Sometimes absence of evidence is evidence of absence

A host of laws and regulations make it clear that the managers of public companies, not their auditors, are responsible for establishing and maintaining effective internal control over financial reporting and regularly assessing the effectiveness of those controls.

External auditors are charged with assessing the effectiveness of management’s efforts and forming an opinion as a basis for designing their audits. For certain large companies, auditors must also express a separate written opinion on those controls.

In recent months, regulators have been responsible for reviewing the work of auditors in the United States and from around the world. They have found a growing number of cases where auditors “failed to obtain sufficient appropriate evidence to support its opinion on the effectiveness of internal control.”

Audit firms have taken criticisms from regulators seriously and have changed their approach. For many audit clients, the new approach means more extensive procedures related to internal controls. For some companies, though, audit changes have caused big problems, including lengthy delays in issuing financial statements, drastic increases in audit work, and millions of dollars of additional audit fees.

The vast majority of companies may believe that they have plenty of evidence to support their assessment of internal control. But a growing number of auditors and their regulators aren’t so sure.

In a recent speech, Andrew Ceresney, Director, Division of Enforcement for the SEC, said a company was cited for having inadequate internal controls when it recorded revenues—without sufficient proof that customers had accepted goods sold. “Senior leadership was not asking the tough questions—and sometimes not even asking the easy questions,” he said. “Senior management, in some cases, was just not engaged in any real discussion about the controls. As a result, employees did not properly focus on them, and the firm and its shareholders are put at risk.”

The message for public companies is clear: regulators and auditors have begun to demand that companies adopt a more evidence-based approach to manage their risks and assess their controls.

What is evidence-based risk management?

Evidence-based risk management is the practice of integrating evidence collection, organization, and analysis for the purposes of risk identification, assessment, and control.

Each year, companies make bold statements in their Form 10-Ks, such as: Our management conducted an evaluation on the effectiveness of our internal control over financial reporting based on the Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 Framework). The evaluation concluded that our internal control over financial reporting was effective.

On top of those bold statements, CEOs and CFOs sign individual certifications stating that they, personally, evaluated
the effectiveness of their financial reporting controls and concluded on their effectiveness.

Yet, CEOs, CFOs, and other senior executives are often far removed from the details of such controls. What could possibly give them confidence to take personal responsibility for their effectiveness? In one word—evidence.

Having said that, few senior executives attribute their success to gullibility. Many are quite proud of their professional skepticism. As semiconductor pioneer Andy Grove once put it, “Only the paranoid survive.” What kind of evidence would prove sufficient to convince a professional skeptic? Does your internal controls process provide that quality of evidence?

To answer that, let’s take a look at two common situations where auditors frequently criticize companies for lack of adequate evidence.

**Recognizing the evidence gap**

**Situation 1**

Managers often point to management meetings held to review operational and financial performance as a key management review control. After all, each of the managers who participate is actively engaged in the business and has a deep understanding of how the business operates and the likely results. If the reported results were materially wrong, these managers would certainly spot the errors and correct them.

Unfortunately, despite conducting these important meetings, key details are often missed in the final record. Specifically there is often:

- No agenda, meeting minutes, or follow-up emails that demonstrate the managers actually reviewed the results, had questions about them, followed-up on those questions, and resolved them successfully
- Absence of the criteria the managers used to identify exceptions worth considering
- No record of the evidence the managers considered to explain variances, or lack of variance, from what they expected

**Situation 2**

Managers often point to their reviews of analyses and the critical calculations prepared by their staff to support important assertions in their financial statements. They sign and date the documents to prove that they reviewed them.

Unfortunately, signatures do not provide needed information about the depth of their review. In many cases, there is:

- No record that they tested the calculations to ensure they were accurate
- Little to no supporting documentation or validation evidence
- No explanation of why and how they concluded that assertions were consistent with GAAP or company policy
- Failure to document why and how they concluded the analyses and/or critical calculations were reasonable

If you were CEO and relying on managers to perform these and similar controls, would you feel comfortable declaring that you were personally responsible for their effectiveness? If not, what kind of evidence would help, and how would you get it without adding to the workload of the people involved?

**Closing the evidence gap**

Companies fail to collect the evidence they can trust for several reasons:

1. The individuals charged with the work aren’t told that they need to collect evidence, and/or there is no consistent way to check their progress throughout the process
2. They lack a consistent, cost-effective way to collect and organize the evidence
3. They struggle with multiple versions of key documents and templates which often have inconsistent data
4. They lack a single repository where they can store, organize, and access the evidence quickly and easily

Further, adding more people, procedures, or making processes more complicated usually compounds the problem.

**What can be done?**

The problem isn’t your people. It’s the tools they have to work with, or rather the lack of integrated risk management tools to help them do their job. The key word here is integrated.

Collecting, organizing, and managing large amounts of disconnected pieces of evidence manually, and usually on an adhoc basis, simply doesn’t cut it in today’s complex business environment—as evidenced by the auditing problems highlighted by the SEC, the Public Company Accounting Oversight Board, and other international regulators.
These approaches are doomed to failure because they don’t scale to enterprise requirements any more than doing your company’s accounting using columnar sheets and calculators. Your financial team members need tools that blend seamlessly into their day-to-day routine, helping make what is otherwise a near impossible job, easier.

Fortunately, there are new cloud-based, reporting platform technologies designed specifically to address the problems of evidence collection, organization, and management—making evidence-based risk management a reality.

Companies adopting these technologies have been able to improve control performance, eliminate version control problems, automate storage and retrieval practices, and reduce the time demands on their jobs—in addition to improving the quality, timeliness, and usefulness of evidence.

**Make it easy to trust**

Evidence-based risk management gives us the ability to trust the results. Collecting evidence also provides an effective reminder of the steps we must take to earn trust.

It’s evidence that enables managers of public companies to be confident and demonstrate to their auditors and senior executives that their internal controls are effective. However, if the act of collecting, organizing, or managing evidence is too hard, it does not get done, at least not consistently, and therein lies the problem.

New cloud-based tools have proven that they can help streamline and simplify the processes, and in doing so, make people’s jobs easier. They make it possible to close the global evidence gap and provide managers and their auditors the ability to trust their results.

**About the authors**

Joseph Howell is a co-founder and Executive Vice President of Workiva. Joe has over 25 years of experience in senior financial management and SEC reporting, and has served as a chief financial officer for several public companies, including EMusic.com, Merix and Borland, and several private companies, including Eid Passport and Webridge. Joe also served as managing director at Financial Intelligence LLC, a company that provides accounting and SEC disclosure advisory services. A certified public accountant (Inactive), he earned a BA from the University of Michigan and an MS in accounting from Eastern Michigan University.

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**Resources**

