

The SOFT Approach to Auditing

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EFORE 2002, MOST INTERNAL AUDITORS used a risk-based approach and performed a range of audits of controls over operational effectiveness, compliance with applicable laws and regulations, and the integrity of financial reporting. They provided value to their company by identifying areas of operational improvement as well as opportunities to improve controls and reduce risk. With the advent of the U.S. Sarbanes-Oxley Act of 2002, many practitioners' work shifted dramatically to a compliance-driven controls focus.

The PCAOB's AS5 presents an opportunity for internal auditors to rebalance their workload and truly add value to the organization.

BY DANIEL GOLDBERG

U.S. regulators translated the few paragraphs in Sections 404 and 302 of Sarbanes-Oxley into detailed regulations, in particular Auditing Standard No. 2 (AS2), An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, issued by the Public Company Accounting Oversight Board (PCAOB). This led to a virtual onslaught of internal controls documentation and testing.

Many companies, struggling to identify resources to complete the documentation and perform the testing of internal controls, turned to the internal audit function as their Section 404 resource. Internal auditors, with the support of the audit committee, accepted this role willingly. However, in the eyes of observers — including many chief audit executives (CAEs) — after the initial issuance of Sarbanes-Oxley and AS2, external auditors placed little to no reliance on management's work (even when performed by competent and independent internal auditors) and performed separate testing. This resulted in significant duplication of effort and drove compliance costs higher than anyone could have predicted.

In May, the PCAOB adopted Auditing Standard No. 5 (AS5), An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements. Pending U.S. Securities and Exchange Commission (SEC) approval, AS5 will supersede AS2 and bring internal auditing back to where it should be: adding shareholder value through a balanced program based on risk. Identification of cost savings, operational audits, and, to a lesser extent, continuous compliance auditing would be added back to the internal audit program. As outlined in AS5, the new standard is primarily designed to:

- Focus the audit on the matters most important to internal control by directing the auditor to the most important controls.
- Eliminate unnecessary procedures by, for example, removing the requirement to evaluate management's process, permitting consideration of knowledge obtained during previous audits, refocusing the multilocation testing requirements on risk rather than coverage, removing barriers to using the work of others, and recalibrating the walk-through requirement.
- Scale the audit for small companies by, for example, directing the auditor to tailor the audit to reflect the attributes of smaller, less complex companies.
- Simplify the requirements by reducing detail and specificity, better reflecting the sequential flow of an audit of internal control, and improving readability.

These key points should alter the focus of the audit to be on the fewer truly key internal controls rather than on a large quantity of controls, not all of which are

detect any material misstatement of the financial statements.

Removing the external auditor's requirement to evaluate management's process

testing on high-risk areas and rely heavily on the work of others for other areas.

Internal audit functions that perform a significant amount of Section 404 work

role and internal perception of internal auditors at U.S.-listed companies. Internal auditing was brought to the forefront at most companies, but acceptance of a compliance role has been both a blessing and a curse. As Section 404 compliance has become routine, management and staff increasingly find it difficult to see the value it adds. Testing areas three to four times a year (not including work performed by external auditors) has taken its toll on companies and has resulted in a negative backlash. Internal auditors can help manage this perception by integrating the Sarbanes-Oxley work with operational audits and performing an integrated Sarbanes-Oxley, operational, financial/transaction (SOFT) audit.

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may significantly decrease the duplication of effort between the company and the external auditor. In some companies, auditors have performed detailed reperformance of management's testing for the sole purpose of concluding on management's assessment process. That will no longer be required. In addition, the increased ability to use the work of others — especially work by internal auditing — allows the external auditor to focus its independent

will add value to the organization through procedures that external auditors rely on, generating a significant reduction of audit fees. The overall easing of the Section 404 burden will free internal auditors to perform a more balanced range of duties where the value is not as transparent as Section 404, including operational audits and due diligence.

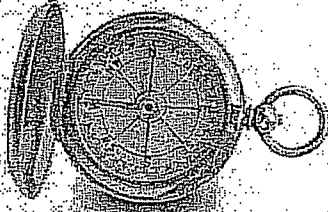
During the past five years, Section 404 compliance has significantly affected the

Internal auditors should be very accepting of an ongoing Section 404 testing role. The benefits can greatly outweigh the costs if the process is managed and staffed appropriately. With the changes in PCAOB guidance, the Section 404 workload is reduced, and internal auditors have an opportunity to not only perform the required Section 404 testing, but also to meet their obligations for assurance and



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for assurance and consulting activities in other areas. If the internal audit department has appropriate management and audit committee support, performing an integrated SOFT audit can add significant value to a company, encompassing value-added techniques as well as compliance and financial testing. A SOFT audit brings together financial, compliance, and operational objectives. By integrating the audit approach, internal auditing can:

- Perform Sarbanes-Oxley compliance testing that is valuable to management and the company.
- Perform operational reviews that can enhance shareholder value through control improvement, improved risk management, operational efficiencies, and direct cost savings.
- Complete compliance reviews in nonfinancial areas (such as health and safety and labor law compliance).
- Perform financial statement testing that external auditors can rely upon in some cases.

Sarbanes-Oxley has gone to great lengths to restore investor confidence in the U.S. public market, albeit at a significant cost.

The act accomplished its intended goals, but the costs have outweighed the benefits. With the updated AS5, the balance should shift to a more even platform.

audit function with the opportunity to use the SOFT approach to retain its high profile with management, while balancing the negative stigma of

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Sarbanes-Oxley has raised the profile of internal auditing throughout public companies; however, unless managed carefully, it could now have the opposite effect. The persons responsible for Section 404 compliance testing — often the internal auditors — may be viewed as a necessary evil unless the work is performed in a way that enables operating management to see value. The new PCAOB standard presents the internal

Sarbanes-Oxley compliance with other value-added procedures.

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