Running Head: THE FUTURE OF ACCOUNTING INFORMATION SYSTEMS REGULATIONS

The Future of Accounting Information Systems Regulations

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Abstract

With all of the recent problems in the financial markets and companies going out of business, a lot of regulatory focus has been placed on the accounting and business systems that supports these companies. Tighter regulations and pronouncements have been and will be developed as a result of business failures. The purpose of this paper is to provide the current reporting requirements of the Public Company Accounting Oversight Board and the Security Exchange Commission's Sarbanes-Oxley Rule 404 for business and what the future may entail on how these pronouncements and rules may be modified to control the current business culture.

The Future of Accounting Information Systems Regulations

In the early 2000's, there were a number of business scandals that included accountants and auditors. In response, Section 101 of The Sarbanes-Oxley Act (SOX) of 2002 established the Public Company Accounting Oversight Board (PCAOB). The PCAOB is a non-profit private corporation, whose main responsibility is to oversee auditors of public organizations. The PCAOB maintains offices in several major cities, with their main headquarters in Washington D.C. "[I]ts stated objective is to 'protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports'" (Olach, 2008, p 50). This is a factor that many people and organizations are not aware of. Many believe that the PCAOB is in place for the protection of organizations rather than that of the public.

> SOX section 103(a)(1) gave authority to the newly created PCAOB to do the following:
>
> > [B]y rule, establish … and amend or otherwise modify or alter, such auditing and related attestation standards, such quality control standards, and such ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors. (McEnroe & Sullivan, 2007, p 34).

More specifically, "Section 103 of the Sarbanes-Oxley Act of 2002 directs the Board to establish auditing and related attestation, quality control, ethics, and independence standards and rules to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the Act or the rules of the Securities and Exchange Commission" (PCAOB, 2002, Standards).

Investors need to feel secure with the accounting records and other documents they review when making financial decisions. Many lost confidence because of the scandals in the early 2000's. One of the goals of the Sarbanes-Oxley Act and the creation of the PCAOB is to restore investor confidence. To keep a system of checks and balances, the PCAOB created the Office of Internal Oversight and Performance Assurance (IOPA). The purpose of the IOPA is to "provide internal examination of the programs and operations of the PCAOB and, in so doing, help ensure the efficiency, effectiveness and integrity of those activities" (PCAOB, 2008, Internal Oversight). The PCAOB is overseen by the Securities and Exchange Commission (SEC). Because the SEC is the primary supervisory body of the financial reporting process in the United States, it has authority over the PCAOB's powers and rule-making, standard setting and changing, as well as leadership appointments.

"Section 103 of the Sarbanes-Oxley Act places responsibility for writing and modifying audit standards with the PCAOB, subject to SEC approval" (Olach, pp. 51-52). Thus far, the PCAOB has established five standards that have been approved by the SEC. These standards are labeled AS1 through AS5, and AS6 is currently awaiting SEC approval. If non-compliance is found, the PCAOB does have the authority to take disciplinary action. The PCAOB has the right to disclose any wrongdoings to the public, which can cause harm to the reputation of the firm. Further, they can enforce fines, suspend activities, revoke the firm's PCAOB registration, and require additional training and education (Olach, p. 54).

Auditing Standard (AS) 1 was approved in May of 2004. AS1 deals with adherence to PCAOB standards by registered auditors. "The most significant provision of AS1 is its authorization for the board to establish audit standards for use by registered accounting firms" (Olach, p. 51). Essentially, this standard shifts the compliance from following generally accepted accounting principles to the standards set forth by the PCAOB when applicable.

The topic covered in AS2 is An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This standard was approved by the SEC November 17, 2004. This standard deals with the internal controls of an organization. This standard required that management's assertions in the financial statements be true to the best of their knowledge. Management thus far had not been required to acknowledge that they had knowledge of what was being represented in the financial statements. This standard also requires that management and auditors attest to the truthfulness and completeness of examinations of internal controls.

"To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting was designed and operated effectively" (PCAOB, 2004, p 165).

"AS3 requires registered accounting firms to prepare and retain documentation under the PCAOB rules" (Olach, p. 52). One of the reasons for this standard was that some organizations and accounting firms, including accounting great Arthur Andersen, destroyed documents in order to escape fraudulent activities being discovered. This standard was approved by the SEC on August 25, 2004 and requires compliance dealing with all documentation from November 15, 2004 and after. Auditors are required to retain for seven years all documentation relating to auditing engagements. This includes all working papers and supporting documentation supporting the conclusions arrived at throughout the audit procedure. Non-compliance with this standard holds strict penalties including imprisonment for a maximum period of 20 years.

The AS4 standard covers whether a material weakness that was previously identified through evaluation, still exists.

"The auditor's objective in performing work under AS No. 4 is to obtain reasonable assurance as to whether the previously reported material weakness still exists. The auditor's work is, therefore, focused on whether the controls specified by management as addressing the material weakness were designed and operating effectively, as of the date chosen by management" (PCAOB, 2006, p. 1). Weaknesses, especially those that have been previously discovered, can affect the outcome of an audit and are therefore a concern of this standard set forth by the PCAOB.

AS5, released in May 2005, is of a somewhat different nature as it supersedes AS2. The label on this standard is: An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements. "AS5 helps increase both external and internal audit efficiency by clarifying the use of relevant work by others, emphasizing the importance of having both internal auditors and their organization's registered accounting firm create clear, comprehensible workpapers and audit related documentation" (Olach, p. 52).

In January of 2008, the PCAOB sent AS6 to the SEC for approval. The intention of AS6 is to:

> update the auditor's responsibilities to evaluate and report on the consistency of a company's financial statements and align the auditor's responsibilities with SFAS No. 154.
>
> Auditing Standard No. 6 also improves the auditor reporting requirements by clarifying that the auditor's report should indicate whether an adjustment to previously issued financial statements results from a change in accounting principle or the correction of a misstatement (PCAOB, 2008, p 1).

However, as of this date, there is no evidence of approval.

All standards and proposed changes to current accounting standards are generally put forth to the public for comment before being sent for approval by the SEC. By doing so, the PCAOB proves its interest and awareness in the accounting profession from the standpoint of the accountant, auditor, organization and individual investor. Their work has been extremely important especially concerning organizations and auditing firms looking to take advantage of those unaware.

Section 404 of the Sarbanes-Oxley Act, *Enhanced Financial Disclosures, Management Assessment of Internal Controls*, mandates sweeping changes. Section 404 in conjunction with the related SEC rules and Auditing Standard No. 2 established by the PCAOB, requires management of a public company and the company’s independent auditor to issue two new reports at the end of every fiscal year. These reports must be included in the company’s annual report filed with the SEC. The required reports include a report by management annually on the effectiveness of the company’s internal control over financial reporting (Sarbanes-Oxley, Section 404).

In conjunction with the audit of the company's financial statements, the company's independent auditor must issue a report on internal control over financial reporting which includes both an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting (Sarbanes-Oxley, Section 404).

The new requirements also highlight the concept of a material weakness in internal control over financial reporting, and mandate that both management and the independent auditor must publicly report any material weaknesses in internal control over financial reporting that exist as of the fiscal year-end assessment date. Under both PCAOB Auditing Standard No. 2 and the SEC rules implementing Section 404, the existence of a single material weakness requires management and independent auditor to conclude that internal control over financial reporting is not effective (www.sec.gov).

Internal control over financial reporting is a process designed and maintained by management to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with United States GAAP. It encompasses the processes and procedures management has established to maintain records that accurately reflect the company's transactions, prepare financial statements and footnote disclosures for external purposes and provide reasonable assurance that receipts and expenditures are appropriately authorized and prevent or promptly detect unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements (www.sarbanes-oxley.com).

An effective internal control structure involves all levels of management. It includes those who maintain accounting records, prepare and disseminate policies, monitor systems and function in a variety of operating roles. In addition, a company's internal control over financial reporting is influenced significantly by its board of directors and the audit committee, which has ultimate responsibility for oversight of the financial reporting process.

Management is responsible for designing and implementing the system of internal control over financial reporting.

Section 404 now requires the auditor to perform an independent audit of internal control over financial reporting and to issue a report including two opinions: one on management's assessment and one on the effectiveness of internal control over financial reporting (Sarbanes-Oxley, Section 404).

As the role of PCAOB is "to provide guidance in a constructive manner and, when necessary, to be a tough overseer to protect the public interest" (McDonnell, 2004, p. 98), the PCAOB is expected to continuously establish effective standards to improve the quality of internal control over financial reporting. Farrell and Shadab (2005) state that "inspections and investigations and enforcement actions are here and are likely to grow in number and significance" (p. 9). Farrell and Shadab also predict that "after several years of annual inspections, significant portions of an auditor's practice will be reviewed…" (p. 9).

One area of the PCAOB's focus to improve the quality of internal control over financial reporting would be to improve the effectiveness of managing the Section 404 implementation. Since the first implementation of Section 404, some implementation processes have become routine (Lin and Wu, 2006). Therefore, the emphasis has shifted from setting up processes, procedures, and accounting information systems to managing them. Lin and Wu also criticize that the PCAOB's standard for internal control over financial reporting focuses on "the reliability of financial reporting," but does not emphasize "internal control needed for countering operational and compliance risks or controls over the crucial management process." (p. 7).

Although continuous effort to improve the quality of internal control over financial reporting is essential, there are a number of publications that emphasize the importance of efficiency in Section 404 compliance, as the high cost of Section 404 implementation has been a significant burden on many public companies (Krishnan, Rama & Zhang, 2007, p. 169; Hill, McEnroe and Stevens, 2007, p. 6). In fact, the average cost of Section 404 compliance between January 2003 and September 2005 was $2.2 million, which includes audit fees, internal labor cost, external consulting fees, and the cost of accounting information systems (Krishnan et al., p. 169). The PCAOB admits that "a large portion of these excessive costs can be attributed to compliance processes and audits that were not as effective or efficient as intended" (O'Brien, 2006, p. 26).

In response to the critics and concerns, the PCAOB and SEC have revised some existing standards. For example, the PCAOB has reduced the amount of testing required for adequate evaluation of internal control over financial reporting (Rankin, 2007, p. 3). On May 23, 2007, the SEC ruled that all public companies, regardless of their sizes, can "scale and tailor their evaluation procedures according to the facts and circumstances" (Graziano and Sinnett, 2007, p. 63). The PCAOB has also decided to allow auditors to use information obtained from previous audits for risk assessment during the current audit (Mullins, 2006, p. 18).

For further improvement in efficiency, a proper distribution of responsibilities between internal auditors and external auditors is also recommended. According to Lin and Wu, the company's internal auditors should be responsible for monitoring the company's operation, information and compliance processes as these are routine and repetitive, while the external auditors should be responsible for monitoring risks and internal controls in the management process.

The PCAOB's major objectives will remain in improving the quality of internal control over financial reporting. However, the PCAOB's future challenge is to provide guidance for more efficient implementation of Section 404 to public companies to reduce the burden of the implementation costs of Section 404 requirements. Hence, the PCAOB's future emphasis will likely be on balancing the efficiency and quality of internal control over financial reporting.

Now that some time has passed since the creation of the PCAOB and the passage of SOX Rule 404, is it working?

> Considering the number of financial restatements of the last several years, the traditional financial statement audit alone is not enough to assure the investor community. A separate SOX examination of internal controls helps fill the gap by providing additional assurance where controls are strong and raising awareness of the potential for future problems where controls are lacking (Dodwell, 2008, p. 11).

Though it appears that the PCAOB and SOX Rule 404 are working, there are limitations. As with any system of internal control, it relies on the management of the company for implementation and application. If management is not following the system, then its usefulness diminishes. This is the heart of the problem. “The concept of internal control is not new; what section 404 introduces is mandatory reports on internal control by management and independent auditors. The belief behind the requirement is that such audited reports could prevent corporate scandals such as Enron and WorldCom” (Lin & Wu, p. 1).

The belief that the PCAOB and the passage of SOX Rule 404 would be a cure-all for the problems in regard to inaccurate financial reporting and the collapse in the financial markets is truly a misconception. “[I]nternal control was not conceptually designed to be a panacea for corporate ills” (Lin & Wu, p. 1).

The problem lies with the management of the companies and the corporate structure they operate in.

> Accounting did not cause the recent corporate scandals such as Enron and WorldCom. Unreliable financial statements were the results of management decisions, fraudulent or otherwise. To blame management’s misdeeds on fraudulent financial statements casts accountants as the scapegoats and misses the real issue. Reliable financial reports rely to a certain extent on effective internal controls, but effective internal controls rely to a large extent on a reliable management system coupled with strong corporate governance (Lin & Wu, p. 2).

Though a good system of internal control is mandatory to the financial reporting of a company, again it cannot be expected to catch everything. Good internal control by itself will not help companies avoid problems from all financial issues.

> A case in point is the fallout from the ongoing subprime credit crisis. While the recent spate of massive portfolio writedowns might seem to indicate failed risk-management controls, the problem is largely founded on illiquidity and the inability to establish fair value in the absence of willing buyers and available funding. The valuation of impaired mortgage securities is an accounting issue made problematic by anomalous market conditions plagued by uncertainty. The writedowns are not generally the result of failed internal controls, but rather a wholesale market repricing (Dodwell, p. 12).

There has been much argument whether the PCAOB should relax some of its reporting standards, especially for smaller companies. As it seems that this is taking place, does the general public really want to lower the compliance threshold for any companies that solicit investors' money? Probably not. Hindsight being twenty-twenty, the PCAOB should have rolled out the compliance aspect in phases, perhaps having the larger companies be subject first.

> [A] smaller number of companies, perhaps the S&P 500 or the Russell 1000, would be required to adhere to the standards as of the date designated by the SEC. This would result in coverage of a very significant portion of the total market capitalization of all U.S. public companies. Then, after those companies have learned from their experience with a

> given standard, and the PCAOB has made any necessary adjustments after the initial release of the auditing standard (perhaps in the second or third year), the remainder of the companies subject to the standard would also be required to comply. This would permit many smaller public companies to benefit from the experience of the largest companies, presumably resulting in better audits, and perhaps lower audit fees, than would have otherwise occurred (McEnroe & Sullivan, p. 6).

This may be a good approach to take for any future changes that are to take place.

It now appears that the costs involved to be in compliance with the PCAOB and SOX Rule 404 are starting to decrease.

> Thanks to SOX section 404 rules and guidance issued by the PCAOB and the SEC in May 2007, many internal audit committees are finding time for other responsibilities.
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> According to *Moving Internal Audit Back into Balance*, a Protiviti survey of 321 internal audit professionals, four in 10 internal audit departments decreased the time devoted to SOX compliance since the new standard and guidance were announced.
>
> As a result, these departments have resumed more traditional internal audit responsibilities, including regulatory compliance and advising senior management and the board's audit committee (Journal of Accountancy, 2008, p. 23).

With change comes opportunity. The creation of the PCAOB and the passage of SOX Rule 404 have created additional opportunity for companies and their management to operate at an even higher level of compliance. The true test will be the change in ethical behavior as a result of the awareness by management that people are watching.

> “Whoever has no rule over his own spirit
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> Is like a city broken down, without walls” (Proverbs 25:28 NKJV).

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