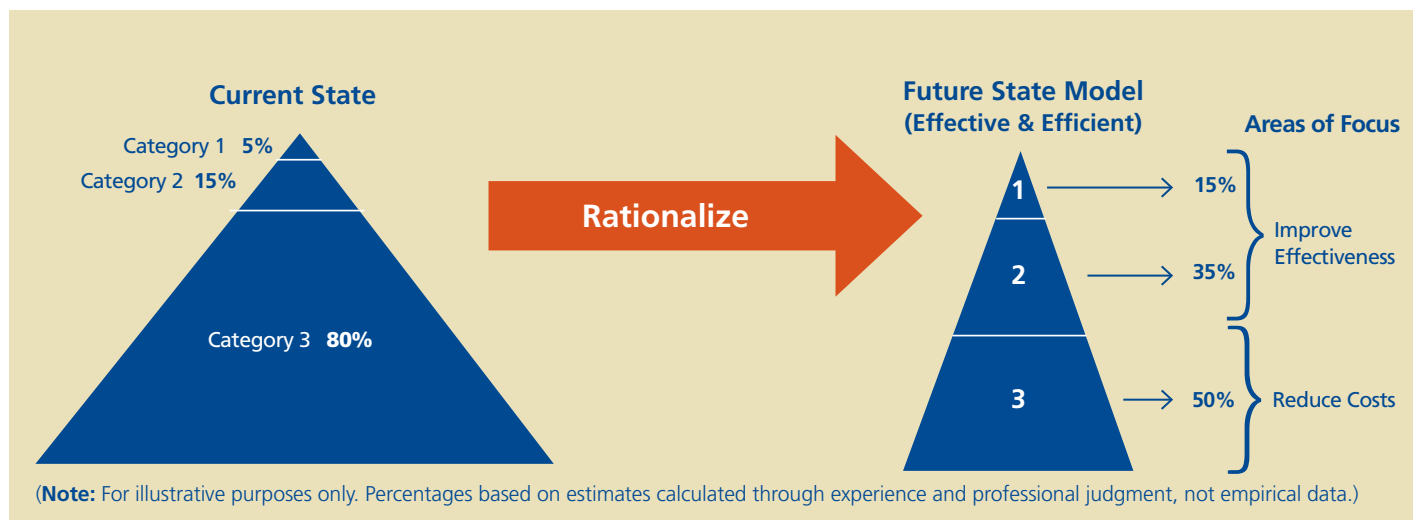
A top-down, risk-based approach is founded on the premise that not all accounts, transactions, and risks are equally important. One should not only consider the relative significance of these items, but also factor in a number of related concerns, including the nature of the business; the inherent riskiness of transactions, processes, controls, and technologies; and the effectiveness of the organization's human resources. For example, it would be difficult for a sales order clerk to defraud the company by creating fictitious customers if the company has only four large customers (as opposed to thousands); thus, control resources would be more efficiently focused on areas of greater risk, such as management override, manual journal entries, and estimates.

Lean and Balanced Control Design

During year one, some companies did not apply a balanced holistic view in their design of controls. Instead, these companies initiated their compliance efforts with a bottom-up approach and treated all controls as equal, regardless of the underlying risk profile. Companies tested a large number of controls at the routine level (which usually address relatively lower risks), often resulting in a bloated and disproportionate control structure, as illustrated in the diagram below.

Figure 1:

Lean and Balanced Control Design



Category 1: company-level controls: control environment, period end financial reporting, anti-fraud programs

Category 2: some general computer controls: controls over non-routine accounts and accounts with significant judgment; controls over other high-risk areas

Category 3: controls over routine, transactional processing

To get an idea of how this bloated triangle illustration relates to real-world circumstances, consider an accounts payable process. In year one, many companies documented and tested numerous controls around disbursements; however, this category of transaction (shown as “category 3” controls) is generally routine, usually automated, and often relatively low risk. Far greater risks may exist elsewhere, such as in the process for estimating accrued liabilities at the end of the month (shown as a “category 2” control), which is a manual process involving significant judgment that should receive greater and more focused control attention. Control Rationalization helps organizations to understand how increased investments to enhance higher-level controls (category 1 and 2) can lead to significant compliance efficiencies and result in overall reduction in their risk profile.

The goals of Deloitte’s Control Rationalization Approach include the following:

- Develop an informed view of the overall design and balance of controls and how they align with financial reporting risks.
- In the short term, apply the above understanding to enhance compliance quality by shifting focus (“rationalizing”) toward higher risk areas. At the same time, derive cost savings by applying more efficient compliance efforts for routine, transactional-processing-related controls.
- Over the longer term, apply this understanding to identify how higher level (company-level) controls can be best leveraged or enhanced to drive compliance efficiencies and reduce the organization’s overall compliance risk profile.

Four Phase Control Rationalization Approach

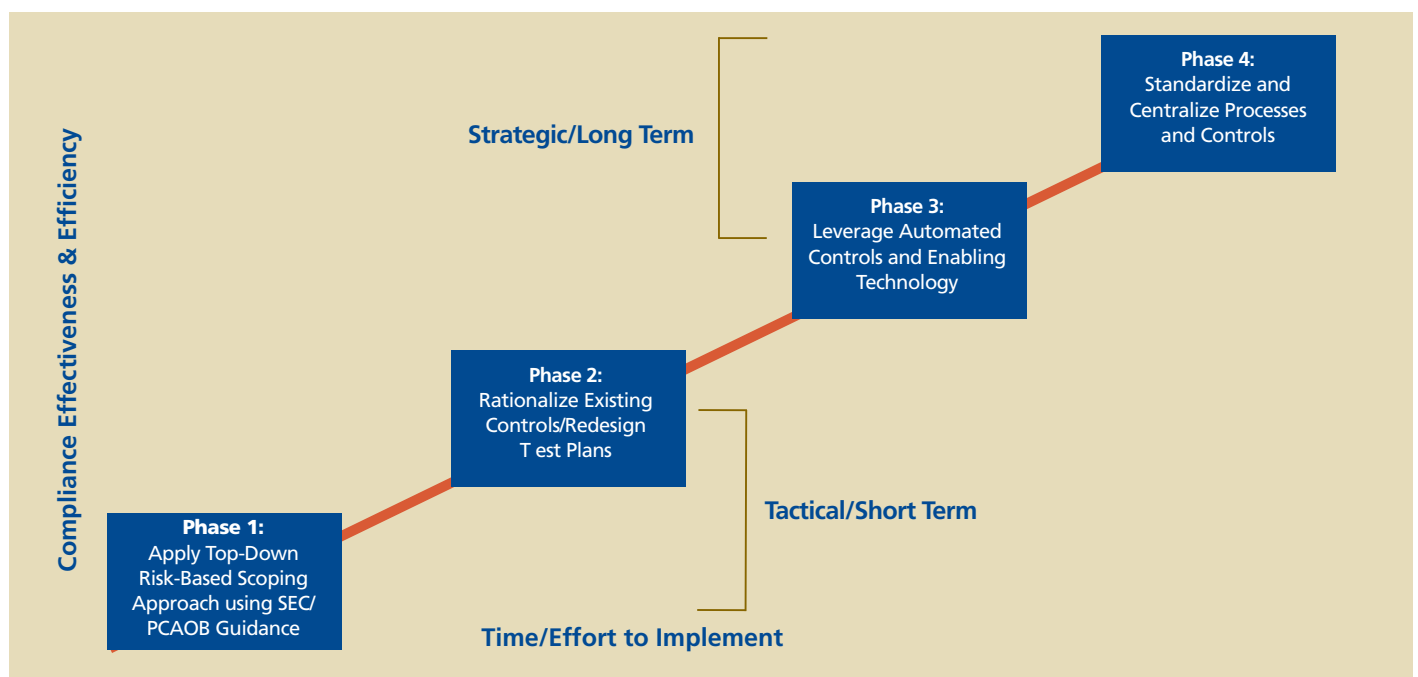
Control Rationalization entails a structured, four-step approach. Phases one and two position a company to realize immediate reductions in compliance costs, to identify future control improvements and enhance compliance efficiency, and to create a foundation for a sustainable internal control program. Phases three and four, because they are transformational and go beyond the basic compliance requirement, may require a greater investment of resources. Yet this investment offers significant potential rewards as the company moves from the bloated to the lean triangle.

Phase 1: Apply Top-Down Risk-Based Approach to Re-Scoping

A “top-down” approach begins with a risk assessment that includes developing a thorough understanding of a company’s financial reporting risks; identifying and considering the design of controls, starting with company-level controls and proceeding down to the identification of significant accounts, key groups of transactions and related processes, and, finally, to the evaluation of individual controls. Approaching Control Rationalization from this vantage point helps to scope appropriate areas into the compliance program and promotes a process whereby “in scope” areas receive a level of attention commensurate with their relative level of risk.

Figure 2:

Four-Phased Risk-Based Approach



The PCAOB has urged companies to adopt a top-down approach, and has provided guidance to assist with the effort. Those recommendations are shown on the left-hand side of the chart in Figure 3. To help organizations apply this guidance, Deloitte has identified potential activities for implementation, shown on the right-hand side of the chart.

Phase 2: Rationalize Existing Controls and Redesign Test Plans
Phase 2 continues the short-term, rapid-benefit activities begun in the first phase. Both process-level and general computer controls are rationalized and test plans are redesigned.

Phase 2A: Rationalize Existing Process-Level Controls (PLCs)
In phase 2A, activities are performed to identify opportunities to improve and enhance the design of controls. Five steps follow, as shown in Figure 4.

Figure 3:
Phase 1 Top-Down Approach and Guidance

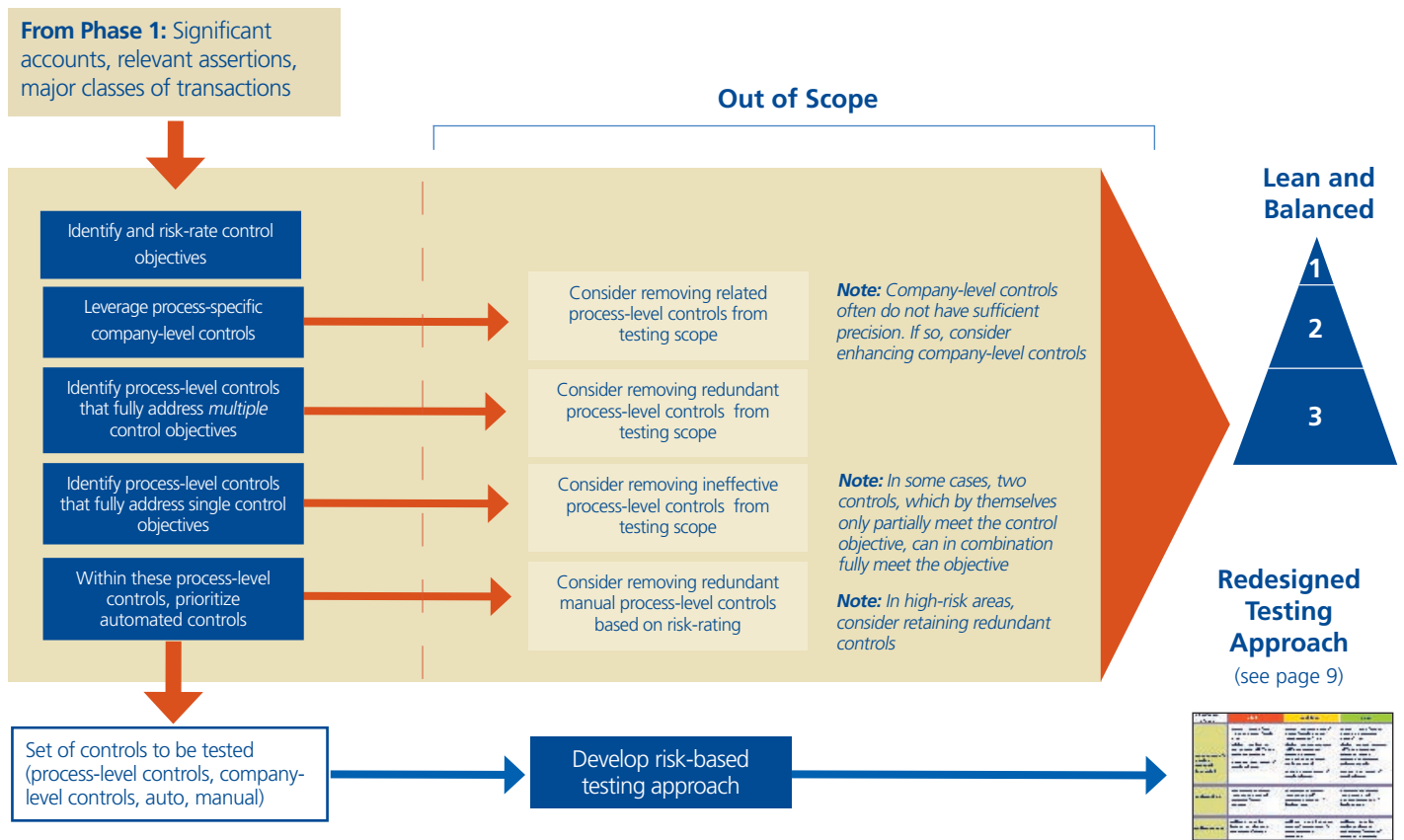
PCAOB's Top-Down Approach	Potential Response
<p>1 Identify and evaluate design of company-level controls.</p>	<p>1 Pinpoint company-level controls that effectively mitigate location/account risks.</p>
<p>2 Identify significant accounts and disclosures.</p>	<p>2 Consider qualitative risk factors (e.g., susceptibility of loss due to errors or fraud), not just quantitative significance.</p>
<p>3 Identify relevant assertions for each significant account.</p>	<p>3 Direct level of effort based on risks related to relevant assertions.</p>
<p>4 Link significant accounts to significant processes and major classes of transactions.</p>	<p>4 Risk-rate major classes of transactions to appropriately focus efforts.</p>
<p>5 Identify the points at which errors or fraud could occur in the process.</p>	<p>5 Confirm that relevant financial reporting risks (including fraud and general computer controls) are identified, and risk-rate control objectives.</p>
<p>6 Identify controls to test that prevent or detect errors or fraud on a timely basis.</p>	<p>6 Rationalize controls and develop appropriate test plans (Phase 2).</p>
<p>7 Clearly link individual controls with the significant accounts and assertions to which they relate.</p>	<p>7 Verify that design of internal controls over financial reporting addresses relevant risks.</p>

The following provides additional detail on the steps illustrated in Figure 4.

- *Identify and risk-rate control objectives:* Risk assessment activities applied at the significant account level need to be linked to an account's relevant control objectives so that control activities will be appropriately considered in a context consistent with their relative importance to achieving compliance and the testing efforts to be applied.

- *Leverage process-specific company-level controls (PS-CLCs):* At this stage, companies should consider eliminating from the testing plans process-level controls that are also effectively addressed by PS-CLCs. (See sidebar on page 8.) To achieve this objective, these PS-CLCs should address the risks with an appropriate level of precision. If this condition is not fully met, opportunities for enhancing PS-CLCs should be identified and considered so future testing efficiencies can be realized.

Figure 4:
Phase 2A: Rationalize Existing Process-Level Controls



Leveraging Process-Specific Company-Level Controls (PS-CLCs)

Those company-level controls that are effective in achieving process-level control objectives are called process-specific company-level controls (PS-CLCs) in this approach. If PS-CLCs are effective, management can rely on them, rather than lower-level detailed controls, for testing lower risk areas.

Examples of PS-CLCs include:

- controls that monitor operations (e.g., business performance reviews)
- controls that monitor other controls (performance management of controls)
- financial close and reporting controls.

To be effective in addressing process-level control objectives, PS-CLCs should possess the following characteristics:

- **Relevance:** The PS-CLCs must address process level risks (i.e., process, class of transaction) and related control objectives.
- **Frequency:** The PS-CLCs should operate with enough regularity to enable timely detection of errors or fraud.
- **Precision:** The PS-CLCs should operate at a sufficiently precise level to adequately address the risk of misstatement (e.g., the controls should be precise enough to detect at least “more than inconsequential²” errors in financial reporting).

- *Identify process-level controls that fully address multiple control objectives:* Next, evaluate and consider replacing process-level controls that address a single risk in favor of process-level controls that address multiple risks. During this activity, identify opportunities for enhancing control effectiveness.
- *Identify process-level controls that fully address single control objectives:* Consider those process-level controls that by themselves are sufficient in addressing the control objective. Consider removing from compliance testing any redundant process-level controls. Also, identify opportunities for future control enhancements to promote process or compliance efficiency.
- *Within these process-level controls, prioritize automated controls over manual controls:* Consider selecting an automated control over a similar manual control addressing the same risk. During these activities identify opportunities for enhancing the use of automated controls.

When these steps are completed, a rationalized set of controls will likely have been identified for testing. Also, throughout the above steps opportunities for improving controls and processes should be identified and evaluated to consider how they may be best aligned and included with future company initiatives.

Phase 2B: Rationalize Existing General Computer Controls

In year one, some companies documented and tested too many general computer controls (GCCs). Thus, the same principles that governed the process of rationalizing process-level controls can be applied to GCCs.

In completing your company's Control Rationalization efforts for GCCs, consider the following:

- Apply a risk-rating approach towards GCC categories and control objectives to promote appropriate deployment of compliance efforts. Although direct linkage to a company's overall risk assessment in many cases is not possible, risk rate categories and control objectives in a manner that results in greater consideration to those areas or control objectives that more directly promote reliability, integrity of financial related processing, and segregation of duties.
- Where GCCs are considered reliable, place higher reliance on IT-related company-level controls (e.g., setting of consistent policy procedures for GCC areas, and effective monitoring capabilities), particularly for lower risk areas.
- Take advantage of opportunities to remove secondary or redundant controls from your testing plan if an effective higher-level control can be identified.
- Consider testing GCC processes before performing detailed tests related to IT configurations for lower risk areas.
- Be sure to prioritize controls addressing multiple risks.

Phase 2C: Redesign Test Plans

By this stage, you probably have developed a rationalized set of controls for compliance testing purposes, which means that you have also accomplished the converse: scoped out controls unnecessary to test for compliance purposes.

The next step is to apply a risk-based approach toward testing. Risk-based test plans vary the nature (*which controls are being tested?*; *how are the tests conducted?*), timing (*at what point or how many times during the year are the tests conducted?*), and extent (*how numerous and extensive are the tests?*) of testing based on the risk being addressed. (See figure 5.) This enables companies to direct their resources toward testing controls related to the highest risk areas.

² In terms of magnitude, “more than inconsequential” is interpreted to mean the following, according to PCAOB guidance: Potential misstatements greater than or equal to 20 percent of planning materiality are presumed to be more than inconsequential. Potential misstatements less than 20 percent of planning materiality may be concluded to be more than inconsequential as a result of the consideration of qualitative matters as required by the standard. (Auditing Standard No. 2).

Figure 5:
Implementing a Risk-Based Test Plan

Classification of Risks	High	Medium	Low
Management's Testing Approach (Example)	<p>Nature: Testing of both process-level controls and process-specific company-level controls</p> <p>Evidence: Re-performance; extensive inquiry; expanded scope of testing</p> <p>Timing: Test closer to year-end with roll-forward testing (as necessary)</p> <p>Extent: Greater number of sample selections</p>	<p>Nature: Increased testing of process-specific company-level controls and reduced testing of process-level controls</p> <p>Evidence: Inquiry with documentation; some re-performance</p> <p>Timing: Any time with basic roll-forward testing consider benchmarking automated application controls</p> <p>Extent: Medium number of sample selections</p>	<p>Nature: Primary focus on testing company-level controls; minimized testing of process-level controls</p> <p>Evidence: Inquiry with observation</p> <p>Timing: Any time; minimize roll-forward testing consider benchmarking automated application controls</p> <p>Extent: Minimum number of sample selections</p>
Performed By	Competent and objective resources (e.g., internal audit) with focused oversight. (Deploy best resources to high-risk areas)	Competent and objective resources (e.g., self-assessment) with high-level oversight	Competent and objective resources (e.g., self-assessment) with high-level oversight
Auditor Impact	Reliance: May place limited or no reliance on management's testing	Reliance: May rely on certain amount of management's testing (if objective and competent)	Reliance: May place significant reliance on management's testing (if objective and competent)

As shown in Figure 5, controls addressing higher risks should receive far greater attention than those addressing lower risks. This means that high-risk areas should usually undergo the most extensive testing using a greater number of sample selections; should be tested by objective and competent resources (which may often be the internal audit group); and should be tested closer to year-end. Some of the cost savings from reducing testing efforts for lower risk areas might be invested into higher risk areas. In addition, focus on reducing re-testing costs. Many companies incurred higher testing efforts and costs due to control effectiveness failures. To combat this problem, some of the cost savings realized from the Control Rationalization program should be reinvested in control design improvements, such as automation. Remember – efficiencies can be gained not just in the performance of the test, but also in not having to repeat the test.

Medium- and low-risk areas, on the other hand, can be tested through the application of fewer selections; can be tested at any time during the year; and can be tested through self-assessment to a greater degree.

Your company will not be alone in using a risk-based classification scheme — your external auditor will likely do so as well. And it's likely that high-risk areas that have the greatest impact on internal control over financial reporting will command the bulk of your auditor's time and attention. We strongly advise companies to work closely with their external auditors throughout their Control Rationalization approach.

A question regarding the auditor's approach frequently arises, due to the related cost implications: To what extent will the auditor rely on management's testing? The answer depends mainly on the level of risk attached to a particular process or importance of the control objective and the objectivity and competence of the individuals performing the testing. External auditors may place limited (or even no) reliance on management's testing of high-risk areas. However, as control risk diminishes into the medium and low categories, auditor reliance can increase (assuming that management's testing is performed by objective and competent personnel).

Companies should consider using an effectively designed self-assessment process as a foundation for their risk-based testing approach. Properly designed, a self-assessment process can generate tangible testing efficiencies.

Phase 3: Leverage Automated Controls and Enabling Technology

Automated controls are less prone to error or manipulation or other potential performance problems that are associated with people-based controls. Thus, to the greatest extent possible, companies should seek to replace manual controls with automated.

Areas to consider for adding new technology

- Manage segregation of duties conflicts
- User access provisioning
- Transaction-level controls monitoring
- System change management
- Fraud detection programs

But before investing in new technology, you should consider using what you already have in-house. A surprising number of companies have never fully enabled the internal control functionality of their enterprise resource planning (ERP) systems. During Phases 1 and 2, companies should identify and give consideration to control enhancements that may be better performed by the application of automated controls.

The potential benefits of deploying automated controls are many. In addition to being more reliable, automated controls can decrease costs by positively impacting the extent, nature, and timing of testing. That is, a lesser number of sample items are required because the likelihood of an exception is low (extent); automated controls are often easier to test than manual controls (nature); and certain application controls can be benchmarked so that testing frequency can be rotated over a reasonable period of time.

In addition to benefits realized in the testing phase, operational benefits result, because automated controls are generally more efficient.

Phase 4: Standardize and Centralize Processes

Another reason behind the bloated triangle depicted earlier (see page 4) is the unnecessary complexity around systems, processes, and locations faced by many companies. Growth through acquisition can leave companies with an assortment of processes and technologies. Compared to the benefits from Phases 1-3, the payoff from standardizing and centralizing disparate processes and controls can be significant. Of course, so may be the investment. Hence, most companies view standardizing and centralizing processes as longer-term strategic objectives.

Typical activities in this phase include consolidating ERP systems, standardizing business activities, and deploying shared services. The potential value derived from these activities extends beyond compliance into operational efficiencies and improvements, and any investment in these areas cannot be justified entirely on the basis of compliance. However, centralization offers the type of scale that enables companies to deploy controls-related technology efficiently, and in doing so help create a sustainable internal control program.

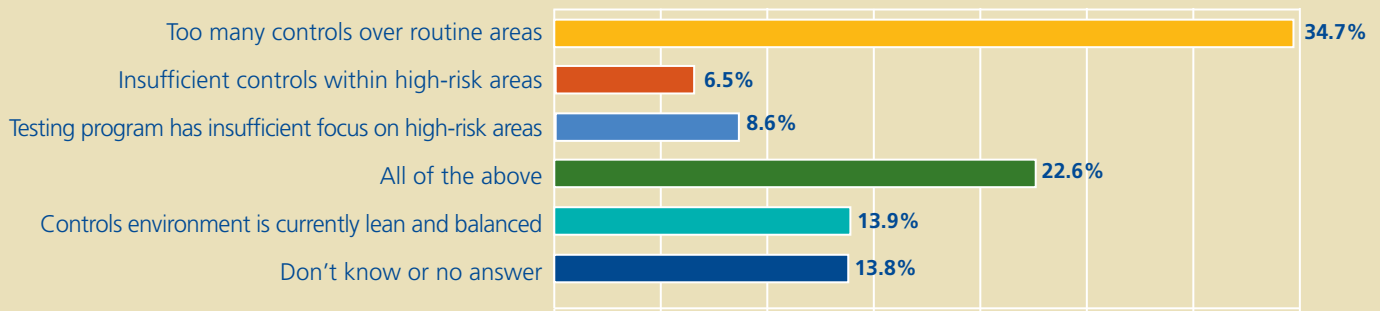
Improvements can be gained in the following operational and compliance areas:

Operational Benefits

- *Reduction in back-office costs:* Companies often experience a meaningful headcount reduction when using a shared services organization.
- *Decrease in overall spend:* Companies have better visibility into their total expenses when accounts payable is centralized.
- *Reduction in IT maintenance costs:* Fewer systems and instances to maintain means lower cost.
- *Better operational risk management:* For example, centralizing credit services enables companies to manage their exposure on an enterprise-wide basis.

How would you describe the current state of your controls program?

In a Dbriefs webcast hosted by Deloitte in autumn 2005, over 800 participants were asked to characterize their company's internal control program.



- *More value-added activities:* Standardization allows employees at business units to focus on value-added activities, rather than transaction processing.

Compliance Benefits

- *Enhanced Monitoring:* Better technology, focused resources, and company-level controls can enable effective monitoring of controls.
- *Less Documentation:* Standardization and centralization can lead to a reduced amount of control documentation (e.g., narratives, flow diagrams, matrices). It also may reduce the number of locations where controls need to be tested.
- *Fewer Walkthroughs:* Enhanced monitoring and less documentation decreases the number of walkthroughs required, both internally and by the external auditor.
- *Uniform Testing Approaches:* With standardization and centralization, companies can create uniform testing approaches that focus on risk, which reduces the time to develop test plans, to train employees, and to evaluate test results.
- *Fewer Sample Sets:* Companies can address a reduced number of sample sets as a result of fewer processes and controls.

Barriers to Achieving Risk-Based Control Rationalization

Like many ambitious initiatives, the potential rewards of risk-based Control Rationalization are great, but the challenges are many. Here are some common stumbling blocks companies can encounter along the way:

- Some companies are focused on conducting their internal control assessment and therefore may not have sufficient resources to also complete a Control Rationalization effort.
- Some companies do not have ready access to leading practices, knowledge-bases, and enabling tools to quickly implement Control Rationalization efforts.
- Some companies have adopted a limited view of Control Rationalization by focusing primarily on rescoping without regard to other possible areas of efficiency gain and cost reduction.

Conclusion: Continuous Control Rationalization

Control Rationalization should be viewed as a continuous process to be integrated into the regular routines of the business and into singular events such as mergers and acquisitions, cost reduction programs, and business process improvements. By so doing, companies position themselves to drive sustained continuous improvement to their program and potentially realize significant cost reductions.

The effort begins with applying a continuous risk assessment process that provides management with an updated, risk-adjusted view of their compliance program and enables them to react in a proactive manner to changing conditions. This ongoing process allows management to direct control enhancement and compliance efforts accordingly and to also reduce compliance efforts as risk levels decline.

It's important to note that the organization's external auditor should be involved at key points in the process. Meaningful inclusion will help external auditors to develop an informed awareness of the organization's inherent financial reporting risks, expected benefits to be derived from Control Rationalization efforts, and how the organization's overall design of controls best align with these risks. This understanding, in turn, will provide the external auditors with better understanding of management's compliance process and a basis for determining the scope of their internal control audit procedures.

Appendix:

Carrying Forward the Momentum

Control Rationalization Approach

Maturity Model for Control Rationalization

Stage 1 (Current)	Stage 2 (Rationalized)	Stage 3 (Sustained)
Approaches for Control Rationalization are not defined or formalized as part of a company's compliance program	Rationalization efforts are tactical in nature; explicit triggers are not defined to enable the organization to identify, act on and take advantage of compliance efficiency opportunities	Rationalization is a continuous formalized process that drives proactive consideration of control efficiency and effectiveness as new systems and processes are being considered or as business risks change
Lacks a formalized top-down approach; risk assessment applied only to determine scope	Top-down approach is applied; risk assessment is formalized and includes qualitative considerations that are applied for scoping efforts and developing test plans	Financial reporting risks are well understood at the enterprise and process-levels; risk triggers are established and implemented to drive reconsideration of control effectiveness and identify opportunities for compliance efficiency
Testing approaches do not consider the relative level of an area's risk to drive the nature or extent of testing efforts or the level of competencies deployed	Testing approaches are risk-based; increased reliance on management's work by independent auditors	Highly competent and objective testing resources for high-risk areas.
Company-level controls evaluated are not linked to underlying process-level controls	Certain company-level controls are leveraged for rationalization efforts; they link with precision to process risks	Company-level controls are a fundamental part of efficient control design, and supplement process-level controls in addressing high-risk areas
No process to identify impact of changes on risk assessment	Established process to identify impact of changes and update risk assessment accordingly	Processes to identify impact are both top-down and bottom-up; integral part of operations
Control design relies primarily on manual detective controls	Increased reliance on system based and preventive controls by 'turning on' existing functionality	Optimal combination of preventive and detective controls largely system-based

This paper has described the concepts, principles, approaches, and expected benefits of a Control Rationalization program. What's the next step? How do you go from theory to implementation?

The above maturity model, which has been developed in the course of providing Sarbanes-Oxley services to over 800 Deloitte clients, provides a tool to assess, at a high level, where your company stands and in what direction it needs to travel.

Our experience indicates that companies nearing Stage 3 of the maturity model are not only far along with driving an efficient compliance program but have leveraged their Control Rationalization efforts as an engine to sustain the future quality of their program. These sustainable elements include:

- embedding compliance into daily operations through re-designing roles and responsibilities
- deploying a formal training program at different levels to build compliance competencies, promote compliance governance and ownership, and anticipate emerging compliance risks
- re-engineering internal control processes, including those around risk management, testing and deficiency evaluation; and creating new processes such as control self-assessment, as required
- integrating Sarbanes-Oxley compliance into other risk and compliance management activities to streamline overall compliance efforts.

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