

## Internal Audit and Risk Management Community

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### Focus on the balance sheet

By Nancy Hala, KnowledgeLeader contributing writer

On July 30, 2002 President Bush signed the Sarbanes-Oxley Act. It marked the US government's response to a rash of corporate corruption that bankrupted corporations, devastated 401k savings plans, and deteriorated investor confidence. In part the Sarbanes-Oxley legislation increases penalties for corporate fraud convictions and enhances protection for corporate whistleblowers. It also requires CEO and CFO certification on all SEC periodic filings that include financial statements, and requires an internal control report to be filed with the Annual Report, along with the CEO and CFO certification of annual and quarterly reports.

As a result of these new levels of scrutiny, CEO and CFOs will be forced to take measures to document appropriate compliance efforts, assure themselves that all relevant parties are receiving adequate, independent legal and support advice, and facilitate a corporate culture that encourages proper, legal behavior.

What this means for internal audit (IA) functions is a point of debate for many internal audit directors. This focus on corporate fraud, and on the necessity for high-level executives to personally certify company financial statements, could mean that IA functions increase their own monitoring of financial statements.

A risk-based audit approach dictates that auditors examine areas of high risk impact and high likelihood. Recent events point to the conclusion that poor quality financial reporting may be more likely and more devastating than previously thought. This suggests that internal auditors will therefore need to increase their focus on the balance sheet. Steve Jameson, Director of Technical Services for the Institute of Internal Auditors, asserts that "this is already happening in many companies." He says, "Corporate management failures are also internal audit failures, because they mean that internal audit failed to detect anomalies." "Traditionally external auditors have focused on financials and internal auditors have targeted both process and operational auditing," says Jameson. The external auditor's role is to provide assurance to the public that the financial statements are reasonably presented and give an accurate picture of the company's condition. In a sense, external auditors (EA) are focused on the accuracy of the *outputs* of the financial and operational processes. Internal audit considers the efficiency and controls around the processes themselves. However, to look at financial processes in an effective way, IA should also look at the outputs of those processes to make sure they are understood and that they make sense. Jameson asserts that internal auditors should develop an understanding of financial statements and provide a complementary and concurrent check. "As an internal auditor if I were asked to audit a business unit, I would cover every aspect of that unit, and certainly a major piece would be the financials."

An outstanding IA department with a well-designed, risk-focused audit plan provides a great deal of comfort to the external auditors that the processes which lead to the financial reports are well-controlled. Jameson asserts, "external auditors have sought out the knowledge and expertise of internal auditors" and sought to partner with them to understand and evaluate internal control systems. From the external auditor's perspective, IA is a key part of the internal control process to which they attest.

Does this lead to a 'duplication of effort' on the part of internal audit and the external auditors? Not necessarily. Norman Marks, Vice President of Internal Audit of Solectron Corporation doubts internal auditors will be asked to provide intense checking of company financial statements. "The smart thing to do is to focus attention on the controls around financial reporting and disclosures," he says. "Internal auditors are experts in internal controls and should be asked to provide annual assurance -- evolving to continuous assurance -- that the company's overall systems of internal controls and risk management are adequate."

Both Jameson and Marks agree that duplication of effort on the part of IA and EA is neither desired or imminent in the wake of increased focus on corporate fraud and CEO / CFO certification of financials. Rather,

both experts say that each function has a role in the process. According to Marks, "IA does not have to duplicate, it has to coordinate and supplement. There is no reason that IA and EA should not evolve into a partnership in the future, with IA reviewing the quality of people and consistency of work. "

Jameson agrees and additionally calls for a "back to basics" auditing approach. "Some IA functions have abdicated any and all responsibility for financials to their EA counterparts, " he says. "Internal auditors stopped looking at financials altogether and just focused on process and operations. You tell me, is Accounts Payable a financial process or an operational one? I would argue that it is both. If an IA group examines an Accounts Payable department from a process standpoint but ignores the financial factors then it is missing too big a piece of the puzzle. A back to basics approach means that internal auditors can no longer leave out the key financial component of the audit plan."

Recent events prove that financial processes in a number of companies gave management opportunity to usurp controls. It has become clear that the internal audit function -- a central control component of the organization -- should review all processes and the outputs of those processes. That includes the corporate balance sheet.

Boards and executive management are under heightened scrutiny and are required to provide higher levels of personal assurance. They will rely upon IA to help provide that assurance. Even if they have not focused on the balance sheet in the past, auditors must prepare for and step up to that role.

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