

Continuous Auditing in the Shadow of SOX: Re-Engineering Interim Reporting and Assurance

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Work in Progress; Subject to Change

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A DISCUSSION PAPER

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Introduction

This discussion paper is based on extensive discussions with capital markets stakeholders in Canada over the past 6 months. These discussions have included issuers/preparers, investors, auditors, board members and regulators. The purpose of these discussions was to surface issues that need to be addressed to reduce information risks borne by capital markets participants and thereby contribute to market efficiency and lower cost of capital. The key points raised in this discussion paper are:

- There is a need to focus more attention on the quality of interim/continuous reporting and disclosure not just annual financial statements, because timely information is highly valued by capital market participants but the reliability of this information can be improved.
- The auditing profession should strive to re-allocate much of the year end “audit” work pertaining to material transactions and events that occur throughout the year into the interim periods in which those transactions and events first occur. This redistribution of audit effort should not lead to increased audit cost, but can lead to more timely reporting on interim information and enhanced reliability of that information.
- There should be more frequent public reporting by the auditor of his or her findings at interim periods, rather than saving up all the findings for the year end. Such reporting will enhance the overall quality of interim information and other disclosures.
- Regulators and investors should rely on independent audit committees to strengthen the reliability of interim financial statements and other continuous disclosures, but must provide them with the tools to be effective; auditors should provide more service to audit committees and more formal reporting on services performed. Reviews of financial statements and other services performed at interim periods should generate written reports to audit committees, not merely oral presentations.
- There should be a clear financial reporting tie in for findings of deficiencies in connection with assessments of internal control over disclosure (ICOD) and internal control over financial reporting (ICOFR) similar to the treatment of going concern risks and other risks and uncertainties; these assessments should not be relegated solely to MD&A or regulatory filings.
- A framework and criteria are needed for the documentation and assessment of ICOD if this is to be assessed in a rigorous and reliable way. Under current regulatory proposals, management is responsible for assessing ICOD with limited guidance on the scope of this task. The overlap between ICOFR and ICOD can lead to a lack of clarity and confusion of responsibilities. For example, the Board is responsible for the annual assessment of ICOFR, but not ICOD; but, ICOD overlaps with ICOFR. Audit committees have no direct responsibilities for either ICOD or ICOFR, but have indirect responsibilities for these assessments via their responsibilities in connection with their oversight

responsibilities in connection with regulatory filings in which management must report its assessment of these controls.

- Assessment of and reporting on ICOFR should be re-engineered – the point in time established by PCAOB AS#2 should be moved from the year end to interim periods and the audit of ICOFR should be decomposed into three sequential phases;
 - Diagnostic audit of entity wide controls at Q2;
 - Diagnostic audit of process level controls at Q3; and
 - Evidential audit of controls that provide evidence for verifying specific financial statement assertions performed throughout the period of reliance on those controls.

Such actions will redistribute audit activity and remove some of the pressure upon the year end, provide opportunities for better scoping of internal control audit work by providing an opportunity for learning from sequential phasing of audit activity, and enable more frequent reporting on key factors underlying the reliability of financial statements. A report on entity wide controls can be issued separately from a report on process level controls. Capital markets would value such reporting since they differentiate these control aspects.

Interim Financial Statements

Interim reporting (used interchangeably with quarterly reporting) is engrained in the North American investor's psyche even though it may lead some investors to focus excessively on short-term results. In addition to reporting earnings for a period, interim reporting can also provide an indication of progress towards longer term goals, reasons for problems in attaining goals, and discussion of actions being taken to get back on track. Institutional investors likely pay more attention to the assumptions and accounting policies used in preparing the financial statements rather than the specific numbers reported in the quarterly financial statements.

While practices vary throughout the world, there is a general trend toward more frequent disclosure of financial information and continuing disclosure of price-sensitive information. In Japan, quarterly financial statements are being phased in over a three year period (2004-2007). In Europe, although supported by a vast majority of European investment professionals,¹ the introduction of mandatory US style quarterly reporting for all 7,000 listed companies has been delayed in certain jurisdictions such as the UK, which gives more weight to continuing disclosure requirements of price-sensitive information. Instead, listed companies are able to issue general trading statements every quarter and financial statements twice a year.²³⁴

¹ http://www.cfainstitute.org/pressroom/03releases/03quarterly_reporting.html; accessed September 8, 2005.

² The European Commission's proposal to have the EU's 7,000 public companies adopt a quarterly reporting approach similar to that of the US met opposition from several countries such as the UK, the Netherlands and Denmark. However, although the form of reporting that was adopted is different (i.e., companies may file quarterly "trading statements" with a general description of their financial position rather than full-blown financial statements) there is a clear move towards more frequent periodic reporting in addition to the requirements for continuing disclosure of price-sensitive information.

³ The UK Listing Authority requires, as part of the Listing Rules (Section 9.9), companies to prepare a half-yearly report. (www.fsa.gov.uk). Quarterly financial statements are not currently required. The half-yearly report does not require an OFR. All it requires is an explanatory statement including: (a) any significant information enabling investors to make an informed assessment of the trend of the group's activities and profit or loss; (b) information of any special factor which has influenced the group's activities and the profit or loss during the period in question; (c)

Canadian securities regulators do not require that an auditor conduct a review engagement on interim financial statements but if a review is not performed they do require that this be disclosed in a notice that should accompany the financial statements.⁵ A sample of public company filings on SEDAR indicates the following opt out rates: TSX-listed SEC registrants 14% exception rate; non-SEC TSX companies (31%); non-TSX SEC registrants⁶ (66%) and TSXV non-SEC registrants (68%). It is noteworthy that the opt out rate is so high for entities that could benefit most from having reviews performed. Such benefits include a more reliable quarterly financial reporting process and more reliable quarterly financial statements, especially in terms of the quality of estimates, accruals and earnings, which are key contributors to information risk. In addition to benefits for the interim reports, there would be flow through benefits for the reliability of the annual financial statements and a potential reduction in the frequency of both quarterly and annual financial statement restatements. For many companies, the additional cost of having quarterly reviews could probably be offset by potential cost reductions due to improved financial reporting processes, better distribution of audit effort and other efficiency gains.

Discussions with preparers and auditors in Canada, indicate that the typical process for interim reporting involves closing off, preparation of subsidiary/divisional information, preparation of checklists and, where applicable, sub-certification at divisional/subsidiary level, consolidation, review with disclosure committee, preparation of package for audit committee/board, review with the audit committee and generally the board. Many companies use checklists to document this process and assist the business unit/subsidiary. Such checklists can run from 5-18 pages. Once the quarterly financial package is available, auditors spend 2-10 days on reviewing it (if engaged to do so.) Then the financial package is brought to the audit committee for its review and then to the Board for its approval. Some companies have the audit committee and board meetings on the same day while others have the board meeting the next day to enable any issues raised by the audit committee to be addressed in advance of the board meeting.

enough information to enable a comparison to be made with the corresponding period of the preceding financial year; and (d) to the extent possible, a reference to the group's prospects in the current financial year.

⁴ The EU's Transparency Directive, which has to be implemented by Member States from 2007, will require more comprehensive half-yearly reports, including an interim 'management report' (more like an annual directors' report than an OFR). This will also require 'interim management statements', providing: an explanation of material events and transactions that have taken place during the relevant period and their impact on the financial position of the issuer and its controlled undertakings; and a general description of the financial position and performance of the issuer and its controlled undertakings during the relevant period.

⁵ This requirement came into effect in March 2004. Prior to that it was impossible to distinguish which companies had a review and which ones did not. A review of a sample of interim financial statements for Q1 of 2003 indicated that virtually none of them reported that no review was performed.

⁶ These include both TSXV-listed and other Canadian companies that are not listed on a Canadian exchange but are listed solely on a US exchange or traded in the US over the counter. In Canada, there are two primary exchanges, the TSX and TSXV (Venture exchange). The TSX has about 1,300 listed companies while the TSXV has about 2,300 listed companies. About 300 companies that are listed on the TSX are also subject to US SEC regulations because they are listed on a US stock exchange or otherwise offer their debt or equity securities in the US. An additional 1,000 companies listed on the TSX are not subject to SEC regulations but are subject to OSC regulations. However, the majority of Canadian public companies are comparatively small companies that are listed on the TSXV and are subject to differential regulatory filing requirements. As a class, TSXV companies are seen as having fewer financial and human resources, potentially weaker internal controls, and higher information risks. According to some sources, TSXV companies are "branded" as being more speculative, riskier investments and this branding may serve as a cautionary warning to investors, obviating the need for some types of regulatory action.

The amount of time taken to complete the quarterly reporting process varies dramatically, even among large sophisticated organizations. Some companies complete the process in as little as 15 days while others use the whole 45 days allowed by the securities regulators⁷.

Interim Audit Reporting is the Cornerstone for the Evolution of Continuous Auditing

Interim (quarterly) reporting is a key element of the continuous flow of information to the capital markets. In fact, the annual report may be viewed as a special instance of interim reporting in Q4 with more extensive requirements than the other quarters. Investment decisions are influenced by the information that flows continuously to the capital markets in the form of interim financial statements, earnings press releases⁸ and material change reports. However, these information sources have received much less attention by the accounting and auditing profession than they deserve while annual reports have received a disproportionate amount of attention, despite their temporal remoteness from the micro decisions made in continuous time that aggregate to overall capital markets.

With the increased recent focus on annual reporting on internal control over financial reporting as at the date of the annual financial statements, there is a risk that the auditor's procedures will focus even more on the annual financial statements than is already the case to the detriment of interim reporting. The so-called integrated audit called for by the PCAOB, focuses on point-in-time reporting at the annual financial statement date and risks saving up audit findings at interim dates for up to a year, instead of reporting important information to the capital markets on a more timely basis. This paper proposes more frequent reporting of relevant and reliable information through an integrated audit whose structure is focussed on interim reporting rather than focusing excessively on the annual financial statements.

Interim financial statements are often not viewed as reliable discrete standalone documents. There are good reasons for this, including seasonality factors that can make quarterly financial results highly variable, the lumpy structure of certain revenues and costs that are received or paid in one quarter but apply to other quarters, and uncertainties about costs that are not known until the fiscal year end. These factors result in estimation of accruals and deferrals for purposes of interim reporting that can make interim financial statements irrelevant or unreliable as standalone documents.

However, an alternative view is that interim financial statements should be viewed as discrete documents that should stand on their own, with controls and audit procedures in place to tie down material transactions and events and prevent shifting income from quarter to quarter through the abuse of accruals, deferrals and estimates. About a third of the restatements reported by US public companies are attributable to restatements of interim financial statements.⁹ Notorious "fourth quarter adjustments" of accruals made during the previous three quarters can undermine the credibility of the quarterly reports and the financial reporting system.

Auditor reporting on interim financial statements originated in the US where the public accounting firms required an interim review engagement as a condition for undertaking the year end audit. Subsequently, the US stock exchanges mandated the engagement. The reporting

⁷ (60 days for Venture companies)

⁸ Robert M. Bowen, Angela K. Davis and Dawn A. Matsumoto, "Emphasis on Pro Forma versus GAAP Earnings in Quarterly Press Releases: Determinants, SEC Intervention, and Market Reactions," *The Accounting Review*, Vol. 80, No. 4, 2005, 1011-1038.

⁹ Huron Consulting Group, *2004 Report on Financial Reporting Matters*, February 28, 2005; www.huronconsultinggroup.com 1-866-229-8700

problems at Enron and other such scandals triggered a review of the US interim review standard that resulted in a more focused engagement including some audit-oriented procedures. Currently, US SEC registrants must have timely reviews performed of interim financial information.

Interim reviews of public company financial statements are based on audit-based knowledge but require only enquiry, discussion and analysis. Such procedures may not be sufficient to establish that material transactions such as business combinations, restructuring provisions, major contracts, lawsuits and other such material events and transactions are accounted for properly in the quarter, potentially resulting in fourth quarter adjustments when more focussed audit procedures are actually performed on those events and transactions. Such adjustments can cast doubt on the integrity of the financial reporting system and the value of quarterly reports.¹⁰

Some audit firms exceed the work effort required by the review standard, the scope being determined by the audit committee and the audit firm. Common issues that involve additional work by the auditor at quarter ends include revenue recognition, legal claims and other contingencies, inventory valuations, taxes, accounts receivable allowances, derivatives, foreign exchange, and consolidation issues. The nature and extent of the additional procedures appears to vary significantly among the firms, and perhaps among clients of the same firm. In some cases the additional work is restricted to enquiry-based review procedures. In others, however, the auditor executes some audit procedures at the same time as he or she conducts the review engagement. These could include examination of material transactions undertaken in the period or in respect of the initial application of accounting policies. When audit procedures are undertaken, documentation is usually segregated between that required for the review engagement and that prepared as a result of the procedures conducted as part of the annual audit. When major transactions are examined, this activity may occur within the reporting period, rather than at its conclusion.

The time spent by auditors at quarter ends varies according to the nature of the assignment and the extent to which the auditor is involved with the audit committee's review. When a client wants a formal report for its audit committee, additional time is required, as is the case when audit or additional review procedures are performed. As mentioned previously, the range appears to be 2-10 days.

Enquiries that extend to assessing changes in internal control over financial reporting (ICOFR) and internal control over disclosures (ICOD) could add one to six days. This large range reflects the need for a firm to often call in its systems group in situations involving changes in IT-based internal control processes.

Given the concerns about the limited scope of review procedures under current review engagement standards, it is natural to consider whether an audit of interim financial statements

¹⁰ A study by Livnat and Tan (2004) of restatements of quarterly earnings by US companies between 1988 and 2002 reports a quarterly restatement rate of 3.4%. (Note that companies with mergers and acquisitions, discontinued operations and fiscal-year changes were specifically excluded.) Quarterly restatements are typically smaller than annual restatements and are often not announced in press releases, becoming known only upon filing Form 10-K with earnings that differ from those released in the quarterly earnings announcement. The restating companies are generally smaller. Most (62%) of the restatements are downward to correct previously overstated earnings. The most frequently restated components of earnings were cost of goods sold and tax expense. The fourth quarter had noticeably fewer restatements than the other quarters, presumably due to the auditor's involvement in that quarter. (Note that during most of the period of the study, auditors were not required to perform a "timely" quarterly review (i.e., at the end of the quarter the financial statements were issued), but could do it "in retrospect" as part of their annual/fourth quarter audit. This was changed starting March 15, 2000.)

should be performed. Based on discussions with auditors and practitioners, and given the characteristics of today's financial reporting systems, it seems that it would be virtually impossible to complete a quarterly audit in respect of interim financial statements for most companies. It would be too expensive, necessarily involving substantive audit procedures such as third party confirmations. As well, it would be too time consuming and would require additional time to be added to the current 45 day (60 for venture issuers) filing requirements set by the securities regulators. In addition, quarterly audits would pose serious staffing issues for the firms, at least in the short term.

However, it would be possible, and some auditors already do this, to require extended procedures to be performed on material transactions and other key items during a period, beyond those required by current review engagement standards. For example, one Big 4 firm identifies significant and unusual transactions and estimates made during the interim period, based on annual financial statement materiality, including: business combinations, restructurings and disposals, applications of new or revised accounting pronouncements and significant new financing arrangements and audits those items during the interim period.

The interim information of all public companies should be subject to audit procedures to increase the level of assurance provided beyond the current level associated with reviews, as a way of reducing information risks in interim reporting periods. Such an expanded review would involve detailed testing of "material transactions and events" during an interim period in order to improve the reliability of earnings and accruals reported in the interim periods and thereby reduce information risks associated with interim reports. The identification of material transactions and events, the nature, timing and extent of procedures to be performed during such an extended review and the form of reporting on the results of those procedures would need to be defined by professional standards.

It is envisioned that auditors will be on increasingly performing specified audit procedures on material transactions and events that occur during a quarter. Interim audit procedures would need to be designed to increase overall engagement efficiency and provide a reasonably high level of assurance that errors in interim reporting will not be missed, only to be detected subsequently during the audit of the annual financial statements. Accordingly, it seems likely that any revised standard in this area would need to require audit procedures to be applied to material transactions and first-time applications of accounting policies as they arise. In addition, extended interim procedures would involve more intensive procedures with respect to ICOFR and ICOD. In the longer term, this may evolve into an efficient quarterly audit process that subsumes today's approach. In the long term, this may evolve into an assurance process that relies on a combination of assurance procedures applied to internal control over financial reporting (ICOFR), internal control over disclosures (ICOD) and to the information being disseminated to add credibility to the information and reduce information risk in the capital markets.

Figure 1 is a maturity model that summarizes a potential path from the current status to quarterly audits and other assurance services designed to ensure the integrity¹¹ of information disseminated to the capital markets. Two aspects of quarterly reporting are considered: the scope of the audit procedures and the nature of auditor reporting on the findings of those procedures.

¹¹ Integrity is defined as completeness, timeliness/currency, accuracy/correctness and validity/authorization, based on a study by J. Efrim Boritz on *Managing Enterprise Information Integrity: Security, Control and Audit Issues*, IT Governance Institute, 2004.

Figure 1

Stages in evolution of quarterly reporting

Current Stage 0	Stage 1	Stage 2	Stage 3	Stage 4	Stage 5	Stage 6	Stage 7 ^[1]
Discretionary review or disclosure that no review was performed (usually on cover of interim financial statements).	Discretionary review with public reporting.	Mandatory review (but no public reporting). This is the current US model.	Mandatory review with public reporting.	Voluntary extended review that goes beyond enquiry, discussion and analysis to fulfillment of specified audit procedures but not as far as complete audit.	Mandatory extended review with formal reporting to the audit committee on specified procedures performed.	Mandatory extended review with formal reporting to the public on specified procedures performed.	Full audit every quarter.

^[1] Stages 8+ repeat stages 0-7 for more frequent reporting

Currently, the auditor reports whether, based on his or her review, the auditor has become aware of any material modification that needs to be made for the financial statements to be in accordance with GAAP. This is in contrast to the negative assurance contemplated in the general review engagement standards. A written report would normally conclude that the auditor is not aware of any material modification that needs to be made for the interim financial statements to be in accordance with GAAP, but prior to that it would explain that an interim review does not provide assurance that the auditor would become aware of any or all significant matters that might be identified in an audit. To some, this appears to be a convoluted, responsibility-avoiding message. Others counter that it is designed to protect the auditor against litigation driven by unreasonable expectations. A public report is not contemplated and it is specifically precluded via restrictions on the use of the auditor's report.

The International Auditing and Assurance Standards Board has approved a standard (June 2005) dealing with the auditor's review of interim financial information that requires public reporting by the auditor.¹²

It is envisioned that interim audit procedures on material transactions and events could be communicated solely to the audit committee (following the agreed upon/specified procedures type of reporting) or to the public as well if they could be described clearly enough to avoid misunderstandings.

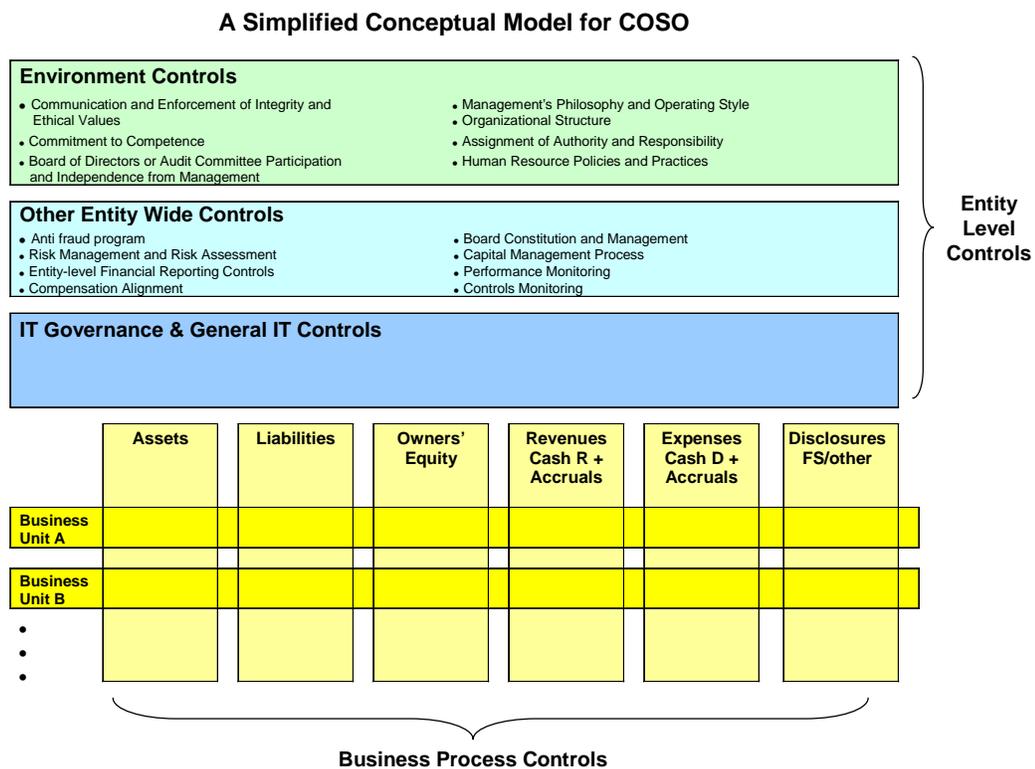
Internal Control Over Financial Reporting (ICOFR)

Internal control reporting modelled along the lines of SOX 404 is not restricted to North America. France has similar requirements and Japan and Canada have proposed a similar rule. Larger US public companies with calendar year ends filed audited Section 404 reports early in 2005. The results of the first year of SOX 404 reporting in the US are currently being evaluated.

¹² International Standard on Review Engagements (ISRE) 2410.

In the US, COSO has been used as the framework for ICOFR (despite the existence of an option to use other frameworks), with COBIT often being used for the IT element.¹³ COSO was integrated into International Standards on Auditing (ISA 315) in 2004 and Canadian auditing standards (Section 5141) in 2005. The framework has a number of components and sub-components, but can be simplified into entity level and process level controls. Figure 2 illustrates this simplification. Entity level controls focus on the broad enablers of reliable financial reporting while process level controls focus on controls related to specific business processes and transaction streams. Transaction level controls pertain to specific financial statement assertions. Weaknesses in entity level controls represent pervasive risks that colour a reader's reliance on the financial reporting discipline of an entity and its financial statements. In contrast, weaknesses in transaction level controls represent more focused risks that point to specific financial statement items.

Figure 2



Cost/Benefit Analysis

Early on it was thought that the material weakness rate in the US would be very high. However, now it appears that the first year of SOX 404 reporting has resulted in a material weakness rate of about 10% - lower than initially contemplated. However, a very large number of significant but not material weaknesses was identified as well, indicating a brittle, risky system.

The big 4 audit firms commissioned a project in the US that addressed the costs of 404 reporting for Fortune 1000 companies. It found that these companies spent on average \$7.8 million US on

¹³ COBIT is an IT control framework published by the IT Governance Institute, an affiliate of the Information Systems Audit and Control Association (ISACA). A Canadian equivalent is the IT Control Guidelines published by the CICA.

SOX 404 compliance in 2004, including \$1.9 million US on audit fees related to 404. The total cost on average represents 0.1 % of a company's revenue. In terms of benefits, the project found that each company on average identified 271 control deficiencies that it remediated in 2004 and a further 77 deficiencies that are expected to be remediated in 2005. These unremediated deficiencies led to 5 material weaknesses in aggregate among the 90 companies in the project. The project report also noted that one of the firms in its internal analysis revealed that 40% of 225 registrants remediated or implemented more than 25% of their key controls.

Financial Executives International also undertook a survey of 217 companies. It found that companies spent on average \$4.3 million US for added internal costs and additional fees for auditors and other consultants. Employees spent on average 26,758 hours to comply with the legislation. Overall 94% of respondents indicated that the costs far outweighed the benefits.

In Canada, the OSC commissioned a study to assess the costs and benefits of internal control reporting in April 2004. Quantitative analyses point to "negative benefits" for TSX companies and even more significant negative benefits for TSXV companies, although a number of qualitative benefits are identified that were not able to be included in the quantitative analysis.¹⁴

Reports by rating agencies indicate that the internal control weaknesses that were identified had a limited impact on their ratings. A report by Moody's indicates that 5% of the 1800 companies that it rates reported material weaknesses or experienced filing delays in part as a result of internal control or accounting related problems. Moody's took rating actions (of varying significance) on 12 of these companies, primarily on the late filers, because it interpreted late filing as representing pervasive control problems. Overall, Moody's concludes that in most cases control problems cited did not impact the companies' credit risk. Similarly, a report by Standard & Poor's indicates that 9% of the 2000 companies that it rates reported material weaknesses or experienced filing delays as a result of internal control or accounting related problems. Of these, only 21 resulted in ratings actions such as downgrades (14) or being placed on credit watch (7) and this was primarily for companies that were below investment grade.¹⁵

Certain regulated companies have had to certify their internal controls to regulators and to have them audited for some time.¹⁶ It is interesting to note, however, that despite being subject to internal control audits under other regulations, 59% of financial institutions that responded to a survey by Standard & Poor's had significant deficiencies in internal control over financial reporting identified by the SOX Section 404 audit, although few material weaknesses. The two most commonly reported significant deficiencies were related to controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and

¹⁴ Charles River Associates Canada Ltd., *The Cost and Benefits of Management Reporting and Auditor Attestation on Internal Controls over Financial Reporting*, April 2004.

¹⁵ Greg Jonas, Managing Director, Moody's Investors Service, "Rating implications of 404 reports: Moody's early experience", May 26, 2005; Neri Bukspan, Managing Director /Chief Accountant, Standard & Poor's, "SOX - Section 404 Ratings Implications", June 24, 2005.

¹⁶ Section 36 of the US Federal Deposit Insurance Incorporation Improvement Act of 1991 (FDICIA) required the chief executive officer and chief accounting or financial officer of each insured depository institution to (1) sign a report stating management's responsibilities in preparing financial statements, establishing and maintaining adequate controls for financial reporting, and complying with the applicable laws and regulations governing such institutions, and (2) assess annually the effectiveness of such internal controls and the institution's compliance with the laws and regulations. In addition, the FDICIA required the institution's independent accountant to attest to management's assertions contained in the report, and it required an independent audit committee.

deficiencies in IT controls (occurring in 57% and 40% of respondents reporting significant deficiencies, respectively).¹⁷

There are very mixed views in the preparer community about the usefulness of internal control reporting. Some managements have used it as an opportunity to enhance their ability to run the business and believe it is a very useful activity to force rigour into systems that ought to be there in any case. The observation often heard, even among large sophisticated organizations, is that the necessary processes existed but were somewhat informal and often not well documented. Another benefit of the internal control reporting requirements is that the process tends to result in more involvement and commitment by the audit committee. However, other preparers find the cost exorbitant and question the cost/benefit ratio.

Some criticisms have been levelled not at ICOFR itself but the frameworks and procedures used for ICOFR. Some have asserted that entity level controls are more relevant to the original purpose behind the SOX reforms while process level controls, particularly IT controls, are too costly to audit. A problem with over-focusing on entity level controls is that they usually cannot identify issues affecting specific financial statement items.

Some have asserted that COSO is outdated (first issued in 1992), too-focussed on manufacturing type entities, too focussed on large companies with formal processes,¹⁸ and too silent on IT controls. These last two criticisms appear to have particular merit. Critics have recounted the disproportionate cost of a COSO-based audit for a small public company and its predicted outcome – a litany of weaknesses that may never be remediated because of a lack of sufficient administrative staff for a division of duties and an absence of an internal audit department. Critics have also complained of the heavy and unjustifiable cost of assessing IT controls. This may be due to the adoption of unsuitable IT control frameworks.¹⁹

Investors and creditors are somewhat supportive of the internal control reporting requirements but investors and creditors may see the cost/benefit differently. For creditors, investments in controls that improve the safety of their collateral at the expense of the bottom line, the cost/benefit may be acceptable. For investors, especially those with shorter term horizons, the high costs of complying with this regulation and their potential to absorb companies' earnings and depress their share prices, the cost/benefit may be less acceptable. Longer term investors with substantial holdings may view the outlays as investments in the professionalism of the financial reporting systems of their investees and, provided that the costs are reasonable, may find them to be more acceptable.

Auditors believe that an audit involving both a financial statement audit and an internal control audit provides greater assurance over the financial statements than an audit of financial statements alone, even when there is reliance on internal control. As well, some auditors question whether a complex organization's financial statement audit could be conducted to a standard of "reasonable assurance" without reliance on internal control.

¹⁷ Standard & Poor's, *Financial Institutions Report Few Material Weaknesses Under Sarbanes-Oxley Section 404; No Expected Ratings Implications*, March 15, 2005.

¹⁸ Note, however, that COSO asserts that it is equally applicable to small companies.

¹⁹ Martin J. Coe, "Trust Services: A Better Way to Evaluate IT Controls", *Journal of Accountancy*, March 2005, 69-75.

Reducing The Cost Of The Audit of ICOFR

The US model lacks guidance for management and has been criticized for leading to excessive work by management which is then repeated by auditors. As a result, it is very expensive to implement and may not be providing significant additional assurance. In the US, there has been significant criticism of the 404 reporting process, directed particularly to the absence of a risk-based approach to the process, scope of testing, timing of testing, the inability to rotate tests on any controls, the extent of reliance that can be placed on internal auditors' work, and the limited ability of a company to consult with its auditor about accounting issues. Many of these issues, however, have been addressed by the SEC and PCAOB guidance issued in May 2005.

It has been suggested that although the audit firms could not integrate the financial statement audit and internal control audit for 2004 year ends they will be able to do so for 2005, thereby achieving significant cost reduction compared to 2004. This would involve further consideration of key controls to determine those that are key for the financial statement audit and expanding testing of these over the entire year. This would be accompanied by reduced substantive audit work, more of which may be conducted at earlier points in the year. Some have expressed doubts about the ability of most auditors to achieve such reductions, since much of their cost is driven by management's work on documenting and testing its controls in advance of the auditor's independent assessment of those controls.

A key issue raised by the previous discussion is keeping the costs of internal control reporting reasonable. There are three main issues to consider in connection with an internal control reporting approach, namely its:

- **Nature:** means to obtaining evidence about financial statement assertions vs. attestation on system of controls assessed against suitable criteria/framework (e.g., COSO)
- **Timing:** at the year end vs. at one other point vs. at several points (e.g., quarter ends) vs. continuous
- **Extent:** point in time vs. throughout a period; design and implementation vs. effective operation

Nature: Until SOX mandated an audit of controls against a framework, the norm had been to perform verification procedures on only those controls that contributed to obtaining evidence to support financial statement assertions. The PCAOB requires an audit of ICOFR against the criteria found in frameworks such as COSO, COCO or Turnbull. Auditing a control system against a framework is virtually certain to lead to significantly more work on internal control than required to express an opinion on financial statements. There may be merit in such an approach as a general diagnosis of the information integrity risks inherent in an entity's financial reporting system. However, it may be overkill if the objective is to simply express an opinion on a set of financial statements. It may be possible to separate the audit of entity-level controls from the audit of process level and transaction level controls. The entity-level and process level controls could be performed once a year, with changes being monitored on a quarterly basis. The transaction level controls would need to be tied to assertions about amounts at a point-in-time or transaction flows throughout a period of time and would need to be audited if they were relied on for establishing the validity of those assertions.

Timing: Currently, the internal control audit requires evaluation of internal control over financial reporting at the entity's year end. This creates problems for staffing with both the internal control and financial statement audits occurring at the same time. One possibility might

be to set the internal control audit for a point in time before the year end and perform roll forward procedures between that point in time and the year end. This would enable issues to be dealt with by the year end, when, if necessary, an additional point-in-time report could be issued. It would also remove some of the pressure from the year end. For controls that operate only at year end, the year-end timing would need to continue.

There are several problems associated with the selection of the year end for the point in time at which the auditor reports on ICOFR. First, much of the work is crammed into one short and intense period which creates unnecessary pressure, inefficiency and cost. If weaknesses are identified, there may be little opportunity to remediate the weaknesses in time for the publication of the audited financial statements. The diagnostic aspects of the audit of ICOFR are excessive in scope and cost. There is no opportunity to scale back from a report against the COSO framework to focus on key controls that relate to specific financial statement assertions.

The key point, however, is that ICOFR leads to a diagnosis of the risk surrounding the preparation of financial statements and financial statements are produced for public consumption quarterly. There is no obvious reason why all of the effort should be concentrated at the year end.

For example, a report on ICOFR at the end of the first quarter would benefit from insights gained from the financial statement audit work performed on year end statements. Alternatively, a report at the end of the second quarter would fall during the mid point of the year after the year end work was out of the way and before the end of year work has started. The mid-year assessment by the auditor would provide time for remedial action to be taken when necessary and disclosure of such action in the third quarter statements. A third quarter audit would permit an efficient audit strategy that encourages auditors to select and roll forward the tests of controls upon which they will rely at year end, without further testing of controls upon which limited or no reliance will be placed in the annual audit of financial statements. Figure 8 illustrates, using a Q2 point-in-time audit of ICOFR, the cycle of financial reporting and auditing as it might be implemented.

Decoupling the SOX audit from the year end audit would reduce the confusion between these two audit approaches and permit more effective integration between the diagnostic audit emphasizing entity-level controls over the financial reporting process and the evidential audit emphasizing transaction level controls related to specific financial statement amounts and assertions.

Extent: A point-in-time audit is more economical than performing an audit throughout a period of time, since it requires gathering less evidence. For a diagnostic purpose and for creating a discipline around ICOFR a point-in-time report may be useful; however, such an approach is at odds with the evidential requirements related to assertions on transaction flow data such as revenues and expenses and cash receipts and disbursements. Assessing the effectiveness of controls throughout a period is more applicable in the financial statement audit process, but may only require such an assessment for a comparatively small set of controls that relate to specific financial statement assertions.

Consider the analogy of a computer system. It has long been recognized that, as long as the system doesn't change, a test at a point in time provides a high degree of ongoing assurance about the system without need of repeated testing. Although ICOFR is not as reliable as a computer system, the logic for the point-time-audit with periodic assessments of changes appears to be based on the same theory. A question does arise, of course, regarding how much testing needs to be done at the initial point-in-time to warrant the ongoing assurance that it is intended to

provide. This in turn hinges on how much assurance is needed. If the test is diagnostic, to establish that controls are suitably designed and implemented, then the assurance can be much less than if the test must establish the validity of a financial statement assertion for a transaction stream that depends on the effectiveness of a particular control throughout the entire reporting period.

The shorter the period of time over which the diagnostic audit of ICOFR is performed, the less costly the audit without significant loss of benefits from having a diagnosis of ICOFR against an accepted framework at a point in time. Current proposals are based on the point-in-time logic but virtually beg for throughout-the-period auditing. This may be responsible for part of the heavy cost incurred. While the opinion is at a point in time, the work to assess the controls will take place before or after the point in time. For example, the testing could be days or even weeks prior to the point in time. Or, the testing could be after the point in time in the form of dual purpose tests designed to substantiate financial statement items as well as reflect on the controls that figure prominently in the accounting for those items. It seems that there is a mismatch between the point-in-time logic of a diagnostic assessment and the requirements of a financial statement audit of selected assertions whose validity depends on the functioning of a comparatively small number of specific controls.

Re-Engineering the audit of ICOFR

Based on the foregoing analysis, it appears that significant efficiencies could be obtained by choosing a point in time that clearly emphasizes and separates the “diagnostic audit” of ICOFR from the audit of annual financial statement assertions and the controls that it may rely on. The second quarter provides for the maximum separation of the ICOFR from the year end work performed during the first quarter and the planning and roll forward work that occurs during the fourth quarter. (Note that much of the work done to express an opinion at the end of Q2 is actually done during Q3.) The findings of the ICOFR at the end of Q2 could then figure in the user’s interpretation of both Q3 and the annual financial statements. (While this is written from the point of view of today’s practice when only annual financial statements are audited, the approach is intended to serve the evolving practice of auditing material transactions during the quarter in which they occur and, in the long term, the audit of the interim financial statements. Such auditing may need to rely on transaction level controls, informed by the risks identified in an earlier diagnostic audit of entity-level controls and intervening changes in those controls.)

Several related proposals are made in this paper: to decouple the audit of ICOFR from the year end, place it in interim periods, use it as a diagnostic tool to identify risks that threaten the integrity of the entity’s financial reporting system and let it serve as a basis for selecting key controls that tie in to specific financial statement assertions for the audit of financial statements. In addition, it is proposed that the internal control audit be subdivided into three logically sequenced phases. Phase 1 (see Figure 5) is the diagnostic²⁰ audit of entity level controls, proposed to be performed primarily as at the end of Q2. This is followed by Phase 2, the diagnostic audit of process level controls as at the end of Q3, informed by the findings of Phase 1. Phase 3 (not shown on Figure 5) is the evidential audit of only those controls upon which the auditor plans to rely for particular financial statement assertions for material transactions and

²⁰ As used in this document, a diagnostic audit at a point in time assesses the suitability of the design of controls for the achievement of specified control objectives and verifies their existence at a point in time. In contrast, an evidential audit expands the assessment by also gathering evidence of the effective operation of controls throughout the period of time they are being relied on to provide evidence in connection with one or more financial statement assertions.

balances. This phase would entail gathering evidence throughout the period of reliance, which could vary.

In addition to the proposed changes in timing, composition and sequencing of the audit of ICOFR, this paper suggests changes in when and how the results of the audit are reported. In keeping with the theme of providing more timely information to the capital markets, it is suggested that the results of the diagnostic audits in Q2 and Q3 should be reported then, rather than be saved up for the year end.

Internal Control Over Disclosures (ICOD)

ICOD are as important as ICOFR to the reduction of information risks and should therefore be treated similarly to ICOFR by regulators. It is doubtful that, in the absence of audit involvement, these controls will be rigorously assessed. Recent US experience indicates that assessments of ICOD are coming up with few deficiencies, reinforcing suggestions that auditor involvement with ICOD is a pre-requisite to their reliable assessment and reports thereon. Compounding the weaknesses in assurance requirements related to ICOD, these controls are subject to vague requirements. Unlike ICOFR which found a ready-to-use framework in COSO, illustrated in Figure 5, (despite its several limitations), ICOD are not blessed with a generally-accepted framework to guide their implementation and assessment. Thus, ICOD are not as well developed despite the fact that regulatory filings depend upon them.

Disclosure controls and procedures are those controls and procedures that are designed to ensure that information required to be disclosed by an issuer in its securities regulatory filings are recorded and reported on a timely basis. This would include the MD&A, 10K, 10Q, 8K and other information that is not directly related to the production of financial statements, such as earnings press releases, material change reports and forward-looking guidance.

Examples Of Disclosure Controls And Procedures

Entity level controls	Process level controls
<ol style="list-style-type: none"> 1. Disclosure committee terms of reference that extend to all regulatory filings. 2. Assignment of authority for decisions about disclosures and process for reporting disclosure issues to the disclosure committee. 3. Information system that surfaces significant events and decisions on a timely basis to assess whether they need to be reported as material changes. 4. Training program to orient new staff to disclosure policies. 5. Risk management system that identifies significant risks and procedures in place to mitigate those risks. 	<ol style="list-style-type: none"> 1. Controls to ensure that performance measures reported in the MD&A, such as production quantities, outstanding sales orders, and customer churn rates, are accurately processed and summarized, and computed in a consistent manner. 2. Controls to ensure that changes in members of the board of directors and audit committee are reflected in regulatory filings on a timely basis. 3. Controls to ensure that the statement of executive compensation is accurate and complete and prepared in accordance with regulatory requirements.

While the CEO and CFO have to certify as to the design and operation and evaluation of disclosure controls and procedures, there is no requirement for the auditor to report on management's evaluation of disclosure controls and procedures. The conclusions from management's evaluation of the effectiveness of disclosure controls and procedures are, however, reported in the MD&A. Accordingly, the auditor is required to read the conclusion to determine whether it is inconsistent with the knowledge obtained by the auditor during his or her audit of the financial statements. This activity also requires the auditor to notify management when he or she becomes aware of any apparent failure of the MD&A to meet the requirements of securities legislation or regulation.

Although ICOD and OCOFR overlap, ICOD addresses matters beyond the scope of financial statements. Because ICOD focus on the information that flows continuously to the capital markets, a generally accepted framework is required to help entities establish effective ICOD, help management and audit committees assess the effectiveness of ICOD and help auditors provide the support to audit committees that they need to fulfill their oversight responsibilities in this area. Professional standards and regulatory requirements need to provide the guidance that is currently missing for assessing ICOD.

Whereas weaknesses in internal controls reflect on the integrity risks in the financial statements, weaknesses in disclosure controls reflect not only on disclosures in the financial statements but also on compliance with regulatory requirements and regulatory filings.

In smaller companies, reporting on disclosure controls and procedures involves issues similar to those related to internal control reporting. In many cases, smaller companies will not have formalized disclosure controls and procedures. In these situations, formal documented processes may be less important because the senior management team is small and intimately involved with everything that takes place.

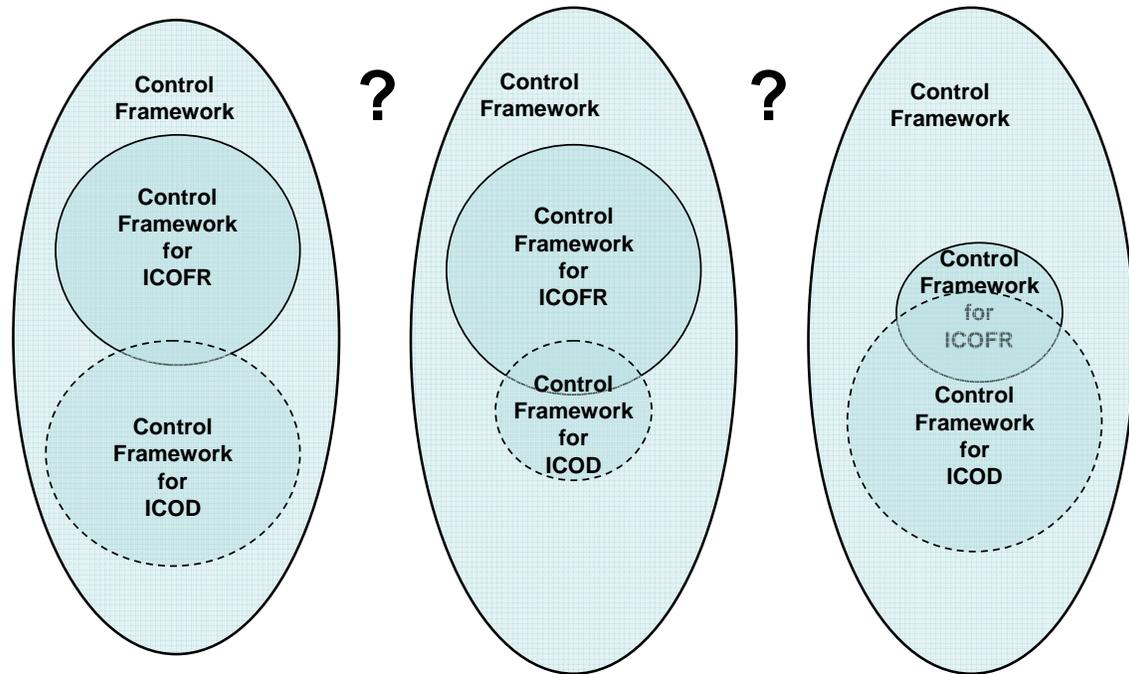
Overlap of ICOD and ICOFR

The definition of disclosure controls and procedures appears to incorporate much of internal control over financial reporting. It is not clear to what extent an evaluation of disclosure controls and procedures involves an evaluation of internal control over financial reporting. Some aspects of ICOD are covered in entity level controls over financial reporting. Other aspects are covered in transaction level controls in each business process. Still other aspects are not covered by ICOFR at all. Some practitioners believe that these aspects represent a large territory while others think that they represent a very small add on to ICOFR.

In Figure 3 the control framework for ICOD is shown with a dotted line because it doesn't actually exist in the form of a publication such as COSO. Nevertheless, because ICOD are now part of regulatory requirements in the US and proposed requirements in Canada, a generally accepted framework is needed to help entities establish effective ICOD, help management and audit committees assess the effectiveness of ICOD and help auditors provide the support to audit committees that they need to fulfill their oversight responsibilities in this area.

Figure 3

ICOD & ICOFR



As Figure 3 illustrates, there is some controversy over the nature of the overlap between ICOD and ICOFR. ICOFR overlaps with ICOD, but does not subsume ICOD. ICOFR only pertains to financial reporting disclosures, whereas ICOD pertains to all disclosures. The nature and extent of work performed on ICOD will depend on management's and the auditor's perceptions of the relative sizes and proportions of overlap between the two circles in Figure 3. The larger the ICOD circle relative to the ICOFR circle, the less ICOD coverage there is in the audit procedures performed on ICOFR. Virtually no guidance has been provided on the areas of overlap, leaving room for an expectations gap to emerge.

The bigger the area of non-overlap (as in the left and right parts of the Venn diagrams in Figure 3), the more important it is to have a separate framework for ICOD and explicit guidance on the areas of overlap. Professional standards and regulatory requirements need to provide the guidance that is currently missing for assessing ICOD. ICOD addresses matters beyond the scope of financial statements.

Financial Reporting Tie-in for ICOD and ICOFR

Currently, there is no recognition of the risks arising from weaknesses in ICOFR or ICOD in interim financial statements. Thus, the information that investors may need to assess the risks associated with the financial statements as a whole or specific items contained therein may be piecemeal rather than being integrated in the interim financial reports to shareholders. This

seems to be inconsistent with the fact that quarterly reviews of ICOFR were mandated by regulators to improve financial reporting.

For example, one anomaly that results in some circumstances is that a company receives an adverse opinion on its report on internal control but an unqualified opinion on its financial statements. In part, this can be explained by substantive procedures that provide sufficient appropriate audit evidence about the financial statement assertion where a key control is deficient or absent. Presumably, internal control weaknesses are signals of riskier/less reliable financial statements on a go forward basis, particularly in the absence of compensating audit procedures. However, current proposals make no provision for incorporating risk disclosures into financial statements. This may be due to the fact that US accounting standards do not provide a ready-made home for such disclosures. In contrast, Canadian standards do, in CICA Handbook Section 1508 - Measurement Uncertainty.

The proposals for management and auditor involvement in the assessment of ICOD and ICOFR pertain at least in part to the reliability of both the annual and quarterly financial statements disseminated to capital markets. However, the record of identified material deficiencies in ICOFR and ICOD is not incorporated in the financial statements. This is akin to filing a statement about going concern uncertainties or measurement uncertainties separately from the financial statements. It is recommended that there should be a clear financial reporting tie-in for findings of deficiencies in connection with assessments of ICOD and ICOFR similar to the treatment of going concern risks and other risks and uncertainties; these assessments should not be relegated solely to MD&A or regulatory filings.

One way of integrating these pieces is by ensuring that the notes to the financial statements contain information about ICOFR and ICOD.²¹ For example, the note disclosing significant measurement uncertainties or a dedicated internal control note would be the logical place for such disclosures. It would also be a logical place for disclosing remediated problems which could then be discussed in more detail in the MD&A. An advantage of including the disclosure in the financial statements as well as the MD&A is that if the financial statements are subject to mandatory auditor review then the auditor's enquiry, discussion and analysis would cover those disclosures, adding rigour to them and reducing information risks.

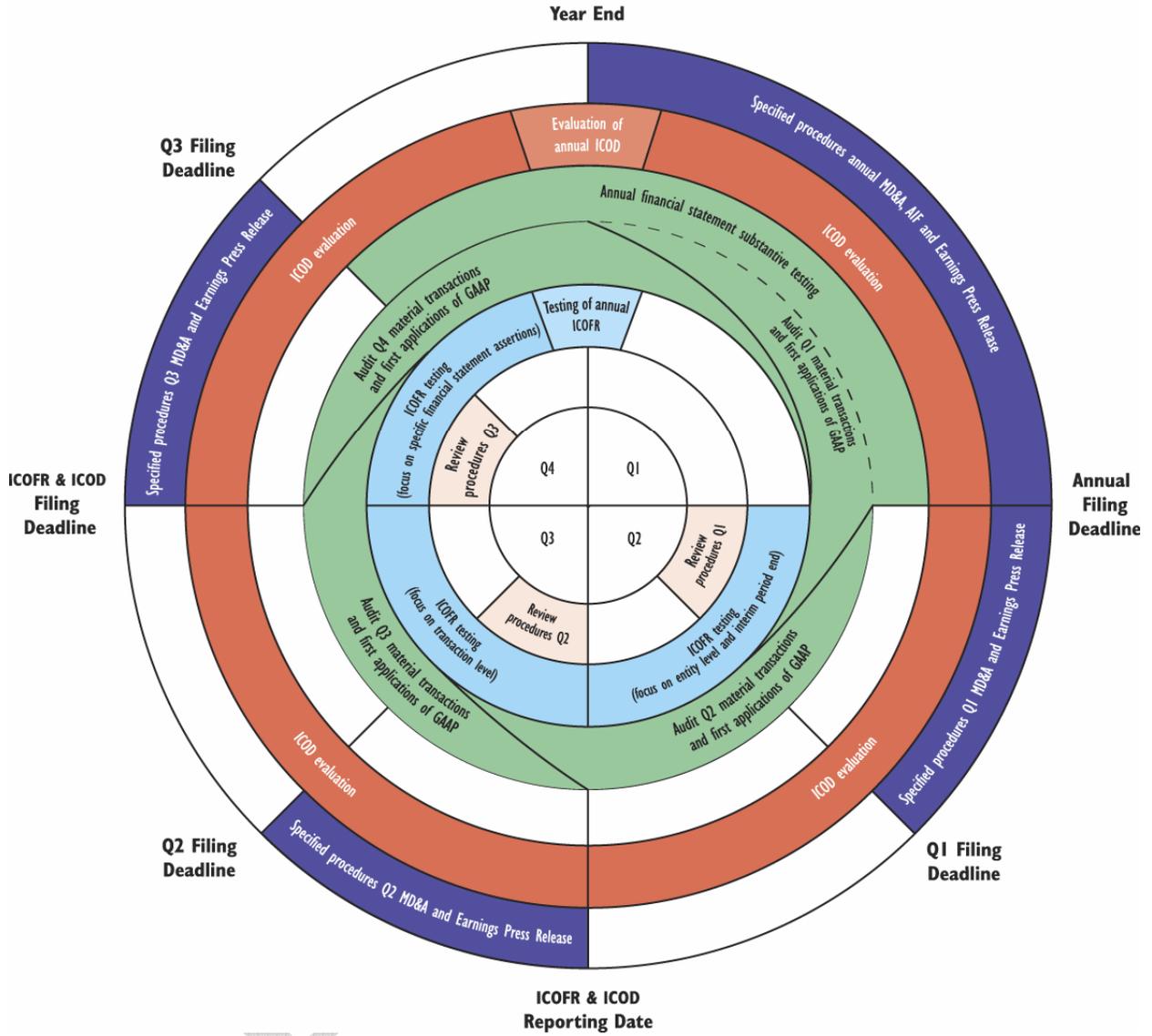
Integrated, Continuous Audit

Figure 4 summarizes this alternative vision of an interim reporting approach that relies on decomposition of the internal control audit into phases that are aligned with interim reporting periods and proper sequencing of those phases to bring maximum information to bear on each phase so as to reduce the total cost of the audit, while improving the quality of the results to reflect the top-down risk-based approach recommended by the PCAOB.

²¹ A rationale for these types of disclosures is provided in J. Efrim Boritz, *Approaches to Dealing with Risk and Uncertainty*, CICA, 1990. Note that AICPA Statement of Position (SOP) 94-6 Disclosure of Certain Significant Risks and Uncertainties, issued December 30, 1994, also discusses disclosures of risk and uncertainties in both annual and interim financial statements, but specifically excludes deficiencies in the internal control structure, although no explanation is provided for this scoping decision.

Figure 4

**THE INTEGRATED AUDIT
Q2 ICOFR**



SUMMARY OF PROPOSALS FOR CONSIDERATION

Interim Financial Statements

1. A formal written report that clearly states the scope of the engagement and the amount of assurance being provided should be issued to the audit committee. This report should also be issued to the public by being attached to the interim financial statements.
2. The auditor's responsibilities in connection with interim reporting should be expanded to include interim audit procedures on material²² transactions and events that go beyond enquiry, discussion and analysis and include specific audit procedures. The specific types of material transactions and events that should be subject to such audit procedures should be defined by professional standards.
3. A formal written report that clearly states the scope of the interim audit procedures on material transactions and events and the results of performing them should be issued to the audit committee as a second report. Consideration should be given to the specified procedures type of report for this purpose. This report (which could be integrated into the original review report if the scope and results can be effectively communicated) or an alternative report that communicates the scope and results of the auditor's extended procedures should also be issued to the public by being attached to the interim financial statements.

Internal Control Over Financial Reporting (ICOFR)

4. The audit of ICOFR should be "uncoupled" from the year end and should be reported on at interim points in time to reduce the costs of the audit, encourage spreading out audit work to a less busy period and enable better integration of the results of the point-in-time audit of ICOFR with the financial statement oriented tests of controls being relied upon throughout a period of time.
5. Consideration should be given to splitting the audit of ICOFR into a "diagnostic audit" of entity-level controls, a diagnostic audit of process level controls and an "evidential audit" of transaction-level controls. The audit of the annual financial statements would only require verification of controls upon which the auditor planned to rely in connection with specific financial statement assertions.
6. It is recommended that the "diagnostic audit" of ICOFR be performed as at the end of Q2 while the "diagnostic audit of process level controls be performed as at the end of Q3. The "evidential audit" of transaction level controls should follow in sequence.
7. The auditor should perform review procedures on management's disclosures about risks arising from changes in ICOFR in the interim financial statements (and possibly additional specified procedures on behalf of the audit committee) and audit procedures in respect of the annual financial statements. The audit committee should take responsibility

²² Materiality should be judged in light of the impact of an issue on a user relying on the interim financial information to make an investment decision. Interim financial statement materiality should not necessarily be presumed to be 25% of annual materiality and guidance on interim materiality should be provided in professional standards.

for these disclosures by virtue of its responsibility for the financial statements, adding rigour to its oversight of these matters which may not be sufficiently specified under current regulatory proposals.

Internal Control Over Disclosures (ICOD)

8. ICOD should be integrated into the financial reporting system in the same way as ICOFR and should be subject to similar audit requirements.
9. A framework for ICOD should be developed to provide the criteria against which an audit could be carried out.
10. The overlapping elements of ICOD and ICOFR should be clearly identified to avoid duplication of effort and misunderstandings about coverage.

Financial Reporting Tie-in for ICOD and ICOFR

11. The results of the annual audit of ICOFR and management's quarterly assessment of the impact of changes in ICOFR should be incorporated into a dedicated internal control note to the financial statements. The financial statements should disclose any material weaknesses identified until they are remediated. Incorporating such disclosure in a note will provide a role for the auditor and the audit committee in connection with the quarterly assessment of ICOFR.
12. The results of management's periodic evaluation of ICOD should be incorporated into a dedicated internal control note to the financial statements. Incorporating such disclosure in a note will provide a role for the auditor and the audit committee in connection with the (annual) assessment of ICOD.