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Why The World Needs The International Accounting Control Standards Board (IACSB)

When the U.S. Securities and Exchange Commission (SEC) issued interpretative guidance on management reporting on internal control over financial reporting pursuant to the now infamous section 404 of the U.S. Sarbanes-Oxley Act they stated that the 1992 Committee of Sponsoring Organizations of the Treadway Commission (COSO) Internal Control–Integrated Framework met their criteria for a "suitable" control assessment framework. Although the SEC stated at the time that other control frameworks, including the UK Turnbull control criteria and the Canadian CoCo framework, also met their defined suitability criteria, pressure from the major public accounting firms and the strong endorsement of the SEC has resulted in the 1992 COSO framework becoming, for all intents and purposes, the only criteria used for public reporting on accounting control effectiveness.

Since the SEC radically elevated the stature and use of the 1992 COSO control framework in 2003 public companies around the world, including companies in Canada and the UK, have come under growing pressure from their accountants, internal auditors, and regulators to follow the U.S. lead and assess their accounting

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control effectiveness using the criteria contained in the now seriously dated and defective 1992 COSO Internal Control - Integrated Framework.

The unstated reality is that the U.S. Securities & Exchange Commission, with support from the U.S. Public Company Accounting Oversight Board (PCAOB), intentionally or otherwise, elevated COSO, a loose consortium of U.S. based accounting associations, to the position of the world's first accounting control standards body. This obvious fact has not been explicitly acknowledged by the SEC or COSO, nor has the appropriateness of the SEC's decision in terms of investor protection been objectively examined.

Key questions that should be asked by the SEC as well as other national securities regulators around the world should be – What are the control attributes and assessment methods that are statistically likely to result in materially reliable external accounting control disclosures? Have those criteria been defined, researched, and periodically revisited by a duly appointed and chartered standards body that follows due process to determine if they are optimal? Is the COSO consortium up to the task of being the world's de facto accounting control assessment standards setter? If the COSO consortium isn't up to the task, or doesn't actually want the responsibilities that come with being a global standard setting body, who should take on the role?

Cutting to the chase, my vote is that the U.S. based COSO consortium is not the best suited organization for the task. COSO has made a number of major contributions to the auditing profession over the past 25 years but was never constituted or resourced to be a global standard setting body. A new organization called the International Accounting Control Standards Board (IACSB) should be established, adequately funded, and given the mandate of producing new guidance for management and auditors on how to publicly report on the effectiveness of accounting controls. This new body should be required to periodically revisit the accounting control assessment guidance they produce at intervals of no less than every four years to improve the overall reliability and usefulness of the guidance they issue and the results produced.

Although currently only the SEC in the U.S. requires public companies report on the effectiveness of control against a regulator approved control framework, accountants and auditors of all types around the world should take an active interest in these developments. Although there is general agreement that the reliability of auditor opinions on the financial statements is directly impacted by the effectiveness of the accounting controls, there is currently little international agreement on what, if anything, stakeholders should be told about the current effectiveness of those controls, and what control assessment framework, if any, has been used by management and/or external auditors to conduct their assessment.

In short, current U.S. requirements in this area are sub-optimal. Other countries, including the UK and Canada, have not, in any real way, addressed whether companies should report against a set of "generally accepted control assessment standards". It's time that debate was held and accountants and auditors from all major countries around the world should participate through their professional associations.

CRITERIA FOR RELIABLE CONTROL ASSESSMENT FRAMEWORK – DOES ANY FRAMEWORK MEASURE UP?

SEC Release 33-8238 Management's Report on Internal Control Over Financial Reporting issued in 2003 spells out what the SEC's believes should be the criteria for a "suitable" control assessment framework:

Specifically, a suitable framework must: be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted; and be relevant to an evaluation of internal control over financial reporting." (Page 14 of 93)

The SEC framework suitability criteria are generally sound. Unfortunately, a critical and somewhat obvious element that should have been included in the SEC suitability list but was not is that the framework **"should produce reasonably reliable conclusions on the ability of the current accounting control framework to produce materially reliable external financial disclosures".**

Unfortunately for investors, a strong argument can be made that the 1992 COSO Internal Control – Integrated Framework doesn't actually meet, at least meet in any absolute way, any of the four defined SEC framework suitability criteria and, more importantly, is producing a shockingly high management/auditor control effectiveness opinion error rate.

IS THE COSO 92 INTERNAL CONTROL INTEGRATED FRAMEWORK UP TO THE TASK?

US listed public companies, including major companies headquartered in countries around the world, began to form opinions on internal control over financial reporting effectiveness using the COSO 92 internal control framework for SOX purposes as early as 2004. SEC regulations require a binary, effective/ineffective, opinion on internal control over financial reporting. SEC materiality rules, up until fiscal years ended after November 15, 2007, established a "more than remote" threshold for reporting that was then changed to "reasonably possible" in PCAOB Auditing Standard No 5 and SEC 's management guidance.

Audit Analytics, a company that tracks restatements of U.S. listed public companies, has reported over the period since SOX 404 was implemented that thousands of public companies and their external auditors that initially reached the conclusion that companies had "effective" internal controls, as defined by SEC rules, and using COSO 92 framework criteria, were subsequently proven wrong by the need to restate to correct material errors. Although a small percentage of these companies and their auditors can successfully argue that the cause of some of these restatements was not ineffective accounting control, the majority cannot. They simply reached and reported the wrong conclusion on the ability of the company's control system to prevent material errors.

To study the impact of accounting control standards on SOX control effectiveness opinions the Institute of Management Accountants in the U.S. commissioned a discussion paper titled Accounting Control Standards: The Missing Piece in the Restatement Puzzle.

One of the key findings of that study was that in 2006 more than 1 in 8 large U.S. listed companies were forced to restate their accounts to correct material errors in their original financial statement filings. Virtually all of these companies and their external auditors had originally indicated they had effective controls in accordance with the 1992 COSO Internal Control – Integrated Framework, or had reported control deficiencies unrelated to the area where the material accounting error or irregularity was subsequently discovered. Although this percentage has improved considerably since then, it isn't clear whether that is because of improved accuracy of control opinions or lower materiality thresholds reporting restatements. What is clear is that hundreds of public companies and their external auditors continue each year **to incorrectly conclude that internal control over financial reporting are effective in accordance with COSO 92 criteria and SEC rules and are subsequently proven wrong.**

IS THE COSO CONSORTIUM UP TO THE TASK?

COSO is currently comprised of five organizations:
American Institute of Certified Public Accountants (AICPA)
American Accounting Association (AAA)

Financial Executives Institute (FEI)
Institute of Internal Auditors (IIA)
Institute of Management Accountants (IMA)

COSO's current mission is defined as follows:
COSO's mission is to provide thought leadership through the development of comprehensive frameworks and guidance on enterprise risk management, internal control and fraud deterrence designed to improve organizational performance and governance and to reduce the extent of fraud in organizations.

COSO's stated mission is both broad and ambitious, but one that does not explicitly acknowledge its SEC de-facto assigned role as a national/international accounting control standards body. To date, COSO has never publicly stated that it believes that the 1992 COSO Internal Control – Integrated Framework actually meets the four control framework suitability criteria set by the SEC. It has also not publicly acknowledged or formally accepted its de facto role of national/international accounting control standards body. The COSO consortium currently has no publicly released plans to update and improve the 1992 internal control framework. It also has made no effort to date to empirically study why thousands of public companies have concluded they have effective internal control over financial reporting as defined by SEC rules in accordance with COSO 1992 and subsequently had to restate their financial statements to correct material accounting disclosures errors and/or irregularities.

Suggestions have been made that COSO should expand its membership to include as full members organizations with expertise particularly relevant to reliable financial reporting and organizations headquartered outside the U.S. This list includes organizations with expertise in IT security, fraud prevention and detection, human behaviour and others. Approaches by ISACA, the ACFE and other important sources of control assessment standards expertise have been rejected. COSO has no funding mechanism to pay full time research staff and has relied heavily on pro-bono assistance from big six accounting firms and large corporations that are financially capable of providing volunteers to research and author COSO guidance. COSO does not follow the type of due process mandated by organizations like ISO and other standards setting bodies. It also does not utilize a transparent decision making process that allows the public and researchers to see public commentary filed on exposure drafts and issued frameworks. In 1991 when COSO issued the exposure draft for the 1992 Internal Control – Integrated Framework a number of comments raised significant concerns related to key deficiencies in the model that were rejected by the Committee. These comments were not posted publicly and are not available to researchers today to examine.

In short, COSO does not appear to want to accept the responsibility of being a national standards body, but also does not want relinquish the power and influence that comes with being the author of the SEC de-facto mandated control assessment framework for public companies.

IF COSO ISN'T UP TO THE JOB OF GLOBAL STANDARDS SETTER WHO IS?

Given the global movement to transition to international accounting standards , albeit a somewhat tentative movement on the part of the U.S, it would seem obvious that the International Accounting Standards Board (IASB) should create a duly chartered sister organization – the International Accounting Control Standards Board (IACSB).

The IASB website indicates that:

The IASB is the independent standard-setting body of the IASC Foundation. Its members (currently 15 full-time members) are responsible for the development and publication of IFRSs, including the IFRS for SMEs and for approving Interpretations of IFRSs as developed by the IFRS Interpretations Committee (formerly called the

IFRIC). All meetings of the IASB are held in public and webcast. In fulfilling its standard-setting duties the IASB follows a thorough, open and transparent due process of which the publication of consultative documents, such as discussion papers and exposure drafts, for public comment is an important component. The IASB engages closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession.

It isn't hard to imagine creating a similar statement and mandate for a new body called the International Accounting Control Standards Board. (IACSB) It could read as follows:
The International Accounting Control Standards Body (IACS) is an independent standard-setting body of the IASC Foundation. Its members (currently 15 full-time members) are responsible for the development and publication of International Financial Control Standards (IFCSs), including the IFCSs for SMEs and for approving Interpretations of IFCSs as developed by the IFCS Interpretations Committee. All meetings of the IACSB are held in public and webcast. In fulfilling its standard-setting duties the IACSB follows a thorough, open and transparent due process of which the publication of consultative documents, such as discussion papers and exposure drafts, for public comment is an important component. The IACSB engages closely with stakeholders around the world, including investors, analysts, regulators, business leaders, accounting standard-setters and the accountancy profession. IFCSs are reviewed and updated as deemed necessary at an interval of no less than every four years consistent with the ISO standard setting process.

CHANGE WON'T COME WITHOUT A CONCERTED EFFORT

The obstacles to get the SEC, COSO, the IASC and IASB, and scores of professional accounting and auditing associations around the world to acknowledge the issues and concerns raised in this article are formidable. It will take a concerted effort and calls from governments and accounting bodies around the world to make the vision described here a reality. ACCA could play a lead role in that process. Creation of the IASCB should be seen as critically important by lawmakers; securities exchange regulators, investors, and the accounting and auditing professions. Creation of the IACSB could literally change the way companies provide information on the controls that directly impact on the likely reliability of the related accounting disclosures. It's time to make management and auditor representations on the effectiveness of a company's internal control over financial reporting more useful, reliable and respected. The accounting profession, if we truly deserve to be called a profession, has a duty to protect the public interest. The improvements called for in this article should be seen as an element of that duty of care.

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