

Corporate governance

Global body must guide on accounting controls

America's COSO control framework is deeply flawed, says guest contributor *Tim Leech*. A replacement is needed urgently

A new international organisation must be created to replace the US-based body now widely used by accountants, regulators and investors for guidance on assessing the effectiveness of accounting control governance in a firm. The current dominant "control framework" being used for this task, the so-called COSO control framework, is seriously out-of-date, defective and prone to high rates of opinion error.

One possibility would be for the International Accounting Standards Board (IASB), the London-based body that sets international accounting standards now accepted in more than 100 countries but not yet in the US, to create a duly chartered sister

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organisation – the International Accounting Control Standards Board, or IACSB. With adequate funding, the new board should be given the task of producing new guidance for management and auditors on how to report on the effectiveness of accounting controls, the internal framework intended to ensure the validity and reliability of a firm's financial statements.

The present rather ad hoc arrangements, which by default rely on the out-dated approach required for US-listed companies, are inherently faulty, and are undermining investor confidence in company veracity.

But it will be a formidable task to get the various interested parties – regulators, accounting standard-setters and auditors – to acknowledge the problem and act. It will take a concerted effort and calls from governments and accounting bodies around the world to bring about change. However, it's time to make management and auditor representations on the effectiveness of a company's accounting controls more useful, reliable and respected.

The organisation that's in effect performing the role of world standard-setter in

this area is currently the Committee of Sponsoring Organisations of the Treadway Commission, known as COSO, a private sector organisation based in the US. COSO provides guidance to management in the public and private sectors on corporate governance. The Committee has developed a common internal control model against which companies can assess their control systems. COSO stems from the setting up in 1985 of the Treadway Commission, a private-sector initiative sponsored by America's five leading professional accounting associations, to review the level of fraudulent financial reporting by firms.

A Sarbanes-Oxley legacy

The stature of COSO was radically elevated in 2003 when the Securities and Exchange Commission (SEC), the US stock market watchdog, said the Committee's internal control model met the criteria for a suitable control assessment framework for the now infamous Section 404 of America's Sarbanes-Oxley (SOX) Act, one of the toughest pieces corporate governance legislation in the world which was introduced in the wake of a series of corporate fraud scandals, including the Enron scandal. Section 404 requires publicly listed firms and their auditors to report information in their annual reports on the effectiveness of their internal control procedures for financial reporting.

The SEC said at the time that other control frameworks, including Britain's Turnbull criteria and Canada's CoCo framework, also fitted the bill. But pressure from the major accounting firms and the SEC's strong endorsement resulted in the 1992 COSO framework becoming in effect the only criterion used for public reporting on accounting control effectiveness. Companies around the world have come under pressure from their accountants, internal auditors, and regulators to follow the US lead and use the flawed COSO framework.

The unstated reality is that, intentionally or otherwise, the SEC, with support from the US. Public Company Accounting Oversight Board (PCAOB), the body set up

under SOX to oversee the auditing profession, raised COSO to the position of the world's first accounting control assessment standards body. This 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.

US listed public companies, including major companies headquartered in countries around the world, began to form opinions on control effectiveness using the COSO 92 internal control framework for SOX purposes as early as 2004. SEC regulations require a binary, effective/ineffective, opinion on accounting control. SEC materiality rules, up until fiscal years ended after November 15, 2007, were that accounting controls must be capable of reducing the chance of even a single material error in financial statements to "less than a remote likelihood." This was subsequently adjusted to less than a reasonable possibility, but the single material error requirement was maintained.

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However Audit Analytics, a Sutton, Massachusetts consultancy that tracks restatements by US listed companies, says that since SOX 404 was implemented thousands of companies and their auditors have had subsequently to correct material errors after first reporting they had effective internal controls as defined by SEC criteria and using COSO 92 framework criteria. The majority reached and reported the wrong conclusion on the ability of the company's control system to prevent material errors.

A key finding of a report commissioned by the Institute of Management Accountants in the US, one of the five COSO sponsoring organisations, was that more than 1 in 8 large US listed companies were forced to restate their accounts to correct material errors in their original financial statement filings. **GRR**

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