



Sarbanes-Oxley Fallout Leads to Auditing Standard No. 2: Importance of Internal Controls

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Confidence in our system of checks and balances that was meant to protect the interests of shareholders, creditors and other beneficiaries of public companies was severely shaken by events of the past five years. An epiphany occurred in October of 2001 when Enron, then the nation's seventh largest company, revealed more than \$1 billion of accounting errors that stunned investors and launched investigations that are continuing today. Since then, dozens of companies such as WorldCom and Tyco have been prosecuted or investigated for financial fraud. In response, Congress passed the Sarbanes-Oxley Act of 2002 (SOX), the intent of which was to raise the standards

of corporate accountability, improve detection and prevention of fraud and abuse, and reassure investors and other users of financial information that they have a level playing field. This Act is the most significant legislation affecting corporate governance and securities laws since the passage of the SEC acts of 1933 and 1934, and CFAs, CFFAs, and CVAs must be knowledgeable about these important changes.

One of the most important provisions of SOX is Section 404 entitled "Management Assessment of Internal Controls". This section requires each annual report of an issuer to contain an "internal control report" that (1) states the responsibility of management for establishing and maintaining an

adequate internal control structure and procedures for financial reporting; and (2) contains an assessment, as of the end of the issuer's fiscal year, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. Each company will need an internal control framework. Each issuer's auditor is required to attest to, and report on, the assessment made by the management of the issuer.

SOX created the Public Company Accounting Oversight Board (PCAOB) to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports. The



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process adopted by the PCAOB results in rules that are then submitted to the SEC for approval. PCAOB standards and rules do not become effective until approved by the SEC.

To implement Section 404, SOX charged the PCAOB with establishing professional standards governing the independent auditor's attestation, and reporting on, management's assessment of the effectiveness of internal control. The PCAOB has implemented this charge by passing Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements*. This standard, which was approved by the SEC on May 27, 2004 and becomes effective for fiscal years ending on or after June 15, 2004, requires the auditor to test the effectiveness of internal control to be satisfied that management's

conclusion is fairly stated. The Board rejected the view that the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and the internal auditors. Instead, the Board decided that two opinions were needed to satisfy an evaluation of the effectiveness of internal controls and the requirements of SOX. The audit of internal controls requires one on management's assessment of the internal controls and another on the effectiveness of the internal controls over financial reporting. The PCAOB has made clear that it attaches equal importance to the evaluation of management assessment and to the direct testing by the auditor of the effectiveness of internal controls over financial reporting (e.g., the accuracy of the financial statements). It specifically states that the more extensive and reliable management's assessment is, the less expensive and costly the auditor's work will be. The Board feels that the information the auditor learns as a result of auditing the company's financial statements substantiates the auditor's conclusion about the effectiveness of the company's internal control over financial reporting.

The 200-plus-page pronouncement is clearly one of the most important standards the PCAOB will ever consider. The Board explicitly states that it recognizes the considerable demands this auditing standard will impose on auditors and public companies. But the Board feels that this standard will enhance the accuracy, reliability and fairness of the financial statements, which are such an important element in the success of our financial markets.

In this paper, we will discuss the provisions of Statement No. 2 and refer to the issues that have aroused concern or controversy. We will highlight some of the issues by reference to several of the 193 comment letters addressed to the board. Finally, we will address its effectiveness in deterring fraud.

Objective of an Audit of Internal Control (Paragraphs 4-6)

The Standard requires the independent auditor to evaluate management's assessment process to determine whether management has an appropriate basis for expressing an opinion on the effectiveness of the company's internal control over financial reporting. Effective internal control means that no material weaknesses exist. Thus, the objective of the audit of internal control is to obtain reasonable confidence that no material weakness exist as of the date identified in management's assessment.

Definitions Related to Internal Control (Paragraphs 7-12)

The standard defines *internal control over financial reporting* as follows:

A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

1. Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company
2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company
3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements

COSO Framework (Paragraphs 14–15)

COSO is the acronym for the Committee on Sponsoring Organizations of the Treadway Commission. The standard cited COSO as a source of guidance for performance and reporting directions. The landmark report commissioned by COSO is *Internal Control—Integrated Framework*. This report established a common definition of internal control that services the needs of different parties and also provided suggestions as to how to improve control systems. Their model has five parts:

1. **Control environment**—management's attitude toward controls, or the "tone at the top"
2. **Risk assessment**—management's assessment of the factors that could prevent the organization from meeting its objectives

3. **Control activities**—specific policies and procedures that provide a reasonable assurance that the organization will meet its objectives. The control activities should address the risks identified by management in its risk assessment
4. **Information and communication**—system that allows management to evaluate progress toward meeting the organization's objectives
5. **Monitoring**—continuous monitoring of the internal control process with appropriate modification made as deemed necessary

Auditor Independence (Paragraphs 32–35)

The Standard cites four principles that should be followed in insuring auditor independence:

1. An auditor must not act as management or as an employee of the audit client
2. An auditor must not audit his or her own work
3. An auditor must not serve in a position of being an advocate for his or her client
4. An auditor must not have mutual or conflicting interest with his or her client

These requirements, however, do not prevent the auditor from making recommendations as to how management may improve the design or operation of the company's internal controls as a by-product of an audit.

The Standard also states that an auditor must not accept an engagement to provide internal control-related services that have not been specifically pre-approved by the audit committee. In other words, general pre-approval is not satisfactory. Finally, management

must be actively involved and cannot delegate responsibility for internal control services to the auditor. The Standard characterizes the required involvement as "substantive and extensive".

Evaluation of Audit Committee Effectiveness (Paragraphs 55–59)

The company's audit committee plays an important role within the control environment and in evaluating internal control over financial reporting. An effective audit committee is an important aspect of setting a positive tone at the top, and the Audit Committee may need to hire outside CFDs and CFFAs to help fulfill this important obligation. The standard emphasizes that although the audit committee plays an important role within the control environment, management (not the audit committee) is responsible for maintaining effective internal control over financial reporting.

The company's board of directors (not the independent auditor) is responsible for evaluating the performance and effectiveness of the audit committee. However, the independent auditor needs to evaluate the effectiveness of the audit committee as part of understanding and evaluating the control environment. In making the evaluation, the independent auditor should focus upon certain factors:

- Independence of the audit committee members from management
- The clarity with which the audit committee's responsibilities are articulated, such as in the charter, and how well the audit committee and management understand those responsibilities
- The audit committee's interactions and involvement with the independent and internal auditor

- Whether the audit committee raises and pursues with management and the independent auditor the appropriate questions, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates; here is where outside or inside CFDs and CFFAs may be helpful

Whether the audit committee is responsive to issues raised by the independent auditor. The audit committee may need to consult with a CFD or CFFA.

If the independent auditor determines that oversight is ineffective by the audit committee of the company's external financial reporting and internal control over financial reporting, then this failing is regarded as a serious deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists. Further, the standard requires the auditor to communicate the nature of the specific deficiency or material weakness in writing to the board of directors. A material weakness in internal controls over financial reporting requires a deadly adverse opinion.

Performing Walkthroughs (Paragraphs 79–82)

The auditor should perform at least one walkthrough for each major class of transactions. During their deterrence work CFDs should make walkthroughs. Major class of transactions is identified as those classes of transactions that are significant to the company's financial statements. A walkthrough requires an auditor to trace a transaction from origination through the company's information systems until it is reflected in the company's financial

reports. The walkthrough should include the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified.

Use of the Work of Others (Paragraphs 108–126)

The Standard affirms that the independent auditor's own work must provide the principal evidence for the auditor's opinion. However, the auditor may use the work of others to alter the nature, timing, or extent of the work otherwise performed (e.g., internal auditors, CFDs, CFFAs). The Standard also acknowledges that the assessment is not subject to precise measurement. The independent auditor's must use his or her judgment in evaluating whether sufficient principal evidence has been obtained. To obtain more information, see SAS No. 73, which defines a specialist.

In evaluating the work of others, the auditor should:

- Evaluate the nature of the controls tested in the work of others
- Evaluate the competence and objectivity of the individuals who performed the work
- Test some of the work performed by others to evaluate the quality and effectiveness of their work

In evaluating the nature of the controls tested by the work of others, the auditor should consider the following factors:

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement
- The degree of judgment required to evaluate the operating effectiveness of the control
- The pervasiveness of the control

- The level of judgment or estimation required in the account or disclosure
- The potential for management override of the control

The external auditor should not use the work of others to test controls that are components of the control environment. These controls include those that are specifically established to prevent and detect fraud. The control environment includes the following factors:

- Integrity and ethical values
- Commitment to competence
- Board of directors or audit committee participation
- Management's philosophy and operating
- Organizational structure
- Assignment of authority and responsibility
- Human resource policies and procedures

The determination of the extent to which the auditor may use the work of others depends upon the degree of competence and objectivity of their work. The more competent and objective the work of others, the greater the use the auditor may make of the work. When evaluating the competence and objectivity of the work of others, the auditor should consider the following factors:

- Their educational level and professional experience
- Their professional certification (e.g., CFD or CFFA) and continuing education
- Practices regarding the assignment of individuals to work areas
- Supervision and review of their activities
- Quality of the documentation of their work, including any reports or recommendations issued
- Evaluation of their performance

Significant Deficiencies and Material Weaknesses

(Paragraphs 9–10 and 130–141)

A *significant deficiency* is a control deficiency with more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected. The significance of a deficiency in internal control over financial reporting should be evaluated initially by considering the following:

- The likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies

The Standard provides the following examples of significant deficiencies in internal control over financial reporting:

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles
- Antifraud programs and controls
- Controls over non-routine and non-systematic transactions
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements

A *material weakness* is defined by the Standard as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not

be prevented or detected. Examples provided by the Standard as a strong indicator that a material weakness in internal control over financial reporting exists include the following:

- Restatement of previously issued financial statements to reflect the correction of a misstatement
- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting
- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective
- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies
- For complex entities in highly regulated industries, an ineffective regulatory compliance function
- Identification of fraud of any magnitude on the part of senior management

Multi-Locations (Appendix B)

Appendix B provides guidance on audit procedures when a company has multiple locations or business units. To determine the locations where tests are to be performed, the auditor must consider the significance of the accounts relative to others on the consolidation statements and the risk of material misstatement. The Standard emphasizes that testing company-level controls is not a substitute for the auditor's testing of controls over a large part of the company's operations or financial position. The evaluation of the

efficacy of the controls is based upon testing a large portion of the company's operations or financial position at the overall level, not at the individual significant account level.

Safeguarding of Assets (Appendix C)

Safeguarding of assets is defined in the Appendix as those policies and procedures that "provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements". The Standard states that safeguarding controls should be evaluated in the context of preventing a material misstatement in the financial statements.

In addition, the standard states that management's plans that could potentially affect financial reporting in future periods are not controls. As a result, the lack of controls over business continuity planning is not part of internal control over financial reporting.

Small Business Issues

The original standard included in Appendix E is a discussion of small and medium-sized company considerations. This discussion was replaced in the final standard with a reference to COSO's guidance on small and medium-sized companies. The Board believes that the COSO report is better suited to providing guidance on special small and medium-sized company issues.

PUBLIC COMMENTS

Although the comment letters were generally laudatory, some objections were noted. One area of concern was the efficacy of the Standard in deterring the incidence of fraud.

The Association of Certified Fraud Examiners (ACFE) did not write a comment letter on the proposed standard, but it did contribute recommendations prior to the PCAOB issuance of the Standard. In the April 2004 issue of *AccountingToday*, the ACFE complained about the scant references to fraud in Auditing Standard No. 2. The ACFE complained that the Standard includes “just three paragraphs on fraud considerations and a list of five areas of related internal control.” The ACFE’s president, Toby Bishop, complained that “People are being asked to perform a task where there doesn’t appear to be sufficient specificity of the requirements and criteria for evaluating operating effectiveness.”

The Standard requires an adverse auditor’s position in the event of a material weakness. Auditing Standard No. 2 does not permit a qualified opinion when a material weakness is present. The American Institute of Certified Public Accountants (AICPA) objected to this requirement. The AICPA urged the Board to retain the auditor’s opinion or an adverse opinion when there is a material weakness in internal control over financial reporting. The AICPA’s

comment letter states “Reporting options provide better, more flexible disclosure and thus are more informative for users of the report.”

Although the requirement for walkthroughs was strongly supported, there was some disagreement about the implementation of this standard. The comment letter of the American Accounting Association (AAA) suggested more guidance about the extent of walkthroughs. The AAA raised the question about the extent of walkthroughs by asking is “one walkthrough for each significant process sufficient?” The AAA also supported “additional guidance on how to perform walkthroughs for control environment issues would be helpful.”

The comment letters of both the Financial Executives International (FEI) and The Institute of Internal Auditors (IIA) complained about the costs assumed by organizations in complying with the PCAOB standard. Both organizations urged a measurement and assessment of such costs and a comparison to the benefits of full implementation. The FEI was explicit in stating that the costs of implementing the Standard will generally outweigh the benefits derived from fulfilling its requirements.

CONCLUSION

The series of business failures that began with Enron shook the confidence of the American public in the integrity and fairness of U.S. capital markets. This public outcry resulted in the passage of the Sarbanes-Oxley Act of 2002 and the passage of that Act resulted in the formation of the PCAOB to implement its provisions. Central to the deterrence of fraud and misrepresentation is an effective system of internal control over financial reporting. The better the system of internal controls, the more likely financial statements will be reliable and objective. Auditing Statement No. 2 was passed by the PCAOB to insure that auditors exercised due diligence in evaluating internal controls and not rubber-stamp the assertions of management about such controls. Although this Standard will place extreme demands on auditors and public companies, the Board is hopeful that the requirements of Auditing Standard No. 2 will result in more accurate and reliable financial statements. CVAs, CFDs, and CFFAs must be familiar with this new environment facing companies. VE

Additional Resources

NACVA and the Center for Economic and Industry Research (CEIR) provide a wide array of assistance. Below we share a sampling; contact us at nacva@nacva.com and ceiranalyst@C-E-I-R.com, respectively, for additional information.

Books:

- *Accounting Irregularities & Financial Fraud: A Corporate Governance Guide, Second Edition* by Michael R. Young

CEIR Services:

- Active file of papers and articles on the Sarbanes-Oxley Act

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