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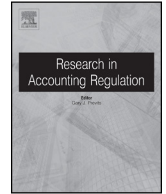

Research Report

The SOX 404 internal control audit: Key regulatory events

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ABSTRACT

Section 404b of the 2002 Sarbanes–Oxley Act (SOX) requires auditors to attest to the effectiveness of a client's internal control over financial reporting (ICFR). In this paper, we provide an overview of key regulatory events in the implementation of the 404 internal control audit. We discuss the early years (under Auditing Standard No. 2) as well as the later years (under Auditing Standard No. 5) of the 404 audit, emphasizing areas of improvement in the efficiency and effectiveness of the audit as well as the remaining problems and challenges highlighted in PCAOB inspection reports and practice alerts. Finally, we address recent regulatory developments pertinent to the 404 audit such as Auditing Standard No. 12 and the recent 2013 update to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) internal control framework.

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1 Introduction

In addition to the traditional financial statement audit, the 2002 Sarbanes–Oxley Act (SOX, 2002) – specifically Section 404b – requires auditors to attest to the effectiveness of a company's internal control over financial reporting (ICFR). As noted by Ernst and Young (2005), the benefit to investors from the effective implementation of the 404 audit can be significant in terms of more reliable corporate financial reports.[1] Along the same lines, the then-SEC Chairman William Donaldson indicated that the 404 internal control audit potentially "offers significant long-term benefits in helping to prevent fraud and misdirection of corporate resources and in improving the accuracy of financial reporting" (Security and Exchange Commission [SEC], 2005). In this note, we provide a brief overview of key regulatory events in the implementation of the 404 audit.

2 The Early (AS2) years of the 404 audit

During the early years of the SOX 404 audit (i.e., the three years beginning with the fiscal year ending on or after November 15, 2004), the applicable auditing standard was Auditing Standard No. 2 (AS2) as issued by the Public Company Accounting Oversight Board (PCAOB) (2004). Consistent with AS2, the SOX 404 audit became mandatory for accelerated filers (i.e., companies with a public float of $75 million or more) for fiscal years ending on or after November 15, 2004.[2] In the event that the client had a material weakness (or weaknesses) in internal control, the standard required the auditor to issue an adverse SOX 404 opinion. Note that a material weakness in internal control

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[1] To vary the exposition, in this paper we also refer to the 404 audit as the SOX 404 audit or the internal control audit.

[2] By contrast, non-accelerated filers (i.e., companies with a market float below $75 million) were given until the fiscal year ending on or after July 15, 2005, to comply with the 404 audit requirement. However, the 404 requirement for non-accelerated filers was repeatedly deferred until September 21, 2010, when the SEC made permanent the 404 audit exemption for non-accelerated filers (SEC, 2010).

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does *not* necessarily imply or result in a financial statement misstatement. Rather, the underlying notion is that a material weakness in internal control *could* result in a material financial statement misstatement. Thus, it is possible (and quite common) for a client to receive an adverse SOX 404 opinion on internal controls and a clean opinion on the financial statements.

To obtain early feedback on issues associated with the implementation of the 404 audit, the SEC held a roundtable on April 13, 2005. Roundtable participants indicated that the 404 audit had the intended benefit of focusing corporate managers' attention on internal control but that the implementation of the audit itself was unduly costly.[3] Further, much of these costs were viewed as unnecessary and resulting from duplicative or mis-focused efforts occurring during the first year of implementing the 404 audit. Put differently, the view was that far too many internal controls and processes were documented and tested due to the lack of proper guidance on what was material and what was not material. Specifically, the AS2 notion of a material weakness in internal control, i.e., "more than remote likelihood" that internal control will not prevent or detect a material misstatement in the financial statements, was ill-defined and ambiguous (i.e., lacked precision) about the probabilities pertinent to the auditor's reporting decision and resulted in substantial over-auditing (O'Hara, 2005; Steinberg, 2006).

In response to the feedback, on May 16, 2005, the PCAOB issued staff guidance Q&As accompanied by a policy statement expressing the Board's view of how to appropriately plan and implement an effective 404 audit (PCAOB, 2005a). Subsequently, in June 2005 the PCAOB's Standing Advisory Group discussed 404 implementation issues and appropriate planning strategies for the second year of the 404 audit aimed at reducing unnecessary costs and the work burden without jeopardizing the benefits of the 404 audit (PCAOB, 2005b). Later, on November 30, 2005, the PCAOB issued a report noting the most common reasons why the first-year 404 audits were inefficient and costly: (1) a failure to properly integrate the internal control audit with the audit of the financial statements, (2) a failure to apply a top-down approach, i.e., a failure to begin by evaluating company-level controls and significant accounts at the financial statement level before moving down to relevant individual controls, and (3) a failure to alter the nature, timing and extent of the testing of internal controls to reflect the level of risk and to use the work of other auditors to the extent permitted by AS2 (PCAOB, 2005c).

During the second year of the 404 audit, the SEC and the PCAOB continued to focus on improving the effectiveness and efficiency of the audit under AS2. Specifically, in May 2006 the SEC and the PCAOB sponsored a second roundtable to discuss the second-year experience with the 404 audit and issued a four-point plan for improving its efficiency and effectiveness. Subsequently, in February 2007, the PCAOB's Standing Advisory Group discussed and proposed changes to AS2.

3 The later (AS5) years of the 404 audit

In 2007, the PCAOB issued Auditing Standard No. 5 (AS5) which superseded AS2 for 404 audits for fiscal years ending on or after November 15, 2007 (PCAOB, 2007). Relative to AS2, AS5 allows more auditor judgment by adopting a "top-down" risk-based approach to selecting the controls to be tested and to improve audit efficiency by focusing on the most significant transactions and accounts. As such, AS5 allows auditors to focus on more important issues in the audit of internal controls, thereby allowing the elimination of unnecessary audit procedures. Further, AS5 makes the audit scalable to fit the size and complexity of a given client. Relative to AS2, AS5 is simpler, less prescriptive, and includes a principle-based approach to determining when and to what extent the auditor can use the work of other auditors.

Further, AS5 mitigated the ambiguity embedded in the AS2 notion of a material weakness in internal control by replacing the term "more than remote likelihood" that internal control will not prevent or detect a material misstatement in the financial statements with "reasonably possible," and by explicitly referring to Statement of Financial Accounting Standards (SFAS) No. 5 for the definition of the term "reasonably possible." In other words, because SFAS No. 5 also defines the same uncertain probabilities as "reasonably possible," the meaning of this new phrase was familiar to auditors as a consequence of applying SFAS No. 5 since its issuance in 1975. Hence, by explicitly referring to SFAS No. 5 in AS5, the PCAOB lowered the ambiguity in determining whether a weakness in internal control is material or not in preventing or detecting a misstatement in the financial statements.

As noted previously, a basic objective of AS5 was to make the 404 audit scalable, i.e., lower compliance costs for smaller companies. Along the same lines, on January 23, 2009, the PCAOB published AS5 implementation guidance addressing issues (such as the risk of management override and segregation of duties) that pose particular challenges in auditing internal controls for smaller companies (PCAOB, 2009a). A related question is whether smaller firms should be exempted from the 404 audit, as a way of lessening the regulatory burden on these firms. As a practical matter, 404 compliance for non-accelerated filers (i.e., companies with a market float below $75 million) was repeatedly deferred until September 21, 2010, when the SEC made permanent the exemption for non-accelerated filers from the 404 audit (SEC, 2010).[4]

[3] For a sample of Fortune 1000 companies, the average audit fee increased from $3.4 million in 2003 to $5.7 million in 2004, suggesting that the first year cost of the 404 audit was about $2.3 million or nearly 103 percent of the average audit fee in 2003 (Eldridge & Kealey, 2005).

[4] Subsequently, the 2012 JOBS Act (U.S. Congress, 2012) exempted what it calls emerging growth companies from the 404 audit. Specifically, an issuer with total annual gross revenues of less than $1 billion (in conjunction with meeting certain other requirements, such as age, volume of convertible-debt issuance, and market capitalization) is considered to be an emerging growth company. However, large accelerated filers with a market float of $700 million or more do not qualify for emerging growth company status under the JOBS Act.

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