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Abstract

In an attempt to bolster public confidence in the accounting profession, the PCAOB issued several standards that were intended to address weaknesses in audit reporting and to increase public confidence in financial reporting. One of these standards, Auditing Standard No.2, added two opinions on an enterprise's internal control to audit reporting requirements. This Standard was superseded by Auditing Standard No. 5, which eliminated one of these opinions. The purpose of this paper is to examine the efficacy of the elimination of the auditor's opinion regarding management's assessment of internal control. The data in this study were taken from 10-K reports filed by Fortune 500 Companies in 2004-2007. From the 10-K reports, copies of audit reports were gathered for 114 of the 120 largest companies and the opinions (unqualified, qualified, or adverse) were recorded.

Keywords: Auditor Opinions, Assessment of Internal Control, Audit Report Format

1. Introduction

Financial reporting scandals and volatility in the stock market have generated significant losses to investors, dampening confidence about the American economy. In today's market, trust does not seem to be prudent. From financial statements and market analysts to politicians and company executives, enough evidence of impropriety has surfaced to raise legislative and investor skepticism for years to come. At the forefront of this problem are concerns regarding the ethical behavior of business enterprises, the effectiveness of financial reporting standards, and trustworthiness of the independent audit function.

The accounting profession has lobbied fervently to continue its history of self-regulation. However, cases involving illusive accounting practices and audit failure have led Congress to create legislation that challenges the profession's ability to do so. The Sarbanes-Oxley Act of 2002 was signed into law on July 30, 2002. The Act was intended by Congress to address the perceived systemic and structural weaknesses affecting financial reporting practices. Specifically, the Act is intended to improve the accuracy and reliability of corporate disclosures that are made pursuant to the U.S. federal securities laws, hold corporate managers responsible for such disclosures, and provide transparency in financial reporting in independent audits of public companies (107^{th} Congress, 2002). The Act, which many consider the most significant change to securities law since the Securities and Exchange Act of 1934, created the Public Company Accounting Oversight Board (PCAOB) and fundamentally changed the way that public enterprises conduct business and how the accounting profession performs audits. The provisions of this Act apply only to public companies and public accounting firms that prepare or issue audit reports for public companies (Akin, Gump, Strauss, Hauer, & Feld, 2002).

In an attempt to bolster public confidence in the accounting profession, the PCAOB issued several standards that were intended to address weaknesses in audit reporting and to increase public confidence in financial reporting. One of these standards, Auditing Standard No.2, added two opinions on an enterprise's internal control to audit reporting requirements. This Standard was superseded by Auditing Standard No. 5, which eliminated one of these opinions. The purpose of this paper is to examine the efficacy of the elimination of the auditor's opinion regarding management's assessment of internal control.

2. Background

The Sarbanes-Oxley Act had a significant impact on financial reporting standards and on public enterprises. The formation of the PCAOB effectively shifted the responsibility for promulgation of auditing standards that apply to public companies from the Auditing Standards Board to the PCAOB. During the pre-PCAOB era, the only opinion the auditor was required to express was on the financial statements. However, Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, required an audit opinion concerning management's assessment of the effectiveness of internal control over financial reporting and the auditor's own opinion regarding the effectiveness of internal controls.

The Sarbanes-Oxley Act also placed responsibility on public enterprises to include in all annual reports management's assessment of the effectiveness of the company's internal control over financial reporting in addition to the enterprise's audited financial statements as of the end of the most recent fiscal year. Management's assessment report must include the following:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to conduct the required assessment of the effectiveness of the company's internal control over financial reporting;
- An assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether that internal control over financial reporting is effective; and
- A statement that the independent registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal Control over financial reporting.

This requirement was effective for public company filings occurring between June 17, 2004 and November 15, 2007. The requirement for the auditor to express an opinion on management's assessment of internal controls was eliminated by issuance of PCAOB Auditing Standard No. 5, which superseded PCAOB Auditing Standard No. 2. Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, was issued on July 25, 2007 and became effective on November 15 of that year. The PCAOB explained its rationale for eliminating the auditor's opinion regarding management's assessment in PCAOB Release 2006-007. The logic was that the opinion was redundant – the auditor was already required to directly express an opinion on the effectiveness of internal controls. The following sections of this paper provide empirical support for this position.

In an attempt to bolster public confidence in the accounting profession, the PCAOB issued several standards that were intended to address weaknesses in audit reporting and to increase public confidence in financial reporting. One of these standards, Auditing Standard No.2, added two opinions on an enterprise's internal control to audit reporting requirements. This Standard was superseded by Auditing Standard No. 5, which eliminated one of these opinions. The purpose of this paper is to examine the efficacy of the elimination of the auditor's opinion regarding management's assessment of internal control.

The data in this study were taken from 10-K reports filed by Fortune 500 Companies in 2004-2007. From the 10-K reports, copies of audit reports were gathered for 114 of the 120 largest companies and the opinions (unqualified, qualified, or adverse) were recorded.

3. Methodology

The data in this study were taken from 10-K reports filed by Fortune 500 Companies in 2004-2007. This time frame was selected for several reasons. First, this period begins after the Sarbanes-Oxley Act was passed in 2002 and includes a brief time in 2004 before Auditing Standard No. 2 required an internal control assessment by management and the

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associated auditor attestation regarding management's assessment. Second, this four-year period contains the entire period during which the auditor was required to issue all three opinions (one about the fairness of the financial statement, one about management's assessment of internal control and one about the effectiveness of the company's internal control), as well as a stub period at the end 2007 during which attestation of management's assessment of internal control (the second opinion) was no longer required.

From the 10-K reports, copies of audit reports were gathered for 114 of the 120 largest companies. The opinions (unqualified, qualified, or adverse) expressed by the independent auditor were recorded in a spreadsheet.

4. Data and findings

Audit reports for 114 companies were obtained. (Audit reports for six of largest 120 companies were not publicly available.) Table 1 shows the type of opinion received for each year from 2001-2004. No companies received a qualified opinion during any of the four years. As the table shows, no company from the top 120 Fortune Companies received an adverse financial statement opinion in 2004, and only one company from this group received an adverse opinion in 2005-2007. This result is expected since large public companies' financial statements have been audited for many years, and these companies are motivated to present financial statements that comply with generally accepted accounting principles. Audited statements reduce information risk to investors interested in the enterprises run by managers. This in turn provides incentive for managers to engage independent auditors. Such desire for "better information for investment decision making" has long been referred to as the information hypothesis (Wallace, 1980).

Table 1: Type of audit opinion received by year

Panel A: Financial Statement Opinion

	2004	**2005**	**2006**	**2007**
Adverse	0	1	1	1
Qualified	0	0	0	0
Unqualified	114	113	113	113
No opinion	0	0	0	0

Panel B: Auditor's Opinion Regarding Management's Assessment of the Effectiveness of Internal Control

	2004	**2005**	**2006**	**2007**
Adverse	0	0	2	0
Qualified	0	0	0	0
Unqualified	89	106	105	12
No opinion	25	6	6	102

Panel C: Auditor's Assessment of the Effectiveness of Internal Control

	2004	2005	2006	2007
Adverse	6	7	4	2
Qualified	0	0	0	0
Unqualified	84	101	105	105
No opinion	24	5	5	7

Since companies were first required to provide reports on internal control in 2004, several companies might be expected to receive an opinion other than an unqualified during the period from 2004-2007. In fact, auditors' assessments of internal control produced six and seven adverse opinions in 2004 and 2005, respectively (see Table 1). The number decreased to four and two in 2006 and 2007. This result might be expected since public companies had not reported on the effectiveness of their internal controls prior to 2004, and the ability of these companies to satisfy audit requirements might be expected to increase with experience.

Another salient observation from Table 1 is that the number of adverse opinions on management's assessment of internal control was substantially fewer than the number of adverse opinions by auditors regarding the effectiveness of internal controls for each year from 2004-2007. Table 1 shows only two adverse opinions about management's assessment of internal control, but nineteen adverse opinions concerning the effectiveness of internal controls. Several explanations are possible. First, management may have correctly expressed concerns regarding material weaknesses that were present in their system of internal controls. The auditor then would provide a similar evaluation of the effectiveness of the control system. Alternatively, this result might be expected since management was aware that their system of internal control was going to be evaluated, and there was communication between management and the auditor regarding weaknesses that were present. Further research in this area could lead to a better understanding the cause(s) for this finding.

5. Conclusion

During the four-year period 2004-2007, the PCAOB required three audit opinions: one on the financial statements, one regarding management's effectiveness of internal controls, and one regarding the auditor's own assessment of internal controls. Since Auditing Standard No. 5 eliminated the auditor's opinion regarding management's assessment of internal control, the implication is that this opinion was not particularly useful. The data in this study support this notion. The finding in this study that the auditor's opinion regarding management's assessment of the effectiveness of internal control showed so few adverse opinions indicates that the auditor's own assessment of internal controls constitutes adequate reporting on the effectiveness of internal controls. An opinion on management's effectiveness of internal control seems an unnecessary reporting step since management has little incentive to misstate its opinion because the auditor is making an independent evaluation of the internal control system. Further, the communication that exists between management and the auditor reduces the likelihood that management's overall assessment of internal control at the end of the day will be significantly different from the auditor's.

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