The Sarbanes-Oxley Act, Public Policy & The Propensity for Fraud

Research Project for Emerging Issues/Advanced Topics Course
Diploma in Investigative and Forensic Accounting Program

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July 4, 2005
(May 31, 2003)

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Summary

The Sarbanes-Oxley Act was passed into legislation by the United States Congress largely in response to the collapse of the Enron Corporation. More specifically it was the manner in which the collapse occurred, through misleading financial reporting which while perhaps in accordance with the letter of GAAP, was not within its spirit, and raised serious questions about the adequacy of financial reporting and the role of auditors. That manipulation of financial reporting and the auditor's involvement, which resulted in the loss of billions of dollars in equity value, caused a crisis of confidence in the United States capital markets to which the United States Congress felt it needed to respond.

To prevent others financial crises from occurring and to restore confidence in financial reporting, the Sarbanes-Oxley Act introduced 'new' requirements on both public companies and their auditors in the 'hope' of preventing any further such crises. While the spirit of protecting the 'public interest' is well intentioned, the Sarbanes-Oxley Act repeats recommendations and principles reported on by commissions and special interests groups from years before. Yet, in spite of the existence of these recommendations, Enron and others occurred. If Enron occurred, with these principles already in existence, is there anything in Sarbanes-Oxley to suggest that it will prevent what the existence of these principles and the powers of the Securities and Exchange Commission in the United States previously could not. Which is not to suggest there are not benefits with respect to Sarbanes-Oxley, but those benefits may have been accomplished by other means.

While well meaning, Sarbanes-Oxley, may yet be another example of a public policy that will eventually fail to significantly decrease the incentive on companies to commit fraud or increase the likelihood of detection. The failure of companies such as Enron are the result of public policy that is lacking in substantive measures that are truly in the public interest or principles that can be enforced without recrimination. This paper reviews the Sarbanes-Oxley Act and the implications for auditors and investigative accountants in applying the principles of Sarbanes-Oxley. The conclusion of this paper is simply that Sarbanes-Oxley will eventually fail because the principles and standards that are provided are vague and subject to interpretation or manipulation. Sarbanes-Oxley introduces few new requirements, or controls that can prevent fraud that are and were not already known, and which had not previously prevented the frauds. As a result it will not curtail the propensity to commit fraud. Consequently, auditors and the accounting profession will again, some time in the future, come under scrutiny for failing to detect fraud.

The failing however, will not be with the auditors necessarily, but with the shortcomings in policy that, although unintentional, provides a pathway for fraud to be committed. The failing will be in not providing those entrusted with 'protecting the public interest', with the authority and protection to actually do so. In the meantime auditors and investigative accountants will be required to comply with the ambiguous application of Sarbanes-Oxley.

The Sarbanes-Oxley Act, Public Policy & The Propensity for Fraud

> Someplace right now, in the layers of a Fortune 500 company, an employee- probably high up and probably helped by people who work for him-is perpetrating an accounting fraud. Down the road that crime will come to light and cost the company's shareholders hundreds of millions of dollars.
>
> Typically the employee will not have set out to be dishonest, only to dodge a few rules. His fraud, small at first, will build, because the exit he thought just around the corner never appears. In time, some subordinate may say "Whoa"! but he won't muster the courage to blow the whistle and the fraud will go on.
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> Until it's uncovered…and the fundamental reason, very often, will be that the company or one of its divisions was 'managing earning' trying to meet Wall Street expectations or those of the boss, trying to pretend that the course of business is smooth and predictable when in reality it is not.[1]

Or the fraud may be as simple as inflating the number of kilometers on a mileage expense report. Whether it is managing earnings, adding a few extra kilometres to the mileage expense report or claiming lunch with a friend as a business lunch, a fraud has taken place.

And while still fraud, the nature of the frauds are different and can be broadly classified as: fraud perpetrated against a company by its own employee, a fraud committed by an outsider in the form of a person or a corporation against another corporation, or a fraud committed by the company itself. Frauds with a criminal origin, such as money laundering, are exceptions as every company may not be subject to or participate in money laundering, but every enterprise is vulnerable to the possibility of false expense reports, not to mention the incentive to manipulate revenues and expenses.

While fraudulent expense reports may be mundane, it does provide an investigative and forensic accountant with a hard set of circumstances to work with, or a scenario to confirm or deny. The nature and origins of these frauds generally stem from internal system control weaknesses or collusion on the part of employees amongst themselves or with outsiders to circumvent a company's financial controls. It seems easy to classify all frauds as the acts of companies and individuals diligently working to circumvent faulty company control systems. However, these frauds may also be seen as the result of faulty, ineffective policy, rather than faulty internal control systems. In the case of curtailing money laundering from criminal activities, the weakness is not necessarily the failings of individuals at banks or companies that unwittingly take part, but rather the ineffectiveness of policy makers to obtain cooperation from offshore banks and other institutions that profit from money laundering and tax havens. If that cooperation was obtained, then money and its origin could be more effectively traced and money laundering curtailed.[2]

In the wake of Enron the United States Congress passed legislation in the form of the Sarbanes-Oxley Act ("SOX"), that was directed at 'cleaning up' the failures of accounting and auditing that had led to the failure of Enron, Worldcom, Health South, Waste Management among others. The legislation effectively put the accounting profession on notice for its failure to act in the 'public interest'. For its failure to prevent, let alone be complicit, in the issuance of false financial statements and the ultimate loss in billions of dollars in market value of shareholders equity. Instead of relying on the accounting

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[1] Carol Loomis, "Lies, Damned Lies and Managed Earnings", *Fortune Magazine-www.fortune.com,* August 1999, Retrieved May 5, 2003,

profession to conduct itself in a professional manner, to see fit that the work necessary to issue clean audit opinions was performed, Sarbanes-Oxley introduces a new policy regime. Rather than public accounting firms complying directly with the Securities and Exchange Commission, the United States Government passed legislation that introduced the Public Company Accounting Oversight Board, which would oversee the accounting firms that issued audit opinions on the financial statements of public companies.[3]

The essence of the Sarbanes-Oxley Act is the failure of Enron, and others like it, occurred because there was a lack of integrity on the part of management and the board of directors that allowed financial manipulations to take place. More importantly, the tone of the act suggests that the lack of integrity could have been detected and the acts prevented with better internal control systems and better board and audit committee oversight. The makeup of the board of directors of Enron from among academics from leading business schools and successful financial executives would suggest however, board of directors naiveté was not the major contributing factor to the collapse of Enron.[4] While there are financial and criminal penalties introduced by SOX, the underlying tone is it was the failure of the financial reporting systems, not the absence of penalties that precipitated SOX.

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[2] House Committee on Energy and Commerce, House of Representatives, Lessons Learned From Enron's Collapse: Auditing the Accounting Industry, H.R. Rep. No. 107-83 at 20, 2002. (See Appendix C)
[3] Prior to the Public Oversight Board, the United States Securities and Exchange Commission had the powers to reprimand auditors and companies for false or misleading financial reports.

Through Sections 301: Corporate Responsibility, Section 400: Enhanced Financial Disclosure and Sections 801 & 1001: Corporate and Criminal Fraud Accountability, SOX addresses the level of vigilance and responsibility expected from company management and its directors. These areas have an indirect impact on the auditors who were directly targeted in Section 103, Auditing, Quality Control and Independence Standards, which is set out below. There has been a well-accepted auditing convention that compliance or internal control systems testing is conducted in order to assess the level of risk associated with conducting the year-end substantive audit and the issuance of the audit opinion on the financial results of the company[5]. SOX now make that aspect of the audit both in terms of management's assessment and the auditor's certification, more prominent:

> s.103(2)(A)(iii) "describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer required by section 404 (b) and present in such report or in a separate report:
> (I) the findings of the auditor from such testing;
> (II) an evaluation of whether such internal control structure and procedures
>> (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
>> (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
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> (III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing.[6] [7]

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[4] Metcalf Lee, Report to Chairman Abraham Ribicoff, Committee on Governmental Affairs, United States Senate, November 4, 1977, p 4.
[5] Shaun F. O'Malley et. Al., *Panel on Audit Effectiveness*, Public Oversight Board, August 21, 2000, p 25; ("Panel").
[6] Sarbanes-Oxley Act of 2002, Corporate Responsibility, 15 United States Congress 7210, 116 Statute 745, Public Law 107-204, 107th Congress ("Sarbanes-Oxley")

As the wording suggests, the Sarbanes-Oxley Act now requires that auditors report on the internal control structure of each company. The implications for auditors responsible for reporting on internal control systems will be wide reaching, if for no other reason than the SOX standards are subject to interpretation. What SOX proposes in the form of internal control testing and reporting was reported on by the National Commission on Fraudulent Reporting and the Treadway Commission ("COSO") years before the collapse of Enron[8]. Yet the existence of those concerns on financial reporting and internal control standards did not prevent Enron or others like it from occurring.

The other implication of SOX to auditors is the year-end audit. The auditor is now required to discuss with management and the audit committee those accounting policies that are considered contentious and the occurrence or possible occurrence of fraud. SOX is reflected in the auditing standards which a more investigative and forensic approach to the audit of financial statements. There is however, no discussion of what constitutes intent. More problematic, the writings do not address how to differentiate who and when would benefit from the 'criminal act' as opposed to poor accounting records or sloppy procedures. Within the time frame of a year-end audit and the quantity and quality of information, it may only be a circumstantial or hypothetical case that can be made against management that would link the 'criminal act' to the 'benefit'. Nonetheless, the focus of

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[7] U.S. Securities and Exchange Commission "Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports", Retrieved May 15, 2003, www.edgar.com, ("SEC Final Rule"),

[8] Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control-Integrated Framework*, (New York, 1991), ("COSO").

SOX on internal control is directed at the principle that a stronger internal control system will make fraud more difficult to achieve at any level.

Another implication for both the review of internal controls and the year-end audit is the standard of care that is expected. While not explicitly detailing the level of work required, references are made to remote likelihood and reasonable assurance. These judgmental standards and the implicit reference to due care in the environment in which SOX has been legislated, may require lower materiality levels and more extensive testing to ensure that due care can be demonstrated and that another Enron does not occur. The environment in the wake of Enron and others, the resulting increase in the standard of care, reviewing of internal controls, and a more forensic approach will make the auditors, and investigative accountants, role increasingly difficult.

Why did Enron Occur?

> Because of the economic and social environment, which now exists, the subcommittee believes it is timely for the public and the accounting profession to reassess the role, which independent accountants should play in making the Nation's economic system function effectively. The pattern of conduct followed by independent auditors and the scope of services they offer must be reexamined to determine whether they are compatible with public expectations. Above all, the Auditor's essential qualities of independence and professionalism must be strengthened and adapted to the present environment.
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> The public must be assured that the primary professional responsibility of an independent auditor is to protect those who rely upon corporate financial reports, and that the application of his or her expertise and judgment continually recognizes that responsibility[9]
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> Serious questions have been raised concerning the independence and competence of the..accounting firms and other independent auditors. Those questions have arisen because of accounting and auditing problems involved in the collapse, fraud, and many other abuses by corporations which have come to public attention in recent years. A common complaint in such cases has been "Where was the independent auditor?"[10]

One could easily conclude that those comments were made during the Congressional hearings into the collapse of Enron in 2002. They were made in 1976 and 1977 during Senate and House Hearings examining the collapse of Penn Central and illegal activities of Gulf Oil and Northrop Corporation. Such was the crisis involving the accounting industry at that time that a report entitled "The Accounting Establishment" was commissioned and involved hearings with each of the major accounting firms at the time. While Enron and all the issues surrounding it seem new, the issues and the solutions proposed were not new and bring to mind the notion that those who do not learn from history are bound to repeat it. In particular the accounting industry which both in

[9] Metcalf Lee, Report to Chairman Abraham Ribicoff, Committee on Governmental Affairs, United States Senate, November 4, 1977,

1975-77 and in 2002 was being challenged on its protections of the public interest, independence, adequacy of accounting and auditing standards. Why the accounting industry failed to respond or was allowed to be left in a position where such criticism could be levied again, is beyond the scope of this paper but it is a question that perhaps challenges the credibility of the profession[11]. However, the accounting industry may not be alone in taking responsibility as legislators and regulators may have left accountants and auditors in a compromised position. In other words, what did regulators and legislators do to follow up on the testimony of SEC Chairman Williams in 1976 who testified:

> What we need to do is, first strengthen the environment in which the profession functions to reduce the pressure on independence, which in turn give rise to poor judgment and professionalism[12]

Why Enron and others like it occurred provides a backdrop from which to assess whether the changes, as contained in SOX, will prevent these events from happening in the future. If not, then what are the implications to auditors and investigative accountants who under the new rules, will be expected to explain why their testing did not reveal the failures about to happen. It is suggested that Enron and others were inevitable[13]. Furthermore it has been suggested that Enron and others like it, and in turn the legislative responses, miss the 'real' issue. That is while Enron perpetrated a fraud, and there is always a salacious interest in fraud, it has nothing to do with accounting. When

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[10] Subcommittee on Reports, Accounting and Management, United States Senate, The Accounting Establishment, p. 7, U.S. Government Printing Office, 1976
[11] Lessons Learned from Enron's Collapse, op. cit. p. 120, (See Appendix C)
[12] Metcalf, op. cit. p. 4.

management is committed to an act of fraud, few things stand in its way, including the accounting audit process.[14]

While the suggestion that the legislative response misses the 'real' issue, Sarbanes-Oxley may only be accidental legislation. Unlike the study undertaken by the United States Senate into the practices of the accounting industry in 1975, in the wake of the failure and activities of major United States corporations, and took two years to report on its findings, the Unites States Senate and Congress in 2002 did not undertake any such studies although hearings were held on a number of areas.[15] The Enron hearings may have been more for political window dressing than a substantive attempt to find a solution to the problem. The Senate and House of Representatives were reluctant to get involved in accounting industry matters, preferring to let the authorized resolve the situation. On the strength of Enron alone, the legislation would likely not have passed; however, the combination of the subsequent failure of Worldcom and an election year compelled the legislators to act.[16] These factors combined with those with policy agenda's such as SEC Chairman Arthur Levitt, gave legislators the easy solution of

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[13] Lawrence Revsine, "Enron: sad but inevitable", *Journal of Accounting and Public Policy* Vol. 21 No. 2002 p. 137.

[14] Robert E. Verrecchia, "Why all the hoopla about Enron?", *Journal of Accounting and Public Policy*, Vol. 22 Issue 2 March 2003, Retrieved May 10, 2003, www.elsevier.com.

[15] Hearings and Reports were heard on: Public Company Accounting Reform and Investor Protection Act,, SEC's proposed Auditor Independence Rules, Destruction of Enron-Related Documents by Andersen personnel, Effect of the Bankruptcy of Enron on the Functioning of Energy Markets, Lessons Learned from Enron's Collapse: Auditing the Accounting Industry; Are Current Financial Accounting Standards Protecting Investors, Financial Collapse of Enron Part1-4, Enron Collapse: Impact on Investors and Financial Markets Part 1

[16] Roberta Roman, "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, *The Yale Law Journal,* Vol. 114, Retrieved May 3, 2005, www.ssrn.com., p 1563.

passing the Sarbanes-Oxley Act.[17] The concern for some legislators is that passing of SOX will draw them into question in the event another Enron occurs since their legislation will not have prevented the collapse as promised. As noted by Senator Dodd: Let me urge you and others in the room, try and work this out. I am no more enthusiastic about Congress legislating in this area than I was when FASB was involved. This is a dangerous area for Congress to get involved in. It gets riddled with politics and that is dangerous, in my view, when you start talking about investor confidence and accountability here. So I would urge you, and urge those in the room, sit back down and try and work this out. The best place to resolve it is there.[18]

Furthermore, the manner in which the legislation came into law may explain why it relies heavily on the control and audit frameworks already in existence.

The issue that was not addressed in the legislation is "not how managers and firms use the accounting process to perpetrate fraud, but rather why managers pursue accounting innovations to bookkeeping entries that improve paper earnings, that are fully disclosed, totally transparent and have no cash flow or tax shield effects".[19] It is suggested by some like Robert Verrecchia that fraud should be forgotten about because it will always be with us. That the name "Ponzi" is etched in the public consciousness to a much greater degree than either "Miller-Modigliani" or "Black-Scholes"[20] This is not to discount the significance of fraud or attempts to prevent it, but to acknowledge that companies are

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[17] Ibid, p 1577.
[18] Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs United States Senate, The SEC's Proposed Auditor independence Rules, S. Hrg 106-1081 at 9, 2000.
[19] Verrecchia, op. cit
[20] Verrecchia, op. cit.

vehicles which are used to commit crimes. If management is so intent on creating 'false and misleading' statements, there may be little that can be reasonably done in terms of cost, to prevent it from happening. Furthermore, little can be done if the auditor abdicates his professional responsibility and condones what s/he knows is wrong.[21]

In which case Enron, and more importantly the response to it, may just be another chapter in a history of financial manipulation, fraud, accounting failures, and the inability of auditors to prevent these events from occurring. In 1991 Lawrence Revsine[22] noted the features that allowed Enron to occur, had been in place for a number of years.

> It is sometimes in the best interest of one or more of the various financial reporting parties-managers, shareholders, auditors, standard setters, regulators, lawmakers or academics-to engage deliberately in what I termed selective financial misrepresentation. For example, these misrepresentations allow managers to achieve bonus goals, shareholders to benefit from higher share prices, auditors to placate clients, standard-setters, regulators and lawmakers to satisfy political goals[23], and academics to curry favor from university department contributions and consulting clients.
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> To achieve misrepresentation, the parties prefer accounting standards that incorporate latitude:
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> Latitude in choosing between diverse alternatives,
> Latitude in determining when economic events are recognized in net income,
> Latitude in determining the amount of report income,
> Latitude in keeping assets and debt off the balance sheet.

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[21] George J. Benston, Al L. Hartgraves, "Enron: what happened and what we can learn from it", *Journal of Accounting and Public Policy*, Vol. 21 (2002), p.122.
[22] Revsine, op.cit. p. 137.
[23] To what extent is Sarbanes-Oxley just a continuation of Revsine's view that legislation is passed to satisfy political goals. The Enron crisis called for a 'political' response and codified conventions that already existed but had not prevented the crisis from occurring.

> The largely arbitrary contrived and flexible reporting rules that constitute GAAP are not an accident-they are a deliberate consequence of the desires of various financial reporting parties.
>
> The Enron debacle represents an extreme example of the selective financial misrepresentation mentality. It is extreme for two reasons: (1) the wide scope of the misrepresentation activities, and (2) the misrepresentations often exceeded the flexibility allowed by GAAP. While extreme, something like Enron was inevitable in the existing financial reporting environment…Things have deteriorated significantly…with the onslaught of "accounting irregularities: and audit failure (CUC International, Livent, Mercury Finance, Sunbeam, Waste Management, among others). Public confidence in financial reporting/attestation process is now justifiably low.[24]

Similar themes about financial reporting, auditor involvement, the involvement of FASB, the standard setting process, and the involvement of the SEC were addressed in the *Accounting Establishment* and the Senate Subcommittee on the Accounting Profession. The conclusions and recommendations of the committee are contained in Appendix A and those recommendations highlighted the need for clearer accounting standards, the need for the Federal Government to establish auditing standards, the need to prohibit certain services and enforce strict codes of conduct so auditors are in fact and in appearance, independent of the companies they audit, the need for the Federal Government to periodically inspect the work of auditors and for Congress to exercise stronger oversight of accounting practices. These are all areas addressed by Sarbanes-Oxley and the Public Company Accounting Oversight Board. The recommendations also included mandatory rotation of firms, which was adopted by Sarbanes-Oxley as the mandatory rotation of audit partners.

[24] Revsine, op. cit. p. 137.

The recommendations of the Senate Committee on the Accounting Establishment were echoed by authors later such as Revsine[25] and Revsine's noted the need for a public oversight board:

> "the general oversight mechanism which monitors adherence to auditing rules and guidelines needs changing. Industry self-regulation by the Public Oversight Board did not work. A reformatted self-regulatory body cannot be the vehicle that restores investor trust. The conflicts are too great and public service suffers.[26]

The Senate Report on the Accounting industry which as its number one recommendation suggested that Congress should exercise stronger oversight of accounting practices promulgated or approved by the Federal Government and Congress, should establish comprehensive accounting objectives for the Federal Government to guide agencies and departments in performing their responsibilities.[27]

Quality reviews should be conducted by broad based teams appointed by the executive board of the accounting organization…The reports of the quality review teams should be submitted to the SEC and made available to the public. The review process would not relieve the SEC of its present responsibilities for investigating and correcting errant behavior by auditors under the Federal securities laws. However, the process should complement the SEC's enforcement activities.[28] Why greater oversight may be necessary is the lack of leadership on the part of the large accounting firms and the AICPA.[29] However, in the report prepared by the Subcommittee on Reports, Accounting

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[25] Revsine; op. cit. p. 139.
[26] Revsine; op. cit. p. 139.
[27] Accounting Establishment, op cit. p. 20
[28] Metcalf, op. cit.p 12.
[29] Lessons Learned from Enron's Collapse, op. cit. p. 120, (See Appendix C)

and Management in 1977, the SEC noted that it had sufficient authority to monitor accounting firms and issues involving public accounting:

> In its testimony to the subcommittee, the SEC pledged to undertake certain projects to improve corporate accountability, and submitted a memorandum outlining its authority to implement reforms. The memorandum was prepared at the request of the subcommittee in response to testimony by Adm. H.G. Rickover that the SEC should exercise its authority immediately to achieve necessary reforms. Admiral Rickover and others testified that the accounting profession has failed to meet its promises to reform in previous years, and that the SEC should no wait any longer to implement reforms directly.
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> The memorandum submitted by the SEC states that is has sufficient authority to oversee the setting of auditing and accounting standards, effect registration and financial disclosure by accounting firms, review the work of independent and discipline those which do not meet minimum standards, and subpoena information from uncooperative accounting firms. The SEC also said it has authority to effect divestiture of management advisory services by independent auditors, promulgate standards of independence for auditors, require use of independent audit committees by publicly owned corporations, assure that the auditor's report clearly informs the public of deficiencies and uncertainties, and require disclosure of the effects of alternative accounting standards on corporate financial statements. Clearly, the SEC has ample authority to implement necessary reforms directly.[30]

At the time of the Enron hearings, the testimony of SEC Chairman Arthur Levitt focused on the independence of auditors[31] and in questioning from committee members, the focus of the questions was on the SEC proposal regarding auditor independence. No questions were directed at Chairman Levitt with respect to why the SEC, on previous occasions had said it had sufficient authority to regulate the accounting industry, yet in spite of that authority, Enron and others ensued. As Cliff Stearns Chairman of the Sub-committee on Commerce trade and Consumer Protection noted in hearings dealing with the adequacy of accounting standards:

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[30] Metcalf, Lee, Subcommittee on Reports, Accounting and Management, Committee on Governmental Affairs, United States Senate, November 4, 1977, p. 20,

> I urge the SEC to begin to fulfill its responsibilities of ensuring adequate disclosure in financial statements. If the SEC had reviewed Enron's filings over the past 3 years, it may have discovered the lack of disclosure and the problems the inadequate disclosure concealed. I am troubled by the SEC's recent assertion that one can violate SEC law even while fully complying with GAAP. It is clear that companies and their auditors have an obligation to comply with both the letter and the intent to GAAP. However, the SEC's comment go too far. The SEC seems to be ducking it responsibility to fix problems with GAAP and corporate disclosure by using its enforcement authority to impose burdensome standards on public companies and their auditors[32]

This point of view is shared by Benston and Hartgraves who note that while Enron has resulted in a clamouring for regulation of CPA's, such a regime already exists in the form of the Securities and Exchange Commission.[33]

> The SEC has the authority to establish generally accepted accounting and auditing standards, review and disapprove as inadequate the financial statements registered with it. The SEC also can discipline CPA's who sign such statements by refusing to accept statements they sign, or by suspending or barring them from SEC practice. While the SEC has the power to discipline CPA's who willfully or recklessly attest to financial statements with it that significantly violate the provision of GAAP or GAAS, the SEC has rarely even attempted to suspend independent CPA's or their firms who have not fulfilled their professional responsibilities, despite the negative externalities that result from situations such as Enron. Granted, it is difficult to prove that an auditor "willfully" or "knowingly", violated professional standards, but a showing of "unreasonable conduct…resulting in a violation of applicable professional standards," could be demonstrated, if that is what occurred.[34]

The auditor's role in the failure of companies is a constant topic of discussion as is the adequacy of accounting standards and whether they are in the public interest. The adequacy of the standard setting process and whether the standards that are promulgated

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[31] Committee on Banking, Housing and Urban Affairs, United States Senate, Hearing Before The Subcommittee on Securities, September 28, 2000, p. 46.
[32] Subcommittee on Commerce Trade and Consumer Protection of the Committee of Energy and Commerce, Are Current Financial Accounting Standards Protecting Investors, H. R. 107-84, 2002, p. 2
[33] George J. Benston, Al L. Hargraves, op. cit. p. 123.
[34] George J. Benston, Al L. Hargraves, op. cit. p. 123.

are in the public interest was discussed as part of the Enron hearings [35] and *The Accounting Establishment*[36]. The conclusion in the Accounting Establishment was:

> FASB is not an independent body. That FASB is dependent on member firms for financial contributions and that the larger firms and other sponsoring organizations have control over the operation of the FASB. Such control is exercised in term of money, personnel and organizational support. As a result there is no reason to expect the FASB to achieve serious reform by establishing a system of uniform and meaningful accounting standards. Such a system is needed to replace the present collection of flexible, alternative standards, which permitted the growth of "creative accounting" as an acceptable option to accurate financial reporting. A study sponsored by the AICPA has listed 31 separate kinds of business transactions with an aggregate 80 different accounting alternatives for reporting transactions.[37]

The shortcomings of the standard setting process as reported in the Report on the Accounting Establishment are echoed by Revsine :

> FASB has been subjected to repeatedly intense lobbying, outside intrusions, threats, and a lack of support on key issues even from sponsoring organizations...The pervasive motivation for selective financial misrepresentation and power of the players indicate that protective devises are useless. Furthermore, standard-setters are themselves subject to regulatory capture.[38] So I reluctantly conclude that developing robust financial reporting standards is futile...resources are wasted in pursuit of unattainably "good" standards. Recent events lead me to propose: that reporting entities be allowed to use whatever reporting standards they wish (US GAAP, IASB rules, or any others, e.g. current cost accounting). Financial reporting regulation would center on broad disclosure rules developed and monitored by the SEC. In this altered system, disclosure becomes paramount.
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> The onus to explain and justify the reporting methods chosen would rest with the reporting entity. Firms clearly have a strong economic incentive to provide lucid, comprehensive explanations. Shifting the financial reporting emphasis to disclosure mitigates the unavoidable failings of accounting standards themselves.

[35] Are Current Financial Accounting Standards Protecting Investors, op. cit.
[36] The Accounting Establishment, op. cit.
[37] The Accounting Establishment, op. cit. p. 16
[38] Revsine notes that regulatory capture exists because regulators are often selected from the group to be regulated. This influences their perspective. So the beneficiaries of regulation are often the regulator rather than the general public.

> In addition, such a system has automatic safeguards. For example, if firms deliberately choose misleading reporting standards, the accompanying disclosure will be unconvincing to knowledgeable readers and will automatically "flag" the misrepresentation strategy. These financial disclosure rules will need to be carefully crafted to ensure that the market participants can readily distinguish between high and low quality standards and assumptions[39]

The difficulty with this position is that while disclosure may be a preferred solution, comparability, or the ease thereof, would suffer perhaps more so than the interpretations given to existing standards. It is not clear though that the Revsine proposal for disclosure only would have solved the problem. Benston and Hartgraves [40] point out that the application of GAAP and GAAS are responsible for Enron because the SEC knew the shortcomings in dealing with SPE's and did not address those shortcoming or request changes to either GAAP or GAAS.

> US GAAP, as structured and administered by the SEC, the FASB, and the AICPA are substantially responsible for the Enron accounting debacle. Enron and its outside counsel and auditor felt comfortable in following the specified accounting requirements for consolidations of SPE's. The SEC had the responsibility and opportunity to change these rules to reflect the known fact that corporations were using this vehicle to keep liabilities off their balance sheets, although the sponsoring corporations were substantially liable for the SPE's obligations

Bentson and Hartgraves are also critical of Arthur Andersen, the Enron auditors, for accepting the Enron representations:

> Andersen appears, at best, to have accepted as sufficient, Enron's conformance with the minimum specified requirements of codified GAAP. They do not appear to have realized or been concerned that the substance of GAAP was violated, particularly with respect to independence of the SPE's (Special Purpose Entities) that permitted their activities to be excluded from Enron's financial statements and the recording of mark to market based gains on assets and sales that could not

[39] Revsine, op.cit. p 141.
[40] George J. Benston, Al L. Hargraves, op. cit.

> be supported with trustworthy numbers. They either did not examine or were not concerned that the SPE's...were of little economic value...Andersen also violated the letter of GAAP and GAAS by allowing Enron to record issuance of its stock for other than cash as an increase in equity.[41]

Benston and Hartgraves believe that Enron revealed two important shortcomings:

> First, the US model of specifying rules that must be followed appears to have allowed or required Andersen to accept procedures that accord with the letter of the rules even though they violate the basic objectives of GAAP accounting.... Second, the fair value requirement for financial instruments adopted by FASB permitted Enron to increase its reported assets and net income and thereby, to hide losses. Andersen appears to have accepted these valuations because Enron was following the specific GAAP rules.[42]

Benston and Hartgraves elaborate how Andersen evidently violated various FAS standards (FAS 121, asset impairment, FAS 5, liability recognition, FAS 57, related party transactions). Andersen also violated various GAAS standards (SAS 85, relying on management representations, SAS 45, related party disclosures). The other lesson that could be learned from the Enron debacle is that "auditors should be aware of the ability of opportunistic managers to use financial engineering methods to get around the requirements of GAAP...Thus as auditors have learned to become familiar with computer systems, they must become aware of the means by which modern finance techniques can be used to subvert GAAP.[43]

As Benston and Hartgraves note

> Andersen's audit personnel also might have been incapable of understanding the complex financial entities and instruments structured by Enron's chief financial officer, Andrew Fastow. These auditors dealt with Enron when it was an oil and gas producer and distributor. In recent years, it became primarily a dealer in

[41] George J. Benston, Al L. Hargraves, op. cit. p. 122.
[42] George J. Benston, Al L. Hargraves, op. cit. p. 124.
[43] George J. Benston, Al L. Hargraves, op. cit. p. 126.

> financial instruments and a developer of new ventures. For reasons that have yet to be explained, Andersen did not replace these auditors or (apparently) provide them with the requisite expertise. Another lesson, then, is that CPA firms should ascertain that their personnel are capable of dealing with the presently existing activities of their clients.[44]

Not discussed by Congress in its hearings of Enron, was the adequacy of the training of accountants and auditors; nonetheless, there are those that consider it a contributing factor to Enron type scandals because it reflects on the professional ability and judgment of auditors:

> In particular "accounting education's greatest failure is in order to perform competent audits, auditors must be 'financial detectives'". But how can they become financial detectives when they are clueless regarding the economic environment, managerial incentives, strategic gaming and other business realities that were omitted from the rules-driven upper level courses many were exposed to? The auditing firms might (and probably do) try to provide this forensic accounting overlay to newly hired graduates. But if these graduates often represent the "survival of the unfittest"[45] how successful can the crash-course overlay be? After all you cannot easily transform a Yugo into a Formula One racing car.[46]

In Revsine's view, accounting educators have contributed to the climate of naiveté that fostered Enron. Worse yet, academic accountants often failed to speak out against the independence and reporting deterioration in the 1990's.[47] There were no op-ed pieces on independence conflicts or earnings management issues authored by academics. Revsine

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[44] George J. Benston, Al L. Hargraves, op. cit .p. 127.
[45] Revsine; Ibid. "Despite decades of reform efforts, many undergraduate accounting curricula continue to stress technical minutia over economic substance. Hours of classroom time are spent on understanding, say, the retail inventory method but little (if any) attention is paid to compensation incentive, special purpose entities, joint ventures and other off-balance sheet vehicles that drove the Enron distortions. Rules driven courses are the norm, and they largely ignore the contracts and economic incentives that motivate selective financial misrepresentation. The boring course content does not hone analytic skills, is not based on real world examples, and drives out many good student. This may lead to what can be called "survival of the unfittest." Fledgling auditors, bankers and others trudging through these topics are unprepared to analyze the real world of financial reporting".
[46] Revsine; op. cit. p 143.

criticizes junior and senior faculty at institutions by saying the former is preoccupied with gaining tenure and the later are comfortable with the familiar and resist change. In the end Revsine concludes that educational reform is as elusive as achieving good financial reporting standards.[48]

The concerns noted by Revsine that education and training does not adequately prepare auditors for the economic environment in which they are expected to work, may be a relevant issue. In fairness however, Enron did not occur because a junior level staff member failed to detect the SPE's. The SPE's were well known by the SEC and senior Arthur Andersen partners who helped create and consulted on their financial presentation.[49]

The other factor is that the auditors may simply have not exercised their professional responsibilities as required as noted by Bentson & Hartgraves

> The most important lesson with respect to GAAS is that Andersen's partners and staff do not appear to have exercised the requisite skepticism that auditors should adapt. Rather, they appear to have accepted too readily management's valuations, and determinations with respect to valuations and related party transactions. It is possible that this presumed lack of skepticism and distance is simply a failing of the particular auditors-in-charge. Or, it may be a consequence of auditors having been associated with Enron for many years. (Familiarity may breed over-involvement with and empathy for management's world view, rather than contempt) Or, the auditors in charge of the Enron audit may have overlooked or supported their client's overly "aggressive" accounting, misleading, and possibly fraudulent accounting practices in order to protect their very salaries and bonuses.

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[47] Revsine; op. cit. p 143.
[48] Revsine; op. cit. p 143.
[49] George J. Benston, Al L. Hargraves, op. cit. p. 124.

> Or, as many critics have charged, the gatekeepers may have been corrupted by the sizable audit and possibly the non-audit fees paid by Enron.
>
> Andersen's audit personnel also might have been incapable of understanding the complex financial entities and instruments structured by Enron's chief financial officer, Andrew Fastow. These auditors dealt with Enron when it was an oil and gas producer and distributor. In recent years, it became primarily a dealer in financial instruments and a developer of new ventures. For reasons that have yet to be explained, Andersen did not replace these auditors or (apparently) provide them with the requisite expertise. Another lesson, then, is that CPA firms should ascertain that their personnel are capable of dealing with the presently existing activities of their clients.[50]

In spite of these contributing factors, there is the belief that the solution can not be found in a 'rule based' reporting regime because it encourages clients to find loopholes that exclude them from the reporting requirement and that the Enrons would have occurred if US GAAP were based on the principle approach rather than the rule based approach.

> We also believe that the UK GAAP, which requires auditors to report a "true and fair view" of an enterprises' financial condition is preferable to the highly specified US model. The US model allows-even encourages-corporate officers to view accounting requirements as if they were specified in a tax code. For taxes, avoidance of a tax liability by any legally permissible means not only is acceptable, but also is an obligation of corporations acting in the interests of their shareholders. Enron appears to have taken the same approach to accounting except that what was done was to the detriment of its shareholders. The gatekeepers seem to have gone along and possibly even participated in this approach to accounting.

Whether the auditor can hold the client to a higher standard within the regulatory-client-auditor-standards and expectations matrix is debatable. How a more 'principle' based reporting system would have avoided situations such as Enron is unclear. Especially, as Bentson & Hartgraves point out, the SEC may have failed to enforce its own rules against companies or its auditors before SOX. Presumably the application of accounting

[50] George J. Benston, Al L. Hargraves, op. cit .p. 127.

principles, rather than rules, would have avoided a great number of cases since the auditor would have greater latitude in which to argue the accounting was not a fair presentation. It may also be argued though, that the principles would allow for broad interpretation by clients and would not in fact make the auditors job easier or any of these cases unavoidable.

At the Congressional Hearing into Current Financial Accounting Standards the Chief Accountant for the SEC, Robert Herdman recommended a move to principle based accounting standards because it would require greater discipline by the corporate community, the accounting profession, private sector standard setting bodies and the SEC staff. [51]

While a principle-based approach may seem like the preferable, even a principle-based system will have its drawbacks if it is not allowed to remain current to the trends or if the principles are compromised as a result of lobbying. The desire to remain current and relevant is a reflection of policy and the application thereof. If changes and concerns need to be addressed, they can be addressed either in the form of rules or in the form of principles. The issue is only if there is a desire to address the issue and not compromise the objective. The issue in Enron and others is not the failure of the rules and standards that were in place, but that there may not have been the willingness to keep the rules current, apply them and provide an environment, established by the policy, that is

[51] Are Current Financial Accounting Standards Protecting Investors, op. cit. p. 15.

conducive to enforcement.[52] As the response from Representative John Dingell, points out, the standards in place may be irrelevant if people are determined to ignore or avoid them:

> I don't believe for an instant that the good folks at Enron and Arthur Anderson would have felt more constrained by general principles than they were by explicit rules. Enron happened because these bad actors stood the rulebook on its head in order to achieve illegal objectives. Crooked management and abetting accountants will have more room to maneuver under general principles with no rules.[53]

This comment may go to the purpose of Sarbanes-Oxley, which is in spite of the laws and good intentions, if an individual is determine to break the law knowingly, then they will, and they will do so with or without SOX.

[52] Are Current Financial Accounting Standards Protecting Investors, op cit.
[53] Lessons Learned From Enron, op. cit p. 10

The Sarbanes-Oxley Act

In response to the passage of the Sarbanes-Oxley Act, the U.S. Securities and exchange commission issued draft and final reports on various aspects of how it expected SOX to be enforced. In particular the Commission issued a rule on 'Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports'[54]. The summary of that rule is as follows:

> As directed by Section 404 of the Sarbanes-Oxley Act of 2002, we are adopting rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. The internal control report must include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting. Under the new rules, a company is required to file the registered public accounting firm's attestation report as part of the annual report. Furthermore, we are adding a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. Finally, we are adopting amendments to our rules and forms under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 to revise the Section 302 certification requirements and to require issuers to provide the certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 as exhibits to certain periodic reports. [55]

[54] SEC, Final Rule, op.cit.
[55] SEC, Final Rule, op. cit.

The discussion paper and the final rule issued by the SEC covered a number of topic such as the definition of internal control, management's assessment of internal control, the method of evaluating, auditor independence rules, material weaknesses, and methods of evaluating. [56] In its Final Rule the SEC relied on the work of COSO for two significant components of its new regulations. They were a definition of internal control and a framework to apply in evaluating a system of internal controls. While at the time the initial rules were issued there was some need for greater clarification in a number of areas, clarification came in the form of the Standards issued by the Public Company Accounting Oversight Board.

The PCAOB stipulated in Standard AS2 the guidelines which auditors were to follow in their assessment of internal control including definitions of internal control, evaluation frameworks, materiality definitions, fraud considerations and other factors to be considered in the assessment of internal control. While the standards provide direction as to the approach to take, in a number of areas, the sense is auditors are to continue to rely on their own professional judgment.

[56] SEC, Final Rule, op. cit.

Definition of Internal Control

In its initial deliberations the SEC proposed that the term "internal controls and procedures for financial reporting" as required by Section 404 of the Act be defined as controls pertaining to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards S319 or any superseding definition or other literature that is issued or adopted by the Public Accounting Oversight Board.[57]

The SEC acknowledged "there has been some confusion over the exact meaning and scope of the term "internal control", because the definition of the term has evolved over time".[58] The SEC understanding at the time is summarized in Appendix B and was based on the COSO definition of internal control. Briefly, the definition of internal control was as follows:

> In 1985, a private-sector initiative known as the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, was formed to study the financial reporting system in the United States. In 1987, the Treadway Commission issued a report recommending that its sponsoring organizations work together to integrate the various internal control concepts and definitions and to develop a common reference point.
>
> In response, the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") undertook an extensive study of internal control to establish a common definition that would serve the needs of companies, independent public accountants, legislators and regulatory agencies, and to provide a broad framework of criteria against which companies could evaluate the effectiveness of their internal control systems. In 1992, COSO published its Internal Control -- Integrated Framework.• The COSO Framework defined internal control as "*a process, effected by an entity's board of directors, management and*

[57] SEC, Final Rule, op. cit.
[58] SEC, Final Rule, op. cit

> *other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories--effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations* (emphasis added). COSO further stated that internal control consists of: the control environment, risk assessment, control activities, information and communication, and monitoring. The scope of internal control therefore extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives, and endeavours of all types at all levels of a company. [59]

That definition was subsequently incorporated as the definition of internal control by the Public Company Accounting Oversight Board:

> A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> > (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
> >
> > (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
> >
> > (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements. [60][61]

As part of the proposal process the SEC received a number of comment letters on their proposals[62]. The most common concern at the time was the proposed standard did not

[59] SEC Final Rule; op. cit.

provide any measure or standard by which a company's management could determine whether internal control is not effective, nor did it provide an explanation as to what defined effective internal control. Without the evaluative criteria or definition of effectiveness, it was suggested the proposed rules could not be implemented effectively.[63] The PCAOB subsequently provided guidance in a number of areas as outlined in Standard AS2 with the process evaluated against a standard of reasonable assurance as set out by the PCAOB and defined as:[64]

> The concept of reasonable assurance is built into the definition of internal control and also is integral to the auditor's opinion. Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is nevertheless, a high level of assurance.
>
> Just as there are inherent limitations on the assurance that effective internal control over financial reporting can provide...there are limitations on the amount of assurance the auditor can obtain as a result of performing his or her audit of internal control over financial reporting. Limitations arise because an audit is conducted on a test basis and requires the exercise of professional judgment. Nevertheless, the audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective [65]

The definition for reasonable assurance is not absolute assurance, reasonable assurance is a high level of assurance.[66] The term "remote likelihood" was defined to have the same

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[60] SEC Final Rule; op. cit.;
[61] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 7, June 18, 2004
[62]SEC Final Rule; op. cit.
[63] SEC Final Rule, op. cit.
[64] PCAOB, Bylaws and Rules-Standard AS2, paragraph 17, June 18, 2004
[65] PCAOB, Bylaws and Rules-Standard-AS2, paragraph 17, June 18, 2004
[66] Ibid, paragraph 16.

meaning as the term 'remote' as used in FASB No. 5, Accounting for Contingencies ("FAS No. 5"). FASB defined remote as the chance of future events occurring is slight.[67] While defined, the final decision on reasonable assurance is left to the professional judgment of the auditor to assess what is remote, reasonably possible and probable.[68]

The other element to be defined was what constituted a weakness. This was clarified by PCAOB Standard AS2 which defined a weakness as a significant deficiency as follows:

- A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions to prevent or detect misstatements on a timely basis
    - A deficiency is design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met;
    - A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively;
- A significant deficiency is a control deficiency, or a combination of control weaknesses, that adversely affects the company's ability to initiate, authorize, record process or report external financial data reliably ...such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.
- A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.[69]

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[67] Ibid, paragraph 9.

[68] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 9, June 18, 2004
[69] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 10, June 18, 2004

The definitions provides some clarification and guidance on the expectation of auditors in terms of determining a weakness and the likelihood of a weakness, but the standard does rely on the auditor's professional judgment to arrive at the appropriate conclusion.

Material Weakness

The Standard AS2 requires the auditor to conclude that internal control is not effective if there is one or more material weaknesses. The Standard AS2 provides guidance on the definition of materiality:

> The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial statement level and at the individual account-balance level. The auditor uses materiality at the financial-statement level in evaluating whether a deficiency, or combination of deficiencies, in controls is a significant deficiency or a material weakness. Materiality at both the financial-statement level and the individual account-balance level is relevant to planning the audit and designing procedures.
>
> The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.
>
> - The quantitative considerations are essentially the same as in an audit of financial statements, and relate to whether misstatements that would not be prevented or detected by internal control over financial reporting, individually or collectively, have a quantitatively material effect on the financial statements.
> - The qualitative considerations apply to evaluating materiality with respect to the financial statements and to additional factors that relate to perceived needs of reasonable persons who will rely on the information.[70]

The Standard AS2 then follows on the qualitative considerations the auditor is to consider in determining materiality by noting:

[70] PCAOB, Bylaws and Rules-Standards-AS2 paragraph 22-23, June 18, 2004

> The auditor should be aware that persons who rely on the information concerning internal control over financial reporting include investors, creditors, the boards of directors and audit committee and regulators in specialized industries such as banking or insurance. The auditor should be aware that external users of financial statements are interested in information on internal control over financial reporting because it enhances the quality of financial reporting and increases their confidence in financial information, including financial information issued between annual reports, such as quarterly information. Information on internal control over financial reporting is also intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements in internal control over financial reporting such as the audit committee and regulators in specialized industries.[71]

Subsequently the PCAOB, in Standard AS2, the PCAOB set out that materiality should be applied at the financial statement level and at the individual account level. Furthermore the PCAOB stated that the conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting including the relevance of both qualitative and quantitative factors. Quantitative considerations are essentially the same as in the audit of financial statements and whether misstatements that would not be prevented or detected by internal control, individually or collectively, would have a quantitative material effect on the financial statements. The qualitative considerations include the perceived needs of people who rely on the financial statements[72]

Materiality as defined by the standard and the concept of due care that is contained in the COSO literature put the company and the auditor in difficult positions. The materiality level is a judgmental evaluation based on perceived or real risk. The Standard provides no

[71] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 6, June 18, 2004
[72] PCAOB, Bylaws and Rules-Standards_AS2, paragraph 22 & 23, June 18, 2004.

additional guidance or parameters with respect to determining an appropriate level of materiality. The Standards only refers to existing materiality guidelines. The Standard AS2 refers to the qualitative or possible users of financial information in determining an appropriate level of materiality. While this is an explicit guidance to consider those groups, it is generally accepted that auditors do consider those groups in making materiality decisions. Furthermore, consideration or obligation to users has been documented in common law. In spite of the guidance on materiality provided by the Standard, the auditor is left to his own professional judgment to determine the extent of testing, based on materiality of each individual account and concluding whether material deficiencies exist based on an overall financial statement materiality.

COSO notes, "although the material weakness threshold is the relevant one for public reporting on internal control, the process of making that determination cannot be expressed in only quantitative terms. Considerable judgment is needed that takes into account all of the facts and circumstances in a particular case."[73] The determination of a material weakness is made by considering how the deficiencies affect the financial statement assertions, the significance of the specific deficiency in relation to compensating controls, and quantitative materiality considerations with respect to the misstatement on the entity's financial statements, timeliness of detection, the users of the company's financial statements and the perceived risk associated with the company. Because of its importance in the process, COSO notes the material weakness concept needs to be evaluated by the appropriate bodies for further refinement, or at least more

[73] COSO, op. cit. p. 159

explicitly defined.[74] This is consistent with the SEC's SAB No. 99 on Materiality which states that entities and auditors should not rely exhaustively on quantitative benchmarks, such as 5% of net income to determine, whether an item, or aggregation of items is material. Various factors such as those noted regarding affect on earnings trends, impact on covenants and analysts projections, need to be considered.[75] Overall, the materiality guidelines are general and provide guidance in what to consider but in the end, the decision is one that will require the professional judgement of the auditor to apply guidelines that existed before Enron.

Evaluation Framework

A company is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework, established by a body of experts. A framework is considered suitable only when it:

- Is free from bias;
- Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;

[74] COSO, op. cit. p. 158.
[75] Panel, op.cit.. 56.

- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal control over financial reporting are not omitted; and

- Is relevant to an evaluation of internal control over financial reporting[76]

The framework that is relied upon to determine effectiveness of internal control is the framework provided by COSO or the COSO framework is the framework to which other frameworks are to be evaluated. The PCAOB endorsed the COSO framework and the performance and reporting standards for internal control purposes required by the AS2 was based on that criteria.[77] The SEC noted that the method of evaluation should vary from company to company and will largely depend on the circumstance of each company.

The PCAOB established standards upon which a conclusion or opinion on internal control systems can be evaluated by the auditor. These standards include the auditor to consider:

- the adequacy of the assessment performed by management and the auditors evaluation of the design and test of operating effectiveness of controls;

- the negative results of substantive procedures performed during the financial statement audit;

- any identified control deficiencies;

- in order to issue an unqualified opinion the auditor must be certain that there are no identified material weaknesses or scope limitations;

- the auditor must evaluate identified control deficiencies and determine whether the deficiencies, individually or in combination, are significant

[76] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 13, June 18, 2004.
[77] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 14, June 18, 2004.

deficiencies or material weaknesses. The evaluation of the significance of a deficiency should include both quantitative and qualitative factors;[78]

- the likelihood that a deficiency, or a combination of deficiencies could result in a misstatement; and
- the magnitude of the potential misstatement resulting from the deficiency.[79]

PCAOB sets out that the significance of a deficiency in internal control is its potential for misstatement and that several factors will affect the likelihood that a deficiency, or combination of deficiencies could result in a misstatement:

- Control deficiencies exist when the control does not allow management in the normal course to prevent or detect misstatements on a timely basis and can be in the form of design or operational weaknesses.
- A significant weakness is a control weakness, or combination of control deficiencies that adversely affect the company's ability to initiate, authorize, record, process or report on external financial data reliably[80].

The Standard AS2 does provide the auditor with guidance in terms of the understanding to obtain in evaluating the system of internal control. The Standard provides guidance on the control environment, risk assessment, control activities, information and communication and monitoring as it relates to the activities of the company. [81] The Standard AS2 also provide guidance to the auditor in terms of identifying company level controls, evaluating the effectiveness of audit committees, criteria to apply when identifying significant accounts, relevant assertions and major classes of transactions.

[78] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 127, June 18, 2004
[79] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 127-131, June 18, 2004
[80] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 8 & 9, June 18, 2004
[81] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 49, June 18, 2004.

Standard AS2 also expands the requirements of the primary objectives of internal control noted in the COSO criteria by extending testing beyond those controls that contribute directly to financial statement preparation, such as those operational or regulatory controls that may also, indirectly, impact financial statements.

> The COSO framework identifies three primary objectives of internal control: efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations. The COSO perspective on internal control over financial reporting does not ordinarily include the other two objectives of internal control, which are the effectiveness and efficiency of operations and compliance with laws and regulations. However, the controls that management designs and implements may achieve more than one objective. Also, operations and compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements are encompassed in internal control over financial reporting. Additionally, not all controls relevant to financial reporting are accounting controls. Accordingly all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and also have a material effect on the reliability of financial reporting, are a part of internal control over financial reporting.[82]

This type of testing would be applicable is in the area of computer system controls such as the security of the software programs and controls over upgrades to programs. While those controls would not have a direct impact on the preparation of the financial statements as they are not involved in an account cycle, the controls become relevant because a failure of a control regarding the effectiveness of the computer systems could lead to a failure in the system to provide financial statements or result in a material error in the financial statements. The consequence of this is the scope of areas to be tested is expanded under SOX, to areas in which auditors have to apply further judgement and perhaps rely on the skills others to evaluate the effectiveness of the controls.

To issue an opinion on the effectiveness of internal control, the auditor needs to consider the following elements in reaching a conclusion on the internal control program:[83]

- determine which controls should be tested including controls over all relevant assertions related to all significant accounts and disclosures in the financial statements such as:
    - controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements;
    - controls over the selection and application of accounting policies that are in conformity with GAAP;
    - antifraud programs and controls;
    - controls, including information technology controls on which other controls are dependent;
    - controls over significant non routine and nonsystematic transactions such as accounts involving judgments and estimates;
    - company level controls including:
        - the control environment
        - controls over the period end financial reporting process
- evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives;
- evaluating the design effectiveness of controls;
- evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness;
- determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses; and
- evaluating whether findings are reasonable

Specifically with respect to evaluating the controls in place the auditor is required to consider the following:

- Evaluating Design Effectiveness
    - Internal control is effectively designed when the controls would be expected to prevent or detect errors or fraud that could detect

[82] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 15, June 18, 2004
[83] PCAOB, Bylaws and Rules-Standards_AS2, paragraph 40, June 18, 2004

material misstatements. The auditor should determine if the controls meet the objectives of the control criteria by:

- Identifying the company's control objectives;
- Identify the controls that satisfy each objective; and,
- Determine whether the controls, if operating effectively, can effectively prevent or detect errors or fraud that could result in material misstatement.

- o Procedures to test and evaluate include inquiry, observation, walkthroughs inspection and a specific evaluation of whether controls are likely to detect errors or fraud.

- Evaluating Operating Effectiveness
  - o Evaluate the operating effectiveness of a control by determining whether the control is operating as designed:
    - Test of control over operating effectiveness include a mix of inquiries;
    - Evaluate responses to inquiry which might provide evidence to the skill and competency of those performing the control, the relative sensitivity of the control to prevent or detect errors or fraud and the frequency with which the control operates to prevent or detect errors or fraud;
    - The auditor should perform additional test of controls to support the operating effectiveness of the controls;
    - The nature of the control influences the nature of the test of controls the auditor can perform. Documentary evidence regarding some aspects of the control environment, such as management's philosophy and operating style might not exist, the auditors tests of controls would consist of inquiries of appropriate personnel and observation of company activities;
    - The auditor must perform tests of controls over a period of time, that is adequate to determine whether, as of the date specified in managements report, the controls necessary for achieving the objectives of the control criteria are operating effectively; and,
    - The auditors testing of the operating effectiveness of such controls should occur at the time the controls are operating.

Of particular note is the specific reference to whether controls can prevent or detect fraud. Under this requirement auditors may require forensic auditors to try and test the systems with a rigour that a day-to-day transaction might not exploit. There is also the requirement that the auditor draw his own conclusions in areas where documentary audit evidence may be readily available or may be the type of evidence upon which the auditor may not rely.

The COSO criteria acknowledges that internal control is subject to inherent limitation of management override, collusion, and circumvention because as noted by COSO, controls are affected by people. Furthermore, internal control as noted by the SEC cannot be expected to provide more than reasonable assurance. The PCAOB in Standard AS2 notes:

> Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgement and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of these limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.[84]

The Standard seems to differ from the conventional thinking that an audit cannot detect fraud and from the COSO thinking that any control system is susceptible to collusion. The suggestion in the last part of the Standard AS2 is that in areas where there is a risk of fraud, and it is known to exist, or the possibility is know to exist, then more than one control needs to be in place to ensure that there is no control break down. This is an area in which an auditors judgement will be challenged in terms of determining which accounts or accounting processes need multiple controls.

Another inherent limitation is a result of how the nine components highlighted by COSO interact and how they are performed. It is not likely that activities in different companies will be the same and therefore neither will the implementation of the nine criteria or their level of effectiveness. There will be a trade-off in the existence or effectiveness of controls from company to company. These variations between existence and effectiveness will likely make it difficult to compare company to company since some internal control components may be stronger than others and may compensate for weaker controls.

Reporting Requirements

The reporting requirement of the PCAOB with respect to the effectiveness of internal control require the annual report include a report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- a statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the

[84] PCAOB, Bylaws And Rules-Standards-AS2, paragraph 15, June 18, 2004.

company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting;

- a statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting; [85]

- Management should provide, both in its report on internal control over financial reporting and its representation letter to the auditor, a written conclusion about the effectiveness of the company's internal control over financial reporting. The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms; however, management is required to state a direct conclusion about the whether the company's internal control over financial reporting is effective;

- Management is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses. In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year; and

- Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective. [86]

In order to issue a statement on the effectiveness of internal control the auditor is required to evaluate management's assessment and accumulate sufficient evidence to support the conclusion that the system of control is effective and does not contain any material weaknesses, as previously discussed.

[85] SEC Final Rule, op. cit.
[86] PCAOB, Bylaws and Rules-Standard-AS2, paragraph 163-165, June 18, 2004

COSO acknowledges that no two entities will, or should, have the same internal control system. Companies and their internal control needs will differ by industry, size, staffing, corporate culture, and management philosophies. While all entities may need each of the components to maintain control over their activities, one company's internal control system may very well look very different from another company depending on which controls are selected and how they are implemented. The inherent limitation is a result of how the nine components highlighted by COSO interact and how they are performed. It is not likely that activities in different companies will be the same and therefore neither will the implementation of the nine criteria or their level of effectiveness. There will be a trade-off in the existence or effectiveness of controls from company to company. These variations between existence and effectiveness will likely make it difficult to compare company to company since some internal control components may be stronger than others and may compensate for weaker controls. While Revsine encouraged the transparency in disclosing the results and the methods selected for the reader to reach his own conclusion, as it relates to internal control it does not present the same quantitative results as financial statements. For financial statements, the reader has results from operations to assess in view of the accounting policies. There is no connection between the internal control report and the financial statements issued by the company even though there is the acknowledgment that an effective control system will reduce year-end substantive work.

The use of the word 'over' financial reporting implies that if effective, internal control should negate any manipulation of financial statements[87]. Rather than just ensuring all the data was completely and accurately entered and reported upon, the internal control system should prevent manipulation by management. As a result this standard will comply with s.103 of SOX that requires management and the auditor to provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements.[88] [89] Even though the SEC through the PCAOB issued auditing guidelines providing some clarification with respect to the thought process and work to follow, the clarifications are subject to professional judgement and the auditor's conclusion whether or not the control weaknesses are significant enough to have a material impact on the financial statements.[90]

Furthermore, as guidance to auditors on which control to tests, one of the criteria used to determine the extent of testing are controls where errors or fraud could occur. [91] Therefore, the auditor in designing a test strategy, may test areas or formulate fraud scenarios in order to test the adequacy of internal control or the capability of the control to prevent fraud

For the auditor, the implication of evaluating internal control, is that in an accounting process that is continually in use, evaluating the effectiveness at a point in time, without

[87] SEC Final Rule, op. cit.;
[88] Sarbanes-Oxley, op. cit.
[89] PCAOB, Bylaws and Rules-Standards-AS2 paragraphs 50-71, June 18, 2004

[90] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 133, June 18, 2004.
[91] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 82, June 18, 2004

specific standards or standard open to interpretation or judgment, will leave the auditor open to question in the event of a failure. Open to questions such as why were more tests not conducted or how the level of materiality was chosen, or how it was determined some controls compensated for others. The other risk is that a breakdown can occur in the internal control system during the year that might result in a material error or a fraud.

The over riding consideration is that internal control is a constant process that reflect the changing nature of the company, the changing importance and relevance of certain controls as things change and this was recognized in the final rule deliberations by the SEC[92]. The implication for the auditor and investigative accountant, and for the legislation, is the reader and the market are left to the judgment of management and the auditor whether or not the design and testing of the control system is adequate and effective. There is no specified control system, evaluation or reporting standard that will allow readers to assess on their own, as in reading notes to the financial statements, whether or not the company has a strong or weak internal control system and what that may mean to the financial statements. Instead, the reader and the market are left entirely to rely on management and the auditor for their information. In this respect SOX and the SEC rules have not provided a specified standard of performance and have not made it less likely that these evaluations themselves are not prone to manipulation and hence a reduced risk that financial manipulation can take place.

[92] SEC, Final Rule, op. cit.

The flexibility in the interpretation of the required components regardless of the framework applied, and the lack of a detailed framework by the SEC will provide, just as the manipulation of GAAP and GAAS resulted in Enron, the opportunity for the manipulation of evaluations both in terms of the set up and evaluation of the control system. This would not appear to be within the spirit of SOX that aimed to remove manipulation from financial reporting.

Substantive Audit Standards

While the SOX legislation specifically targeting internal control requirements in the hope of curtailing management fraud, no such legislation was introduced with respect to auditing specific accounts for fraud as part of the year-end audit opinion. As a result of Standard AS1, the PCAOB adopted the American Institute of Certified Public Accountants Auditing Board's Statement on Auditing Standards no. 95 as its own audit standard.[93] There was not specific reference made to additional fraud procedures to be followed. Standard AS2 outlines that the audit of internal control over financial reporting should be integrated with the audit of financial statements. The understanding of internal control and the procedures the auditor performs in expressing an opinion on management's assessment of internal control are interrelated with the understanding and procedures used to assess control risk.[94] However, the specific directives in AS2 as noted with respect to fraud, and the additional guidance that the understanding of the control risk or assessed risk of material misstatement on the financial accounts to be audited should determine the approach taken by the auditor in his audit approach. Of note however, is the increased reference the Standard AS2 makes in relation to fraud. Standard AS2 specifically identifies that:

> The auditor should evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. These controls may be a part of any of the five components of internal control over financial reporting as discussed. Controls related to the prevention and detection of fraud often has a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

[93] PCAOB, Release 2003-025, December 17, 2003
[94] PCAOB, Bylaws and Rules-Standard-AS2, paragraph 145 & 146, June 18, 2004

- controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements;
- company's risk assessment processes;
- code of ethics/conduct provisions, especially those related to the conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board;
- adequacy of the internal audit activity and whether internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit; and adequacy of the company's procedures for handling complaints and accepting confidential submissions of concerns about questionable accounting or auditing matters.

Part of management's responsibility when designing a company's internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud.

In an audit of internal control over financial reporting, the auditor's evaluation of controls is interrelated with the auditor's evaluation of controls in a financial statement audit as required by AU. Sec 316 Consideration of Fraud in a Financial Statement Audit. If the auditor identifies deficiencies in controls designed to prevent and detect fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies as provided in paragraphs .44 and .45 of AU sec. 316.[95]

Specifically the standard set out that the auditor's substantive procedures must include reconciling the financial statements to the accounting records. The standard also requires that audits follow Consideration of Fraud in Financial Statement Audit, AU sec. 316, and perform certain tests for details to further address the risk of management override, whether or not a specific risk of fraud has been identified. [96] The Standard has increased or introduced and mandated a level of fraud awareness. As a result, firms may change

[95] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 24-26, June 18, 2004
[96] PCAOB, Bylaws and Rules-Standard-AS2 paragraphs 145-155

the composition of their audit staffs, and audit approaches in order to accommodate this fraud mindset.

If the internal control system is effective, then there may be less of a need to perform year-end substantive work directed at fraud. Nonetheless, the impact of SOX is reflected in year-end audit procedures. Standard 99 outlines standards and considerations auditors must consider to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error. [97] The Standard focuses on the auditors' consideration of fraud in financial statements in areas such as characteristics of fraud, professional skepticism, awareness of misstatement due to fraud and fraud risk identification, among others. [98].

These proposed amendments in response to SOX, indicate that a greater investigative and fraud awareness, should be added to the substantive year-end approach if a greater risk of fraud is perceived. The issue is how a greater risk of fraud is perceived. As noted in the area of internal control, the presence or absence of the COSO nine internal control criteria and how effective they are may be a significant factor. Financial statement audits, as noted by the SEC and COSO, were never designed and cannot be expected to uncover fraud as noted by the use of the terms absolute versus reasonable assurance.

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[97] AICIPA, *Consideration of Fraud in a Financial Statement Audit*, Statement on Auditing Standards , 92 (now 99), October 2002, p. 3. ("Standard 99")
[98] Standard 99, op. cit., p. 7.

Nonetheless, with the emphasis on fraud detection, the standard presumes that the audit 'evidence' analyzed will support the conditions of fraud. Those conditions include that for the fraud to have been committed, there was an incentive to perpetrate a fraud, the opportunity and the rationalization to justify the action.[99] Even that may not be enough because to make the accusation of fraud, there is the remaining condition that those who engaged in the 'fraudulent' activity profited from their actions and did not only have the incentive to do so. This is a further complication as it relates to the onus on the auditor to 'judge' the benefit. In a simple case, increasing the mileage on an expense report clearly benefits the perpetrator in the form of additional, unearned, money. In the case of the executive, is the benefit merely retaining his job? It is unclear. Yet the auditor is left to sort this out with no guidance in the standards as to what is considered 'fraudulent'.

For example, in 1987, the National Commission on Fraudulent Reporting considered that fraudulent financial reporting was defined as the following:

> ...the intentional or reckless conduct, whether act or omission, that results in materially misleading financial statements. Fraudulent financial reporting can involve many factors and take many forms. It may entail gross and deliberate distortion of corporate records such as inventory count tags, or falsified transactions, such as fictitious sales or orders. It may entail the misapplication of accounting principles. If the conduct is intentional or so reckless that it is the legal equivalent of intentional conduct, and results in fraudulent financial statements, it comes within the Commission's operating definition of the term fraudulent financial reporting. Fraudulent financial reporting differs from other causes of materially misleading financial statements such as unintentional errors.[100]

[99] Standard 99, op. cit., p.20.
[100] Commission, op. cit. p. 2.

This broader definition is based on the premise that regardless of the reason, or the potential benefit, if the financial statements are materially misstated then they are fraudulent. The Standard points out "material misstatements due to fraudulent financial reporting often result from an overstatement of revenues or an understatement of expenses. The Standard specifically points out that there should be a presumption that improper revenue recognition is a fraud risk and the auditor should plan his steps accordingly. [101] However, the premise that recording of revenue is deliberately in error would suggest a more investigative mindset than that of an audit. As noted by the standard, the nature of the auditors' testing to get reasonable assurance may not uncover sufficient evidence to prove or disprove the premise. Therefore investigative techniques, directed more at absolute assurance, would seem to be implied by the nature of the presumption, since the purpose of the standard is such that the auditor is to comment that the financial statements are free from fraud. The investigative response to the risk of material mis-statement due to fraud will affect how the audit is conducted in terms of assignment of personnel, the accounting principles and the predictability of auditing procedures.[102]

The premise reflected in Standard 99 that there is manipulation of revenues, is supported by the Panels finding. The Panel found from SEC records that the greatest risk was with misstated revenue based on thirty-eight cases in which twenty-six involved misstated

[101] Standard 99, op. cit., p. 23.
[102] Exposure Draft op. cit. p. 26

revenue and thirteen involved misstated expenses[103]. In spite of this knowledge, little appeared to have been done by the SEC to stop the practice prior to Enron. This failure to curtail manipulative revenue reporting is the type of conduct, which indicates the policy system and the application thereof, and not the auditors alone, share in the blame for Enron and similar failures.

If revenue is a risk area, then the auditor must consider what pressures exist on management that would motivate a misstatement of earnings or revenue management. This is complicated by the distinction between fraud and earnings management and whether earnings management is indicative of a weak internal control system or even fraud.[104] The Panel on Audit Effectiveness[105] noted that the term 'quality of earnings' has no universally accepted definition. What it means to one individual may not be what it means to another.[106] As the Panel notes, it is the acceptability of an accounting policy under GAAP that draws the line on the continuum distinguishing legitimate earnings management from fraud. However, determining whether or when the behavior in the earnings management continuum crosses the line from legitimacy to fraud is not always easy [107] and may also reflect on the adequacy of financial reporting.

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[103] Panel op. cit, p. 223.
[104] Panel, op. cit. p. 77.
[105] Panel, op. cit. p. 79;
[106] Panel, op. cit, p 79,
[107] Panel, op. cit, p 79.

The motivations suggested for committing fraud was in terms of meeting expectations of analysts and even boards of directors.[108] The Panel notes that the pressures on management and the consequences of failing to meet financial goals can be extraordinary. At many levels, the financial incentives based directly or indirectly on accounting results can be significant. At some point in the continuum, the motivation behind earnings management may become so strong as to result in 'fraud'.[109] As Verrecchia suggested, Enron may not be the problem as much as the motivation behind the reporting. Or more simply, it should be accepted that these entities offer an opportunity for otherwise honest people to commit fraud.

The Panel's comments suggest the SOX personal certification by management as to the internal control and the accuracy of the financial statements would offer little in the way of deterrence to management in perpetrating a fraud because the pressure created by boards, stock markets and the benefits in their own compensation. Some would suggest that key officers were already signing statements filed with the SEC and this did not prohibit Enron from occurring. If the pressures are so great as to manipulate the financial statements, and if the thinking is the fraud will not be detected, then there will be no consequence to certifying statements that are not accurate. The SOX deterrence in fines and jail sentences may make management and chief financial officers more diligent in some respects, but there is little to suggest that the personal certification aspects of SOX would have prevented Enron.

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[108] Panel, op. cit, p. 80.

With a greater fraud risk attributed to audits, both in terms of possibility of fraud and those involved or knowing of the fraud at the management or board level, the auditor may respond to an identified risk of material misstatement due to fraud by assigning additional persons with specialized skill and knowledge, such as forensic and information technology specialists... and the extent of supervision should reflect the risks of material misstatement due to fraud.[110] This would be a forensic-type fieldwork phase.[111]

> Not unlike the traditional planning, interim, final, and review phases of audits, this new forensic-type phase would become an integral part of the audit, with careful thought given to how and when it is to be carried out. A forensic-type fieldwork phase does not mean converting a GAAS audit to a 'fraud audit'. Rather the characterization of this phase of a GAAS audit as a forensic-type phase seeks to convey an attitudinal shift in the degree of skepticism. Furthermore, use of the work phase does not mean that the work cannot be integrated through out the audit. The key question that auditors should ask is "Where is the entity vulnerable to financial statement fraud if management were inclined to perpetrate it?[112]

Substantive tests would be directed at the possibility of fraud including tests to detect the override by management. Tests should be conducted in high-risk areas where the opportunity for fraud is higher than normal such as revenue. However the Panel, while emphasizing a greater forensic direction in the nature of the work recognized that many procedures would be impractical or impossible.[113]

COSO describes, integrity, ethical values and competence as important criteria to evaluate whether effective internal control exists. Furthermore, it is also important there

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[109] Panel, op. cit. p. 2.
[110] Standard 99, op. cit. p. 26.
[111] Panel, op. cit. p. 88.
[112] Panel, op. cit, p. 89

is a control environment and the atmosphere is conducive to internal control that is practiced at all levels of the organization, including the board of directors. To effectively conduct both an internal control and substantive audit, it appears relevant to evaluate the ethical make up of management and the board of directors and the motivations that may exist to commit fraud. COSO noted that the effectiveness of internal controls couldn't rise above the integrity and ethical values of the people who create, administer and monitor them.[114] This evaluation was also considered pertinent by AS2 and the auditor's evaluation of internal control. Yet COSO offers little in the way of suggesting what does or does not constitute ethical behavior because integrity, ethical values and competence are highly subjective and difficult to evaluate; nonetheless, an assessment of their presence and influence on people's behaviour should be made.[115]

The implication of this standard to the auditor and investigative accountant is while there are checklists and questions to assist in the determination; these checklists may also provide a means for management wishing to engage in fraud. A means by which management can prepare answers that create the appearance of an ethical environment when it is not. Even if, as noted before, an exception is found that may indicate upper level management involvement and suggest an unethical environment, without a connection to a benefit, it will be difficult to suggest there is criminal fraud. However, by the Commission's standard, the fact the statements are in material error may be sufficient to say the statements are fraudulent. As has been noted, the final determination is based

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[113] Panel, op. cit, p. 89.
[114] COSO, op.cit. p. 59.

upon a subjective evaluation of management by the auditor, which is not based on a strict set of guidelines and may vary from auditor to auditor.

The difficulty with the evaluation of an ethical control environment is it puts the auditor and investigative accountant, in a position, which they are not readily equipped. Presumably the investigative accountant would be consulted because they have experience in dealing with people who have committed frauds and will use their experience accordingly to assess the ethical makeup of management. The difference with a public company and a 'normal' forensic assignment is in a 'normal' forensic/investigative assignment the accountant starts with a situation based on facts or at least a viable scenario. For example, 'money is missing', or 'contracts are being lost to competitors in a peculiar fashion'. Based on the available evidence surrounding the situation the auditor and investigative accountant arrives at a scenario as to what has taken place. The investigation will eventually involve interviews with those the accountant believes can assist in the investigation and with the suspect(s). Only on the basis of the accumulated factual evidence can a case be made about fraudulent activity. The interview of a suspect may assist in accumulating more evidence, but without a confession the interview alone will be insufficient.

It will be different scenario for an auditor or investigative accountant to be contacted and asked to interview somebody suspected of being unethical and a potential fraud risk as it relates to the accuracy of financial statements. The auditor and investigative accountant is not presented with a loss scenario, but with a speculative scenario in terms of financial

[115] COSO, op. cit. p. 64.

statement fraud, and whether, and how the individual would take part and how they would benefit. This may be offset in some respects by the presumption that revenue is the easiest and most often manipulated and so an investigative approach to these accounts may be appropriate. A greater level of skepticism is encouraged while achieving a balance between needing management's assistance to do the work versus not trusting them completely. While management may be involved in manipulations it may also be difficult to suspect every company's management of manipulations or dishonesty. Yet this may be a consequence of the Enron environment and one implication of the changes brought about by SOX which require the assistance of investigative and forensic accountants to assist in evaluating top management and their propensity to commit fraud.

If investigative accountants are able to evaluate the ethical makeup of management or their staff, the final determination would have to be considered in view of the conclusions made on the other features of a control system set out by COSO. Whether there are compensating controls or whether the controls in place would prevent management from misrepresenting the financial statements. This along with other factors would be considered as to whether there was a material control weakness or the possibility for one. This is not to suggest that the pursuit of curtailing fraud will never succeed. As the Panel noted most of the mis-statements involved relatively routine accounts and transactions as opposed to complex judgmental areas and more esoteric accounts and transactions such as derivatives, in-process research and development and development charges.

Approximately 70% of the cases involved the overstatement of revenue from either premature or fictitious revenue recognition.[116] Specific targeted investigative procedures will be beneficial, but will be limited by the volume of transactions at any one company. The fact neither the SEC nor COSO stipulates the level of testing or the standard of testing to be completed could be problematic and even the few investigative approaches suggested, such as investigating revenue, will be offset by the latitude in judgment on the results from the testing applied. While absolute assurance may not be attainable, it is clear there is a theme that more than reasonable needs to be done, with greater due care and a focus on areas susceptible to fraud, or believed to be, and with greater skepticism than before.

[116] Panel, op.cit., p. 85.

Due Care

The Standard AS2 defines due professional care as exercising professional skepticism[117]and defines professional skepticism to consider:

> Regardless of any past experience with the entity or the auditor's beliefs about management's honesty and integrity, the auditor should recognize the possibility that a material misstatement due to fraud could be present. Furthermore, professional skepticism requires the auditor to consider whether evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor must not be satisfied with less-than-persuasive evidence because of a belief that management is honest.[118]

In deliberating the steps to be taken in obtaining reasonable assurance COSO noted the trade off in terms of cost and benefit and the need to find the 'right balance'. To do so, despite the difficulties, cost-benefit decisions should be made taking into account the "prudent person" concept. This concept asks, taking everything into account, including the risks and costs involved, would a prudent person, operating in the real world, institute a particular control.[119] COSO provides the following definition of the prudent person:

> Now this reasonably prudent man is not infallible or perfect. In foresight, caution, courage, judgment, self-control, altruisms and the like, he represents and does not excel the general average of the community. He is capable of making mistakes and errors of judgment, of being selfish, of being afraid-but only to the extent that any such shortcoming embodies the normal standard of community behavior. On the other hand, the general practice of the community, in any particular, does not necessarily reflect what is careful. The practice itself may be negligent. "Neglect of duty does not cease by repetition to be neglect of duty." Thus the standard represents the general level of moral judgment of the community, what it feels ought ordinarily to be done, and not necessarily what is ordinarily done, although in practice the two would very often come to the same thing.[120]

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[117] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 36, June 18, 2004
[118] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 06, June 18, 2004
[119] COSO, op. cit. p. 16.
[120] COSO, op. cit. p. 17.

The attributes that COSO derived from this passage with respect to reasonable assurance and a prudent person are:

> A prudent person should exercise judgment equal to that of the level in his or her community. This person is not expected to be omniscient, nor is his or her judgment to be critic sized on the basis of advantageous hindsight. The prudent person's judgment must be as sound as that of another individual possessing the same information.
>
> A prudent person should use the knowledge he or she possesses with reasonable intelligence. He or she is considered to have the average ability to perceive risks and their consequences, and is expected to be aware of his or her own ignorance and to perceive the risk of proceeding or acting in a state of ignorance of potential hazards. As more knowledge becomes available to all, the prudent person is expected to keep up with his or her community both in general and specialized knowledge.[121]

The COSO report quotes Justice Learned Hand on the degree of care required from a prudent person:

> The degree of care demanded of a person by an occasion is the result of three factors: the likelihood that his conduct will injure others, taken with the seriousness of the injury if it happens, and balanced against the interest which he must sacrifice to avoid the risk.[122]

The Standard AS2 defines reasonable assurance as the understanding that there is a remote likelihood that material mis-statements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.[123] For auditors and investigative accountants the standard of 'prudence' and 'community standard' will affect how much testing of all aspects of the internal control system and the substantive audit, is required to avoid future corporate failures due to fraud. The standard of due care would be further emphasized by the

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[121] COSO, op. cit. p. 18.
[122] COSO, op. cit. p. 19.
[123] PCAOB, Bylaws and Rules-Standards-AS2, paragraph 17, June 18, 2005

explicit reference to the prevention and detection of fraud through internal controls in Standard AS2. The interpretation which could be given to the community standard, in the political and regulatory environment created by Enron, and the seriousness of the injury (loss in equity value) would be a the degree of care in the form of testing that may be greater than normally expected to provide reasonable assurance. Under the political environment, the definition of reasonable assurance may have changed based on the availability of more specific and specialized knowledge regarding fraud and how failures have occurred in the past.

The community standard, in the political and regulatory environment in the aftermath of Enron, may set the moral judgment of the community at a level that a prudent person would extend sufficient testing to such a point as to ensure that frauds no longer occur. This contradicts the conventional cost benefit tradeoff that exists with sample testing, the reliance on reasonable rather than absolute assurance and the ability to detect fraud or system failures based on the evidence reviewed. In spite of the understood limitations of testing, the judgment of the community would set a higher standard than would be expected and that auditors would do more testing than normally expected. In effect there would be a chilling affect on auditors. The legislation and the application of terms such as community standard would increase the level of expectations such that the accounting and audit community may not be allowed to make a mistake and allow another fraud, regardless of the circumstances that lead to the fraud.

Policy and the Public Interest

The SOX legislation has added whistle blower protection to employees of publicly traded companies who provide evidence of fraud.[124] It had been acknowledged that there was a need to strengthen the environment in which the profession functioned in order to reduce the pressures on independence, which gave rise to poor judgment and professionalism[125]. Yet no protection had been provided to the audit firms, those who 'serve the public' by reporting on the accuracy of the financial statements. The firms and the clients regarded this 'important service', as a commodity.[126] Other service lines such as consulting were perceived to have higher levels of growth and profitability and the emphasis was on providing profit enhancing ideas to client management so the audit would appear to have value.[127]

The perception was the non-audit services were compromising the integrity of the audit process and as such the SOX legislation barred non-audit services. However, the premise that non-audit services compromised audit performance was open to question. As Senator Phil Gramm noted at the Subcommittee Hearings on the testimony of Arthur Levitt:

> Our accounting firms are the envy of the world. Some of the most respected companies in America are the very companies that would be dismembered by this proposal. It seems to me that if we are going to consider this, there has to be hard evidence that (A) there is a problem and (B) this dismemberment is going to solve the problem. And I think that basically is the issue. It is what I have se out as the standard that must be met if these changes are going to be made and

[124] Sarbanes-Oxley, op. cit. s.806.
[125] Subcommittee on Reports, Accounting and Management, p4
[126] Panel, op. cit. p. 99
[127] Panel, op. cit. p. 99.

> sustained....But if you are going to make the changes the SEC is talking about, then you must do more than argue there might be a conflict and that it might override the credibility of those who are leading these firms. It seems to me that you must have hard evidence. That is what we are looking for. [128]

Nonetheless, legislation passed with respect to auditor independence rules and as noted the entire Sarbanes-Oxley legislation may have been the result of converging circumstances with the failure of Worldcom during the hearings into Enron. But as with the comments on hard evidence and auditor independence, it is not clear that there is any evidence to suggest that the initiatives of SOX would have prevented the failure of Enron or others like it.

SOX has focused the importance, if not temporarily, back on the fairness and accuracy of the financial statements, and the consequences of not complying with the regulations. However, it is difficult to conclude in the case of Enron, that approximately $27 million in consulting fees rather than the $25 million in audit fees for the year 2000 compromised the auditors' independence[129]. The logic would suggest, had the auditors not been allowed to consult, Enron would not have happened because for the audit fee alone, the auditors would have been more strident in their application of GAAP and GAAS standards. DeFond, Raghunandan and Subramanyam in fact found that non-audit service fees do not impair auditor independence that contradicts 'consulting' assignments as a motivating factor in Enron[130], and the Panel drew a similar conclusion.[131]

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[128] The SEC's proposed Auditor Independence Rules, op. cit. p. 13
[129] Bentson & Hartgraves, op.cit. p. 107.
[130] Mark L. Defond, K. Raghunandan, K.R. Subramanyam, "Do Non Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions", *Journal of Accounting Research*, Vol 40 No 4.

While employees of public companies are subject to protection from making officials aware of fraud with the 'whistle blowing' section of SOX[132], protection was offered to auditors in the legislation by virtue of the fact that the auditors are retained solely by the audit committee, which, is to be comprised of outside directors and directors not involved with company management. If auditors now have a conflict with the board of directors or management with respect to the presentation of financial statements or the weakness of internal control systems, they are expected to bring forward areas of disagreement without fear of losing the audit and are at less risk than they have been in the past.

Nonetheless, over time auditors have been expected to protect the 'public interest' and risk the continuation of their fee revenue by challenging management on the weakness of their internal controls systems now required by SOX and the presentation of their financial statements. This loss of revenue and not consulting assignments has perhaps been the largest contributing factor in the 'involvement' of accounting firms in frauds.

Auditors for years have commented on financial statements and have been aware of the users of financial statements, all the while performing, the best they can, their gatekeeper, and whistle-blowing function with no protection from the potential position of conflict with management. While they have a 'public' duty, and indirectly they work for the

[131] Panel, op.cit. p.
[132] Mark L. Defond, K. Raghunandan, K.R. Subramanyam, "Do Non Audit Service Fees Impair Auditor Independence? Evidence from Going Concern Audit Opinions", *Journal of Accounting Research*, Vol 40 No 4.

public and not management and the directors, management and the directors, not the public, decides if they continue in their assignment the next year. There is an inherent conflict of interest built into the auditors' relationship from the outset. The relationship is put at risk whenever the auditor challenges management on accounting treatments. The auditor does not have the benefit of isolating themselves from the influence of management entirely, precisely for the reasons related to continuing the engagement. The new requirements that auditors report to the audit committee along may solve the previous issues that auditors had with being paid by and then in turn having to report on the same management. A cost of being a public company is the audit requirement. Companies comply with this requirement directly by paying for audits rather than being 'taxed' by the SEC who would then contract audit firms to issue opinions on the financial statements of public companies. The latter would change the auditor-client relationship such that the auditor, paid by the SEC would strive to satisfy the SEC and in turn the public rather than 'compromising' to satisfy management. . In a different fashion it has been suggested that auditors should really become underwriters to insurance companies on the accuracy of financial statements. If a company would sustain a bankruptcy the insurance company would pay out to the stakeholders and then recoup the money lost from the auditor. The incentive for companies is that their premiums would be a reflection of the internal control mechanisms and risk of fraud based on the evaluation of the audit.

While SOX has suggested partner rotation as a solution to preventing firms becoming to familiar with their clients, a concern expressed by Bentson & Hartgraves, a more substantive solution would enact legislation that protected auditors. Require public companies to retain their auditors for (say arbitrarily) five years and that only under extreme cases could the auditor be replaced within the five-year period. The SEC could establish a tribunal for hearing and ruling to their satisfaction on accounting or auditing issues that would result in an unfavourable audit or internal control opinion where the client and the auditor cannot agree. It would also act as an authority to approve a company's request to change auditors for non 'opinion shopping' reasons before the five years were up. This would provide the audit firms with the support to conduct the audits in the interest of the public and the markets at large since the annual element of risk in losing the audit would be eliminated.

An alternative to fixed term audit engagements would be to require public companies over a certain size to be audited by two accounting firms, a joint audit. It would be coordinated in such a way that it would not be an additional cost to the client. The benefit would be that both firms would have to be in on the misstatement of financial statements if it were to occur, which would be more unlikely.

Overall, SOX, after a number of years, did consider in its legislation the environment in which auditors were expected to work and the role they were expected to perform. SOX saw consulting assignments as contributing to the auditor's complacency towards adverse audit opinions when the real issue may be the absence of policy protecting auditors. In any event, since auditors report to audit committees, they are less susceptible to pressures from management.

Conclusion

The Sarbanes-Oxley Act was brought into law in the belief that the accounting and auditing principles, along with other legislative changes, would reduce the propensity for fraud. Sarbanes-Oxley has compelled companies and auditors to document, understand and test internal control systems and their impact on the preparation of financial statements. This had been a long-standing auditing convention; however, the rigor with which it was pursued or the reasons why it was not pursued, as it should have, was not the focus of this paper. But Sarbanes-Oxley did rely on the auditing conventions and principles that have been in existence for a number of years. In spite of their existence, fraudulent reporting has been an issue in the United States, Canada, and around the world, was written upon by Federal Commissions and professional bodies, yet it continued until Enron. The role of the accounting profession in the failure to enforce these principles or to take leadership on issues such as the public trust, are also unanswered questions. In spite of the Sarbanes-Oxley Act, fraudulent financial reporting will likely continue, although it may be more difficult if internal control systems are more rigorous. As some have suggested, the problem is not financial or fraudulent reporting, it is the motivation behind the frauds and Sarbanes-Oxley Act cannot legislate away those pressures.

Furthermore, the regulatory and government agencies with the rules and power of enforcement already available to them prior to Sarbanes-Oxley chose to do relatively little to prevent or curtail the continuation of problematic practices. While audit firms such as the one that audited Enron, have sometimes been complicit, there have only be a few changes in the new legislation that changes the motivation or the environment in which audits will be conducted. Auditors are still in the position of having to 'protect the public interest' by using their professional judgment and can now better do so now that they report only to audit committees. That alone may have been a sufficient change rather than the entire force of the Sarbanes-Oxley Act which some would suggest fundamentally changed the accounting profession, in spite of the fact those who enacted the changes had no evidence to support the idea that what was being proposed would actually have made a difference in Enron.

Audits historically have not been seen as fraud oriented. SOX has changed that direction with its specific and direct language on the effectiveness of controls in preventing and even detecting fraud. The tenor of SOX on fraud has also found its way into year-end audit procedures. These principles will require auditors to increase the forensic or fraud component of the work, and increasing the level of skepticism regarding what is presented and the financially risky areas. The auditors may now be required to contemplate fraudulent scenarios in order to test controls. However, all of this 'new' focus relies on the auditor's judgment on a variety of factors such as materiality, significant deficiencies, remote likelihood as well as evaluating qualitative factors in a number of different areas. Those circumstances were in existence prior to Enron; however, Sarbanes-Oxley may have made the requirement that these factors be considered more explicit.

The requirements outlined by the Sarbanes-Oxley Act infer that it was a weak system of internal control that was the major contributing factor to Enron. Implementing and requiring formalized testing and disclosure of the results may not achieve the desired objective because the principles espoused by the SEC and Sarbanes-Oxley, are themselves unspecified and subject to interpretation and inevitably, manipulation.

Although well intentioned, it is shortcomings in the public policy, such as those highlighted in the Sarbanes-Oxley Act the Auditing Standards of the Public Company Accounting Oversight Board and the SEC, that lead one to conclude it is not only the 'normal' factors such as unethical personalities, and pressure to attain never ending increases in financial performance, but, the failure of policy to adequately address these factors and provide practical solutions. When another Enron occurs in the future and answers are sought out, once again accountants including investigative and forensic auditors will be asked, 'what went wrong?' and again challenged on their ability to fulfill their obligation to the public interest. The questions should be more properly addressed at the shortcomings in the objectives and the application of public policy to curtail the propensity for fraud.