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Preventing the next wave of unreliable financial reporting: Why US Congress should amend Section 404 of the Sarbanes–Oxley Act

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Tim Leech
is Managing Director Global Services at Risk Oversight Inc. (www.riskoversight.ca). He has spent the past 25 years helping public and private organizations around the world implement more cost-effective risk oversight and assurance solutions. He has provided training on risk oversight to numerous boards; has presented training for tens of thousands of risk and audit professionals around the world on risk oversight, internal audit transformation, Sarbanes–Oxley, risk management and fraud prevention/detection; written and contributed to books and scores of technical papers and articles; and made presentations to the SEC and PCAOB on more cost-effective approaches to SOX 404. From 1991 to 2004, he was founder and CEO of CARDdecisions, developer of the world's first integrated risk and assurance training and software platform. CARDdecisions was sold to Paisley/Thomson Reuters. Leech has received recognition for outstanding contributions in the field of risk management and assurance from the Ontario Institute of Chartered Accountants, the Institute of Internal Auditors and the Association of Certified Fraud Examiners.

Lauren Leech
is Senior Associate, Risk Oversight Inc., and has spent a decade providing insight on risk management, internal audit and Sarbanes–Oxley. She played an important role in the development and testing of CARDdecisions' software platform and globally acclaimed risk and control assessment training materials. She co-authored a publication *Sarbanes–Oxley and the Canadian Response* for the Richard Ivey School of Business and has lectured at University of Toronto, Continuing Studies Internal Audit Program.

ABSTRACT **Sarbanes–Oxley Section 404 calls for opinions from CEOs, CFOs and external auditors of US listed companies on control effectiveness over financial reporting. Section 404 has almost certainly proven to be the most costly regulatory intervention in the history of securities regulation, costing billions of dollars each year. Unfortunately, since Section 404 was implemented in 2004, thousands of materially wrong financial statements supported by SOX Section 404 control effectiveness assurances have been issued from CEOs and CFOs, including those at financial institutions at the center of the 2008 global financial crisis, as well as their external auditors. In light of SOX 404's poor track record and massive costs, the authors recommend that US Congress enact an amendment to Section 404 to require CEO, CFO and external auditor opinions on the 'effectiveness of risk management processes' – not 'control effectiveness'. A true risk-based approach would allocate resources to the most statistically probable root causes that account for the majority of materially wrong financial statements. The authors believe that this legislative change will result in significantly more reliable financial statements, reduce long-term Section 404 compliance costs, better align with the new global regulatory focus on risk management and risk oversight and, most importantly, restore global confidence in US corporate governance and capital markets.**
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Correspondence: Tim Leech
Managing Director, Global Services,
Risk Oversight Inc., Canada
E-mail: tim.leech@riskoversight.ca

INTRODUCTION

Over the past 50 years, investors in US listed companies have experienced pronounced waves of materially unreliable financial reporting. As each wave of malfeasance and negligence rose to prominence and attracted political and regulatory attention, new commissions and hearings to study the problem were convened. Reports were issued and, in some cases, subject to the political pressures of the day, steps were taken to try and improve the reliability of financial reporting.

Starting in the 1970s, after a wave of significant unreliable financial disclosures, the Cohen Commission studied the problem of fraudulent financial reporting and concluded that a key element of the solution should be management and auditor assessment of, and reports on, something they termed 'control effectiveness'. This conclusion was for all intents and purposes ignored at the time by Congress and the Securities Exchange Commission (SEC). In the 1980s, following another wave of massively unreliable financial statements precipitated by the savings and loan crisis, the Treadway Commission explored the problem again and reached similar conclusions.

Twenty-four years after the Cohen Commission reported, and 15 years after Treadway, following what has been referred to as the 'perfect storm' of fraud and unreliable financial reporting led by Enron and WorldCom, US Congress dredged up the archives of the Cohen and Treadway Commissions and, in record time, enacted the Sarbanes–Oxley Act of 2002. This now infamous piece of legislation mandated for the first time CEO and CFO reporting on control effectiveness with parallel external auditor opinions – Section 404(a) and (b). Evidence suggests that the relatively short paragraphs that comprise Section 404 may well hold the world record as the single most expensive regulatory imposition in the history of securities regulation (FEI, 2007; US Chamber of Commerce, 2007; Alexander *et al*, 2010).

The recent global financial crisis, unequivocally the most damaging wave of unreliable financial reporting in world history, materialized more than five years after the hugely expensive Sarbanes–Oxley legislation was enacted. With the benefit of time, it has become clear that the financial statements of some of the world's largest financial institutions were massively wrong leading up to the eventual global collapse, not by billions this time but by trillions of dollars.

Once the 2008 global crisis materialized, more Commissions and hearings were convened in the United States and in other countries around the globe to try and identify root causes of the unprecedented US corporate governance breakdown. The G-20 leaders requested the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to evaluate and report on what went wrong in the area of accounting and auditing standards. The result was the creation of the Financial Crisis Advisory Group ('FCAG'). The FCAG concluded, 'Accounting was not a root cause of the financial crisis, but it has an important role to play in its resolution' (2009).

In the United Kingdom, the House of Lords Economic Affairs Committee was charged with studying what caused the great financial crisis of 2008. This UK Committee has played a lead role calling the accounting and auditing professions to account for their deficiencies (2011, para.138–144). On 6 April 2011, Lynn Turner, a past SEC Chief Accountant and a witness at the US Senate Banking, Housing and Urban Affairs Committee hearings, also examined the role of the accounting and auditing professions, and called for an in-depth analysis of the role of auditors in the crisis.

In the wake of the global financial crisis, influential commissions were convened, including the powerful Senior Supervisors Group ('SSG') and the National Association of Corporate Directors ('NACD') Blue Ribbon Commission, to study the root causes of the problem. These groups, among others, have converged on the belief that deficient risk management and deficient board-level risk oversight are two of the root causes of the 2008 global financial crisis.

Make no mistake – the root problems identified by these groups of deficient risk management and deficient risk oversight directly impacted the reliability of the financial statements of the institutions at the center of this storm in the period leading up to the global crisis. The vast majority of the most leveraged companies at the heart of the crisis, including Lehman Brothers, AIG, Bear Stearns, Fannie Mae, Freddie Mac, Bank of America and others, were all deemed in the period leading up to the global crisis by their CEOs, CFOs and external audit firms in their SOX certifications to have 'effective' systems of internal control over financial reporting in accordance with the dated and obsolete (Leech, 2008) 1992 COSO Internal Control Integrated Framework – the primary assessment framework used by US listed companies as required by the SEC. Simply stated – There was no warning for investers. None of the organizations at the root of the global crisis, including those that met their demise as a result of stupendously bad investment decisions, reported in the period leading up to the global crisis that they had any material control deficiencies when referenced against the 1992 COSO internal control framework.

In light of these developments and conclusions, key questions investors and regulators all over the world should be asking are:

1. Why did so many major financial institutions at the heart of the global crisis produce massively wrong SOX 404 control effectiveness opinions and financial statements in the period leading up to the global crisis? Why did the auditing profession sign-off on these opinions? Particularly when major Commissions studying these events have concluded that these organizations had seriously deficient risk management and risk oversight, and 'risk management' is one of the five COSO internal control integrated framework categories companies are required to assess under SOX.
2. Why have major commissions asked to study the root causes of the global crisis, including the IASB and the FASB, not called for SOX 404 reforms?
3. What needs to change to increase the reliability of financial statements during periods of, in the famous and ironic words of Alan Greenspan, past Chair of the US Reserve Bank, 'irrational exuberance' (1996) to reduce the chances of another global financial crisis?

What is absolutely clear is that SOX 404, a massively expensive regime that applied to the majority of financial institutions at the heart of the 2008 global crisis; a regime in place for over five of the years leading up to the 2008 global economic crisis; a regime heavily focused on low-level control identification and control testing; a regime that produced clean external auditor opinions linked to some of the largest corporate asset misstatements in US history; a regime that still requires the use of the 1992 COSO Internal Control Integrated Framework, an obsolete control assessment framework that is now almost 20 years old; completely missed the storm bearing down on some of the world's largest financial institutions and investors around the world.

Without significant legislative and regulatory change, there is little certainty that the current massively expensive control-centric SOX 404 assessment regime will fare any better next time at detecting the next wave of unreliable reporting. This article proposes a bold, yet incredibly simple, step to reduce the likelihood of yet another wave of unreliable financial reporting – a short amendment by US Congress to the wording of Section 404 of the Sarbanes–Oxley Act of 2002 to focus the attention of senior management and external auditors on risk management effectiveness. This legislative amendment would need to be accompanied by changes to SEC and Public Company Accounting Oversight Board (PCAOB) implementation rules to require assessments done by CEOs and CFOs

(SOX 404(a)), and external auditors (SOX 404(b)), to focus on evaluating and reporting on the effectiveness of the risk management processes to reliably identify, assess and manage significant risks to the goal of materially reliable financial reporting account balances and note disclosures.

This article explores at a high level:

1. Four distinct waves of unreliable financial reporting in the United States, including the period leading up to the 2008 global financial crisis;
2. The US legal and regulatory response as each wave of significant unreliable reporting emerged, focusing on the link commissions and regulators made at the time between a company's control environment and reliable financial reporting;
3. The deficiencies of the massively expensive 'control-centric' assessment approach to SOX 404, an approach that the majority of financial institutions at the root of the global crisis and their auditors are currently forced by current rules to use by US Congress, the SEC and PCAOB;
4. What a true 'risk-centric' SOX assessment approach would look like, and why a risk-centric approach has a far greater likelihood of detecting and treating risks with the potential to destabilize national and global economies at a substantially lower cost than the current SOX 404 regime;
5. Why a SOX 404 amendment to require reports on effectiveness of risk management processes, not control effectiveness, is necessary to align financial reporting approaches with recent best practices and regulatory reforms requiring enhanced board and senior management risk oversight;
6. Steps the US government, the SEC, the PCAOB and security regulators around the world should take to reduce the risk of yet another wave of unreliable financial reporting, and yet another crisis of investor confidence and crippling impacts on world economies.

UNRELIABLE FINANCIAL REPORTING – WAVE #1 – THE 1970S – LEAVE IT TO THE AICPA TO FIX

Paul Clikeman, in his thought-provoking book, *Called to Account: Fourteen Financial Frauds that Shaped the American Accounting Profession* summarizes events in the 1960s and 1970s:

> In the late 1960s and early 1970s, a series of accounting scandals including Continental Vending, Four Seasons Nursing Home, US Financial, Yale Express, Giant Department Stores, and National Student Marketing, raised questions about whether auditors were doing enough to fight financial crime.
>
> Equity Funding, in 1973, cast new doubt on the nation's financial reporting system. '…a lot of people decided that if the auditing system didn't catch the Equity Funding Fraud, then the system was a bad one,' the Wall Street Journal reported, '…after Equity Funding, it's hard for accountants to argue that a massive swindle, with thousands of victims is beyond the scope of a routine audit.' (2009, p. 127)

In response to the outcry, the American Institute of Certified Public Accountants ('AICPA') funded *The Commission on Auditor's Responsibilities*, better known as the Cohen Commission. The Commission task was to:

> Develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors. It should consider whether a gap may exist between what the public expects and needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved. (1978, p. xi)

A key element of the study was to determine why an alarming number of external auditor

opinions on public company financial statements were subsequently proven wrong. A key conclusion of the Commission in light of the current global financial crisis more than 30 years later was:

> The public accounting profession has failed to react and evolve rapidly enough to keep pace with the speed of change in the American business environment. That failure in the development of accounting principles was noted by the Study Group on the Establishment of Accounting Principles (the Wheat study group), whose report led the formation of the Financial Accounting Standards Board. We believe this Commission's report demonstrates a similar failure of the development of the accounting function. Therefore many of the recommendations in this report are designed to speed the pace of change in the profession and to make it more receptive to the forces of change in the future. (1978, p. xii)

The report goes on to state:

> Users expect the auditor to be concerned with the possibility of both fraud and illegal behaviour by management. In all of these areas, users expect more than they believe they are receiving. (1978, p. xvii)

To reduce the incidence of auditor opinion failure, an important conclusion of the Commission noted:

> A major step in implementing the Commission's proposed evolution, which should be adopted as soon as possible, would require the auditor to expand his study and evaluation of the controls over the accounting system to form a conclusion on the functioning of the internal accounting control system. If the auditor finds material weaknesses in the internal accounting control system, and those weaknesses are not corrected, material deficiencies may occur in the preparation of accounting information or in the control of the corporation's assets. (1978, p. xxiii)
>
> The standard of professional skill and care should be amplified to require a study and evaluation of controls that have a significant bearing on the prevention and detection of fraud. The auditor should report material weaknesses to the proper level of management, including, if appropriate, the audit committee or the full board of directors, and should follow-up to determine whether the weaknesses have been eliminated. (pp. 39–40). Methods and procedures should be adopted for public accounting firms to exchange information on developments in perpetration and detection of fraud. The AICPA should establish means for regular dissemination of that type of information. (1978, p. xx)

The Commission was clearly not shy or conflicted in offering specific and radical changes to the *status quo*. It called for a formal report from management on control:

> The report by management should present management's assessment of the company's accounting system and controls over it, including a description of the inherent limitations of control systems and a description of the company's response to material weaknesses identified by the company's independent auditor. It should describe the work of the company's audit committee and its internal auditors. The first report by management following a change in independent auditors should disclose the change in a manner similar to that now required in SEC Form 8-K. The report by management should avoid purely subjective judgments designed to impress users with the quality of management. (1978, p. xxiv)

Legal/regulatory response

These radical 1977 recommendations of the Cohen Commission were, for all intents and purposes, ignored by both US regulators and the auditing profession. The Chairman of the landmark Cohen Commission, Manuel F. Cohen, died before the Commission's report was released.

The government of the day and the SEC were largely content to leave corrective action in the hands of the AICPA. The AICPA's response at the time was to issue Statements on Auditing Standards ('SAS') No. 16, The Independent Auditor's Responsibility for the Detection of Errors and Irregularities. SAS 16 contained sweeping limitations on what could be expected of auditors when fraud was involved. No concrete steps were implemented to require auditors to assess the company's system of controls, including specific attention to controls to prevent material fraud, and formally report on their effectiveness. No effort or resources were expended to formally study and identify the root causes of material accounting misstatements.

UNRELIABLE FINANCIAL REPORTING – WAVE #2 – THE SEC IGNORES TREADWAY RECOMMENDATIONS BECAUSE OF COST CONCERNS

The 1980s brought a fresh wave of outrageous frauds where the company's financial statements were auditor certified. A sample includes ZZZZ Best, Crazy Eddie, ESM Government Securities, Continental Illinois Bank, and Penn Square Bank to name a few.

Paul Clikeman chronicled the reaction to the two major bank failures in his 2009 book *Called To Account*:

> Angered by the costly collapses of Continental Illinois Bank and Penn Square Bank, Dingell announced plans to hold seven or eight hearings 'to see how the accounting profession is functioning as part of the federal regulatory system.' Noting that nonaudit services and competitive pressures had increased significantly during the previous seven years, Dingell expressed concern about auditors caving in to pressure from clients. Subcommittee members wanted to know why so many banks failed without receiving a modified opinion from their auditors.
>
> The hearings did not begin well for the accountants. Dingell attacked SAS No. 16 in his opening statement: 'The public expects that independent auditors will make reasonable efforts to assure that fraudulent corporate activity will not go undetected and unreported. And the first witness recommended radical changes to the public accounting profession. Professor Abraham Briloff, a veteran of the Metcalf/Moss hearings, urged congress to ban public accounting firms from providing management and advisory services to their audit clients. Professor Robert Chatov said the SEC should take over the public function of writing accounting and auditing standards. Chatov also wanted the SEC to assign auditors to publicly held companies and rotate the auditors periodically. (p. 130)

In 1985, five not-for-profit organizations – AICPA, the American Accounting Association, The Institute of Internal Auditors, the National Association of Accountants (now the Institute of Management Accountants) and the Financial Executives Institute – banded together and formed the *Committee of Sponsoring Organizations of the Treadway Commission* to sponsor and fund another study to explore the new rash of fraudulent financial reporting. The Chairman of the Commission was James C. Treadway Jr. That Committee became best known as a result of self-proclamations COSO. COSO's stated founding mission in 1985 was 'to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence' (1987, p. 1), an ambitious and noble goal at the time.

In October 1987, the Treadway Commission's final report recommended that, 'The Commission's sponsoring organizations should cooperate in developing additional, integrated guidance on internal control' (p. 44). Another key recommendation of the Treadway Commission built on recommendations made by the Cohen Commission a decade earlier:

> All public companies should be required by SEC rule to include in their annual reports to stockholders management reports signed by the chief executive officer and the chief accounting officer and/or the chief financial officer. The management report should acknowledge management's responsibilities for the financial statements and internal control, discuss how these responsibilities were fulfilled, and provide management's assessment of the effectiveness of the company's internal controls. (p. 44)

Legal/regulatory response

In May of 1986, following the formation of the Treadway Commission, Ron Wyden introduced a bill in Congress that would have required auditors to report suspicions of fraud to the SEC. Clikeman, in his book *Called to Account*, chronicled the reaction of the day. The position taken by Arthur Anderson at the time, in light of the much later events at Enron and others that led to their demise, is particularly ironic.

> But many people opposed Wyden's Bill. Price Waterhouse chairman Joseph E. Conner said the proposal would 'convert independent auditors into a police state'. Duane Kullberg of Arthur Anderson said the Bill would 'make the auditors surrogate for a government investigator' and would force auditors to reach conclusions without giving their clients a chance to defend themselves. Even the SEC opposed Wyden's Bill, saying it would impose unnecessary costs on public companies.
>
> Wyden later softened the fraud notification provisions, but his Bill never gathered enough bipartisan support to pass Congress or survive a likely veto by the pro-business, anti-regulation Reagan administration. Public outrage over accounting scandals had not yet reached the level necessary to induce government action. (2009, p. 131)

Treadway's recommendations on management reporting on control effectiveness, a recommendation that essentially repeated the Cohen Commission's recommendation a decade earlier, was not adopted at the time by the SEC. A speech in 1989 by Joseph Grundfest, Commissioner US Securities & Exchange Commission and Max Berueffy, Counsel to Joseph Grundfest summarizing the SEC's and its Commissioner's position on the Treadway recommendations:

> *Commissioner Cox*. In a recent address Commissioner Cox observed that 'the Treadway recommendations that, if implemented, would have the greatest impact on reducing fraudulent financial reporting are basically horatory statements directed to corporate managers and are not calls for regulatory actions…. Commissioner Cox stated the SEC has a relatively 'minor role to play in addressing the reforms proposed by Treadway'. In his view, the relative importance of the SEC's role is 'reflected by its response over the past year –one that has exhibited a lack of urgency and has included the rejection of certain Treadway recommendations'.
>
> *Commissioner Cox* also emphasized the need for careful cost-benefit analysis of the Treadway recommendations, and notes that the Treadway Report is candid in stating that companies would incur considerable costs in implementing its recommendation, and that costs would be especially significant.'
>
> *Commissioner Grundfest*…. Moreover, because the costs and benefits of specific Treadway recommendations can differ dramatically from company to company

> without generating commensurate social benefits – Commissioner Grundfest recommends that policy makers avoid 'pounding square pegs into round holes' by forcing all companies to comply with standardized requirements, regardless of their specific circumstances. (p. 5)

What is clear from this 1989 speech is that the SEC of the day did not think this was a problem that they should address; and that reporting on control effectiveness would be a costly exercise that would not produce benefits commensurate with the cost.

UNRELIABLE FINANCIAL REPORTING – WAVE #3 – ENRON/WORLDCOM PERFECT STORM

Paul Clikeman's book provides a concise summary of the events that have been called the perfect storm of unreliable financial reporting.

> The Dow Jones Industrial Average reached an all-time high of 11 723 on January 14, 2000. But 316 earnings restatements in 2000 and 2001 revealed that many high-flying technology firms of the late 1990s were not nearly as profitable as had been claimed. Enron's bankruptcy in December 2001 shattered investors' confidence. The DJIA dropped more than 2000 points during the first half of 2002 amid fears that other 'Enrons' remained undiscovered. 'This is the biggest crisis investors have had since 1929,' said accounting analyst Howard M. Schilit. 'Investors don't know who they can trust.' Clearly, investors didn't trust accountants. CPAs, once held in high esteem by the American public, fell below politicians and journalists in public opinion polls.
>
> WorldCom was the proverbial straw that broke the camel's back. New York Times Columnist Floyd Norris Attributed Sarbanes-Oxley to WorldCom CEO Bernie Ebbers. 'His name is not on the law, but maybe it should be,' Norris wrote. (2009, p. 278)

Legal/regulatory response

In the face of the Enron/WorldCom perfect storm, even the Republicans decided that they could not risk denying there was a problem that warranted government intervention. The Sarbanes–Oxley Act of 2002 was signed in to law – a response enacted in record time with almost unanimous support of both the Democrats and the Republicans parties. Management reporting on control effectiveness, dismissed in the 1970s when first recommended by the Cohen Commission, and again in the 1980s when proposed by the Treadway Commission on the basis that it would not produce benefits commensurate with the cost, was historically approved by both parties. Section 404 is a deceptively small, but core and massively costly element of the Act. The SEC administration of the day, regardless of earlier misgivings of SEC's Commissioners regarding the cost/benefit equation, was assigned the task of implementing the most radical reform of security regulation in the history of the United States.

Key elements of SOX that illustrate the reforms called for in past studies include:

1. Stripping the self-regulation rights of the AICPA and the creation of the PCAOB to police the audit profession – a recommendation made by Professor Robert Chatov at the Dingell hearings on the accounting profession in the 1980s.
2. Implementation of Professor Abraham Brilloff's recommendation at the Dingell hearings in the 1980s to restrict the range of management services public accounting firms were allowed to do to reduce conflicts of interest.
3. Implementing an annual certification on the effectiveness of internal controls over financial reporting – a recommendation

first made by the Cohen Commission in 1978.
4. Requiring a report from the company's external auditor on the effectiveness of internal control over financial reporting – implementing a recommendation made 22 years earlier by the Cohen Commission.

In order for companies to comply with SOX 404, they had to use a control framework deemed 'suitable' by the SEC. The control framework that virtually all public companies elected to use at the time and still use today, a framework deemed 'suitable' by the SEC, was COSO's 1992 Internal Control Integrated Framework, sponsored by the COSO Committee. The COSO committee was the result of the 1987 Treadway Commission recommendation that the Commission's sponsoring organizations develop guidance on internal control. The authors of this 1992 framework were partners and staff of Coopers & Lybrand (*Note*: Coopers & Lybrand has now become PricewaterhouseCoopers in the era of 'the big four', one of the 'big 8' auditing firms in existence at the time).

What was massively underestimated at the time SOX was enacted was just how costly the two short paragraphs that comprise Section 404 would prove to be. The bill did not call for any formal public effectiveness review to determine whether the legislation was actually successful in achieving its central stated purpose to 'protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to securities laws, and for other purposes' (US Congress, 2002), and no independent hearing has been held since it was enacted to probe that question.

UNRELIABLE FINANCIAL REPORTING WAVE #4 – THE GLOBAL FINANCIAL CRISIS

Few people in the business world are unaware that a significant number of the world's largest financial institutions hovered on the brink of bankruptcy in late 2008 and early 2009. In the case of a few financial companies in jeopardy, the US government mysteriously deemed them unworthy of saving and they were forced to declare bankruptcy. Others were considered too big to fail or were simply included on the bailout list because of the global panic and saved at a massive cost at the time to the US Treasury and other governments around the world.

There is little doubt that the financial statements of hundreds of major banks and companies in the period leading up to the global financial crisis were materially wrong. In spite of their decisions to make massive 'bet the farm'-type bets on seriously risky assets, Lehman Brothers, AIG, Bear Stearns, Fannie Mae, Freddie Mac, Bank of America and others were all deemed in the period leading up to the global crisis by their CEOs, CFOs and external audit firms to have 'effective' systems of internal control over financial reporting in accordance with the dated and obsolete COSO 1992 Internal Control Integrated Control framework. (Leech, 2008). What is less clear is whether financial statements were prepared correctly, following rules of the day that companies and their auditors were obliged to follow and, of even more importance, whether accounting and auditing rules, including SOX 404 reporting, were followed correctly; however, the financial statements were still massively wrong. This state would be best summarized as – correctly prepared in accordance with the rules of the day, including management representations that internal control was effective in accordance with COSO's 1992 integrated control framework; correctly audited in accordance with PCAOB auditing standards, including external auditors opining that the company maintained 'effective' internal controls; but massively misstated and, in many cases, virtually insolvent in the absence of government intervention.

Lehman Brothers Holdings Inc. is one example of a firm at the center of the global crisis that reported clean control effectiveness certifications. The key paragraph noted in the Lehman Brothers Holdings Inc. 10K filing,

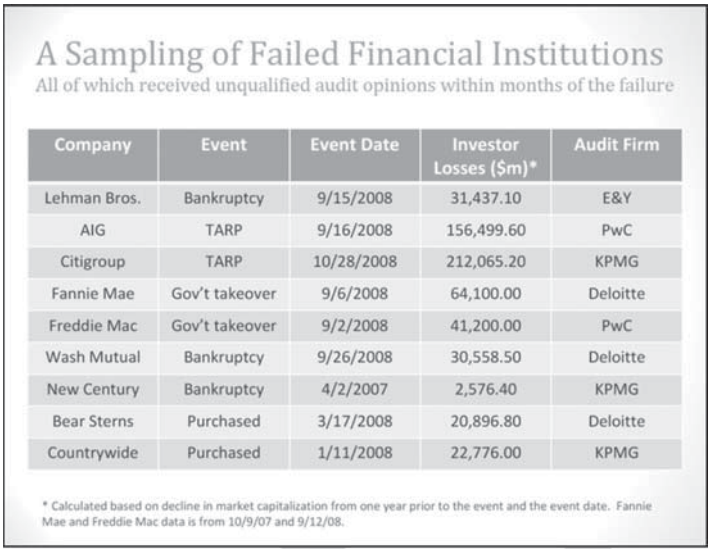
dated 30 November 2007, from their CEO and CFO reads as follows: 'The Company's management assessed the effectiveness of the Company's internal control over financial reporting as of November 30, 2007. In making this assessment, it used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control–Integrated Framework. Based on our assessment we believe that, as of November 30, 2007, the Company's internal control over financial reporting is effective based on those criteria' (p. 82). The key paragraph from the Ernst & Young external audit opinion in the same filing, 'In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of 30 November 2007, based on the COSO criteria' (p. 83). Again, on 30 May 2008, Lehman Brother Holding Inc's CEO and CFO provided a clean SOX 404 opinion in heir 10Q filing (p. 109).

The PCAOB Investors Advisory Committee drew on a sample of failed financial institutions at the center of the global financial crisis in a 16 March 2011 report shown in Figure 1. This table puts the spotlight on financial institutions that issued unqualified financial opinions, including SOX 404 control effectiveness opinions, and the related investor losses (p. 6) in the period leading up to the collapse. Again, it is important to note that these firms certified that accounting controls over the areas that later proved to be toxic for investors, including the risk management dimension of those controls, were rated as 'effective' in accordance with criteria in the 1992 COSO Internal Control Integrated Framework by the company's CEO, CFO and external auditors.

Legal/regulatory response

As of the date this article was finalized, governments and regulators around the world were just beginning, at least in any serious way, to analyze and report findings on the role of accounting and auditing in the global financial crisis.

Commissions and hearings were convened in the United States and in other countries around the globe, to try and identify root causes of the unprecedented US corporate governance breakdown. As part of this root cause analysis, G-20 leaders requested the IASB and the FASB evaluate and report on



A Sampling of Failed Financial Institutions

All of which received unqualified audit opinions within months of the failure

Company	Event	Event Date	Investor Losses ($m)*	Audit Firm
Lehman Bros.	Bankruptcy	9/15/2008	31,437.10	E&Y
AIG	TARP	9/16/2008	156,499.60	PwC
Citigroup	TARP	10/28/2008	212,065.20	KPMG
Fannie Mae	Gov't takeover	9/6/2008	64,100.00	Deloitte
Freddie Mac	Gov't takeover	9/2/2008	41,200.00	PwC
Wash Mutual	Bankruptcy	9/26/2008	30,558.50	Deloitte
New Century	Bankruptcy	4/2/2007	2,576.40	KPMG
Bear Sterns	Purchased	3/17/2008	20,896.80	Deloitte
Countrywide	Purchased	1/11/2008	22,776.00	KPMG

* Calculated based on decline in market capitalization from one year prior to the event and the event date. Fannie Mae and Freddie Mac data is from 10/9/07 and 9/12/08.

Figure 1: PCAOB Investor Advisory Group 16 March 2011 Presentation *The Watchdog that Didn't Bark Again*.

what went wrong in the area of accounting and auditing standards. The result was the creation of the FCAG. This group, after a relatively short and cursory study of the issue given its importance, concluded, 'Accounting was not a root cause of the financial crisis, but it has an important role to play in its resolution' (2009).

In the United Kingdom, the House of Lords Economic Affairs Committee, one of many groups charged with studying what caused the great financial crisis of 2008, did not accept the position taken by the FCAG and other 'blue chip commissions' studying the global crisis, which had concluded that accounting, and external audits that certified the accounting, were not significant contributory causes of the global crisis. This brave and lonely UK Committee has launched the most strident attack on the accounting and auditing *status quo* to date:

> We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. 'It may be that the Big Four carried out their duties properly in the strictly legal sense, but we have to conclude that, in the wider sense, they did not do so. It cannot (or at least should not) be taken for granted by auditors that banks in difficulties will be bailed out by the authorities and the taxpayers. We do not accept therefore that this should at any time be a decisive consideration in making the 'going concern' judgment. (2011, para. 142 and 144).

The UK House of Lords Economic Affairs Committee has clearly taken the lead in calling the accounting and auditing professions to account for these deficiencies:

> The banking crisis of 2007–2009 raised the question (among others) why there was so little warning that so many banks were in trouble and that the world's financial system was at risk. The role of auditors in the crisis is naturally of most interest to this inquiry. We do not seek to apportion blame but to draw lessons, bearing in mind that, with hindsight, responsibility for the crisis and the lack of warning was shared by almost all the players in the system. As Lord Myners put it, 'the financial crisis revealed the failure of just about everybody … [but] the auditing profession, the accounting profession, cannot be excluded from those who must share responsibility and, more importantly, seek to learn lessons'. (2011, para. 138)

A day after the UK House of Lords report was released, the PCAOB Investors Advisory Group called for an in-depth investigation of the role of auditors in the crisis (2011). The PCAOB Investor Advisory Group in their 16 March 2011 meeting noted in their presentation slides entitled *The Watchdog that Didn't Bark… Again*, 'While auditors did not cause the financial crisis, it is difficult to look at the list of failed institutions that received an unqualified audit just months before they failed and conclude that auditors didn't play a role' (p. 6). The same presentation also questions Sarbanes–Oxley, 'The financial crisis of 2008 raises significant questions about why the Sarbanes-Oxley reforms failed to bring about the promised improvements to the independence and quality of public company audits. In Europe and the United Kingdom, these questions are receiving significant attention from regulators and policymakers. But, so far at least, the United States has lagged behind in that evaluation' (p. 17).

Pending litigation against virtually all the major audit firms linked to the global financial crisis has understandably and negatively impacted the willingness and ability of accounting and auditing experts from these firms to offer candid and objective testimony. A number of current SEC and PCAOB staff are ex-Big 6 audit firm staff members, or are

on secondment from the Big 6 audit firms that are now the subject of litigation related to their performance leading up to the global crisis. Expressing opinions deemed detrimental to their past or potentially future employers could be very dangerous. Also, a number of SEC and PCAOB staff that would be expected to objectively examine the issues and the performance of audit firms leading up to the crisis are accounting professors on secondment from US universities that have close financial ties with the major accounting and auditing firms. Many major US universities have chairs endowed by the Big 6 accounting firms. Publicly raising serious concerns with the audit profession's performance in the global crisis could materially and negatively impact future accounting faculty funding and damage relationships with the major audit firms.

In the United States, the Senate Committee on Banking, Housing and Urban Affairs met on 6 April 2011 to explore the topic of *The Role of the Accounting Profession in Preventing another Financial Crisis*. The testimony of Lynn Turner, an outspoken critic of the accounting profession, is particularly interesting. Excerpts from his testimony that day are included below:

> Unfortunately, as described later on, gatekeepers including the auditors did play a role in the financial crisis. They failed to act on and provide information available to them to investors. This left investors much like the ship Titanic as it approached an unforeseen iceberg, without any red flags or warnings of the imminent dangers. In doing so, the auditors helped contribute to a crisis in confidence. (2011, p. 6)

> The failure on numerous occasions of the FASB to issue timely standards that would provide the capital market participants with the information necessary to make informed decisions when allocating capital, has proven costly. Failed standards such as those related to off balance sheet debt and disclosures of risks and uncertainties have resulted in the capital markets being inefficient due to a lack of important information. It also has resulted in markets being unable to effectively discipline themselves. Any notion that 'free markets' can and will regulate themselves has gone out the window. (p. 10)

It should be no surprise that investors both in the US and abroad, are asking 'where were the auditors?' The findings of the PCAOB and others have raised a question as to whether auditors were in fact acting as objective examiners of the financial reports. Some have also questioned whether the auditors maintained the requisite level of professional scepticism as they performed their audits. Others are questioning the fundamental value of an audit in today's digital world and whether audits are relevant. (pp. 11–12)

It seems as if Congress agrees the FASB's independence is important – but only so long as some constituency isn't being pushed towards greater transparency by the FASB. I would hope that someday Congress can find a better balance between its oversight responsibilities with respect to accounting standard setting, the need for millions of American investors to receive transparent information, and the demands of special interest groups. (pp. 15–16)

Others such as Warren Buffet have also recommended there be greater transparency with respect to the discussions between audit committees, auditors, and financial management, including with respect to internal controls, completeness of disclosures and whether adjustments are needed to reported numbers or not. (p. 18)

In fact, despite over 14 000 audit opinions issued on an annual basis by auditors of public entities, almost 4900 restatements of financial statements being reported

> during the years 2005 through 2010, and a significant increase in the number of violations of the Foreign Corrupt Practices Act ('FCPA'), there has been on average *less than one* class action lawsuit brought each year against each of the ten largest auditing firms during that same period. As a result it is not surprising the ACAP[1] was unable to reach a consensus that any further litigation reform is necessary for auditors. (pp. 21–22)

The last comment excerpted from Lynn Turner's testimony is particularly important. Although Mr Turner has referenced 4900 restatements, neither the auditing profession nor the SEC or PCAOB have launched a serious study to determine the root causes of those accounting failures. Efforts that have been made are piecemeal and largely done by point-in-time Commissions calling for anecdotal evidence; not serious, empirical fact-based analysis conducted by independent and objective researchers.

In the wake of the global financial crisis, commissions were convened to also study the root causes of the problem. These commissions have converged on the belief that deficient risk management and deficient board-level risk oversight are two of the root causes of the global financial crisis. The highly influential SSG, a group made up of financial regulators of the world's most powerful economies, concluded that the roots of the global financial crisis are linked to the following:

> The failure of some boards of directors and senior managers to establish, measure, and adhere to a level of risk acceptable to the firm; compensation programs that conflicted with the control objectives of the firm; inadequate and often fragmented technological infrastructures that hindered effective risk identification and measurement; and institutional arrangements that conferred status and influence on risk takers at the expense of independent risk managers and control personnel. (2009, introductory letter)

The *Report of the NACD Blue Ribbon Commission on Risk Governance: Balancing Risk and Reward*, while not directly suggesting deficient board oversight of risk was a root causes of the global crisis, did infer it:

> Given the events of 2008–2009, it is clear that a broader view of risk in the context of strategic decision making is needed to help organizations properly engage risk and its consequences – with the aim of restoring public confidence in the role of boards, and in corporate governance. In this report, the BRC recommends the following ten principles to guide directors in their efforts to provide effective oversight of risk: (1) Understand the company's key drivers of success. (2) Assess the risk in the company's strategy. (3) Define the role of the full board and its standing committees with regard to risk oversight. (4) Consider whether the company's risk management system – including people and processes – is appropriate and has sufficient resources. (5) Work with management to understand and agree on the types (and format) of risk information the board requires. (6) Encourage a dynamic and constructive risk dialogue between management and the board, including a willingness to challenge assumptions. (7) Closely monitor the potential risks in the company's culture and its incentive structure. (8) Monitor critical alignments – of strategy, risk, controls, compliance, incentives, and people. (9) Consider emerging and interrelated risks: What's around the next corner? (10) Periodically assess the board's risk oversight processes: Do they enable the board to achieve its risk oversight objectives? (NACD, 2009, pp. 2–3)

Make no mistake – the root problems identified by the influential SSG, and the governance deficiencies inferred by the NACD Blue Ribbon Commission noted above, directly impacted the reliability of the financial statements of the institutions at the center

of this storm in the period leading up to the global crisis.

It appears that there is a noticeable shift occurring not only from the SSG and the NACD, but also from regulators around the world, which is resulting in demands for significantly greater focus on risk management and risk management oversight.

In February 2011, Carlo V. di Florio, Director Office of Compliance Inspections and Examinations, US Securities and Exchange Commission noted in his remarks at the CCOutreach National Seminar:

> The financial crisis revealed just how dramatically risk management failures can harm investors, jeopardize market integrity and hinder capital formation. It also revealed the interdependence between various risk categories (e.g., liquidity, funding, market, credit, operational, compliance and reputation risks), and demonstrated how that interdependence can accelerate risk concentration and harm to investors and markets.
>
> Finally, the financial crisis revealed the need for better oversight of risk at the board and senior management levels, and the need for stronger independence, standing and authority among risk management, control and compliance functions so senior management and the board understand the true risk in the business model and more proactive and effective risk management decisions can be made timely.

As of the date this article was written, the best way to summarize the findings of various commissions on the role of reliable accounting and auditing in the global financial crisis is – 'The jury's still out' – literally, in the case of some CEOs and CFOs at the center of the crisis and a number of the world's largest auditing firms, and figuratively in the case of US Congress, FASB, the SEC, PCAOB, US financial regulators and others.

The IASB and FASB, in spite of claiming bad accounting was not a key element of the problem, are scrambling to push through changes to plug at least some of the holes that allowed major financial institutions to legitimately conceal their true financial position. Many experts believe that the lawsuits filed to date, including a state of New York action against Ernst and Young linked to Lehman Brothers, are just the start of a much larger assault on why the financial statements of some of the world's largest company's were subsequently found to be massively wrong.

THE 'CONTROL-CENTRIC' APPROACH TO RELIABLE FINANCIAL STATEMENTS – WHAT IS IT AND WHAT ARE ITS DEFICIENCIES?

In 2002, Section 404 of the Sarbanes–Oxley Act of 2002 ('SOX') stated:

> (a) RULES REQUIRED. – The Commission shall prescribe rules requiring each annual report required by Section 13(a) or 15(d) of the Securities Exchange Act of 1934 to contain an internal control report which shall –
>
> (1) State the responsibility of management for establishing and maintaining an adequate control structure and procedures for financial reporting; and
>
> (2) Contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of internal control structures and procedures of the issuer for financial reporting.
>
> (b) INTERNAL CONTROL EVALUATION AND REPORTING – With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made

> by the management of the issurer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestations shall not be the subject of a separate engagement. (Section 404)

The genesis of the SOX 404 legislation was drawn from conclusions of Commissions that studied the problem of unreliable accounting dating back to the late 1970s referenced earlier in this article. Those commissions called for reports on 'control effectiveness'. Although 25 years after Cohen first called for it, SOX 404 made it the law of the land. Other countries, including Canada and Japan, have followed suit and now require management representations on 'control effectiveness'.

The SOX 404 sections referenced above were initially implemented via the much maligned and criticized Auditing Standard No. 2 ('AS2') enacted by the PCAOB. The focus of AS2 was on documenting and testing controls. A word search analysis of AS 2 reveals that it uses the word 'risk' 98 times compared with 1802 instances of the word 'control'. When the implementation of this auditing standard resulted in the SEC's original cost estimates of $91 000 (SEC, 2003, p. 41) per registrant, then escalating in the case of even medium-sized filers to millions of dollars, with the total cost of SOX 404 compliance running in the billions of dollars globally, Auditing Standard No. 2 was scrapped and replaced by Auditing Standard No. 5 ('AS5'). The PCAOB was told by the SEC to come up with a more 'risk-based' approach.

The PCAOB, listening to the resounding global criticism of the cost of AS2, made a tentative attempt to respond to criticism. In AS5, the word 'risk' appears 193 times versus the word 'control', which appears 943 times. No attempt was made by the PCAOB at the time, as far as public records and inquiries to the PCAOB reveal, to actually consult risk experts or international risk management standards to develop a true 'risk-based' approach. The fixation on documenting processes and testing controls in AS5 suggests that the PCAOB authors tried to modify their core thinking, but continued to approach their task drawing on out-dated auditing protocols and terminology that were originally developed in the late 1970s, together with the core tenets of COSO Internal Control Integrated Framework, a control framework developed around 1990–1991, more than two decades ago.

A section of AS5, PCAOB's second attempt at SOX 404 regulation, does suggest that auditors should complete a 'risk assessment', and states that auditors should focus 'more of his or her attention on the areas of highest risk'. (*Note*: presumably 'more' means more than auditors did using the guidance of AS2 which wasn't much). The relevant section of AS5 is reproduced below:

Role of risk assessment

> 10. Risk assessment underlies the entire audit process described by this standard, including the determination of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the evidence necessary for a given control.
>
> 11. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention that should be devoted to that area. In addition, the risk that a company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility

> of material misstatement to the financial statements.
>
> 12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures. (PCAOB, 2007, pp. A1–A8)

What AS5 doesn't do is specifically require that external auditors determine statistically what the most common root causes of material accounting misstatements are generally; what are the most common root causes of misstatements for the business sector being audited; what are the most common causes of material errors in the books of the specific company they are auditing; or provide any substantial guidance on how to identify and assess the likelihood and consequence of risks to the reliability of specific account balances and supplemental note disclosures given the current 'risk treatments' in place. AS5 also does not suggest that auditors use authoritative guidance on 'risk assessment' provided by the globally accepted risk management standards, such as ISO 31000, or even the risk assessment approach recommended in the much criticized 2004 COSO ERM framework to identify and assess risks to the reliability of the financial statements. These assessment frameworks are not deemed to be 'suitable' frameworks by the SEC.

On the basis of a comparison of AS5 and contemporary risk management standards, such as the ISO 31000 Risk Management Standard, it would appear that the PCAOB connotation of 'risk-based' control assessment and auditing dates back to concepts used by the accounting profession in the late 1970s, not risk assessment approaches generally accepted today by the global risk management community.

In the years following the introduction of SOX 404, compliance costs spiraled. Unfortunately, as shown in the fallout of the financial global crisis, the massively high SOX 404 compliance costs did not produce significantly more reliable financial statements.

An Institute of Management Accountants discussion paper concluded:

> In February 2007, Audit Analytics published, '2006 Financial Restatements: A Six Year Comparison.' One of the most profound trends highlighted in this report is that 512 US Accelerated Filers (companies with market capitalization in excess of $75 million) issued restatements in 2006 to correct one or more material errors in their original accounting filings with the SEC. With a total reported registrant population of 3861 Accelerated Filers, that represents an error rate of 13.3 per cent. Stated simply, the rate of material errors being corrected in original filings by Accelerated Filers in 2006 was more than one in every eight. (2008, p. 5)

Ignoring for a minute the massively unreliable financial statements published by the companies at the heart of the 2008 global crisis referenced in the last section, more current research suggests that there have been some signs of progress. A 2010 report produced by Audit Analytics 2010 suggested that the frequency of restatements had improved from the dismal performance in 2006. Financial statement restatements issued by companies covered by Sarbanes-Oxley 404 in 2010 at that time were running around 5 per cent or, stated another way, one in every 20 auditor-certified financial statements was later found to have material errors that required restatements under US GAAP. It is important to note that virtually all of the financial statements that had to be restated to correct material accounting errors contained CEO/CFO/External Auditor SOX certifications in the original filings that stated the internal accounting controls over financial reporting are 'effective'. 'Effective' is a term defined generally by the PCAOB and SEC as a conclusion that the controls that support the reliability of financial disclosures are capable of preventing even a single material accounting error/misrepresentation.

The cost of SOX 404 compliance today, while lower than costs experienced during the implementation stage, continues globally to be in the billions of dollars each year. SOX 404 compliance costs are so onerous that US Congress, via the 2010 Frank-Dodd Act, decided that in spite of the original Act calling for Section 404 (a) and (b) to apply to all public companies, small-cap public companies would be exempt from the complying with SOX Section 404(b) that requires auditors attest to the effectiveness of controls.

Although the SEC has made a few, what are best referred to as, poorly funded and half-hearted efforts to evaluate the cost/benefit of Sarbanes–Oxley Section 404, what has not been done, at least not in any serious way, is empirical research to determine the impact of SOX 404 compliance on the actual reliability of financial statements (that is how much more reliable are financial statements post Sarbanes–Oxley than they were before SOX; how much more reliable are statements year over year; and how does the reliability of statements from US listed companies compare to other jurisdictions such as Canada and the United States that have less costly regimes). This is true, in spite of the fact that collectively over 19 000 US listed companies, including major corporations with headquarters in other countries, incur SOX 404 compliance costs in the billions of dollars each year, and the fact that accounting and auditing practices leading up to the global financial crisis are now coming under intense scrutiny. (*Note*: small-cap companies are exempted from SOX 404(b) but must still comply with SOX 404(a)).

Can the control-centric approach to SOX 404 withstand the scrutiny to come? It would appear that organizations such as the SSG and NACD are already moving forward to focus on risk oversight and risk management, as noted in this article's financial global crisis analysis. Security regulators are also moving in this direction. In 2004, the New York Stock Exchange adopted governance rules that require audit committees of listed firms to oversee management's risk oversight processes. In 2009, the SEC introduced new proxy disclosure rules, requiring US listed companies to include information about the board's involvement in risk oversight in their annual proxy. Given the regulatory focus on the importance of effective risk management, if SOX 404 is left unchanged as a representation on 'control effectiveness', it will be increasingly be out of sync with the broadly accepted belief that more effective risk management is what is really needed going forward.

WHAT WOULD A TRUE 'RISK-CENTRIC' APPROACH TO SOX 404 LOOK LIKE?

Simply put, a true risk-centric approach to SOX 404 would use a 'risk-based targeting'[2] approach to allocate assurance resources, and would manifest attributes of an 'enhanced risk management' framework, such as the description offered in Annex A of the International Standard ISO 31000 Risk Management – Principles and Guidelines, considered one of the world's leading risk management frameworks. The approach would be specific to the overall objective of producing materially fault-free financial reporting. Annex A of the ISO 31000 is reproduced below. Permission to use portions of ISO 31000 was provided by Standards Council of Canada. No further reproduction is permitted without prior written approval from Standards Council of Canada.

ISO 31000 – ANNEX A

Attributes of Enhanced Risk Management

A.1 General

All organizations should aim at the appropriate level of performance of their risk management framework in line with the criticality of the decisions that are to be made. The list of attributes below represents a high level of performance in managing risk. To assist organizations in measuring their own

performance against these criteria, some tangible indicators are given for each attribute.

A.2 Key outcomes

A.2.1 The organization has a current, correct and comprehensive understanding of its risks.

A.2.2 The organization's risks are within its risk criteria.

A.3 Attributes

A.3.1 Continual improvement
An emphasis is placed on continual improvement in risk management through the setting of organizational performance goals, measurement, review and the subsequent modification of processes, systems, resources, capability and skills. This can be indicated by the existence of explicit performance goals against which the organization's and individual manager's performance is measured. The organization's performance can be published and communicated. Normally, there will be at least an annual review of performance and then a revision of processes, and the setting of revised performance objectives for the following period. This risk management performance assessment is an integral part of the overall organization's performance assessment and measurement system for departments and individuals.

A.3.2 Full accountability for risks
Enhanced risk management includes comprehensive, fully defined and fully accepted accountability for risks, controls and risk treatment tasks. Designated individuals fully accept accountability, are appropriately skilled and have adequate resources to check controls, monitor risks, improve controls and communicate effectively about risks and their management to external and internal stakeholders. This can be indicated by all members of an organization being fully aware of the risks, controls and tasks for which they are accountable. Normally, this will be recorded in job/position descriptions, databases or information systems. The definition of risk management roles, accountabilities and responsibilities should be part of all the organization's induction programmes. The organization ensures that those who are accountable are equipped to fulfil that role by providing them with the authority, time, training, resources and skills sufficient to assume their accountabilities.

A.3.3 Application of risk management in all decision making
All decision making within the organization, whatever the level of importance and significance, involves the explicit consideration of risks and the application of risk management to some appropriate degree. This can be indicated by records of meetings and decisions to show that explicit discussions on risks took place. In addition, it should be possible to see that all components of risk management are represented within key processes for decision making in the organization, e.g. for decisions on the allocation of capital, on major projects and on re-structuring and organizational changes. For these reasons, soundly based risk management is seen within the organization as providing the basis for effective governance.

A.3.4 Continual communications
Enhanced risk management includes continual communications with external and internal stakeholders, including comprehensive and frequent reporting of risk management performance, as part of good governance.

This can be indicated by communication with stakeholders as an integral and essential component of risk management. Communication is rightly seen as a two-way process, such that properly informed decisions can be made about the level of risks and the need for risk treatment against properly established and comprehensive risk criteria. Comprehensive and frequent external and internal reporting on both significant risks and on risk management performance contributes substantially to effective governance within an organization.

A.3.5 Full integration in the organization's governance structure
Risk management is viewed as central to the organization's management processes, such that risks are considered in terms of effect of uncertainty on objectives. The governance structure and process are based on the management of risk. Effective risk management is regarded by managers as essential for the achievement of the organization's objectives. This

is indicated by managers' language and important written materials in the organization using the term 'uncertainty' in connection with risks. This attribute is also normally reflected in the organization's statements of policy, particularly those relating to risk management. Normally, this attribute would be verified through interviews with managers and through the evidence of their actions and statements.

The current approach to SOX 404 mandated by the SEC and PCAOB, while claiming to be 'risk-based', is not in fact risk-based, at least not from the perspective of risk management professionals and standards. This conclusion is supported by the following authors' observations:

- Registrants are currently forced by the SEC rules to use COSO Internal Control Integrated Framework, a 'control framework', not a risk framework, as the primary assessment criteria to complete the assessment;
- The vast majority of SOX 404 assessments today are done with no attempt to utilize statistical information on the most likely areas where material accounting errors and irregularities occur;
- The vast majority of SOX 404 assessments do not direct assurance resources to assessment and testing areas proportionate with their statistically probable and highest impact risks;
- The current standards do not require a formal review when SOX 404 control opinions and the supporting external audit opinions are found to be wrong to determine what went wrong;
- The current SEC and PCAOB standards provide virtually no guidance on how to actually identify risks that threaten the reliability of the financial statements as a whole, or specific account balances and note disclosures, and how to identify and analyze the likely effectiveness of the 'risk treatments' in place to mitigate those risks.

In addition to the global risk management standard ISO 31000, other efforts are underway currently, including efforts by the Institute of Internal Auditors and Open Compliance & Ethics Group ('OCEG'), to develop formal guidance management and auditors can use to assess whether an organization has, or does not have 'effective risk management processes'. Whether the approach used should result in a binary opinion (that is, effective/ineffective), like the one currently required by SEC/PCAOB SOX 404 regulations, or ordinal (that is, providing a numeric or other form of information on the degree to which the processes manifest effectiveness) is one of the major points of debate. It is fair to say that the 'how to do it' knowledge is still at an embryonic stage.

For the definition of risk based targeting above to be true for the objective of producing reliable financial reporting with the SEC defined tolerance of zero material errors, companies would need to determine themselves, or be told by the SEC, or a source recognized by the SEC as legitimate, what areas of their financial disclosures, and the financial statements of others in their business sector, have historically shown the highest statistical probability of being materially misstated and why. Information on which elements of public company financial statements most frequently require restatements is available currently from only one credible source in the United States, a company called Audit Analytics. There is no reliable source for information on the most statistically probable root causes of restatements. Other countries, including Canada, the United Kingdom, Europe, and elsewhere do not currently have any reliable source that is statistically tracking and reporting details on material errors found in published financial statements through restatements and the root causes of those misstatements. The absence of reliable information on the statistical root causes of misstatements is, in itself, indicative of the lack of regulatory focus on determining the real risks that threaten the goal of reliable financial reporting.

The amount of disclosure companies and auditors must make when material errors in prior period disclosures are discovered is highly variable and generally limited. (*Note*: The usefulness of information on restatements should improve substantially once all information on restatements filed by public companies are categorized using globally accepted XBRL taxonomy. This will allow the areas impacted by restatements to be electronically tagged. This in turn will open up opportunities to do statistical analysis at a company level, business sector level, national level and international level on the statistically most probable areas of auditor-certified unreliable disclosures.) Historical information on the most likely areas of material error in a company's disclosures and the root cause(s) of those errors/irregularities would have to be supplemented by efforts to identify new emerging risk areas that could produce 'potential adverse impact' in the future (for example, the stock option backdating scandals, or the problems at the heart of the 2008 global crisis including collateral-backed securities and others). Identifying what is generally referred to as 'emerging risks' requires drawing on risk management processes recommended by organizations like the Bank for International Settlements, more commonly referred to as BIS, to identify emerging risks, including risks in new products, services, systems and other areas (2010, p. 10).

The Institute of Management Accountants ('IMA') in the United States produced what is arguably the most complete description of what a true risk-based approach would look like in their discussion paper 'A Global Perspective on Assessing Internal Control over Financial Reporting' issued in September 2006. (*Conflict disclosure*: One of the authors of this article is the primary author of the IMA paper.) This paper was filed with and presented to the SEC but not accepted at the time as a valid approach for SOX 404 assessments. The IMA paper, unlike PCAOB AS2, notes techniques to build a reasonable list of risks for financial reporting and provides details on how to identify relevant risks, including use of research and observation, company-specific history, experience of senior level staff, industry-specific scenario analysis, risk source analysis and industry checklists.

A sample of macro-level risks at the root of some of the most significant accounting misstatements in history, based on the author's experience and research, includes the following:

1. CEO and CFO have significant financial incentives to falsify and/or inappropriately manage financial results.
2. Senior management has major financial incentives to direct backdating of stock options.
3. Senior management directs improper/fraudulent post-close journal entries to manage profits and/or hit earning targets disclosed to the market.
4. Management overrides controls to hit bonus targets or prevent loss of positions.
5. Audit committees have financial incentives not to ask management tough questions.
6. Accounting staff are not current on accounting standards.
7. Management lacks the appropriate knowledge and skills to deal with accounting for complex or significant judgment-related transactions.
8. In-house accounting personnel lack the necessary training and experience to deal with the scope of the organization's operations.
9. The external audit team's objectivity is compromised by conflicts of interest.
10. External audit team lacks appropriate knowledge/skills, and/or the courage to challenge management's assumptions.

With some modest research funding (modest in comparison to cost of failure), this illustrative list could be refined and list in order of frequency/consequence the most significant risks that have been at the root of major financial misstatements of US listed public companies over the past 20 years. One of the

few attempts to date to empirically examine this area was published in 2008 by Marlene Plumlee and Teri Lombardi Yohn, *An Analysis of the Underlying Causes of Restatements*. Unfortunately, other than the Plumlee and Yohn paper, very little empirical research on the topic exists today. This is likely true because of the political sensitivity of completing analysis on auditing failure given the funding audit firms provide and the fact that there are significant barriers to completing that research, most notably litigation risk to companies and external auditing firms that would have to cooperate. These barriers would need to be addressed by SEC endorsement and regulatory support and sufficient funding.

Following the issuance of the IMA discussion papers on attributes of a true risk-based approach to SOX 404, a formal request was made to the SEC by the one of the authors of this article to modify their SOX 404 guidance to allow the use of ISO 31000, a generally accepted risk assessment framework (Leech, 2010). Arguably, ISO 31000 is better equipped to meet the SEC defined 'suitability' criteria than the three control frameworks currently sanctioned by the SEC. (COSO, 1992; Cadbury/Turnbull, 1994; and CoCo, 1995) The SEC's response at the time was they were only prepared to offer a response if a request to use ISO 31000 as a 'suitable' framework for SOX 404 assessments was made by a registrant via their pre-ruling process. (*Note*: The SEC has refused requests from one of the authors of this article to produce the evidence they have relied on when they concluded in 2004 that COSO 92, CoCo 95 and Turnbull 94 met their stated suitability criteria).

WHAT US CONGRESS, THE SEC AND PCAOB NEED TO DO TO PREVENT THE NEXT MAJOR WAVE OF UNRELIABLE FINANCIAL REPORTING

To improve the reliability of financial reports, including the external audit opinions that accompany them, this article proposes three relatively simple steps.

1. *Congress makes a simple amendment to Section 404 of the Sarbanes–Oxley Act of 2002.* To implement a true risk-based approach capable of reducing the number and magnitude of material errors in financial statements, we recommend SOX 404 be amended as follows:

   SEC. 404. MANAGEMENT ASSESSMENT OF FINANCIAL REPORTING RISK MANAGEMENT PROCESSES.

   (a) RULES REQUIRED. – The Commission shall prescribe rules requiring each annual report required by Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 USC 78m or 78o(d)) to contain risk management effectiveness report, which shall –
      (1) state the responsibility of management for establishing and maintaining adequate risk management processes for financial reporting; and
      (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the risk management processes of the issuer for financial reporting.

   (b) RISK MANAGEMENT PROCESSSES EVALUATION AND REPORTING. – With respect to the risk management processes assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

2. *The SEC issues new guidance on how to assess the effectiveness of the risk management processes that support the objective of materially fault-free financial reporting.* The SEC would need to amend its current guidance for management and describe how

to evaluate the effectiveness of a company's risk management systems that support the core objective of issuing materially fault-free financial disclosures. This would need to include methods that are accepted by the global risk management community. This guidance would need to require, at a minimum, that the risks that statistically have been at the root of materially wrong financial statements over the past 50 years be identified and assessed, as well as statistically probable risks, including emerging risks, relevant to a company's specific business sector and personal accounting restatement history. Once a list of statistically material risks is produced, management would need to, as a minimum, evaluate the likely effectiveness of the current 'risk treatments' (a term similar to 'control' that is preferred by ISO 31000) in place to mitigate the statistically most dangerous risks to reliable financial disclosures. Any SOX 404 work done to date that can be linked to the most statistically probable/high-consequence risks to the goal of materially fault-free financial reporting would still be relevant.

The changes necessary to convert from the current costly 'control-centric' approach to one that uses globally accepted risk management principles has been outlined in more detail in two IMA discussion papers: *Accounting Control Assessment Standards: The Missing Piece in the Restatement Puzzle and A Global Perspective on Assessing Control Over Financial Reporting*.

The SEC could also draw on guidance issued in December 2010 by the Institute of Internal Auditors titled *Assessing the Adequacy of Risk Management Using ISO 31000*.

To date, the SEC has refused written requests to formally recognize risk management approaches and standards identified in frameworks such as ISO 31000 and the more dated and lengthy 2004 COSO ERM as 'suitable' frameworks for SOX 404 assessments.

3. *The PCAOB issues new guidance for external auditors on how to assess and opine on the effectiveness of a company's risk management processes.*

Once the SEC has issued sufficiently detailed guidance for management on how to complete their assessment of the effectiveness of their risk management processes that support the goal of reliable financial disclosures, auditors should be able to use the same criteria to independently opine on the effectiveness of the company's risk management processes supplemented by guidance on how to assess and report on the effectiveness of management's risk management processes.

THE BUSINESS CASE FOR MOVING TO A TRUE 'RISK-BASED' SOX 404 APPROACH

The three steps proposed above to transition from the current control-centric approach to a true risk-based approach would be relatively inexpensive to implement by legislators. There would, however, need to be significant changes to the current SOX 404 and Canadian equivalent NI 52-109 assessments being done today by over 24 000 US and Canadian listed companies (Directory of Public Companies in the United States). This would entail some initial short-term incremental implementation costs to determine and address the statistically probable root causes of material errors and irregularities. The approach used by tens of thousands of external auditors and tens of thousands of internal SOX 404 assessment staff around the world would also have to change.

Reliable information on the root causes of materially wrong financial statements would need to be kept and analyzed and used to better identify, measure and track risks to reliable reporting, ideally linked to XBRL tags to allow for sophisticated computer analysis. The real risks to the objective of materially reliable financial statements would need to be identified, including sensitive risks, such as 'CEO and CFO collude and manipulate earnings', 'CFO/Controller isn't technically current', 'Accounting staff aren't adequately

qualified and/or trained', 'external audit team lacks required experience and knowledge', 'external audit staff's objectivity has been compromised', and the adequacy of the risk treatments in place re-evaluated. On the basis of informal polls taken by the authors of this article at scores of presentations around the world, evaluation of this type of hugely material, but highly sensitive risks to reliable financial reporting does not occur in any serious documented way in the majority of publicly listed companies today.

Radical change is rarely easy to implement, and Congress may be reluctant to embark on this path in the absence of a persuasive business case. A list of critical reasons why US Congress should take the bold step of amending the wording of SOX 404 follows:

REASON #1 – The current control-centric approach to SOX 404 costs a lot and produces a high failure rate

To date, no country in the world other than the United States has accepted the cost/benefit business case for SOX 404(b) that requires a separate external auditor opinion on 'control effectiveness'. Only the United States has elected to require a separate auditor opinion on control effectiveness. In spite of the United States requiring two separate and very costly opinions on 'control effectiveness' – one from a company's CEO and CFO and the other from the company's external auditor each year – there is no empirical support that this costly approach produces any more reliable results than the assurance approach taken in countries such as Canada and the United Kingdom. Neither of these countries requires a separate opinion from the company's external auditor that financial reporting controls are 'effective'. Both emphatically rejected adopting the equivalent of SOX 404(b) based on cost/benefit analysis done by regulators in those countries. In spite of companies being forced to spend tens of billions of dollars each year opining on control effectiveness, there is also no empirical research that the authors of this article are aware of the fact that demonstrates that US listed financial statements are statistically more reliable in the post-SOX 404 world than they were before SOX 404 was enacted.

The truth is that there is clear evidence that thousands of US listed companies that have spent billions of dollars to implement the current control-centric approach to SOX 404 have published materially wrong financial statements. Annual reports from the US-based Audit Analytics continue to confirm that, although the numbers of materially wrong financial statements published by US listed financial statements have decreased since peaking in post-SOX 2006, the total dollars of misstated balances each year continues to be a staggering number. If the balance sheets of the organizations at the root of the 2008 global financial crisis that have been assessed by some as 'technically correct, but massively wrong' are included in the misstatement total, it is literally an 'earth-shaking' number.

REASON #2 – The current control-centric approach misses the really big risks

In the years leading up to the global financial crisis of 2008, companies around the world accumulated trillions of dollars of assets whose value was directly linked to one key assumption – the US housing market would continue to rise indefinitely. Figure 2, featuring an index of American housing prices going back to 1890, published by Yale economist Robert J. Shiller, provides a graphic illustration of why that assumption should have been regularly and aggressively questioned as a key risk by both management of the companies at the center of the global financial crisis and their external auditors (Tapscott and Tapscott, 2008).

In addition to identifying risks to asset valuations, including the risk of a correction, there should have also been formal analysis of

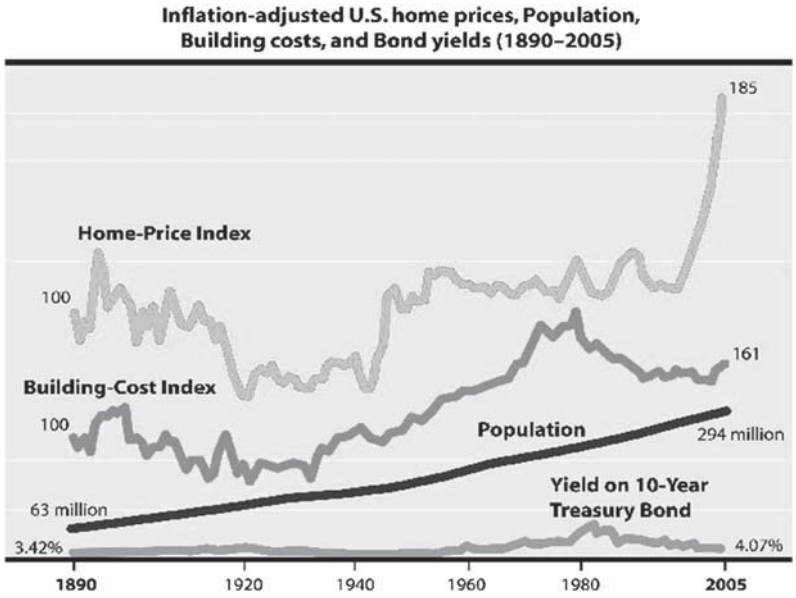


Figure 2: A History of US home values.
Source: Shiller (2006), Figure 2.1.

the 'risk treatment' strategy in place in all companies impacted by that chart to manage the risk the trend line would not continue to rise forever. In cases where this risk was 'financed' or 'transferred', the ability of the counterparty to absorb the risk should have similarly been rigorously examined. The risk management processes related to the asset value assigned to these assets should have been rigorously examined and opinions provided to the board on the effectiveness of the risk management processes and the adequacy of the risk treatments in place. No evidence has been produced that this step was done as part of the massively expensive SOX 404 control effectiveness assessment process.

What is certain is that billions of dollars were spent during the run-up period of 2005–2008 on internal and external staff testing controls linked to line items of those companies' financial statements that have never been, and are likely never to be, the source of material errors. By way of illustration, very few companies or their external auditors identified the reward systems in companies at the root of the global crisis as material risks to the reliability of the financial statements. Commissions have also identified deficient board oversight of risk as another major root cause. On the basis of research done by one of the authors of this article SOX 404 control effectiveness assessments have rarely, if ever, determined that any US listed company has a deficient audit committee (Leech and Gupta, 2004, p. 18). Major commissions in the United States and globally are unanimous that reward systems and deficient risk oversight are two of the root causes of the financial crisis. A true risk-centric approach that included the SEC stipulating the statistically most probable and significant risks to reliable financial reporting would have at least stood a chance of identifying this type of risk. History demonstrates that control-centric SOX 404 testing using the now dated COSO 92 control framework as criteria completely missed the mark. COSO 92 puts very little emphasis on the importance of aligned reward systems or rigorous

board oversight of risk management processes including those used to ensure reliable financial reporting. (*Note*: COSO announced plans in late 2010 to update the 1992 COSO Internal Control Integrated Framework. However, it is important to note that the COSO chair stated 'This project is not intended to change how internal control is defined, assessed, or managed, but rather provide more comprehensive and relevant conceptual guidance and practical examples'.)

REASON #3 – The current approach isn't aligned with ERM methods

Companies that are working on implementing some form of enhanced ERM to better manage risks of all types currently face a significant problem. The SOX 404 assessment approach required by the SEC and PCAOB is not aligned with generally accepted risk assessment methods and terminology. If a company uses enterprise risk management software, they must have one module for SOX 404 work and a separate system or module for other elements of ERM. This means that companies must implement a pure form of risk assessment approach across all of their operations using the type of approach in ISO 31000 or COSO ERM, except for the objective of publishing materially fault-free financial statements. For that objective, they must use the type of methods prescribed by the SEC and PCAOB that their external auditors will accept, including the use of the COSO 1992 Internal Control Integrated Framework, which does not use modern risk management terminology.

The need to use separate terminology and approach creates yet another 'silo' – the 'SOX 404 control effectiveness silo'. Silos are another one of the global crisis root causes identified by major commissions. The SOX 404 silo today must use terminology and approaches that are inconsistent with those used to implement ERM in virtually all other areas of the company. In essence, work units must learn two different languages – SOX 404 Control centric terminology, and another for ERM based on the type of terminology found in ISO 31000 and the related ISO Guide 73. This creates considerable additional expense and confusion. The SEC now requires proxy disclosures related to risk oversight, and boards will be asking management whether they believe risk management to be effective for all aspects of the company, except the goal of reliable financial reporting. For that dimension the board receives management's opinion on control effectiveness, not risk management effectiveness.

REASON #4 – Assure the world that the United States is taking tangible steps to fix one of the root causes of the global crisis

The general global consensus is that the roots of the global financial crisis were planted and nurtured in the United States through a confluence of factors, including political support for the creation and support of gigantic organizations such as Freddie Mac and Fannie Mae charged with making affordable housing; reward structures in the major US financial institutions at the root of the crisis; deficient regulatory oversight; accounting standards and auditing practices that allowed for accounting deception vehicles such as the now infamous REPO 105 transactions; deficient capital requirements and regulatory oversight; and others. The dramatic decline of the US dollar relative to other major currencies around the world is evidence of a decrease in global confidence in the US governance and political systems.

What has not yet been acknowledged, perhaps as a result of the enormous influence of the major auditing firms, is the role the accounting and auditing frameworks, including the costly SOX 404 regime currently in place in the United States, played in the period leading up to the global financial crisis. If the United States is to regain its position as the most trusted economy in the world, dramatic steps need to be taken. One of those steps could be to acknowledge

that, in spite of imposing costs in the tens of billions of dollars on US listed companies all over the world through SOX 404 as a solution to unreliable financial reporting a massively costly and arguably obsolete solution that has not worked very well in terms of assuring investors financial statements are reliable. Recognizing this fact, US Congress, rather than attempting to continue to defend and maintain a costly regulatory regime that does not work very well, is taking dramatic steps and replacing the current control centric SOX 404 process with one that focuses on, and better treats, the truly material risks to the reliability of financial disclosures.

SERIOUS POSITIVE CHANGE – WHAT WILL IT TAKE?

At the current time, few people have raised the points made in this article about the link between a flawed SOX 404 regime and the global financial crisis, and few are objecting to the current SOX 404 regime for any reasons other than cost and inconvenience. This article makes a case that the current control-centric SOX 404 regime should be added to the list of root causes of the global crisis and steps taken to address it. This will take a concerted and joint effort by legislators, regulators, public companies and the accounting and external audit professions starting with the willingness of US Congress to amend the wording of SOX 404. If US Congress is willing to make the legislative amendments proposed in this article, the authors believe it would be a monumental step towards preventing another massive wave of unreliable financial reporting. This article will be distributed to all the major US Congressional Committees and international committees studying what went wrong in the period leading up to the global financial crisis, as well as the SEC, PCAOB and security regulators in other major countries. A small legislative change could make a massive difference in restoring global confidence in US corporate governance and capital markets.

NOTES

1 ACAP-US Treasury Advisory Committee on the Auditing Profession.

2 Risk-Based Targeting: Allocation of funds and other resources to areas identified as having the highest actual or potential adverse impact. *Source*: Business Dictionary .com, http://www.businessdictionary.com/definition/risk-based-targeting.html, accessed April 2011.

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