Increasing External Auditor Reliance

Guiding Internal Auditors to realize the benefits of raising the bar on External Auditor Reliance.

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SOX Software Made *Simple*

Table of Contents

Section I: Introduction

The Public Company Accounting Oversight Board (PCAOB) allows external auditors to utilize and rely on the work of internal auditors when complying with Section 404 of the Sarbanes-Oxley Act. Although the PCAOB has provided explanations in the form of clarifications and alerts, there is still a considerable degree of ambiguity on the nature and extent of the external auditor's reliance decisions. In fact, many in the industry would consider this area to be more of an art than a science in some regards.

The concept of external auditors utilizing the work of internal auditors is not new. Before formal regulatory guidance was issued in the area, the idea was being discussed among academic researchers since the mid-20th century. Since then, the Internal Audit function gained prominence as an enabler of operational efficiency and has been entrusted with significant importance as a result of factors such as new auditing and accounting guidance, the introduction of the Sarbanes Oxley Act, and revised listing rules.

Guidance issued by the American Institute of Certified Public Accountants (AICPA) between the 1970s and 1990s (and later adopted by the PCAOB) set forth standards for external auditors' evaluation of the Internal Audit function and their use of work performed by internal auditors. Statements on Auditing Standards (SAS) No. 9 and SAS No. 65 (superseded SAS No. 9) helped auditors plan their audits and factor in the efforts of the internal auditors, specifically:

a) Using the work of the Internal Audit function in obtaining audit evidence, and
b) Using internal auditors to provide direct assistance under the direction, supervision, and review of the external auditor

The introduction of the Sarbanes Oxley Act (SOX) set the stage for the Internal Audit function to expand its role within an organization and play a larger role in contributing to efficiencies. The Sarbanes-Oxley Act of 2002, a landmark legislation passed by Congress on July 30, 2002, was a reaction to several major corporate and accounting scandals, including Enron and Worldcom. The bill was designed primarily to safeguard investors by improving the accuracy and reliability of corporate disclosures. Section 404 of the Act moreover, imposes the biggest impact on corporations in America. Companies are now required to document, assess, test and remediate the internal controls over financial reporting (ICFR). To further strengthen SOX, the Securities and Exchange Commission (SEC) approved new rules in 2003 that required all listed companies to have an Internal Audit function. These new rules brought about a big change in the attitude of companies towards internal controls while placing new responsibilities on the external auditors, who now attest to the overall efficacy of internal controls in the organization in the annual report.

Excerpt from the Sarbanes-Oxley Act of 2002 report for section 404

"(a) Rules Required: Each annual report to contain an internal control report, which shall--

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) Internal Control Evaluation and Reporting. With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer."

These new requirements increased the workload of public accounting firms. Now, not only did they have to audit the financial statements, but also the internal controls of public companies. Internal auditors seemed the most logical partners in this new initiative, and were looked upon to help comply with these requirements in an efficient and cost-effective way. With the release of Accounting Standard 5 (AS 5: An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements) in 2007, the partnership between the external and internal auditor received a fresh impetus.

AS 5 states:

> *"The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself."*
>
> *"For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements."*

With rising audit costs driven by increasing auditor workload and growing expectations on audit quality, more and more organizations are starting to realize the benefits of increasing external auditors' reliance on the work of internal auditors.

Section II: Factors impacting external auditor reliance

Certain factors impact the external auditor's reliance decisions more than others. An analysis of these factors is important in understanding how best to structure an Internal Audit function in an organization. AS 5 states that during an integrated audit of the financial statements and ICFR, the auditor should apply AU sec. 322 (SAS No. 65) when evaluating the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. While AU 322 (SAS 65) (and more recently AU-C 610 [SAS 128] for GAAS audits) contains brief instructions and factors to consider before relying on the internal auditor's work, there is no single ground rule illustrating all the major points. Based on existing guidance and other industry research, here is a detailed explanation of the factors impacting external auditor reliance on Internal Audit:

1. COMPETENCE OF THE INTERNAL AUDIT FUNCTION

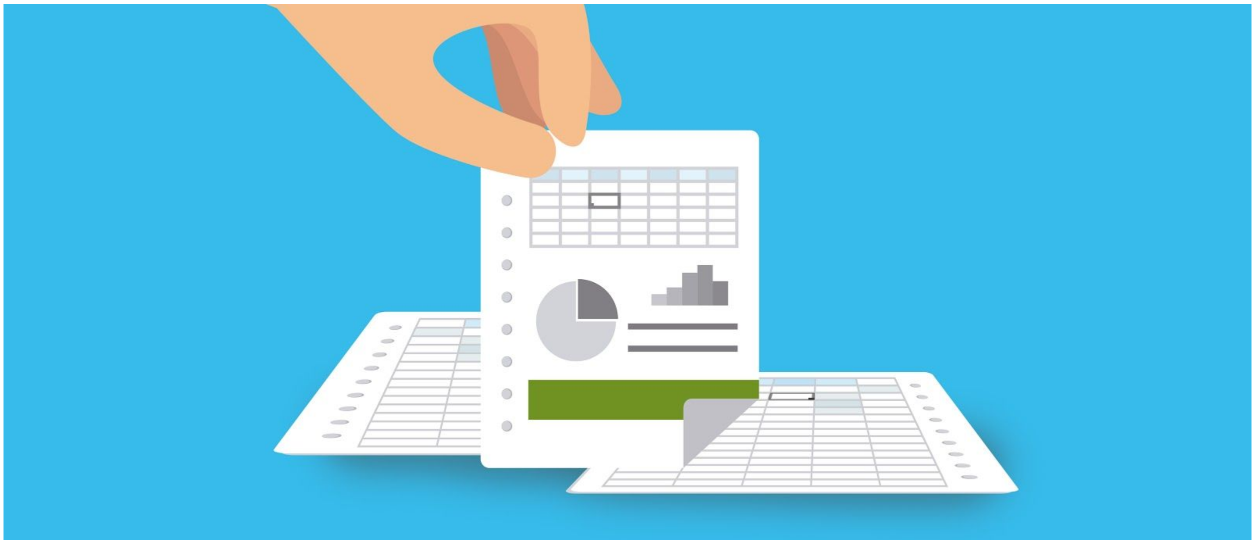
When external auditors are satisfied with the internal auditors' competence, they place more reliance on the procedures performed by the internal auditors. Qualification, practices, and documentation are key elements in gaining the trust of the external auditor. AU 322 lists the following factors as key in determining internal auditor competence:

- *Educational level and professional experience of internal auditors.*
- *Professional certification and continuing education.*
- *Audit policies, programs, and procedures.*
- *Practices regarding assignment of internal auditors.*
- *Supervision and review of internal auditors' activities.*
- *Quality of working-paper documentation, reports, and recommendations.*
- *Evaluation of internal auditors' performance.*

2. OBJECTIVITY OF THE INTERNAL AUDIT FUNCTION

Objectivity refers to the ability to perform tasks without bias, to avoid conflicts of interest and to reject the influence of others. The internal auditor's objectivity primarily depends on the prevailing reporting hierarchy and the existence of company policies that curtail his/her independence. AU 322 mentions the following factors as impacting the organizational status of the internal auditor:

- *Whether the internal auditor reports to an officer of sufficient status to ensure broad audit coverage and adequate consideration of, and action on, the findings and recommendations of the internal auditors.*
- *Whether the internal auditor has direct access and reports regularly to the board of directors, the audit committee, or the owner-manager.*
- *Whether the board of directors, the audit committee, or the owner-manager oversees employment decisions related to the internal auditor.*



The same section also advises of policies that will maintain the internal auditor's objectivity.

- *Policies prohibiting internal auditors from auditing areas where relatives are employed in important or audit-sensitive positions.*
- *Policies prohibiting internal auditors from auditing areas where they were recently assigned or are scheduled to be assigned on completion of responsibilities in the Internal Audit function.*

3. SCOPE OF WORK PERFORMED BY THE INTERNAL AUDIT FUNCTION

External auditors must consider whether the planned nature or scope of the work performed by Internal Audit is relevant to the external auditor's overall audit strategy and plan. When evaluating the scope of work performed by the internal auditor, the external auditor will consider the following factors:

- Scope of work is commensurate and appropriate to meet the audit objectives
- Existence of any limitations on the scope of Internal Audit's activities
- The adequacy of audit plan and test procedures, including nature, timing, and extent
- The appropriateness and adequacy of period covered by audit procedures

4. ASSESSED RISK OF MATERIAL MISSTATEMENT

Risk and reliance have an inverse relationship. If there is a high risk of material misstatement, the auditor will choose to rely less on the work of the internal auditor.

AS 5 mentions this risk and reliance relationship:

> *"The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases."*

Other determinants impacting the assessed risk of material misstatements include prior history of qualified opinions in the audit report, complexity of audit procedures, degree of judgment related to evaluating audit evidence, and past deficiencies in the internal control framework.

5. QUALITY OF THE WORK OF THE INTERNAL AUDIT FUNCTION

External audit firms maintain high quality standards and pride themselves on the accuracy, completeness and consistency of audit procedures. They expect the same quality of work from other parties on whom they rely. External auditors place more reliance on the Internal Audit function when they notice the following characteristics:

- Standardization, consistency, and completeness of test procedures
- Quality assurance procedures, including adequate review and supervision
- Competence of internal audit testers, reviewers and supervisors
- Deliverables (including work papers) are on par with external auditor's expectations

Section III: Benefits of increasing external auditor’s reliance on the work of internal audit

1. REDUCED EXTERNAL AUDITOR FEES - SOX COMPLIANCE COSTS

External auditor’s fees are rising every year. A survey done by the Financial Executives Research Foundation revealed that public companies paid an average of $1.5 million in audit fees in 2014, with a median audit fee of $402,812, representing a median increase of 3.4 percent over the audit fees paid in 2013. About 63% of public companies indicated that the volume of annual audit work by external auditors in 2014 has increased compared to 2013, mainly to obtain an auditor’s report on internal controls.

Another interesting observation in this survey was that 20.6 percent of SEC filers reported ineffective internal controls over financial reporting. The median increase in audit fees for SEC filers that reported ineffective internal controls over financial reporting was 3.0 percentage points higher than the median for all SEC filers. Through these findings we observe the direct correlation between an ineffective internal control system and higher audit fees. When external auditors are faced with ineffective internal controls in an organization, more procedures are performed, meaning more man hours for testing, reviewing, and documenting, eventually leading to higher audit fees. A robust Internal Audit function in an organization helps ensure the adequacy of internal controls and minimizes the frequency/severity of internal control issues, which in turn, results in reduced external auditor work and man hours.

2. INCREASES THE INTERNAL AUDIT FUNCTION'S VALUE-ADD TO COMPANIES

The role of the Internal Audit function has evolved to one that adds value to an organization by achieving operational excellence. An increase in external auditors' reliance on internal auditors' work will only reinforce this mission. Management will look to utilize Internal Audit in other critical business improvement programs such as operational audits, inventory verifications or due diligence exercises to name a few.

3. SUPPORTING TRANSPARENT AND COLLABORATIVE RELATIONSHIPS BETWEEN EXTERNAL AUDITORS AND INTERNAL AUDIT

Organizations understand the importance of maintaining healthy relationships between the audit committee, internal auditor and external auditor. Both from a financial reporting and internal controls perspective, collaboration among these parties is critical for the organization. Increasing external auditor reliance will strengthen these relationships, as effective coordination between the external and internal auditors can contribute positively to the external audit.

Section IV: Company's action plan to increase external auditor's reliance on internal audit

The obvious goal for the organization is to reduce the number of hours spent by the external auditor on validating internal controls. This goal, simple as it may seem, will require concerted effort on the part of management to create an internal control environment that meets or exceeds the high standards expected from the PCAOB. Some ways in which companies can increase external auditors' reliance on internal audit are:

1. REGULARLY MONITOR THE CONTROLS ENVIRONMENT AND PERFORM RISK AND CONTROLS OPTIMIZATION ACTIVITIES

In order to achieve a robust internal control environment, it is vital to have a process that assesses the system's performance over time. Regular monitoring could include management supervisory activities and separate evaluations. Internal control deficiencies have to be brought to the notice of Senior Management as soon as possible, and necessary remediation plans have to be determined. The internal control system should be interlinked with the organization's operating infrastructure and be part of the essence of the enterprise. When the controls are "built into" the fabric of the organization, they help avoid unnecessary costs and support quality initiatives.

Risk and Controls Optimization activities should be high on the priority list of companies that are dealing with high costs of compliance and struggling to convince the business about the value propositions of controls. Optimization is a continuous process of improvement, reflecting a company's objectives and risks and management's risk appetite by establishing effective and efficient internal controls. It basically implies "establishing the right controls at the right cost for the organization." Some steps that companies can take to move towards an optimized control environment are:

- Evaluate and assess risk that impacts operational and strategic value of the business
- Enable stakeholders within company to view status of compliance activities
- Develop metrics to illustrate quantitative and qualitative benefits of control improvements to the business
- Design controls that can adapt to the ever-changing business environment

2. IMPLEMENT SUSTAINABLE AND INDUSTRY-LEADING PROCESSES, INCLUDING CONTROL AUTOMATION

Using automated controls in the process can directly impact SOX compliance costs by cutting down the number of manual touch points (thus reducing the risk of manual control errors) and labor-intensive detective controls. In certain processes such as backups of application and data files, network security (use of firewalls, intrusion detection /prevention systems, etc.) and change management, the use of automated controls is highly recommended to ensure consistency and reliability of operations. At the same time, certain controls like reconciliations and user access reviews cannot be performed without some degree of manual intervention. It is important to strike the right balance between automated and manual controls within the control environment.

3. UTILIZE NEW TECHNOLOGY TO HELP MANAGE SOX COMPLIANCE EFFORTS, NOT JUST BUSINESS OPERATIONS

Achieving Sarbanes-Oxley compliance imposes a significant cost on companies. This cost is mainly incurred on external auditor fees and the cost of running the Internal Audit function. Technology can play a key part in reducing this cost. It is no more a question of 'if' SOX compliance efforts can be aided by a compliance software, but rather a question of 'which' software to implement in order to better serve the organization. There are plenty of software solutions in the market that offer a range of solutions for enterprise GRC, internal audit, SOX, etc. It is necessary to understand the specific compliance requirement to be satisfied, the complexities in the organizational structure, and then select a software that best fits the company's needs and internal control environment. SOXHUB is one such solution that has been successfully accepted by many public companies in the U.S. for SOX compliance.

Conclusion

External audit and internal audit are complementary functions, and both are essential to the effective governance of an organization. It is to the benefit of the organization to ensure the activities these two functions perform are coordinated rather than duplicated. The PCAOB is constantly pressuring the audit profession to perform at a higher standard which directly impacts internal auditors and the companies being audited. The end result will be a more thorough audit requiring more time and resources to complete. Organizations should strive to develop an independent, efficient and competent Internal Audit function, armed with the necessary tools such as SOXHUB to help take on a portion of this increased audit burden. Presently, the jury is still out as to what extent Internal Audit functions can step up to this task and save SOX compliance costs for their organizations.

Only time will tell!