

Readings

A Framework for Internal Auditing's Entity-wide Opinion on Internal Control



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At least annually — and usually far more frequently these days — every chief audit executive (CAE) will sit in front of his or her audit committee to deliver a report on the state of internal control. CAEs have learned to expect the "big question." It comes without fail in a variety of forms, but in its simplest version, the audit committee chair asks, "Is everything under control?"

Upon hearing that question, the wise CAE will squirm, cross his or her fingers, and say, with as few qualifications as possible, "Yes," knowing too well both the limitation of audits and the unacceptability of any other answer.

In the world of accounting, auditors are hired to confirm their affirmation in aggregate financial statements, reflecting millions of individual transactions prepared according to generally accepted accounting principles. Until The Committee of Sponsoring Organizations of the Treadway Commission (COSO) developed its *Internal Control – Integrated Framework* in 1992, there was no framework for forming an aggregate opinion — taking into account thousands of individual audit results and other control related information — on whether a company's internal control framework conformed to any generally accepted set of control criteria.

In *A Framework for Internal Auditing's Entity-wide Opinion on Internal Control*, authors Wanda Wallace and G. Thomas White attempt to help CAEs answer the big question with greater confidence. The book includes a step-by-step prescription for forming an entitywide opinion on internal control using COSO's *Internal Control – Integrated Framework*. It also provides a basis for defining the audit universe, planning audits, and aggregating, evaluating, and reporting the results.

UPDATED STUDY

First published in 1994 as *The Internal Auditor's Role in Management Reporting on Internal Control*, this updated research study does not limit its scope to internal control over financial reporting — the subject of the U.S. Sarbanes Oxley Act of 2002 that receives the most attention from internal auditors. It ambitiously addresses all four of the broad categories of objectives established by COSO: reliable financial reporting, operating effectiveness and efficiency, compliance with applicable laws and regulations, and safeguarding of assets. It also covers all five elements of the COSO control model: control environment, monitoring, risk assessment, information and communication, and control activities.

Since the original publication of this research study, the world has changed dramatically for internal auditors. A foreword by Dr. James Roth does an excellent job of positioning the study in today's context. The IIA has issued progressive new standards as part of its Professional Practices Framework; Sarbanes-Oxley and the related Public Company Accounting Oversight Board (PCAOB) audit standards have affected the role of internal auditors and their relationship with external auditors dramatically; and, more recently, the long-awaited release of COSO's *Enterprise Risk Management – Integrated Framework* has provided practitioners with new insights. Still, none of these events challenges the fundamental premise of this study: that by using the COSO *Internal Control – Integrated Framework*, it is possible to provide a reliable entitywide opinion on internal control effectiveness.

PRACTICAL APPLICATION

The book begins with an excellent executive summary followed by a seven-step overview of the prescriptive framework. Subsequent sections expand on the framework and provide suggestions, technical advice, and possible solutions. Numerous exhibits provide specific, practical ideas for applying the concepts advanced by the authors.

Wallace and White recommend developing an audit universe and proposing an audit plan based on their potential to elicit evidence to support the entitywide opinions on broad COSO objectives. They also show how audit results and other evidential information can be aggregated into a table showing the COSO objective category (e.g. compliance with laws and regulations) and the related COSO control criteria along with a rating of control effectiveness. This is likely the way the authors of COSO's internal control framework intended for it to be applied.

ACCEPTABLE FAULTS

A Framework for Internal Auditing's Entity-wide Opinion on Internal Control does not seem to weight the various elements of the COSO model. In other words, breakdowns in the control environment are given equal consideration to breakdowns in control activities.

Recent publications by Moody's Investors Service and other credit rating agencies indicate that they intend to give far more weight to broad, companywide environmental issues than to account-specific control breakdowns when assessing control deficiencies reported to the U.S. Securities and Exchange Commission under Sarbanes-Oxley.

The study also fails to provide specific guidance as to what degree of conformity with COSO control criteria is sufficient for an adequate control rating, either in a specific situation or at an entitywide level. However, the authors do introduce the concept of "material weaknesses" in rating formula.

Also, at the time of the original study, usage of anonymous voting technology to evaluate control criteria was not widespread. This technology has since proven to be a powerful tool for identifying, aggregating, and analyzing control criteria. Although valid, the tables proposed in the study for aggregating audit reports and opinions would be tedious and complex in practice. Recent developments in database technology for recording an audit universe and aggregating and analyzing incidents and audit results would provide far more powerful mechanisms than the authors contemplated in this study.

Still, the faults in this research study are to be expected in a pioneering effort, and to some extent are based on hindsight. Professional practitioners are sure to find solutions to many of these

problems given additional time, tools, and experience. COSO needs to be applied in the field by practitioners and the framework steadily evolved.

RELIABLE RESULTS

A Framework for Internal Auditing's Entity-wide Opinion on Internal Control provides auditors with a powerful guide for applying and testing the COSO internal control framework and producing an entitywide opinion on internal control. This research study should be required reading for practitioners who intend to rely on COSO.

Sarbanes-Oxley and related PCAOB standards have taken a unique approach to evaluating and forming an opinion on internal control over financial reporting. They do not require reporting against control criteria to the level of detail proposed in this study. Some argue that they have set auditing back several decades. Internal auditors may find that the methods suggested in this study — coupled with today's tools and technology — can produce reliable results far more efficiently and effectively on a broader range of objectives.

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