The Challenges and Effects of the Sarbanes-Oxley Act on the Internal Audit Profession

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How must the internal auditing profession change so that it will be recognized as one of the cornerstones on which effective corporate governance must be built?

How can internal auditing measure its progress toward achieving this goal?
**Introduction:**

The internal audit profession has achieved significant quality and quantity growth over the past 62 years since the founding of the Institute of Internal Auditors. The relatively young profession has matured with “Progress Through Sharing” as its trademark. The transition from a control emphasis to a “Risk-Controls” emphasis is perhaps even revolutionary. During the past fifty years, internal auditing has experienced dramatic change comparable to that of manufacturing businesses during the Industrial Revolution. Fortunately or unfortunately, part of this growth can be attributed to events that changed the face of business as well as unethical wrongdoings that rocked the confidence of financial markets and many corporate stakeholders. The profession in the U.S. has certainly been positively impacted by legislation including: the Foreign Corrupt Practices Act of 1977 (FCPA), the Federal Sentencing Guidelines of 1991 (FSG’s), and most recently the Sarbanes-Oxley Act of 2002 (SOX). Similar events and the numerous Blue Ribbon Reports (Cadbury, King II) have impacted the profession internationally. Each of the three pieces of legislation listed was established as a deterrent to corporate wrongdoing that diminished the investors’ trust of corporations.

The following paragraphs provide an overview of how the internal audit profession can add value and enhance corporate governance by reducing the risk of potential reoccurrences of wrongdoings. The definition of internal auditing presents very succinctly the challenges of the profession. This paper also suggests steps needed in order for the profession to become one of the
cornerstones of a strong system of corporate governance. The paper will also provide recommendations for how the profession will be able to measure the effects of recent changes in the legal environment and practice of internal auditing in achieving the new goals and objectives expected by the public.

“If you do not study history, you are sure to repeat it”.

During the late 1960’s through the mid-1970’s, globalization played a major role in the growth of business practices throughout the world. The massive growth of the world economy brought with it unfair dealings such as payments and benefits (bribes) in exchange for favorable treatment for business. These sensitive payments eventually led to the establishment of the FCPA that is often referenced as the “Internal Auditors’ Full Employment Act”. Although the legislation led to a significant increase in the demand for internal auditors, the nature of professional practice was not significantly changed.

In the decade following the codification of the FCPA, the U.S. economy was shocked by multiple business failures in the Savings and Loan Industry as well as other industries. Shareholders were dismayed to find that they had lost billions of dollars due to unethical behavior of management and demanded future protection. As a result, the FSG's were enacted to provide stricter consequences for corporations and their executives involved in inappropriate behavior and breach of fiduciary responsibility. The FSG's provided for reduced penalties for organizations having adequate control functions, which once again led to an increased focus on the internal audit profession. The guidelines encouraged corporations to develop audit functions to reduce their risk of potential penalties.
for certain legal violations. Though certainly not as significant as the FCPA, the FSG’s legislation led to a small increase in the number of auditors in the profession, but it did not have a significant impact on audit methodology. The evolutionary development of internal audit led to improved overall quality of business, as the function was new or expanded at many organizations.

Comparable to events leading to the FCPA and the FSG’s, a handful of companies including Enron, WorldCom, Adelphia, and Tyco to name a few, have once again led shareholders to doubt the accuracy of corporate communications and representations of financial results and stability. At a time that many people believed the economy was beginning to recover after a significant economic downturn, hopes began to unravel as a result of improper financial reporting practices. Politicians across the U.S. were pressured to introduce legislation requiring stricter punishment of key corporate personnel responsible for companies with ineffective control environments. With the insistence of the American public, the United States’ Public Company Accounting Reform and Protection Act of 2002, also know as Sarbanes-Oxley Act of 2002 (SOX), was passed into law.

Once again the profession of internal auditing received an impetus as SOX promises to mandate many changes in business and the practice of internal auditing. The SOX legislation has been designed to prevent and identify many of the recent frauds effecting organizations and their investors. As a result, the audit profession will once again gain numbers, however this time the role and methodology of the internal audit function will change to meet requirements of
the new legal mandates. Internal auditing will need to take a “Big Picture” view and audit from the top down.

**Challenges Facing the Practice of Internal Auditing**

In 1992, the Committee of Sponsoring Organizations (COSO) of the National Commission on Fraudulent Financial Reporting (Treadway Commission) provided a standard definition of internal control and the ‘Internal Audit - Integrated Framework’ (COSO Model) to assist organizations in achieving financial, compliance, and operational goals and objectives. Also identified in the report were five interrelated areas of internal control (Control Environment, Risk Assessment, Control Activities, Monitoring, and Information and Communication). The model as presented on the following page, along with recommendations contained in the 1992 report, has many overlaps with SOX regulations.

Business organizations are currently being challenged to review, modify, and evaluate (and develop in some instances) their entire control system to meet the established required dates of compliance for financial reporting. As a result, internal auditing and the corporate control environment are receiving increased attention and resources necessary to comply with the newly enacted legislation. Executive Management and Boards of Directors are looking toward internal audit today with a sense of urgency to provide them with a level of confidence on the overall corporate control environment before their external auditors provide any indication of an ineffective control environment. Despite the increased exposure and buy-in from executive management, internal audit departments are faced
COSO Model

Monitoring
Methodology used for assessing the quality of internal controls.

Control Activities

Hard Controls:
- Segregation of duties (AAA)
- Safeguarding of assets
- Transactions Recorded
- Accountability
- Periodic Reconciliation

Risk Assessment
Common factors used in identifying and assessing materiality of risk

Control Environment

Soft Control:
Corporate Culture
Tone at the Top

Information and Communication
In-transit media throughout all levels of the organization
with many challenges in providing shareholders, boards, and executives with assurance on the effectiveness of their organizations control systems.

One such challenge facing internal auditors will be the increased need to view the business from the top-down. The recent headline frauds that initiated the SOX legislation have involved major weaknesses in the tone at the top and the control environment. Many audits of the past focused on transactions within departments at various business units, while acts of fraud were being committed by executives at corporate headquarters. Looking at the big picture will require an increase in the types and extent of reviews at corporate offices, including not only day to day transactions, but specific monthly, quarterly, and yearly processes that can have severe effects on the financial statements.

Another challenge that many organizations will face is the development, and monitoring of a Management Risk Process. Due to recent types of frauds, it appears that the risk assessment processes that many companies use will require additional input from management, the board of directors, and the audit committee. The penalties that have been defined for non-compliance with recent legislation should provide additional incentives for employees to contribute input and take a proactive approach to reduce the risks of fraud within their organizations. With an increase in awareness and interest in corporate governance, the audit function may become stressed with increases in the number of special requests. In addition to this increase in demand for services, implementing a system to evaluate and prioritize the nature and timing of
services will provide an additional challenge for businesses and their audit function.

Although some companies, primarily in financial services, incorporated the COSO framework model into their audit process over a decade ago, many companies will be working to implement COSO or a similar model into their organization. The length of implementation should be reduced by “Progress Through Sharing” of information and communication throughout the profession. Hopefully, organizations will be able to assist each other by sharing experiences and lessons. It would also be advantageous for boards and executive management to drive the implementation of such a model throughout the business. This should provide those in the trenches with a better perspective on risks and controls and what areas need to be considered in the everyday conduct of business to allow employees to take a proactive approach to enhancing the control environment.

Recent events should lead to more integration of audit teams and require auditors to be more knowledgeable of their company and their industry. Audit organizations will focus on recruiting and developing auditors with a combination of skills that will require knowledge of finance, information systems, operations, and business processes.

The final and perhaps most difficult challenge to overcome will be internal auditing's ability to be perceived as a value-added service to the organization while being forced to take a control based approach. The amount of work that will be required to provide assurance for the control environment will cut into
consulting activities. This will provide the CAE with a challenge to continue to work with their staff to focus on value-added audits and recommendations.

**What may come?**

One of the keys to becoming one of the cornerstones of business corporate governance is how well audit plans are developed. After the revised COSO framework model has been implemented, the model should become the driving force in developing and driving audit plans. Audit plans will be more dynamic than ever, and input from all levels of the organization will be necessary. Thanks to role models like Cynthia Cooper at WorldCom and Sharon Watkins at Enron, more and more channels of communication will be available for employees to provide input without the fear of retaliation. With a limited number of resources and a potential exponential increase in the number of concerns reported, it will be very important to implement a review system to ensure that leads are reviewed based on perceived risk.

In the future, audits may become more compliance oriented with the same audits being conducted at many different business locations with reports on these processes being consolidated and the risks of the company's overall control environment being reported. This method should create additional credibility with management by helping to identify best practices. This would allow risk based type samples to be drawn, while consolidating the results would tell more about the control environment of the organization as a whole. At the same time this will allow for best practices to be developed and shared throughout the field to locations with similarities. This should provide value to the
organization through efficiencies that may be achieved by allowing non-audited locations to gain an understanding of systematic risks within the organization. This would provide time and allow the locations to take a proactive approach to help ensure a well-established control environment. Hopefully, this would encourage business functions to implement self-audits to provide an overall increased level of confidence in the organizations ability to accomplish its goals.

**How will the Profession of Internal Auditing benefit from Sarbanes-Oxley?**

As SOX legislation has been enacted to protect investors, it will provide the internal audit profession with a prime opportunity to become one of the cornerstones of business. The Treadway Commission’s report suggested some of the same changes that SOX requires. Accordingly, companies will not have the option to accept or reject the proposed changes as they have become law. Enactment of related regulations will provide internal audit departments with the backing necessary to make positive contributions to improve the control environment for the organizations they support.

Charters of the internal audit department and the audit committee should be updated to reflect changes that are required by SOX. Such modifications will include the requirements of independence of each member of the audit committee. Audit committees will also be expected to take a more active role in the audit process from reviewing and contributing to oversight of the risk assessment process to the review of status reports of control deficiencies. The internal audit charter should include changes in the reporting structure that will formalize the departments formal ties to the audit committee and the indirect
reporting responsibility to the company’s’ executive management. The modified charter should also include internal audits responsibility for providing management with evidence as to the effectiveness of the overall corporate control environment. The modified internal audit department charter should also stipulate a requirement that the Chief Audit Executive provide the Audit Committee with a representation letter as to the departments’ compliance with the charter. Together these charters will reflect a more integrated relationship between the internal audit department and the audit committee.

Since the majority of the major frauds of late have been failures of corporate governance systems, audit committees should demand audits at the executive levels. Such audits of executive management should become mandatory and include reviews of:

- conflicts of interest to determine if executives have interest in competitors, suppliers, or customers of the company,
- executive expense reports to ensure that the executive management is complying with policies and making a statement that there are no exceptions to the rules, and
- compensation and benefits to make sure that all compensation and benefits provided to executives have been approved by the compensation committee of the board of directors.

Such audits will help to provide an evaluation of the corporate governance structure and a basis to evaluate the effectiveness of the control environment.
The Management Risk Process stands to benefit a great deal from enacted legislation. A more active and vocal audit committee and greater input of risk concerns and support of the CEO and CFO level will contribute to a better evaluation of corporate risk for consideration in the risk assessment process and development and updating of the annual audit plan. Enhancements to the management risk process will include the following proactive steps, which are discussed in greater detail in the following paragraph:

- Audit Plan Support of Business Plan
- Input from Planning Committee

In the past, audits have not been adequately planned to determine if the organization is achieving the goals and objectives as communicated by management. Despite the definition of internal auditing, some audit departments have not played a significant role in assisting organizations achieve defined goals and objectives that support the Business Plan. Instead audit has evaluated company risk that has not included support of the company business plan.

The risk of reducing the level of effectiveness of the control environment while modifying processes and systems will require greater participation from the audit function. Therefore, in the future, a planning committee will provide significant input into the audit planning process and ensure that project teams include internal audit representatives during the planning, evaluation, and post-implementation phases of projects that may have a significant effect on the control systems within organizations. Prior to going live with new systems and or
processes, audit should be required to provide an evaluation of implementation risks and an opinion on go-live.

Companies must also be very sensitive to the following five types of misrepresentations identified by Arthur Levitt the former Chairman of the Securities and Exchange Commission:

- **Big Bath Charges** - New management teams recognizing losses in excess of the actual loss in order to enhance the view of their performance.
- **Creative Acquisition Accounting** – Hiding excess costs for poor acquisition decisions in goodwill and other intangible assets.
- **Cookie Jar Reserves** – Booking reserves in excess of estimations to provide for cushion to meet expectations in the event that the company experiences weaker performance than expected by the market.
- **Materiality** – Larger organizations have a higher materiality level, thus what is material to one is not material to all.
- **Revenue Recognition** – Improper booking of sales transactions prior to meeting Generally Accepted Accounting Practice requirements.

Occurrence of any of these five practices opens companies, their shareholders, and their executive management team to significant monetary losses as well as prison time for management.

Past efforts of the internal audit function focused on risk of business units rather than the risk of specific significant processes of the organization. The future of auditing may change with risks being evaluated at the process level. Reviews of processes that provide the greatest risk should be conducted at
various locations and summarized to identify significant weaknesses that are systemic throughout the organization, thus providing an indication of risk that are unacceptable and are likely to prevent the organization from achieving established goals and objectives in compliance with corporate and legal requirements.

A greater level of coordination between the internal and external audit functions can be expected to provide greater organizational audit coverage and additional confidence of the control environment. This will allow the two functions to assist each other instead of dividing the two functions. Internal audit should also become more active in reviewing the work performed by as well as the fees and expenses charged by the external audit firm. This should provide a basis for an assessment of the external audit review for the audit committee to make future decisions on continuance of its relationship with its external audit firm.

Management also needs to rely on the audit function to educate and train employees on the necessities of effective processes and controls. This may be accomplished in a variety of different ways, which may lead to increased awareness throughout the organization. Hopefully, the education process will provide employees with the capability of evaluating risk and controls in their daily activities and encouraging departmental self-audits.

How to measure the progress?

There are a number of different ways in which to measure the effectiveness of internal audits progress to achieving the goals and objectives set out by SOX. One-way that may initially come to mind for many, would be to wait
and see how many companies have significant financial restatements during the next five years. Taking the evaluation farther to obtain explanations for the cause of restatements could provide important information to be shared throughout the profession. Additionally, attempting to determine the amount that investors have lost due to financial misrepresentations that should have been detected and comparing these statistics to historical statistics would provide evidence to evaluate the progress that the internal audit profession as a whole has made toward achieving its goals.

**Conclusion:**

There are many changes and challenges that internal audit faces in implementing strategies to comply with SOX, but the profession is in an excellent position to return confidence to investors and other corporate stakeholders. Board members and executive management have never had greater incentives to support the internal audit function and assist it with accomplishing its mission. Although it could be a while before past frauds are uncovered, the enhanced compensatory and criminal penalties should hopefully provide an additional incentive for companies to enhance their control environment and regain the respect of the investing public. Internal audit is positioned to become part of the corporate governance cornerstone in the efficient and effective conduct of business operations.
References


http://www.coso.org/Publications/NCFER_Part_5.htm