

Restoring Trust

**It's time for
internal auditors to
step up and be counted
in the ongoing effort
to rebuild faith in the
public company.**

BY TIM J. LEECH

AS COMPANIES CONTINUE their work to meet the requirements of the U.S. Sarbanes-Oxley Act of 2002, internal auditors need to ask themselves where internal auditing was during the period leading up to the enactment of these new rules. It has become increasingly clear from the amount of new work required in documenting, assessing, and testing related controls, as well as in correcting gaps, that most internal audit departments had scoped their company's financial statement preparation, disclosure area, and processes out of their "risk based" audit plans. Common reasons cited to explain why one of the highest possible risk areas to a public company was frequently not in the internal audit plan include:

- It would have been inefficient to duplicate what the external auditors were already addressing.
- Internal auditors lacked the necessary skills to evaluate controls in these areas because of the complexity and rapidly changing technical requirements of Generally Accepted Accounting Principles and tax law.
- The chief financial officer (CFO), to whom internal auditing often reported, did not want internal auditing to cover this area.
- Earnings management was a game widely practiced in corporate America. Sometimes it is wise not to poke into areas known to be dangerous.
- Few audit committees ever asked internal auditing for specific assurance on the reliability of external accounting disclosures.

Unfortunately, because internal auditing's profile in the area of reliable external disclosures was generally low, the U.S. Congress, Securities and Exchange

Commission (SEC), and Public Company Accounting Oversight Board (PCAOB) did not initially see internal auditing as a key element of the Sarbanes-Oxley solution. A careful study of the act and the voluminous regulations issued by the SEC and PCAOB indicates that the internal audit profession's value proposition in key risk areas has been largely overlooked or, worse, rejected. Although the PCAOB has made some recent concessions on the degree of reliance that can be placed on the work performed by an independent and professional internal audit shop, the external audit profession has been assigned the primary role in rebuilding the public's faith in the disclosures — ironically, the same external auditors who certified as reliable virtually all the financial statements that were subsequently proven to be materially wrong and led to Sarbanes-Oxley.

Internal auditors need to recognize the actions of the SEC and PCAOB for what they really are — a wake-up call to elevate internal auditing's game and stature. A first step would be for The IIA Research Foundation to study why such an obviously high-risk area as financial reporting and disclosure was scoped out of the audit plans of thousands of internal audit departments — departments that regularly cited that they were governed by, and fully complied with, The IIA's standards.

Audit departments are having increasing difficulty attracting and retaining high-quality staff in a post-Sarbanes-Oxley world. A primary problem is that PCAOB Auditing Standard No. 2 (AS2) promotes the concept of internal auditing handling the low risk/low level testing while external auditing handles the evaluation and testing of important con-

control areas like macro-level controls, the financial close process, anti-fraud controls, IT general controls, and other key areas. Some internal audit departments are reacting by distancing themselves from Sarbanes-Oxley and leaving it to the controller's department to set up and staff Sarbanes-Oxley quality assurance units. However, it can be easily demonstrated that assurance testing would be less expensive if the independent control evaluation and testing unit reported to the chief audit executive (CAE). External auditors have been specifically told by the PCAOB that they can place greater reliance on work done by staff reporting to a company's CAE. In fact, for maximum savings, it is important that the CAE report directly to the audit committee, not the CFO, a practice that continues in many companies.

Another area of intense debate is the question of whether internal auditing can maintain its independence if it plays a key role in testing and evaluating control effectiveness. One perspective holds that internal auditing cannot play a key role in testing controls to meet Sarbanes-Oxley mandates and still maintain its independence. This position is valid in cases where internal auditing plays a primary role in documenting and evaluating control effectiveness. The solution is to ensure that management and work units are fully responsible for formally assessing and evaluating control effectiveness, including representing whether controls are adequately designed and functioning effectively as documented. If management makes these primary representations in writing before internal auditing's evaluation and testing work, there should be no debate as to whether the auditors have maintained their independence.

In cases where internal audit quality assurance testing repeatedly confirms that management and work units are being diligent and honest in their control status representations, the level of internal testing and eventually that of external auditing should be significantly reduced. In cases where management and the control owners consciously misrepresent whether the controls function as described and/or their effectiveness, internal auditing must address this as a serious weakness in the company's control environment. When work units and

controllershship staff lie about whether controls are actually operating as described in the documentation, this should be viewed as a far more severe control problem than the noncompletion of specific controls.

IIA leadership should continue and even intensify its efforts to lobby the SEC and PCAOB to make Sarbanes-Oxley regulations more practical and allow increased reliance on internal auditing. This reliance should include reliance by the external auditors on work done by internal auditing in high risk/high profile areas — provided that internal audit departments can prove they are truly independent and professional. Internal audit departments that report to the company's CFO cannot meet this test.

In addition to lobbying for increased reliance on internal auditing, IIA leadership needs to carefully study why Sarbanes-Oxley costs have spiraled out of control and make specific, practical recommendations to the SEC and PCAOB defining how the assessment methods being used by SEC registrants and their internal and external auditors can be improved. Although thousands of chief executive officers and CFOs have publicly stated that they have done their control assessments and their controls are effective in accordance with the 1992 controls framework developed by The Committee of Sponsoring Organizations of the Treadway Commission (COSO), evidence is mounting that the many thousands of Sarbanes-Oxley Section 404 assessments reported (together with the related external auditor opinions — as evidenced by the Nov. 30, 2005, report by the PCAOB that described inefficiencies and their causes) have actually been done in a rules-based fashion. The assessments are based on a highly conservative interpretation of PCAOB AS2, and not based on a principles-based, top-down approach that is consistent with COSO.

It is important to recognize that COSO was not built for the purpose for which the SEC is recommending it be used. COSO sponsors (the American Accounting Association, American Institute of Certified Public Accountants, Financial Executives International, Institute of Management Accountants, and IIA) need to formally acknowledge this

fact and begin working on a new control assessment and reporting framework that is better suited to cost effectively guide companies and auditors in their control assessment work.

Sarbanes-Oxley costs are expected to continue in excess of the US \$6 billion per year range. The impact of the Sarbanes-Oxley regime is being felt around the world. The time for action is now. Internal audit practitioners can:

- Personally and through their organizations provide even more feedback to the PCAOB and SEC on more efficient approaches to the audit of internal control over financial reporting, including a more principles-based, top-down approach that makes extensive use of internal audit capabilities — even in “high risk” areas.
- Lobby the PCAOB and SEC for more specific guidance for management.
- Assist management, through their understanding of internal controls, ensuring that the organization's assessment approach and that of the external auditor are efficient and effective. The IIA can:
 - Continue to lobby the SEC and PCAOB for enhanced guidance for external auditors, including clearer and more reasonable guidance on relying on internal auditors' testing of high-risk areas.
 - Join with other professional organizations to assess whether COSO is “fit for purpose” and whether revisions or a whole new framework are needed.
 - Develop guidance for management, separate from that provided to the external auditors by the PCAOB, on the efficient and effective assessment of controls over financial reporting.

Internal auditors can take the lead in restoring public faith at a reasonable cost to shareholders if they are prepared to call for quantum, not incremental, changes. It is time to step up and be counted.

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