SOX 404 Consulting: Where to Begin

by Michael Ramos

The Sarbanes-Oxley Act of 2002 promises to be one of the more enduring legacies of Enron and the financial frauds that followed. One of the more significant provisions of the Act is the requirement that management report on the company's internal control. The first of these reports is required in 2004. Adding teeth to this requirement, the company's external auditors must audit the internal control report in much the same way they now audit the company's financial statements.

During this past year, participants in the financial reporting process have expended a great deal of collective energy and angst in trying to comply with the new internal control reporting requirements. As the deadline approaches, compliance efforts will only intensify.

This is the first in a series of articles designed to explore emerging issues in the nascent discipline of internal control testing and reporting. A second article will be included in the January Practicing CPA, and future articles will be included in the Journal of Accountancy. In this piece, we'll describe the basic requirements for evaluating and reporting on internal control and explore ways in which CPAs may provide services to help management teams faced with compliance.

The Players

The SEC is responsible for setting the rules to implement the internal control reporting requirements of Sarbanes-Oxley. The Commission issued its final rules in May 2003. In general, the SEC rules describe the form and content of management's annual report on internal control. These rules do not, however, provide detailed guidance on the procedures required by management to test and evaluate internal control or by the external auditors to audit management's report. That guidance is provided by the auditing standards.

The Public Company Accounting Oversight Board (PCAOB) now is responsible for setting auditing standards. In October 2003, the Board issued a draft of a proposed standard relating to the audit of management's internal control report. This proposed auditing standard describes an overall framework in which the auditor forms an opinion based on evidence from three sources.

- An evaluation of the effectiveness of management's process for evaluating internal control.
- Reliance on certain tests performed by the company to evaluate internal control effectiveness
- The auditor's own tests

The standard directly applies only to external auditors. However, because of the extensive guidance provided to help auditors assess the effectiveness of management's overall process and the testing and documentation of controls, the standard will have a significant, indirect effect on the procedures performed by the company.

The Auditing Standard Drives Management's Process

The proposed auditing standard describes a process for auditing internal control that is every bit as rigorous as a financial statement audit. (The proposed standard weighs in at a hefty 135 pages). As management prepares for the audit of its internal control report, it should be prepared to support its conclusion about internal control with a process and related documentation that is as thorough, reliable, and verifiable as the information supporting their financial statements.

A later article in this series will explore the new standard in detail. As a starting point, the following is a brief description of the elements in the standard that will have the most significant effect on management.

- Required elements of the process. The proposed standard provides detailed guidance on what should be included in management's internal control assessment process in order for it to be considered effective. To implement the process described in the standard will be a significant undertaking.

- Documentation. Significant controls are required to be documented, and the proposed standard provides extensive guidance on the content (but not the form) of this documentation. Many companies already have discovered gaps in their internal control documentation, particularly IT-related controls.

- Reliance on management's tests. The external auditor will be permitted to rely on some of the company's control tests. To reduce their overall costs of compliance (without sacrificing quality) management would be well-advised to—

    - Understand which tests the auditor may rely on, and

    - Design and perform the tests in a way that is usable by the auditors

What CPAs Can Contribute

The successful documentation, testing, evaluation, and reporting on a company's internal control will require the contributions of professionals from many different disciplines. Internal auditors, IT experts, fraud specialists, and professionals in the fields of management and organizational development all can provide important perspectives in the understanding and assessment of internal control. No one profession has a monopoly on all of the skills and knowledge required.

By the same token, compliance with the requirements of the SEC and PCAOAB rules and standards depends on an in-depth knowledge of certain fundamental concepts that CPAs in general, and auditors in particular, find at the core of their professional experience, including—

- The COSO internal control framework, which is expected to the primary criteria against which internal control effectiveness is judged

- The financial reporting process

- Financial statement assertions

- The documentation of internal controls in tests of internal control

- Testing and other evidence gathering techniques for supporting a conclusion about internal control effectiveness

- The identification and evaluation of internal control deficiencies

This professional experience and training puts the audit profession in a unique position to help management meet the challenge of complying with Sarbanes-Oxley internal control reporting requirements.

An Opportunity to Provide Value

Many of the challenges faced by management are resource-related—companies simply lack the expertise, personnel ,or both that are necessary to perform a thorough assessment of internal control. Within this environment, CPA firms have begun to provide services to management of publicly traded companies to help them in their internal control evaluation efforts. Emerging areas of need include the following.

- Project planning, implementation and coordination. In this capacity the CPA may serve as an overall project coordinator that *helps*—but does not supplant—management's efforts to—
    - Design an assessment process that meets the expectations of the external auditors
    - Manage the day-to-day activities of all phases of the compliance plan
    - Coordinate the company's efforts with those of the external auditors
- Implement the company's documentation software package. Most companies will use a computer software application to warehouse and maintain the company's internal control documentation. Ultimately, this software is just a tool, and to implement it successfully, management will require the input from individuals who possess an in-depth understanding of internal control and financial reporting concepts as well as the ability to communicate that knowledge to the users of the software package.
- Design and document internal control policies and procedures. During their assessment process, companies may find some controls to be missing or undocumented. In those situations, new controls will need to be designed and implemented.
- Test controls. Many companies lack the manpower necessary to perform all the required tests of control. With their experience in testind, documenting and evaluating internal control, CPAs would be a natural fit to help close this resource gap.

Where to Begin

Much of the CPA's unique value stems from his or her technical understanding in two areas: internal control and auditing. To strengthen and highlight this competitive advantage, firms that are considering offering Sarbanes-Oxley related services should begin by furthering their understanding of—

- COSO. Most auditors have a passing familiarity with the language of COSO. Very few have the working knowledge of the framework that is necessary to conduct an effective evaluation of internal control Your knowledge should be at a level where you can understand internal control and explain it to others (non-CPAs) in your own words.
- The relevant auditing standards. The new PCAOB auditing standard, when it becomes final, will have a significant effect on management's assessment process. The CPA's ability to understand the requirements of the standard and its implications for the company will add greatly to the benefit he or she can provide management.

A New Era

The passage of the Sarbanes-Oxley Act signaled the start of a new era in financial reporting, on par with the requirement of seventy years ago that the company's financial statements be audited by an independent CPA. Then, the capital markets looked to our own profession for help in implementing this new requirements. Now we seem equally well-positioned to make a significant contribution as our country's financial reporting process embarks on another new direction.

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Question of the Month We are a one office firm with a good-sized audit practice consisting of 20 professionals. Do you think that providing Sarbanes-Oxley consulting services would be a good business for us to start providing? Are we big enough?

Answer Here is my classic "auditor's answer" to a difficult question such as the one you've posed.

"It depends."

First, I'm not sure that the size of one's firm is the definitive factor. I have seen sole practitioners begin providing these services successfully. Here are some questions I would consider to help decide whether SOX 404 consulting is a good fit for you.

Once you obtain the training and refine the expertise necessary to deliver these services, how will you market them? Before making a significant commitment to developing these services, give some serious thought to how you will roll them out. The good news is that the market is real, and it has legs. Unlike some other service opportunities that CPAs have considered in recent years, the market does not have to be created (a la assurance services)—Sarbanes-Oxley created the market. This is not a one-time service opportunity (see Y2K). Internal control reporting is an annual service that will be required until Sarbanes-Oxley is required. The bad news is that there is a lot of competition out there, and you will need to have a good understanding of your marketing strategies before you begin.

If you commit your firm to obtaining the necessary expertise, will you realize benefits from this investment outside of the revenue stream generated from providing consulting services? I have worked with several firms who determined several years ago that their audit process was too dependent on substantive testing and that to become more effective, the firm had to train its auditors on how to understand and evaluate internal control. For these firms, the decision to invest in SOX 404 training became a "no brainer" when they realized that they could use this knowledge to improve their audit process. The cost of "getting up to speed" on internal control would provide benefit even if they ultimately were not highly involved in providing consulting services.

Is the testing and evaluation of internal control the type of work that you will enjoy and find professionally rewarding? This might be the most important question of all. I find internal control work to be extremely interesting, challenging, and ultimately, rewarding. One of my friends said that after working on a SOX 404 engagement, she didn't want to go back to doing a regular audit. Not everyone shares our enthusiasm for the work. Other friends of mine think that Sarbanes-Oxley is overkill that adds no real value to investors. For them, internal control reporting has no intrinsic value—it's simply a compliance requirement. So why get involved? One of my writing instructors had a favorite phrase: "The pleasure is the work." That rings true to me. If internal control seems interesting to you, pursue it; if it doesn't, then don't.

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Michael Ramos is the author of *How to Comply with Sarbanes-Oxley Section 404: Assessing the Effectiveness of Internal Control*, to be published by John Wiley & Sons in January 2004. This article is the first in a series he will be writing for the AICPA/PCPS on Sarbanes-Oxley Section 404.