Reliability and continuity of EDP systems

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Introduction

In addressing the implications of the recent Dutch requirement for auditors to comment on the relability and continuity of EDP Systems in their report to management I would first like to provide a background of international developments touching on the role of the auditor. Then I will summarize the actions being taken in a number of countries around the world relating to internal control and the role of the auditor. I will comment on certain specific aspects of the Dutch requirement in Article 393:4, review modern audit approach , services and business in light of these developments and finally will provide some thoughts on the future direction of the auditor's role.

International Developments

During the 1980s a series of corporate failures round the world called into question the role of the auditor. The savings and loans situations in the United States, some spectacular business failures in the UK, Canada, Australia and other countries led to criticism of our profession – 'Where were the auditors?' The public tended to associate *corporate* failure with *audit* failure, while the accounting profession fell back on the defence that the public had too high an expectation of auditors. This expectation gap was a possibility foreseen by Professor Theodore Limperg of the University of Amsterdam in his series of articles, (written in the 1930s), on 'The Function of the Accountant and the Theory of Inspired Confidence'. I quote (in English!) 'There are two alternatives in the event of confidence placed, and the manner of fulfilment, not covering each other; there can be an *exaggerated* confidence or a *shortcoming* in the fulfilment of the function. (My quoting Professor Theodore Limperg demonstrates how well Gijs Bak took care of the education of his colleagues in IFAC's International Audit Practices Committee where I first met him). This 'expectation gap' has led to a series of excellent studies and reports around the world examining the role of auditors.

The MacDonald Commission in Canada produced a report in June 1988 entitled The Public's Expectations of Audits. It concluded that, 'for the most part, the public's expectations of audits are reasonable and achievable ... and expectation gaps will be narrowed only by the profession's acceptance of the need for change and improvement'. Such a conclusion would not have surprised Professor Limperg who saw that the services of the accountant are used in order to meet a need of the community, that it is expected that the accountant will meet the need and that the needs of the community will change in the course of time.

The MacDonald Commission report and other reports have focused on the community's need and the auditor's role in the context of corporate governance – the responsibilities and relationships of the board of directors, management, regulators, major stakeholders and independent auditors. Such a report is the United Kingdom's Cadbury report, one of whose conclusions is that the board of directors should 'retain full and effective control over the

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company and monitor the executive management', and further, that 'the directors should report on the effectiveness of the company's system of internal control'.
Of great significance to these initiatives is the report issued in September 1992 in the United States 'Internal control – integrated framework'. This was commissioned by the committee of sponsoring organizations – known as COSO – of the Treadway Commission. It was written by Coopers & Lybrand and provides a definitive framework against which businesses and other entities can assess their control systems and determine how to improve them. The report has been remarkably well received around the world as an authoritative statement on the subject and is emerging as the basis on which most countries are likely to develop guidance for management and auditors.

A key feature of the COSO report is its breadth, defining internal control as encompassing all aspects of controlling a business. Internal control is seen as a *process* designed to provide reasonable assurance, not absolute assurance, in relation to:
- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with applicable laws and regulations

Internal control is seen as consisting of five inter-related components, derived from the way management actually runs a business:
The Control Environment, which sets the tone of the organization, the foundation for all the other elements, providing discipline and structure. It consists of such features as integrity, ethical values, competence, management philosophy and operating style, delegation, the development of people and the direction provided by the Board of Directors.
Risk Assessment, what risks may stand in the way of a corporation achieving its objectives and how can they be managed.
Control Activities, the policies and procedures that help ensure that management directions are carried out and that necessary actions are taken to address risks. Control activities consist of such things as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.
Information and Communication, accurate and timely information to enable people to carry out their responsibilities. It includes not only information system reports which contain operational, financial and compliance-related information that makes it possible to run and control the business, but information about external events necessary to informed business decision-making. It is also broad in scope, including external parties such as customers, suppliers, and shareholders.
Monitoring, the process of assessing the quality of the internal control system's performance over time. It includes ongoing monitoring in the course of operations and separate evaluations deemed necessary according to the risks identified and the effectiveness of ongoing monitoring procedures.

I thought I should provide this detail of the COSO report for two reasons:
- Its significance to the future development of standards of governance and the responsibily of the auditor.
- To provide a background against which to view the recent requirement in Dutch corporate law that the auditor refer in his report to management on the 'reliability and continuity of EDP Systems'.

Actions Being Taken Around the World

So what actions are being taken around the world? My colleagues on the C&L's International Professional Standards Committee have provided me with information which I can summarize as follows:

In the *United Kingdom* a joint working group of preparers of financial statements and the accounting profession, as recommended by the Cadbury Committee, is developing crite-

ria for assessing the effectiveness of a company's system of internal control and guidance for directors on how to report on this to the company's shareholders. A taskforce of the Auditing Practices Board is developing guidance for auditors on how to examine, and report on, the directors' statement. The guidance drafted to date is based on the framework developed in the COSO report. An interesting conclusion in the first draft, however, is that, while agreeing that directors have responsibility for all aspects of internal control, including effectiveness and efficiency of operations, it is believed sufficient for the directors to report on the effectiveness of internal *financial* controls i.e. controls over preparation of a corporation's published financial statements.
The *Canadian Institute of Chartered Accountants* has established a Criteria of Control Committee (known as COCO), which includes operational and compliance controls and is considering the development of an auditing standard setting out definitive guidance on the communication of matters identified during an audit of financial statements.
In *Germany*, I learn that it is possible that the Institute will set up a working group on auditing internal control, following the COSO and Cadbury reports. However, there is a strong sense that the subject is already dealt with sufficiently in German professional literature and statements, particularly in the requirement for a long form audit report. This report must state specifically whether the accounting records comply with the legal regulations and German professional and ethical rules extend that to include reporting on the system of internal control, in practice restricted to reporting on significant changes or weaknesses.
In *South Africa*, a committee on corporate governance, known as the King Committee, has been formed but has yet to report.
Australia is closely monitoring developments around the world and considering what initiatives it should undertake to highten awareness of the role which internal control can play in management. Its Auditing Standards Board has commissioned a discussion paper on 'The Concept of Internal Control and External reporting on Internal Control'.
In the *US* the AICPA's auditing standards board is revising SAS 30 under the new title 'Reporting on an entity's Internal Control Stucture Over Financial Reporting' which will provide guidance to auditors when they are required 'to report on management's written assertion about the effectiveness of an entity's internal control structure over financial reporting at a point in time'.

The International Auditing Practices Committee has a project on 'reporting on Internal Control' which has not yet progressed very far. It appears that it is in the context of a separate attest engagement recognizing the requirement for an independent set of criteria for evaluating internal control and a framework for reporting.

Specific aspects of the Dutch Requirement

It is clear that the Dutch requirement is consistent with a trend around the world for the auditor to play a role in assessing and reporting on internal control. However, the Dutch requirement is legislated by the government, whilst elsewhere the accounting profession, in its self-regulatory mode, is taking the initiative though perhaps with the prospect of government intervention if it fails to do so. An exception tends to be in the financial service sector, because of the need for protection of depositors, where government or government agencies in their regulatory role have imposed statutory obligations on the auditors. In the UK, for example, the auditors must report generally on internal controls to the regulator of financial institutions and in Canada there is a growing number of statutes governing financial institutions which now require the auditor to communicate certain transactions and conditions encountered during an audit of the financial statements.
The preferred approach which is evolving

around the world is for internal control to be recognized as the responsibility of management, who should be required to report on its effectiveness, while the auditor's role would be to examine and report on management's statement.

But before proceeding further, let us examine the Dutch requirement more closely. First of all it speaks of 'the reliability' of EDP systems. Clearly this falls within COSO's concept of internal control. Relevant, accurate and timely information is required by management to run the business effectively. It is also clearly linked to the objective of reliable financial reporting, including the prevention of fraudulent public financial reporting, with which the auditor is directly concerned. Under auditing standards around the world, the auditor is required to examine internal controls on which he intends to rely in determining the nature, timing and content of other audit procedures, essentially his substantive tests of account balances in the financial statements. There will be cases, therefore, where the auditor might choose not to examine the system of internal control and therefore not to address directly the reliability of the EDP system. He might be able to arrive at his opinion on the financial statements without assessing the risk that the system of internal control is not designed properly or operating effectively. In such a case he would have no basis for making any observation about the reliability of the EDP System in his report to management, and would presumably say so. This may come as a surprise to management, who may believe that the auditor *was* examining the system of internal control. It may also cause dismay, leading management to ask why the auditor does not examine the system of internal control. The dismay will be more acute if it turns out that there was a problem in the reliability of the EDP system. Clearly, therefore, this is an issue on which there needs to be an understanding between management and the auditor at the outset. It would be advisable for the auditor to discuss his audit approach, and consequently the nature of any comments that might be made in the report to management, before the audit starts. This might lead to a change in both the scope of the audit and the cost.

The Dutch requirement also speaks of the continuity of the EDP system, by which is understood the ability of the business to continue obtaining necessary information in the light of a system failure or disaster. This is a risk that businesses face, the degree of risk being related to the dependency of the business on its EDP System. As we saw earlier, the assessment and management of such risk is one of the components of internal control as analyzed by COSO. However, this risk does not appear to bear directly on the reliability of financial reporting, or at least not on the historical financial statements that the auditor is examining. An auditor might question whether management has plans to address such a risk and might comment on the absence of an effective back-up and recovery plan in the same way as he might comment on inadequate insurance or ineffective hedging policies to protect against foreign exchange risk. In other words, a discretionary service provided by the auditor, not seen as fundamental to issuing an opinion on the financial statements but of benefit to management. Some, however, might make a different case. Namely that, if disaster affecting the EDP system could threaten a corporation's ability to stay in business, it becomes a going concern issue, threatening a basic concept on which the financial statements have been prepared. In effect, the business is being operated in an unsafe manner which could result in its being unable to continue in business should disaster strike. Clearly, this is important information for the shareholder, just as the existence of other significant business risks would be important knowledge. The question arises, if the auditor has additional information which would be useful to shareholders, should he be required to report it publicly? Would that meet the public's expectations? The MacDonald Commission described the additional knowledge the auditor has obtained as

a result of his audit as a 'bucket', perhaps with the sense that the auditor should empty it when reporting to the shareholders. Sensibly the commission recognized that the first requirement should be for the *financial statements* to provide more information, particularly relating to risk and uncertainty, alternative values, going concern issues and management's discussion and analysis of results and prospects. Accounting standards are in the process of being developed in Canada on these issues. This approach reinforces the traditional relationship between management's responsibility to provide information to the shareholders and the auditor's role to lend credibility to these statements by reporting on them. And clearly this is the trend internationally. I do not see the Dutch legislative action as contrary to those developments, rather as providing further impetus to them in the Netherlands. It is now up to the profession to set the standards to meet these requirements and there is significant research and precedent around the world to assist in that process.
On the other hand there is the traditional role of auditors providing services to clients in assessing effective business control. When one hears of losses in foreign exchange trading, of failure to comply with securities laws resulting in significant fines, of breaches of environmental regulations, it is the result of a breakdown in internal control in the broad sense defined by COSO. Auditors are skilled at assessing the effectiveness of business controls and in this area we carry out successful mandates for our clients that stretch far beyond the scope of a statutory audit.
In real life it can be difficult to get people to consider precautions against a potentially disastrous event. First of all people may simply think that a disaster is too terrible to contemplate, and the cost of identifying and putting in place alternative arrangements can be high. The rationalization for not doing anything is that the possibility is remote. However, surveys in the UK of the top 500 companies show the encouraging result that 80% either have plans in place or have a project to address the issue. Closer scrutiny reveals that these plans may not always be as effective as management would expect if ever put to the test. An interesting example of a disaster recovery plan is that of a major food retailing client in Canada, with close to two hundred stores and twenty-five thousand employees, which suffered a fire which destroyed its head office and computer centre. Fortunately, it had put in place a disaster recovery plan which it had rehearsed. It had arranged for a hotsite in the US the effectiveness of which it had tested. As a result employees received their pay cheques on time three days after the fire. Stores continued to get supplies, based on model shipments prepared for each store in the event of disaster, based on each store's history. I said they had rehearsed it, but they had not rehearsed under simulated crisis conditions. One problem they encountered was that they had to send two trailer vans full of tapes to the US site and they got held up at the border – by customs. It required a midnight call to the American ambassador to Canada to get them released.

Thoughts on the Future Direction of the Auditor's Role

First, I would like to quote a statement from the MacDonald Commission report on the Public's Expectations of Audits, published in June 1988:
'The Commission gave serious consideration to the need for some basic restructuring to help the profession minimize expectation gaps – we have considered the present corporate disclosure system ... and related responsibilities assigned to different parties ... the existing organization of the accounting profession and its arrangements for setting standards and regulating performance by auditors ... and the kinds of business engaged in by public accounting firms. Our final conclusion is that the available evidence does not clearly require basic change in any of these structures. However, this conclusion could change if the profession does not recognize and respond to the

present and potential expectation gap problems ...
The future of the profession will be determined mainly in two places ... the marketplace of users, depending on user perceptions of cost-effective value added by audits – the second is in the regulatory bodies, government and courts.'

That is five years ago, and in my perception we have not heeded that warning. What was an expectation gap is now a crisis of confidence – a serious threat to the future of our profession. We are going to have to deal with issues of fraud, illegal acts, poor risk management, weaknesses in external control. We will have to rebuild trust. If we can look to the US, where this crisis of confidence may be most acute, the AICPA's Board recently issued the following statement: 'Public confidence in the financial reporting system has been shaken in recent years by highly publicized business failure which have raised questions about the effectiveness of the independent audit function and the integrity, objectivity and competence of independent auditors and the self-regulatory system. Action is needed to solidify public trust'. This statement introduces an initiative to undertake significant reforms in pursuit of five major goals:
- Improving the prevention and detection of fraud;
- Making financial statements more useful;
- Assuming auditor independence;
- Rationalising the liability system;
- Sharpening the teeth of self-regulation.

In summary, therefore, I would observe that:
- The auditing profession around the world is suffering a crisis in confidence;
- The changes that this crisis is bringing about will affect the scope of financial reporting as well as a broadening in the role of the auditors;
- The focus is on internal control, spurred and facilitated by the definitive COSO report;
- The accounting profession has the opportunity to set the appropriate standards for these changes;
- But the regulators around the world are impatient and are pushing for action.

Literature

Theodore Limperg. The function of the accountant and the theory of inspired confidence *MAB* 1932/1933; english version in *'The social responsability of the auditor'*, 1985 Limperg Instituut Amsterdam.