



**SCHOOL OF ECONOMICS  
AND MANAGEMENT**  
Lund University

Master Thesis  
June 2006

Department of Business Administration

# Internal Control

- Efficiency in the Audit Process

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# Summary

- Title:** Internal Control - Efficiency in the Audit Process
- Seminar date:** 2006-06-13
- Course:** Master Thesis in Business Administration FEK 591, 10 Swedish credits (15ECTS)
- Authors:** Cecilia Nordenadler  
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- Keywords:** Internal control, Efficiency, Audit methods, The Swedish Code of Corporate Governance, Sarbanes-Oxley Act
- Purpose:** The purpose of this research is to examine the implications of the provisions in the Swedish Code of Corporate Governance (the Code) concerning auditor attestation of the internal control report. We will focus on how the auditors' augmented responsibilities will affect the efficiency in the audit process.
- Methodology:** An inductive approach and a qualitative research method have been utilised in a descriptive manner to illustrate the effects of the new internal control requirements from the auditor's perspective.
- Theoretical perspectives:** The literature study presents previous research on the field of study to enhance the understanding on how the Code provisions on internal control affect the efficiency in the audit process. Regulations concerning internal control, such as the Swedish Code of Corporate Governance, Sarbanes-Oxley Act, Cadbury Report and other international frameworks are presented.
- Empirical foundation:** Interviews with six respondents have been conducted. The views and opinions of the respondents constitute the empirical foundation of our research.
- Conclusions:** Our research indicates that the main benefit from reviewing the internal control report is achieving more reliable internal controls, which results in greater prevention of misstatements in the financial statements. This will affect the efficiency in the audit process since the auditor can place more reliance on internal controls when performing audit procedures. This implies that the benefits of preventing misstatements could outweigh the efforts and resources spent on reviewing the internal control report.

# Sammanfattning

- Titel:** Intern kontroll - effektivitet i revisionsprocessen
- Seminarie datum:** 2006-06-13
- Ämne/Kurs:** FEK 591 Magisteruppsats, 10 poäng
- Författare:** Cecilia Nordenadler  
Elisabeth Änghede
- Handledare:** Professor Anne Loft  
Professor Claes Norberg
- Nyckelord:** Intern kontroll, Effektivitet, Revision, Svensk kod för bolagsstyrning, Sarbanes-Oxley Act
- Syfte:** Syftet med denna uppsats är att undersöka implikationerna av de nya kraven på revisorerna gällande intern kontroll som Svensk kod för bolagsstyrning (Koden) ger upphov till. Fokus ligger på hur revisorns utökade ansvarsområden kommer att påverka effektiviteten i revisionsprocessen.
- Metod:** En induktiv ansats och en kvalitativ forskningsmetod har använts för att på ett deskriptivt sätt, ur revisorns perspektiv, illustrera effekterna av de nya kraven på en rapport om intern kontroll.
- Teoretiska perspektiv:** Litteraturstudien behandlar tidigare forskning på området för att öka förståelsen om hur effektiviteten i gransknings processen påverkas av Koden regler angående intern kontroll. Även regelverk gällande intern kontroll presenteras, bland annat Svensk kod för bolagsstyrning, Sarbanes-Oxley Act, Cadbury Report samt andra internationella regelverk.
- Empiri:** Intervjuer med sex respondenter har genomförts. Respondenternas uppfattningar och synpunkter utgör den empiriska grunden i vår undersökning.
- Slutsatser:** Den huvudsakliga nyttan med att granska den interna kontroll rapporten är att mer tillförlitliga interna kontroller uppnås vilket resulterar i att felaktigheter i de finansiella rapporterna kan undvikas. Detta påverkar effektiviteten i revisionsprocessen eftersom revisionen kan förlita sig på interna kontroller i revisionen. Detta medför att fördelarna med att förebygga felaktigheter kan uppväga resurserna som spenderas på att granska den interna kontroll rapporten.

# Preface

This thesis would not be possible without the respondents at Deloitte, Ernst&Young, KPMG and Öhrlings PriceWaterhouseCoopers who took time to answer our questions and thereby contributed with valuable information. We would like to thank these people for their effort. Furthermore we would like to thank our supervisors, Anne Loft and Claes Norberg, who assisted us with good advice and suggestions.

Lund, June 2006

Cecilia Nordenadler

Elisabeth Änghede

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# Abbreviations

<b>AICPA</b>	<b>American Institute of Certified Public Accountants</b>
<b>COSO</b>	<b>Committee of Sponsoring Organizations of the Treadway Commission</b> Provides a framework for internal control
<b>ESB</b>	<b>Ethics Standards Board</b> Responsible for identifying and setting the agenda for the development of ethical standards by the accountancy bodies in the UK
<b>EU</b>	<b>European Union</b>
<b>FAR</b>	<b>Föreningen för revisionsbyrå branschen</b> Authorised Public Accountants' Association in Sweden
<b>FASB</b>	<b>Financial Accounting Standards Board</b> Issues accounting standards in the US
<b>FRC</b>	<b>Financial Reporting Council</b> Independent regulator for corporate reporting and governance in the UK
<b>IAASB</b>	<b>International Auditing and Assurance Standards Board</b> Issues international Standards on Auditing
<b>IASB</b>	<b>International Accounting and Standards Board</b>
<b>ICAEW</b>	<b>Institute of Chartered Accountants in England &amp; Wales</b>
<b>IFAC</b>	<b>International Federation of Accountants</b>
<b>ISA</b>	<b>International Standards on Auditing</b> Standards issued by International Auditing and Standards Board
<b>OECD</b>	<b>Organisation for Economic Co-operation and Development</b>
<b>PCAOB</b>	<b>Public Company Oversight Board</b> Oversees the auditors of public companies. It is created by the Sarbanes-Oxley Act of 2002.
<b>RS</b>	<b>Revisionsstandard</b> Auditing standards in Sweden based on IAS
<b>U.S. SEC</b>	<b>U.S. Securities and Exchange Commission</b> Supervise the American stock markets
<b>SOU</b>	<b>Statens offentliga utredningar</b> The Swedish Government Official Reports

# 1. Introduction

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*The new Swedish Code of Corporate Governance requires companies to issue an internal control report, which must be reviewed by an auditor. We intend to examine how this additional review affects the efficiency in the audit process. The efficiency we intend to explore refers to how the audit process can be conducted with the least expenditure of efforts and resources while still achieving the objective of reliable audits. This chapter will present the background relevant to understand the current context in which auditors in Sweden operate.*

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## 1.1 Background

In the wake of recent accounting scandals such as Enron and Parmalat, the failure of auditors to detect and reveal illegal practices in these companies was obvious. Investors and the public expected auditors to provide a so-called ‘whistle blowing function’, which they failed to do. Audit reports issued before the fraudulent practices came to light, did not communicate any problems even though it seemed obvious that some companies did not accurately fulfil their accounting responsibilities. This turn of events has seriously crippled the audit profession’s credibility. After these scandals the main priority of regulators in the US as well as in Europe has been to restore investor confidence. In the US new legislation was passed swiftly. The Sarbanes-Oxley Act of 2002 aimed at rebuilding trust. It introduced stricter and more rigorous rules regarding corporate governance. While regulators in Europe acted less rapidly to what has been referred to as the global disease ‘Enronitis’, the Parmalat debacle made it obvious that Europe was not immune to these problems (Engelen 2004, Vinten 2003). Although legislation was perceived as necessary in Europe, the Sarbanes-Oxley Act was not well received because of the extraterritorial powers given to the Public Company Oversight Board (PCAOB) to ensure compliance with its rules. An industry spokesman described the meaning of the Sarbanes-Oxley Act as follows:

That’s when two members of U.S. Congress fiddle and half a million accountants in Europe start dancing. (Engelen 2004)

Since the Sarbanes-Oxley Act was released, other countries have followed the US example and issued new corporate governance codes or best practice recommendations. In the two years following the implementation of the US legislation, 28 countries published similar regulations (Baker 2005). In Sweden the Swedish Code of Corporate Governance (hereafter the Code or the Swedish Code) was introduced in 2004. To prevent future auditing failures and to restore trust in financial reporting, regulators and standard setters around the world introduced measures to effectively reduce the risks.

### 1.1.1 The Evolving Audit Context

Auditors are facing a new context in which they operate, created by scandals and the impact they have had on laws and regulations. To prevent further incidents of Enron-magnitude, regulations are being imposed upon the audit profession on a global, regional and local level. By responding to these new requirements auditors can retain the legitimacy they need to justify the audit function in society. The role of the auditor could be described as lending credibility to the financial statements. There exists a need for investors to be reassured that management is reporting business operations of the company in a true and fair way. Since they are unable to attain this information by themselves, the audit provides the mechanism through which this need is fulfilled (Flint 1988). The demands and expectations on how the auditors are to conduct their function are not static conditions. The president of the International Federation of Accountants (IFAC), Graham Ward, emphasises that the accountancy profession is facing new challenges with a stricter regulatory framework (Ward speech 2005a). The societal pressure to increase regulation has resulted in a number of different rules to which the audit profession must comply. New duties and responsibilities have also been introduced.

These rules and standards originate from several sources. As mentioned the jurisdiction of the Sarbanes-Oxley Act expands across borders but national and regional codes and standards must also be considered. Hence the profession must respond to a complex network of regulations with competing jurisdictions (Held and McGrew 2002 p. 10). The regulations impose new aspects to the auditors' responsibilities by which auditors have to conform, in order to enhance investor confidence. As Graham Ward mentions in a speech regarding demands on the accounting profession to maintain high quality:

While we all may have the best of intentions, meeting these criteria is difficult in today's environment. We are pressed to do more in fewer hours and to deliver "real time" information. (Ward 2005b)

Among the new duties required of the auditor is reviewing internal control reports, which is the focus of this research. In the next section we will discuss the development of internal control provisions and regulations which are influential in the Swedish context.

## 1.1.2 Internal Control Requirements

The debate regarding mandatory internal control reports started over 20 years ago. As early as 1978 the Cohen Commission, in the US, encouraged companies to issue reports to indicate the effectiveness of internal controls. In 1987 the Treadway Commission, in the US, recommended that companies should report on management's assessment of accounting systems and controls. A framework developed by the Committee of Sponsoring Organizations of the Treadway Commission in 1992 (Hermanson 2000). In the UK the Cadbury Report from 1992 covered provisions regarding corporate governance and internal controls. It utilised a 'comply or explain' model<sup>1</sup> which has since then been influential when preparing codes in other countries. Hence, internal control is not a new concept, but the mandatory report on the internal control issued by the board of directors and management required by section 404 in the Sarbanes-Oxley Act of 2002 introduced a communication forum, which previously was not available (Hiseu Lin and Wu 2006). Auditors are required to attest to the board of directors' and management's assertions concerning the internal control in the US. The Public Company Oversight Board (PCAOB) issued Auditing Standard No. 2 *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, which constitutes a more comprehensive regulation for achieving compliance with section 404 of the Sarbanes-Oxley Act of 2002. It establishes a process to conduct audits of internal control in conjunction with auditing the financial statements.

According to a PCAOB report on the implementation of Auditing Standard No. 2, released on 30 November 2005, there is evidence that the auditors are not effectively accomplishing the objectives of the standard. The report suggests that the audit methodologies are not efficient, a term which refers to achieving the objectives of the standard with the least expenditure of effort and resources (Report on implementation of AS 2 2005 p. 2). The PCAOB acknowledges the challenges of implementation in the first year. They believe that if future audits are performed in accordance with the standard, resources and time will be utilised more efficiently. Experience from the American implementation of internal control provisions is relevant to understand the possible implications of introducing equivalent regulation in Sweden.<sup>2</sup>

In the new world economic order, auditors on a national level must adhere to global, regional and national rules. Among these are the new 8<sup>th</sup> Company Law

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<sup>1</sup>The principle 'Comply or Explain' derives from the UK and the Cadbury Report (1992). See further section 2.5.

<sup>2</sup>Through the extraterritorial powers of the Sarbanes-Oxley Act the rules in the legislation applies to auditors of companies listed on US stock markets regardless of jurisdiction. In Sweden 15 companies are registered with US Securities and Exchange Commission (SEC), therefore the rules in Sarbanes Oxley apply to these (Precht 2005). Hence, the internal control provisions in section 404 could have a direct influence on auditors in Sweden, however this is beyond the scope of this thesis.

Directive applicable to statutory audits in the EU member states. The EU adopted the new Directive on 25 April 2006 ([www.euractive.com](http://www.euractive.com) 2006). This new regulation, which includes provisions on internal controls, also concerns corporate governance issues and is aimed at prohibiting further scandals and restoring investor confidence (Press release 2005).

So far we have dealt with global and regional internal control regulations but auditors in Sweden must also adhere to the Swedish Code of Corporate Governance, applicable since 1st of July 2005, which is the focus in this study. The internal control provisions in the Code resemble in many respects the Sarbanes-Oxley Act, however the Code is considered to be a light version of the American legislation. It is applicable to 46 companies on the A-list at Stockholm Stock Exchange and to 32 companies with a market value over 3 billion Swedish crowns on the O-list ([www.omxgroup.com](http://www.omxgroup.com) 2006). Section 3.7 in the Code covers the responsibilities of the board of directors and management to issue an internal control report and the duty of auditors to attest to the validity of the report. In the Swedish context there are many regulations with overlapping jurisdictions to consider. The multilayered regulation patchwork is complex and could result in confusion of which rules to give priority to (Held and McGrew 2002). While implementation of new internal control reporting requirements has already begun in the US, auditors in Sweden have only recently been forced to deal with the challenges of this new responsibility as a result of internal control provisions in the Code.

## **1.2 Field of Study**

The Code introduced the new concept of an internal control report in the Swedish context. The report shall be prepared by the board, and be included in the annual report. It constitutes a complement to the Swedish legislation and companies listed at the Stockholm Stock Exchange are required either to comply or to explain deviations from the Code. Auditors are required by this regulation to review the report and express an opinion (the Code p. 3.72). Guidance for companies on how to implement the Code was released in 2005. Neither the Code nor the guidance for companies includes criteria, form or scope applicable for auditors. Although the companies have been subject to the regulation, which was effective from the 1st of July 2005, the auditors were granted respite from carrying out the review the first year. Auditors experienced a lack of guidance on how to perform this duty. It has been referred to by some as an 'empty frame', one which must be filled with recommendations and rules (Precht 2006). In absence of more detailed guidance auditors will be reluctant to sign off on internal control reports (Precht 2006). A transition period in 2005 has been allowed for auditors. During this period FAR (The Authorised Public Accountants' Association in Sweden) is responsible to produce a recommendation for auditors carrying out the review (FAR INFO nr 1 2006) and a recommendation is

circulating for consideration. According to Lars Träff, President of FAR and Dan Brännström, Secretary General of FAR, the intention of the guidance is that the auditors will be able to provide opinions on internal control (Waymaker 2005).

In the US, the cost of implementing section 404 has been a major concern for many parties (Hall and Gaetanos 2006) and this issue has also been discussed in Sweden (Halling 2004). The new regulation could increase the demand for auditing services (Halling 2005) however the method by which auditors will perform this new duty is not yet evident. The magnitude of the effect on the traditional auditing services is unclear and depends on which procedures and techniques the auditors will apply in order to provide an opinion. In the American model, which to some degree is influencing the Swedish framework, the review of internal control is aimed to be conducted in combination with performing the audit of financial statements. Whether auditors in Sweden will implement this model will influence the development of audit fees and hours spent on reviewing internal control reports. As noted earlier, according to the report issued by the PCAOB, problems with effectiveness when auditing the internal control reports were revealed in the US. This could imply that the same concerns might arise in the Swedish context.

### **1.3 Purpose and Basic Question**

In this thesis we will examine the implications of the Swedish Code of Corporate Governance requirements concerning auditor attestation of the internal control report. We will focus on how the auditors' augmented responsibilities regarding the internal control report review will affect the efficiency in the audit process. The efficiency we intend to explore refers to how the audit process can be conducted with the least expenditure of efforts and resources while still achieving the objective of a reliable audit. The basic question of the thesis is:

How will the review of the internal control report affect the efficiency in the audit process in a Swedish context?

### **1.4 Definitions**

Our definition of efficiency originates from the PCAOB's terminology. They refer to efficiency as a process conducted with least expenditure of effort and resources while still achieving the objective of a reliable audit. We have chosen three areas that we believe is related to the efficiency in the audit process; cost-benefit, synergies in the audit process and the framing of regulations. Cost-benefit is directly applicable to the efficiency concept since it evaluates whether the utility of

the review exceeds the costs. Synergies could influence the efficiency by reducing expenditures and efforts in the audit process. The framing of regulations and recommendations could influence the methods used when reviewing the internal control reports. The degree of detail in the recommended review procedures for auditors affects how efficiently the work progress can be conducted and how reliability of the internal control report can be secured. We define the audit process as the methods and procedure used to conduct both the review of the internal control report and the audit of financial statements. The integration of these processes is essential to the outcome of introducing the new requirement.

There are three different types of audits and related services according to International Standard on Auditing 120, which are mentioned in this thesis; audit (revision), review (översiktlig granskning) and agreed-upon-procedures (granskning enligt särskild överenskommelse). They provide different levels of assurance, which is a concept that in this context refers to the auditor's satisfaction regarding the reliability of an assertion being made by one party. In an audit a high but not absolute level of assurance that the information audited is free of material misstatement. The auditor expresses this positively as reasonable assurance in the audit report. A review provides a moderate level of assurance that the information is free of material misstatement. In the audit report the auditor expresses negative assurance where the auditor states that no material weaknesses have been detected. Agreed-upon-procedures do not provide an expressed assurance since these are procedures agreed upon with the client and not an independent audit where an opinion is expressed in an audit report. The auditor only provides a report of the factual findings (www.ifac.org 2006a).

## **1.5 Delimitations**

The corporate governance debate world-wide has in the recent years resulted in the creation and implementation of new laws and regulations in many countries. In this thesis we will only conduct empirical research on the Swedish Code of Corporate Governance, although other national and international regulations will be presented as a frame of reference. The regulations chosen for this purpose, the US Sarbanes-Oxley Act, the UK Cadbury Report, the EU's 8<sup>th</sup> Company Law Directive and the audit standards issued by IAASB, have all been significant when developing the Swedish Code of Corporate Governance. Of course there are other influences relevant to the development and awareness of corporate governance, for example France, Australia and the Netherlands, which have been progressive in this area. However we are not able to include them all in our thesis and we have chosen the ones we have found to be most frequently debated in Swedish professional journals.

Further, we limit our research to the paragraphs in the Swedish Code of Corporate Governance concerning internal control. We take an auditor perspective and only the required review of the internal control report is examined. These delimitations result in a focused research, which we find preferable in such a broad and scattered field as corporate governance. The empirical studies carried out in this thesis consist of six interviews with respondents from the Big Four audit firms Deloitte, Ernst&Young, KPMG and Öhrlings PriceWaterhouseCoopers. We have chosen to not interview auditors from smaller audit firms because the requirement of an internal control report only applies to public companies with market value over 3 billion Swedish crowns, which in Sweden are usually audited by one of the Big Four. In addition the larger audit firms are often progressive and take a leader role, setting guidelines influencing the audit profession.

## **1.6 Outline**

The remainder of this thesis will be structured in six chapters. In the next chapter we will present a literature study relating to audit efficiency. The content in this chapter will be relevant when conducting the analysis of the empirical findings to be able to support our conclusions. This chapter is aimed to provide a comprehensive conception of the challenges ahead, which might emerge due to the new regulation. In chapter three the research method utilised to achieve the purpose outlined above will be described. With this chapter we will provide the reader with the ability to critically scrutinise the stringency of the thesis. In chapter four regulations concerning internal control will be presented, to achieve a more profound apprehension of the subject at matter. Laws and regulations relevant to our field of study will be presented. The internal control provisions in the Code will be described since the implications of this for auditors are of interest for this study. However other regulatory frameworks from other jurisdictions and international standards have influenced the auditors and the Code, and are therefore also included in this chapter.

The empirical findings will be described in chapter five. It will be structured into four parts, each dealing with a separate theme in order to facilitate the analyses of the findings. This structure is preferable to provide a synopsis of the respondents' answers and further the ability to obtain an overview perspective of the material. The analyses of each theme presented in the preceding chapter will be presented in chapter six, however the discussion will not strictly follow this theme structure. In certain areas it is necessary to go beyond the theme structure utilised in the presentation of the empirical findings to achieve a dynamic analysis. In the last chapter of the thesis we will present our conclusions and the chapter is aimed to answer our basic question. Furthermore the study have induced suggestions for future research in certain areas, which will be described in the last chapter.

## **1.7 Chapter Summary**

In this introductory chapter we have presented the field of study and a background to the current context in which auditors in Sweden operate. A new responsibility for auditors in Sweden is to audit the internal control report required by the Code. While the Code is developed and applicable in Sweden it has been influenced by global regulations and these will be more extensively presented in chapter four. This thesis has an auditor perspective concerning the implications on the audit process. In the next chapter we will present a literature study relevant to understanding possible implications of the internal control provisions.

## 2 Literature Study

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*In this chapter literature relevant to understand the factors which might influence audit efficiency will be presented. By utilising this literature when analysing the empirical findings in chapter six we hope to be able to obtain support for our conclusions. The literature is concerned with cost-benefit, synergies and the framing of regulations when introducing the auditor review of internal control reports.*

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### 2.1 Chapter Introduction

This chapter contains a literature study divided into four sections relevant to the basic question of this thesis. Next section is concerned with different perspectives on audit efficiency. The second section presents literature on cost-benefit relevant to an internal control perspective. In the third section we will present three factors influencing the potential synergies of performing a review of the internal control report in relation to the audit of financial statements. The last section explains aspects concerning the framing of regulations and the principle ‘comply or explain’. The insight and understanding of the literature presented will constitute the basis when analysing the empirical findings.

### 2.2 Perspectives on Efficiency

When using the concept of efficiency different perspectives can be applied, depending on the context in which it is discussed. In the Webster dictionary efficiency is defined as the ability to produce a desired effect with a minimum of effort, expense or waste. This constitutes a general definition of the concept. In the common debate we expect that the concept might be utilised without extensive considerations of the definition. Cultural background and nationality might also affect what is perceived efficient. We are aware that our respondents could have individual conceptions of what the term efficiency implies and might use it in a more common language. Our literature study deals with both popular debate and scientific research, and these might result in arguments based on different perspectives on efficiency. The literature does often not include definitions of the terminology regarding this concept. Academic literature also tends to lack definition of efficiency.

Depending on the field of research and the background, the authors of the articles in our literature study might have different frame of reference, for example economic, social or legal perspectives. This might have implications on the interpretations of their conclusions and therefore it is important to recognise that this factor could affect comparability. We have applied a definition utilised by the

PCAOB, which is an American perception of efficiency that potentially could be different from the view of our Swedish respondents. However if we revisit the general definition we found in the Webster dictionary we recognise the different components in the definition utilised by PCAOB, which we intend to use. In our definition the desired aim is to achieve a reliable audit with the least expenditure of resources and efforts. Three areas we perceive as related to our concept of efficiency are the audit process; cost-benefit, synergies in the audit process and the framing of regulations.

## 2.3 Cost-Benefit

A cost-benefit analysis is essential when evaluating the efficiency in the audit process. In order for the internal control review to create value, the benefits obtained must compensate for the additional costs. An efficient audit process will reduce costs while still obtaining the objectives of a reliable audit. This section is concerned with the debate regarding cost-benefit of introducing reviews of internal control reports. The literature we employ mainly originates from an American context and is therefore concerned with implementing the provisions in section 404 of the Sarbanes-Oxley Act. We will discuss whether the benefits of mandatory internal control reports attested by auditors justifies the costs. Compliance costs due to section 404 have been quantified in studies but the benefits of introducing the new requirements suffer from difficulties to be quantified.<sup>3</sup> Furthermore it is not obvious to whom the positive effects of the regulation are aimed at, the investors, public interest or perhaps the companies themselves. We will start with presenting the debate in professional journals regarding the potential benefits of introducing the new requirements.

Detection and prevention of fraud is expected to be the result of introducing section 404 of the Sarbanes-Oxley Act of 2002 (Martin 2005). Reducing the threat of corporate scandals regarding fraud is by some interpreted as the major benefit of implementing the new legislation.<sup>4</sup> However, this could be a misguided aim according to other parties. One reason for this is that the traditional concept of internal control implies mechanical procedures and a narrow scope, with only the accounting process in focus (Hsieu Lin and Wu 2006). Riise Johansen (2006), who wrote a paper on the consequences of corporate governance in an auditor context, expresses the opinion that there is actually very little evidence that the new legislation in the US has the inherent properties to prevent corporate scandals.

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<sup>3</sup> See Hermanson (2000) who prior to the Sarbanes-Oxley Act studied the demand for internal control reports. He concluded that whilst the users of the reports agreed that mandatory reporting would enhance oversight and improve controls, they were neutral as to whether they thought it would affect decision-making.

<sup>4</sup> Earlier studies concerning detection of fraudulent behaviour could not present any evidence for increasing likelihood of detection when evaluating internal controls (Smith *et al.* 2000), see further section 2.4.

One interesting aspect of the subject in question is whether the implementation of the provisions in section 404 of the Sarbanes-Oxley Act has actually resulted in disclosure of material weaknesses in companies' internal control systems. In 14 percent of the reports, weaknesses were disclosed but the reactions from investors were not significant (Riise Johansen 2006). At a London conference for internal auditors where some non-US internal auditors expressed that they do see benefits of section 404, due to increased documentation and systematic testing of systems. The internal auditors argued that senior management has gained increased understanding of controls and how effective they are in practice, since a more rigorous and prescriptive approach is required (Baker 2005). Enhanced investor confidence is cited as a benefit resulting from implementing section 404. It is also believed to improve financial reporting quality. However in a comment letter to SEC internal auditors stated that the first year compliance costs were excessive in relation to the benefits received (Cornett *et al.* 2005). This was also one of the concerns ICAEW expressed as a reason why the extensive regulations implemented in the US were not deemed to be suited for the UK (ICAEW submission to SEC roundtable 2005).

Preparing the mandatory report adds additional costs and management is required to maintain an adequate system, which is an ongoing-process. To be able to comply with the legislation companies might be forced to direct more resources into software, consultants, internal audit functions and external audit fees. These costs are attributed to extended needs of documentation, detailed policy developments, self-assessment and attestation requirements. Expenses related to compliance with section 404 increased on average with 3.1 million USD per company (Hall and Gaetanos 2006). Costs due to increased auditor fees accounts for 24 percent of the expenses to comply. Further, 36-44 percent of the fees are derived from the actual audit of the report required by section 404 (Riise Johansen 2006). This increase in costs has made delisting from US stock exchanges a hot topic in the debate on the implications of Section 404 in the Sarbanes-Oxley Act. According to some this alternative might be especially attractive for smaller companies trying to avoid overwhelming compliance costs due to the new legislation (O'Conner 2005). However delisting might be difficult due to dependence on the US capital market (Precht 2005).

The costs of requiring auditors to attest to the internal control report have been considered in the Swedish context. While some parties were reluctant to accept the additional costs auditor attestation would imply, the Code group believes that the benefits of the report in absence of attestation might be seriously limited (SOU 2004:130). Therefore this requirement was not removed in the final version of the Code. Further they expect the cost of compliance in smaller less complex companies to be insignificant (SOU 2004:130). However in the American context implementation in the first year suffered from deficiencies according to a report on the implementation of Auditing Standard No.2 issued by the PCAOB. When these deficiencies are corrected the costs could be reduced (Report on

implementation 2005). It is therefore of interest to consider the experience of implementation in the US to gain understanding of what to expect from the Swedish regulation. In the next section potential synergies of introducing reviewed internal control reports will be discussed.

## **2.4 Synergies in the Audit Process**

Creating synergies in the audit process is essential to improve the efficiency when reviewing the internal control report. The costs due to this new requirement can be reduced if synergies can be obtained between the review of the internal control report and the audit of financial statements. Even though auditors were not required to audit reports on internal control over financial reports prior to the Sarbanes-Oxley Act of 2002, a number of studies have dealt with the potential usefulness of this function. Furthermore the above mentioned report from PCAOB on the implementation of Auditing Standards No. 2 provides a current discussion on the problematic issues with implementing mandatory internal control reports. According to the official report on implementation some audit procedures and methods were not utilised optimally in the first year of implementation (Report on implementation 2005). In this section we will present three areas that provide opportunity to obtain synergies in the audit process when implementing the internal control provisions. We will examine the influence on audit efficiency when auditors apply the following audit procedures and methods:

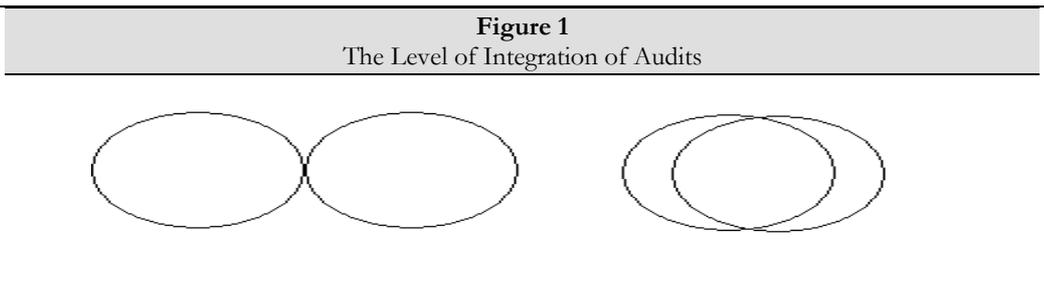
- integrated audits,
- using the work of others and
- applying a risk-based approach.

The PCAOB performed inspections of auditors to assess the effectiveness and efficiency of the audits with respect to the objectives of Auditing Standard No. 2, which include applying these methods and audit procedures. An audit of internal controls over financial reporting is conducted to identify any potential material weaknesses. The PCAOB stresses that the audit should not be designed to detect deficiencies, which are neither material individually nor in the aggregate (Report on implementation 2005 p. 5).

### **2.4.1 Implementation Difficulties**

In Auditing Standard No. 2 the intention is that the auditor performs the audit of financial statements and internal control audits in conjunction. This integrated approach implies a use of procedures designed to simultaneously achieve the objectives of both audits. Knowledge obtained in one area might result in

improvements in planning and performing the other. The major problem with efficiency in the US, according to the PCAOB report on implementation of Auditing Standard No. 2, was due to the inability of auditors to conduct these audits in an integrated manner during the first year of implementation. Time-consuming double work was the result when two parallel audits were performed. The failure of some auditors to use the information obtained about deficiencies found in one area to improve the audit of the other also reduced audit effectiveness (Report on implementation 2005 p. 8).



*Fig. 1 The audit efficiency is depending on the level of integration of financial statement audits and the audit of internal controls. Implementation of Auditing Standard No. 2 implies contemporaneous audits with the auditor taking advantage of the knowledge and experience from one area to improve audit procedures of the other.*

According to an early study by Kreutzfeldt and Wallace (1995) auditors perceive evaluations of internal control as useful when auditing financial statements. They investigated whether client attributes such as internal controls could be useful to predict error rate. They found that internal control attributes could be used in audit planning to predict error rate (Kreutzfeldt and Wallace 1995). Interaction between substantive testing and internal control systems and the related matter of resource allocation to these procedures has been examined in more recent empirical studies. In a situation where internal controls are strong the incentive for management to override the system decreases (Smith *et al.* 2000). Smith *et al.* (2000) investigates whether substantive testing is less useful than internal control assessment when the control systems are strong and finds that it is cost-efficient for the auditor in these cases to direct efforts towards testing control systems. However, no evidence is found that allocation of resources into either of the two procedures increases the probability of detecting fraud. When the substantive testing is sufficiently effective the auditor directs all efforts and resources to this procedure (Smith *et al.* 2000). According to Daigle *et al.* (2005) auditors first evaluate if internal controls are in place and whether they are working effectively. They obtain this knowledge by understanding the system, a task that is simplified when the auditee provides documentation of the system structure. The verification process of the asserted controls can be more easily conducted if internal control systems are well designed and documented. It could potentially reduce the amount of effort needed to complete an audit of internal controls (Daigle *et al.* 2005). Daigle *et al.* (2005) investigated how the quality of information system affects the amount of audit effort and fees when evaluating the reliability of controls. The results of the study showed indications that cost-savings are

possible when control systems are proven to be reliable. A possible explanation for this is according to the authors that well-documented internal controls are relied upon to reduce audit procedures if they are assessed to be working effectively (Daigle *et al.* 2005).

The independent auditor is, according to Auditing Standards No. 2, allowed to rely on the work of others. In the changed environment with new demands on the auditor to assert the internal control reports, there might be synergies to be gained which could increase effectiveness and efficiency in the audit of financial statements. In an early study O'Keefe *et al.* (1994) examined to what degree the auditor relies on internal controls affect the nature and mix of labour in an international audit firm in order to obtain reliable financial statements without material misstatements. They found that auditor reliance on internal controls did not have any effect on the level or the mix of external audit input. However, more recent studies have found conflicting evidence on this matter. Felix *et al.* (2001) investigated whether the internal audit contribution has any effect on the external audit fees. The internal auditors may contribute to the work of external auditors as assistants during the audit of financial statements or performing audit work continuously during the year, which the external auditor may rely on. According Felix *et al.* (2001) the internal audit contribution is a determinate of the external audit fee. Further, they found that the level of contribution is related to the extent of co-ordination between internal and external auditors. Co-ordination could potentially enhance overall audit efficiency since it minimises the duplication of efforts (Felix *et al.* 2001). Control self-assessment activity is a tool utilised to improve internal controls and is performed by operational employees or lower level managers. This information could provide independent auditors with a deeper understanding of critical factors (Joseph and Engle 2005). A study by Joseph and Engle (2005) found that independent auditors could benefit from control self-assessment activities, which provides auditors with an opportunity to evaluate soft internal controls (Joseph and Engle 2005). They also found that external auditors did not utilise this opportunity. In the report on the implementation of Auditing Standards No. 2 the PCAOB concludes that auditors who more effectively use the work of others as permitted will be more efficient in auditing internal control. Therefore the responsibility will be less time consuming. If auditors in the future use the work of others to avoid duplication of effort the overall efficiency would be enhanced (Report on implementation 2005 p. 11).

A risk-based approach, which implies a focus on higher-risk areas, is allowed by Auditing Standard No. 2. However, in their inspections, the PCAOB found that auditors did not alter the audit according to this recommendation. Whilst effectiveness could be improved by designating testing of controls to high-risk areas, auditors instead seemed to take a uniform approach to testing. Not only did this treatment reduce effectiveness but it also took attention away from certain areas with high-risk of material weaknesses. One method to avoid this problem could be an increased use of judgement from senior members of the audit team

rather than excessive reliance on forms and checklists (Report on implementation 2005 p. 10-11). Prior research on the matter of client risk in relation to audit design and planning has indicated a lack of strong relationship. Mock and Wright (1999) investigated to what extent audit programs are responsive to client risks. They believe their study to be important since it is of interest to determine the degree to which client risk has impact on audit efforts. Since this should affect the costs of performing the audit it is of importance to study the area. If client risk assessment is not utilised it suggests that over-testing could be a problem inducing audit inefficiency, moreover it could result in ineffectiveness in sufficiently testing high-risk areas (Mock and Wright 1999). Bierstaker and Wright (2004) examined the impact of business risk models on internal control documentation and testing. They examined how the formats of internal control documentation changed and if increased reliance on internal control induce less substantive testing in favour of testing controls. Bierstaker and Wright (2004) believe it reasonable that an increased focus on risk may induce reliance on internal controls, and reducing substantive testing could improve the efficiency of the audits. The knowledge of risks in a company would better provide the auditor with an understanding of strengths and weaknesses of the internal control systems and hence increase the reliance on these (Bierstaker and Wright 2004). Auditors rely on narratives to a larger extent, when business risk models are applied, to enhance the efficiency of the audit. However, too much reliance on one form of documentation might result in reduced audit effectiveness since internal control deficiencies could be overlooked according to Bierstaker and Wright (2004).

## **2.5 The Framing of Regulations**

The methods used when reviewing the internal control report are influenced by the framing of regulations. The efficiency of the audit procedures, both the work effort and the reliability, could be affected by the degree of detail in the recommended instructions for the auditors. A debate seems to evolve around the reliance of a rulebook approach and an application of judgement based on principles. Sir David Tweedie, chairman of the International Accounting Standards Board (IASB) describes principles as a big test, and asks “if people are able to apply judgement and if the regulators can hold off”. In the debate there is often a conflict between the more pragmatic European style and the rule-oriented lawyer-dominated US approach, as they are often described. However, a gap between what is desired and what is requested is apparent (Financial Times 2006). Charles Grieve, of the Securities and Futures Commission in Hong Kong states:

People will chant the mantra of principles while asking for even more rules.  
(Financial Times 27 april 2006)

The benefits and shortcomings concerning the degree of detail of accounting and auditing standards have been debated for years. Difficulties arise when trying to classify a standard as either rule or principle based since different criteria can be used as measurement and there is a lack of consensus of the definition. Schipper (2003) applies an accounting perspective and makes a contribution to the scientific debate in an article analysing the effects of rule-based and principle-based accounting standards. The US regulations are often perceived as comprehensive containing a large amount of detailed rules, however Schipper (2003) claims that the US standards are in general based on principles but also include descriptions of scope, treatment and exceptions which add to the complexity and length of the regulations. The degree of detail can also be derived from requests for explanations and clarification of a more precise application of standards, which increases the clarity and simplicity. The demand for a more specific guidance results in detailed implementation guides. Even if a standard leans towards overall principles, auditors must develop a common understanding of how to apply the standard in an appropriate manner. Often audit firms create their own working models when interpreting regulations (Schipper 2003).

In our field of study the Auditing Standard No. 2 constitutes an implementation guide for auditors on the Sarbanes-Oxley Act requirements regarding the internal control report. A Swedish equivalent to this guidance is yet to be filled with content and it is not clear to what degree of detail it will specify the responsibilities of the auditors. According to Schipper (2003) the detail level in audit standards affects the three basic elements in FASBs Conceptual Framework, which are relevance, reliability and comparability. An inherent trade-off between these concepts can be identified, where relevance with timely reporting require estimates and professional judgement, whereas reliability needs little estimation since it is based on transactions and visible values. There is also a trade-off between comparability and predictive ability where firm specific information is of importance (Schipper 2003). Schipper (2003) draws the conclusion that comparability is enhanced when detailed implementation guidance is available. This is due to a reduction of the effect caused by differences in professional judgement among auditors. Another benefit resulting from specified guidelines is a unity of measurement methods, which increases verifiability (Schipper 2003).

In a study about ethics and auditing culture Satava *et al.* (2006) argues that the recent scandals indicate failure to protect investors and other stakeholders when complying with rule-based ethical perspectives. They refer to AICPA who claims that the audit profession “requires much more than compliance with specific rules”. An undesirable consequence of a detailed framework is the loss of focus on intent and purpose of the regulations, where technicalities provide loopholes rather than insurance. According to Satava *et al.* (2006) professional judgement ought to be utilised when facing ethical dilemmas because detailed rules are ineffective and can be circumvented. Satava *et al.* (2006) concludes that auditors shall incorporate a rule-oriented perspective, when assessing the financial

condition, and principle oriented perspective when evaluating the financial health of an entity.

In accordance with Satava *et al.* the Ethics Standards Board (ESB) in the UK advocates a framework based on principles since they believe detailed standards are inflexible and insensitive to changes over time. However the ESB realises that the effectiveness and credibility of a principle approach depend on a clear identification and recognition of relevant principles and ethical considerations. When applying principles there is a risk of inconsistent utilisation and therefore guidance and rules are used when subjective areas are examined. More detailed rules are also useful when specifying actions that should be required or prohibited (Ethics Standards Board 2002).

### **2.5.1 ‘Comply or Explain’**

The Swedish Code of Corporate Governance encourages self-regulation and applies a ‘comply or explain’ principle with the choice to deviate from the standards if a motivation is publicly disclosed in the corporate governance report. This is a principle derived from the UK and the Cadbury Report<sup>5</sup>. It is up to the marketplace to determine if the explanations are acceptable since there are no requirements or oversight function setting the level of accuracy and reliance on the explanations (The Swedish Code of Corporate Governance 2004). Riise Johansen (2006) is concerned that this ‘soft law’, with a mix of required and voluntary information could result in auditing difficulties. The high degree of assurance that the auditor is asked to provide is, according to Riise Johansen (2006), unrealistic at reasonable costs and sensible responsibilities. It can not be expected that the auditor, to any greater extent, should take up a definite position on the reasonableness and accuracy of the explanations provided when deviations occur.

The principle ‘comply or explain’ is the basis of the code-based European approach in corporate governance issues (Press release European Forum 2006). Internal Market and Services Commissioner McCreevy argues:

The principle of ‘comply or explain’ is a central element of EU corporate governance. So it is important to have a common understanding of the principles’ scope and of the conditions that need to be put in place for it to work effectively.

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<sup>5</sup> The Cadbury Report will be further discussed in section 4.4.1.

The European Corporate Governance Forum released a statement regarding the 'comply or explain' principle in February 2006. The Forum strongly supports the approach of 'comply or explain', which they find more beneficial since it accounts for a variety of conditions in individual companies. Further the Forum states that if implemented in an effective manner, this principle is better and more efficient than a more detailed regulation. To apply the principle effectively, criteria such as a real obligation to comply or explain, a high level of transparency and possibility to hold boards accountable for the decision to comply or explain, is needed. This means that the regulatory framework surrounding the principle is crucial to the level of efficiency obtained. The Forum argue that a judgement of the value of the explanations is a matter for the shareholders. The auditors are not supposed to evaluate the judgements of the board's explanations, they only review facts provided in the corporate governance report (Press release European Forum 2006).

## **2.6 Chapter Summary**

In this chapter we have presented issues relevant to understanding the potential influences that the internal control provisions in the Code might have on audit efficiency. The current debate on the cost-benefit of the new requirement was presented. Potential synergies in the audit process were discussed with a focus on implementation difficulties in the US. The framing of regulations has been discussed with a focus on the degree of detail in the recommendation and further a discussion on the 'comply or explain' model utilised in the Code. In the next chapter the method utilised in this thesis will be explained.

# 3 Research Methods

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*In this chapter the research methods used to acquire conclusions relating to our basic question are presented. Further the research procedures and sources of empirical basis will be described. The purpose is to provide the reader with the opportunity to critically analyse the stringency of the thesis.*

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## 3.1 Theoretical Perspective

When scientific research is conducted, empirical evidence and theory must be combined in a manner that best describes reality (Andersen 1998 p. 29). One approach is to start with a theory, create hypotheses and then test empirical findings against that theory. Another approach is to draw general conclusions out of observations, which would result in theoretical reflections and analyses (Bryman and Bell 2003 p. 9). In this thesis the latter, so called inductive approach, has been applied. The inductive stance offers an open mind to new information received in the research process. Since the purpose of this thesis is to examine the impact of new internal control regulations in an auditor context, the focus of the research is on the empirical information collected through interviews and literature studies. In order to theorise and draw inferences on the matter we gathered information regarding auditors' expectations and perceptions about future impacts on audit methods, synergies and other potential influences on the audit due to the internal control provisions.

Since our intention is to explain the reality of the situation and views of the auditors, we applied a descriptive and analytical attitude with emphasis on context, in contrast to a normative approach which suggests guidance and direction. The descriptive method is more frequently utilised in qualitative research that aim to obtain a contextual understanding of social behaviour and values (Bryman and Bell 2003 p. 25).

## 3.2 Research Strategy

The choice of strategy when collecting data and empirical evidence should be determined by the purpose of the research. Accumulating data can be performed either by quantitative or qualitative strategies and the fundamental distinction between these are that quantitative methods involve measurement of data, while qualitative methods are concerned with deeper contextual interpretations (Bryman and Bell 2003 p. 25). We have utilised a qualitative strategy with the objective to acquire a detailed description of the auditors' perspectives and opinions regarding the new requirements facing the profession. We have conducted intensive rather

than extensive interviews with a few auditors, and our impression is that they have provided a comprehensive image of the tendencies in the audit profession. The intention has been to give voice to the subjects affected by the changing audit environment in order to understand the legitimating of the process and the conformity challenges subsequent to such an adjustment (Townley 2003). A critique of qualitative research is the difficulty in replicating and generalising a study (Bryman and Bell 2003 p. 25). However, when we interviewed the professionals, our intention was not to make them representative of the whole population, but rather generalise theoretical reasoning and inferences (Bryman and Bell 2003 p. 25). The study will provide indications to how audit efficiency might be affected and enhance the understanding of possible areas where the changes had negative or positive effects. We do not intend to investigate to what degree the efficiency will be impacted, but the aim is rather to enhance knowledge on how different factors can influence audit efficiency in the Swedish context.

### **3.3 Sampling**

We have made a selection of respondents from a population consisting of representatives from the four big audit firms and FAR. Since the Code only applies to public entities, which are usually audited by one of the big four, we have chosen to exclusively interview auditors from the big four auditing firms. By covering all of the big audit firms the possibility of different audit methods utilised in the different firms were ensured to be acknowledged. A so-called convenience sampling was then adopted, where eligible respondents with a certain level of knowledge on internal control, were chosen. By using this method we gained access to individuals competent in the field of study and thereby obtained information relevant to this research. The risk with this selection method is the problem of generalising the findings (Bryman and Bell 2003 p.105).

### **3.4 Data Collection**

The laws and regulations relevant to our research constitute a base for this thesis. We have covered the Swedish, American, British and EU regulations as well as the international standard setting body IAASB, since the aspiration is to apply an international perspective. These regulations have influenced the Swedish Code of Corporate Governance and are therefore essential when examining the characteristics of the Code. Also, the regulations from the US and the UK have a substantial and leading role in the development of corporate governance provisions. The internal control framework of COSO has been described as well as the auditor guidelines available. In professional journals like *Balans* and statements from FAR we examined the current debate in our field of research. Both Swedish and international papers and journals were used, but more literature is to be found originating from the US and the UK since regulations on internal

control reports have been applied there for some time. By searching in databases for scientific journals we found papers and articles applicable to our research. These and other papers written on internal control were used to establish the prevalent research frontier and were also used as reference when we analysed our findings.

### 3.4.1 Empirical data collection

The empirical data accumulated to analyse the field of study constitutes six interviews with auditors from the big four audit firms and profession representatives. The respondents were found by requesting interviews with auditors familiar with the internal control report. We also found eligible respondents through articles written on internal control. One respondent has been involved in the work to develop the guidance for the companies and also the recommendation for auditors on how to implement the internal control provisions. We conducted semi-structured interviews, which are preferable when individual judgements and conceptions of complex phenomenon are researched (Lundahl *et al* 1999 p. 116). A structured questionnaire was prepared but when interviewing the respondents it was slightly modified or augmented as we also asked situation-based questions with room for extended considerations. Our primary choice was to meet with the respondents in person. By performing face to face interviews we were able to receive more profound answers and we were able to ask follow up questions. Most of the interviews were recorded to prevent misstatements and the respondents had the opportunity to review the material to make sure no misunderstandings occurred. Two interviews were not recorded so there is a risk that reliability in the empirical research could be reduced. The interviews were conducted in Swedish and the answers and quotes were translated into English when presenting the empirical findings. The following respondents participated in the thesis:

- David Carlsvi, Global Risk Management Solutions, Öhrlings PriceWaterhouseCoopers, Malmö office, 13 April 2006
- Bertel Enlund, Auditor and FAR member, Ernst&Young, Gothenburg office, 24 April 2006
- Joakim Thilström, Auditor and FAR member, KPMG, Stockholm office, 26 April 2006
- Anders Hult, Partner Enterprise Risk Services and FAR member, Deloitte Stockholm office, 27 April 2006
- Anonymous, Auditor, Öhrlings PriceWaterhouseCoopers, Malmö office, 2 May 2006
- Tommy Mårtensson, Auditor and FAR member, Deloitte, Stockholm office, 5 May 2006

### 3.4.2 Validity

The concept of validity is critical when performing empirical research, and we have strived to attain a high internal validity with a good match between observations and theoretical inferences (Bryman and Bell 2003 p. 286). This has been done in a comprehensive way associating regulatory framework and previous research with empirical findings. The choice of respondents and their credibility has an impact on the internal validity and therefore we chose professionals with specific knowledge in the field of study. The respondents were familiar with the subject through personal experiences, which enhances the validity. However the respondents might not be objective when they evaluate their own performance, which could affect the validity negatively. Also the structure of the interview affects the validity and we attempted to develop a questionnaire, which was closely related to the purpose of the thesis. Face to face interviews enabled us to receive exhaustive and detailed answers with opportunity to ask follow-up questions. A weakness with the qualitative research is the difficulty to generalise the conclusions and with a limited number of respondents this could be the case. However, the intention was not to generalise the frequency of a phenomenon but rather to explore its features in a contextual environment. Also the respondents' individual perceptions of certain concepts might induce difficulties to generalise and influence the validity of our analysis.

The validity of previous research and articles we used in this thesis should also be evaluated. Previous research in the field of study mainly employs an American view, and it is debatable whether this applies in the Swedish context. The requirements in the Sarbanes-Oxley Act and the Swedish Code of Corporate Governance differ regarding audit obligations. This implies possible difficulties to compare the American experience with the expectations of introducing internal control provisions in Sweden. There are differences in international accounting due to factors such as legal systems, prevalent providers of finance and the strength of the accountancy profession (Nobes and Parker 1991 p. 11). One of the differences noticeable in our field of study is countries' choices of regulation on the matter of corporate governance. While the US could be classified as a predominately 'Legalism' country, which implies reliance on state principles, Sweden could be classified as a 'Corporatism' country. Corporatism implies state reliance as well but with more significant influences from the community and partial reliance in markets to ensure compliance (Nobes and Parker 1991 p. 55). These different backgrounds could possibly influence the relevance of American studies in the Swedish context. Articles from professional journals are not scientific and their sources of information can be questioned. At the same time these writers are knowledgeable and competent in the area of auditing and their thoughts and opinions are also valuable to our research. Despite the possible threat of biased media views, we determined it necessary to describe the current debate and express the attitudes of professionals.

### **3.4.3 Reliability**

The interviews were structured to enhance the reliability of the received information. To avoid misstatements and incomplete empirical data most of the interviews were recorded. The respondents also got access to the interview material some time before the interview to have the opportunity to prepare well formulated opinions. Attempts were made to form unbiased questions and let the respondents unrestrictedly verbalise personal positions and perspectives. The fact that the interviews were conducted in Swedish might imply differences in interpretation of meaning and substance. Replication is an element in reliability and it is usually difficult to replicate qualitative research (Bryman and Bell 2003 p. 25). Further it is an area that will continue to evolve and this also introduces difficulties to replicate the study.

## **3.5 Chapter Summary**

In this chapter our research methodology has been presented. With an inductive approach we aim to obtain an understanding of and describe the internal control from an auditor perspective. By conducting qualitative research with six interviews a comprehensive image of contextual perspectives was acquired. The validity and reliability of this thesis have also been examined to provide a reference when evaluating the stringency of the thesis. The process of gathering relevant literature and the empirical research strategy has been described. In the next chapter the regulations relevant to our purpose will be further examined to provide a deeper insight in the field of study.

# 4 Regulations on Internal Control

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*This chapter is aimed at providing more thorough insight to the multiple laws and regulations concerning internal control. International regulations are included to obtain an understanding of possible sources of influences in the Swedish context. An often applied framework of internal control will also be described.*

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## 4.1 Chapter Introduction

This chapter is dedicated to laws and regulations on corporate governance and internal control. First the Swedish Code of Corporate Governance with focus on the internal control report requirement will be described. Then an overview of international regulatory influences will be presented. The US Sarbanes-Oxley Act of 2002 and the related Auditing Standard No. 2 establishes mandatory internal control reports and further requires auditors to attest to it. In the UK the Cadbury Report is a framework which has impacted the internal control provisions not only on a national level but also in Sweden. In addition regulations on a regional and international level, such as the new EU 8<sup>th</sup> Company Law Directive and International Standards on Auditing (ISA) will be discussed. An important framework utilised by other legislative forces is the so-called COSO framework, which defines internal control.

## 4.2 Swedish Code of Corporate Governance

In spring 2003 the Commission on Business Confidence (Förtroendekommissionen) started developing the first code on corporate governance in Sweden. International frameworks on corporate governance issued by EU and OECD have had an influence on the Swedish context. The EU released an action plan to enhance corporate governance in the member states in May 2003 and the OECD revised its principles regarding corporate governance in 2004. Corporate scandals and the introduction of corporate governance regulations in several countries also contributed to the Swedish development. Prior to the Swedish Code of Corporate Governance, Sweden did not have a generally accepted code on corporate governance. However, the Swedish Companies Act<sup>6</sup> states in principle that the board of directors is responsible for ensuring that internal controls are effective, but no report is required. While the Code is based on the Swedish Companies Act it goes beyond the legislation and provides a more

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<sup>6</sup> In paragraph 8:3 of the Swedish Companies Act from 1975 the responsibilities of the board of directors is specified. They are responsible for the design of the company's organisation and are to ensure that the financial situation is controlled in an appropriate manner.

comprehensive regulation concerning corporate governance. The Code is aimed at codifying best practice and take the development of Corporate Governance practices one step forward (www.bolagsstyrning.se 2006). The Commission on Business Confidence was appointed to develop a code on corporate governance by the Swedish government and decided to form the Code group (Kodgruppen) together with representatives of industry and commerce (SOU 2004:46). The Code has been applicable since 1 of July 2005 and applies to publicly held companies in Sweden. The purpose of the Code is to improve corporate governance and in turn enhance the efficiency and competition in the corporate public market. Also the aim is to strengthen the credibility and knowledge of the Swedish capital market to attract foreign investors and capital. This is achieved through greater transparency towards shareholders and other stakeholders in a separate section devoted to corporate governance in the annual report (Swedish Code of Corporate Governance 2004).

The Code is a self-regulating instrument and is based on the principle ‘comply or explain’. The principle implies that even at a company where the Code is applicable, it is possible to diverge from individual rules. However, in such a case, the company has to submit an explanation where the motives for each divergence are identified. The flexibility is justified since companies have different structures and all requirements might not be appropriate for all companies. There is no disciplinary authority to review the validity of the explanations submitted by a company. Instead it will be the marketplace that has to pass judgement (Swedish Code of Corporate Governance 2004).

The Swedish Code of Corporate Governance is based on the fundamental features of other international codes and regulations. However, the Swedish Code acknowledges differences in culture, ownership structure, laws and regulations compared to the Anglo-Saxon model. Therefore the Code is modified to be suitable in the Swedish corporate environment. One of the most important differences is that Swedish ownership tends to be concentrated to a few larger owners instead of a diffused ownership. The governance in the Swedish system is a combination of the Anglo-Saxon one-tier model and the Continental European two-tier model. The corporate governance is the responsibility out of the board of directors, the CEO and the annual meeting of shareholders where much of the power is allocated since the shareholders in certain issues have an exclusive right to make decisions. The board of directors usually has less management representation in Swedish public companies and the CEO is not allowed to be the chairman of the board. Further the employees are entitled to representation on the board (Swedish Code of Corporate Governance 2004).

Section 3.7 *Internal control and internal auditing* in the Code considers requirements of reporting on internal control issues. The board of directors of a company is obligated to write a section in the annual report regarding the features of the

company's internal control mechanisms and make assessments of the effectiveness of these mechanisms. Three requirements are specified by the Code:

**3.7.1** The board is to ensure that the company has a sound system of internal controls and keep itself informed of and assess how well it functions.

**3.7.2** The board is to submit an annual report on how that part of internal control dealing with financial reporting is organised and how well it has functioned during the most recent financial year. The report is to be reviewed by the company's auditors.

**3.7.3** The board in companies that do not have a special internal audit function is annually to evaluate the need of such a function and explain the position that it has taken in its report on internal control.

The Code does not further specify how these requirements are supposed to be executed in practice, nor does it explain which methods should be used performing an audit of the internal control report. A guidance for companies on the Swedish Code of Corporate Governance was published 2005 by the Confederation of Swedish Enterprise and FAR, which is the association for the accountancy profession in Sweden. The recommendations in this guidance will be further presented in the next section.

#### **4.2.1 Guidance on the Swedish Code of Corporate Governance**

In the guidance, internal control is defined as a process realised by a company's board of directors, management and personnel, to provide reasonable assurance regarding effectiveness of operations, reliability of financial reporting and compliance with applicable laws and regulations. The control environment is a vital concept that the board and management are able to influence by incorporating it in the corporate culture. A functioning control environment provides structure and discipline to components like risk assessment, systems for information, monitoring and other control activities to prevent, detect and correct deviations (Guidance on the Swedish Code of Corporate Governance 2005).

The information requested in the board's report on internal control is limited to financial reporting, which is regulated in the requirements 3.7.2 and 3.7.3. Internal control over financial reporting is a process used to obtain reasonable assurance of the reliability of financial reporting and the preparation of financial statements in compliance with generally accepted accounting principles, laws and regulations.

Examples of internal control policies that a company can use as safeguards to secure the reliability are providing reasonable assurance that transactions are authorised and recorded according to relevant accounting principles and to establish mechanisms to prevent and detect unauthorised use of the company's assets. Internal control can not guarantee full assurance since it is limited by inherent risks such as human errors and fraud (Guidance on the Swedish Code of Corporate Governance 2005).

The board's report will cover the preceding fiscal year and should be based on the concept of transparency. The report is a legal and public document in the Swedish jurisdiction because of the companies' signing contracts with the Stockholm Stock Exchange. The disposition of the report contains an introduction, a description and a statement. In the introduction the board express that the report complies with the Swedish Companies Act and the Swedish Code of Corporate Governance, and that it abides by the requirements 3.7.2 and 3.7.3. In the next section the board gives a general description of the company's internal control functions with considerations of business specific features and circumstances. If the company has an internal audit function that deals with internal control over financial reporting, a descriptions of its activities, how its principles are established and to whom it should report, shall be included. Changes in the internal control systems also need to be disclosed. The report mainly covers the control environment, risk assessment, control activities, information, communication and monitoring. In the last section the board makes a statement regarding how well the internal control over financial reporting has functioned during the financial year. Any material weaknesses in the internal control over financial reporting that have been discovered are to be disclosed as well as the measures that have been taken to resolve the problems. If a company does not have an internal audit function specifically for internal control over financial reporting, the board should analyse whether such a function would improve the quality and credibility in the financial reporting (Guidance on the Swedish Code of Corporate Governance 2005). Recommendation for auditors on how to review the internal control report has not yet been published although FAR has developed a proposal, which is circulating for comments.

### **4.3 Regulation in the US**

Corporate scandals in the US made new legislation inevitable. To prevent future failures and to enhance investor confidence congress passed the Sarbanes-Oxley Act of 2002, which contains stricter and more rigorous rules than previous legislation. It is relevant to present this regulation since it contains internal control provisions. The new requirement in the US regarding auditor attestation of companies' internal control reports has certainly influenced the Code and furthermore the American experience of implementing the provisions concerning internal control is of interest in the Swedish context. However in the US the

auditor has to perform both an audit of management's assessment of the effectiveness of internal control over financial reporting and the effectiveness of the internal control over financial reporting.<sup>7</sup> In Sweden the auditor will give an opinion on the assessments of the internal control report but not on the effectiveness of internal control. In the following sections the Sarbanes-Oxley Act and Auditing Standard No. 2 will be presented.

### **4.3.1 Sarbanes-Oxley Act**

The Sarbanes-Oxley Act was passed and implemented in 2002 in the US and applies to public companies. The purpose is to enhance accuracy and reliability in corporate disclosures. Section 404 *Management Assessment of Internal Controls*, was an inspiration when designing 3.7 *Internal control and internal auditing* in the Swedish Code of Corporate Governance. In section 404 it is stated that the annual report should contain an internal control report that acknowledges the responsibility of management to create and maintain a satisfactory internal control structure. The report shall also include an assessment of the effectiveness of the internal control functions and financial reporting procedures. A registered accounting firm shall attest to, and report on, the assessments made in the report (Sarbanes-Oxley Act 2002).

Section 302 *Corporate responsibility for financial reports*, in the Sarbanes-Oxley Act states that the signing officers of the company are responsible for establishing a functioning internal control and evaluating the effectiveness of it. The signing officers shall also disclose to the auditors and the audit committee, material insufficiencies in the internal control with implications on reliability in the financial data and report suspected fraud that involves management or personnel related to the internal control (Sarbanes-Oxley Act 2002).

### **4.3.2 Auditing Standard No. 2**

The Sarbanes-Oxley Act reformed the regulatory structure when it established the Public Company Accounting Oversight Board (PCAOB). The PCAOB is a standard setting body with investigative and disciplinary authority. Audit firms that audit public companies are obligated to register with the board. In 2004 the PCAOB issued Auditing Standard No. 2, which outlines the expectations of an internal control audit. Since section 404 in the Sarbanes-Oxley Act calls for an auditor attestation of the internal control report but excluded further explanation of which procedures such an audit requires, Auditing Standard No. 2 is an

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<sup>7</sup> In appendix C an example by the PCAOB of an unqualified audit opinion is presented. There is not yet a recommendation available for auditors in Sweden and hence we are not able to present an example of an audit opinion.

important guideline for auditors. The auditor should evaluate the statement in the report regarding management's responsibility of internal control and whether a suitable internal control framework has been applied. In addition to the presentation of the assessment, the auditor should also evaluate management's assessment of internal control and make sure it is free of material misstatement. The auditor should also analyse if identified material weaknesses have been adequately disclosed in the report.

When testing the internal control over financial reporting, the objective for the auditor is to obtain evidence about the effectiveness of the controls to evaluate if management's assessments are fairly presented in order to be able to support the auditor's opinion. The opinion refers to the effectiveness as of a 'point in time', which means that the obtained evidence only has to cover a sufficient period of time. The opinion of effectiveness should be expressed 'taken as a whole', which indicates that evidence should also be obtained regarding all relevant assertions on the effectiveness of the internal control functions and related accounts. These requirements imply that the auditor must test the design and operating effectiveness of internal control functions, which would not normally be conducted in an audit of financial statements. When auditing financial statements, test of controls are also performed but they focus to a greater extent on assessment of control risk and evidence covering the *entire period*. Even if some procedures differ, there are also synergies that can be utilised. For example an understanding of the company's internal control is necessary in both an audit of internal control over financial reporting and an audit of financial statements. By co-ordinating the procedures performed, understanding of internal control can be obtained and the auditor will be more efficient.

The audit of internal control is supposed to be integrated with the audit of the financial statements and the steps in the audit process are similar. The first step of the internal control audit is the planning of the audit where the auditor has to consider both the internal control environment in the company and the general business conditions in the industry. Next, the auditor obtains knowledge about and evaluates the management's assessment process to find out how the effectiveness of different control functions has been assessed. The auditor should also evaluate whether management has identified risks of material misstatement. Then the auditor should obtain an understanding of the internal control over financial reporting in the company. The design of specific control functions are analysed by applying procedures such as inquires, inspecting documents, observing application of controls and tracing transactions. Next step is to test and evaluate design and operating effectiveness, which is done using inquires, observations, inspection of documentation and a specific evaluation of the controls which determines whether they are likely to prevent and detect error and fraud. The purpose is to identify the company's control objectives and the functions that satisfy those objectives. Whether the controls are operating as designed and if the person performing them has the appropriate authority, is also

to be evaluated. Sufficiency of testing should be considered and followed by this the auditor shall formulate an opinion on the effectiveness of internal control over financial reporting, where all evidence is evaluated to determine the adequacy of management's assessments. An unqualified opinion can only be issued when no material weaknesses are found. If there are material weaknesses an adverse opinion should be expressed. When the auditor has been restricted and limitation of scope exists, a qualified opinion or a disclaimer of opinion should be issued. At this step the auditor also evaluates the significance of identified deficiencies and determines their impact on the risk of misstatements. At the end of the audit process a report on internal control is issued and the findings are communicated to the audit committee and management (PCAOB Auditing Standard No 2 2004).

The auditor must perform enough testing to meet the criteria that the work of the auditor constitutes the principal evidence in the auditor's opinion. The work of others can still be used to alter the nature, timing and extent of the work that would otherwise have been performed by the auditor. It is mainly the work of internal auditors and company personnel that can be used to obtain audit evidence, but it entails a strict judgement from the auditor when determining the credibility and reliability of the work of others (PCAOB Auditing Standard No 2 2004).

## **4.4 Regulation in the UK**

The regulators in the UK have taken a somewhat different approach compared to the US and the Sarbanes-Oxley Act. Similar to Sweden the UK has chosen to rely on self-regulation. Furthermore the 'comply or explain' model in the Swedish Code originates from the UK. An important step towards improving internal control in the UK was taken in 1992 with the Cadbury report. However the regulators in UK are not interested in implementing a British 'Sarbanes-Oxley Act'. This was evident when the Institute of Chartered Accountants in England and Wales (ICAEW) submitted feedback to a SEC roundtable on the implementation of Sarbanes-Oxley internal control provisions. They stressed that retaining certain aspects of the UK practice were warranted, based on the experiences from implementing Sarbanes-Oxley Act. In particular avoiding detailed prescriptions and maintaining a focus on all controls rather than controls over financial reporting were of interest. Also the use of private board assessment of effectiveness instead of published statements should be preserved. Among the critical arguments concerning section 404 adduced by ICAEW is that the costs of implementation exceeds the benefits (ICAEW submission to SEC roundtable 2005). In this section the regulation in the UK regarding internal control will be presented. The UK does not require auditors to attest to the board of directors' report on internal control as opposed to the US and the new Swedish regulation.

#### **4.4.1 The Cadbury Report**

The Cadbury Report on the Financial Aspects of Corporate Governance (hereafter Cadbury Report) from 1992 presents different ways to increase the effectiveness and value of the audit. One of these methods is that the directors report on the effectiveness of internal controls and that the auditors report on their statement (Cadbury Report 1992). In this report the 'comply or explain' principle was introduced and has since been applied in several codes in other jurisdictions, including in the Swedish Code on Corporate Governance (SOU 2004:130). Criteria for assessing the effectiveness of the internal control systems and guidance for companies and auditors should according to the report be developed by the audit profession and the suppliers of the financial statements (Cadbury Report 1992).

#### **4.4.2 The Combined Code**

In 2003 the UK the Financial Reporting Council (FRC) issued the Combined Code on Corporate Governance (hereafter Combined Code). The Combined Code deals with the rules concerning the board of directors and management's responsibilities regarding internal control. It contains a main principle regarding internal control (C.2) and a provision (C.2.1), which further develops the board responsibilities:

**C.2** The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

**C.2.1** The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems.

To enable compliance with the requirements of the Combined Code regarding internal control, the FRC provides 'Guidance for Directors on the Combined Code', the so-called 'Turnball Guidance', which was revised in 2005. The revised guidance is applicable in financial reports issued on or after the 1 of January 2006. Changes to the original guidance from 1999 are limited and the major alteration is a new preface which establishes the importance for companies to review their application of the guidance continuously and providing shareholders with information in their annual reports ([www.frc.org.uk](http://www.frc.org.uk) 2006). The Turnball Guidance sets out best practice on internal control for companies listed in the UK. It is meant to be principle-based without detailed descriptions to obtain a flexible approach with possibilities to adapt to the specific business environments. This has proved efficient according to the Review Group that investigated the

result of implementing the provisions of the Turnbull Guidance, and found that substantial improvements of internal control were achieved (Turnball Guidance 2005).

The Turnbull Guidance contains recommendations on how to maintain a sound internal control system and lays out the responsibilities of the board of directors to assure it is effective. Further they are to assure that the internal control is functioning with respect to managing risks. It also requires the management to implement the policies decided by the board, concerning risk and control. Furthermore it requires the board to review the effectiveness of internal control and they should continuously monitor the process. In the statement required by the Combined Code principle C.2, the board should disclose information on internal control. The responsibility of the board concerning internal control and the review should be acknowledged in the statement (Turnball Guidance 2005).

## **4.5 Regulation in the EU**

In May 2003 the EU released an action plan on how to enhance corporate governance in the member states as a response to the development on the international level. It is recommended that the member states designate codes of corporate governance which apply to listed companies. Further it is recommended that the 'comply or explain' model should be utilised. In Sweden the process with the Code started in October 2003. The EU recognised that in certain areas enhancement of existing regulations was necessary but in other areas the rules were already robust and deemed to be sufficient. In the action plan it is stated that self-regulation is not always efficient to ensure sound corporate governance, hence "a common approach should be adopted at the EU level with respect to a few essential rules". In this action plan the EU also communicated intentions to modernise the Company Law Directive, which we will present in the next section (European Commission 2003).

### **4.5.1 The New 8<sup>th</sup> Company Law Directive**

The European Commission has presented a proposal for a new 8<sup>th</sup> Company Law Directive, in order to harmonise the approach to statutory auditing in the EU and to create a more effective international co-operation with regulatory bodies such as the PCAOB. It was adopted by the EU on 25 April 2006 and will be implemented in the member states ([www.euractiv.com](http://www.euractiv.com) 2006). The Directive is a response to the recent scandals in the US and the EU and it acknowledges that the statutory audit is important when ensuring reliability of financial statements. One concern addressed in the proposal deals with the importance of effective internal control systems and the auditor's role to add credibility to the companies'

internal control functions and the financial statements. According to article 39 of the 8<sup>th</sup> Directive the statutory auditor of public interest entities<sup>8</sup> will be required to provide a report to the company's audit committee, regarding material weaknesses in the internal control (European Commission 2004).

## 4.6 International Regulations

The International Auditing and Assurance Standards Board (IAASB) is a committee of the International Federation of Accountants (IFAC), which is a global organisation for the accountancy profession with 163 member organisations in 120 countries. Their objective is to establish high-quality professional standards and improve the degree of uniformity of auditing practices by promoting further convergence of audit standards (www.ifac.org 2006b). IAASB issues, along with other regulatory frameworks, International Standards on Auditing (ISA) that auditors can apply when reporting on historical financial information (Hayes *et al.* 2005 pp. 6-7). IAASB trusts in voluntary international acceptance of the ISAs but a membership in IFAC induces an obligation to comply with the rules. The aim is to achieve endorsement and adoption of ISAs by the European Commission, which is in process (www.ifac.org 2006b). The FAR membership in IFAC implies an obligation for Swedish auditors to comply with ISA.

### 4.6.1 International Standard on Auditing 315

There is no ISA equivalent to the PCAOB's Auditing Standard No. 2, which requires a special auditor attestation of an internal control report, but the ISA framework still provides a rigorous structure for audit procedures related to internal control. ISA 315 *Understanding the entity and its environment and assessing the risk of material misstatement* requires that the auditor obtain an understanding of the company's internal control relevant to the audit. Understanding the internal control is vital when the auditor identifies and evaluates potential misstatement threats. The auditor also has to evaluate the design of the control functions and determine whether they are implemented and if they are capable of effectively preventing, detecting and correcting material misstatements.

The auditor should obtain an understanding of all the five components of the internal control stated by the COSO framework. The components include the control environment, the entity's risk assessment process, the information system

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<sup>8</sup> Broadly defined by the Commission as listed companies of certain size and nature, banks, or insurance companies (Hayes *et al.* 2005).

relevant to financial reporting, control activities and monitoring of controls. It is up to the auditor to determine which controls are relevant to the audit. When this professional judgement is exercised the auditor has to consider circumstances like materiality, size of the entity and the nature of the entity's business including its organisation and ownership characteristics. The controls established by the entity regarding the completeness and accuracy of information can be relevant to the audit when designing and performing further audit procedures. Understanding of the control activities is also relevant when assessing risks of material misstatement at the assertion level and designing further procedures responsive to assessed risks. Control activities are policies and procedures that ensure that the management's directives are carried out. Examples of these are authorisation, performance reviews, information processing, physical controls and segregation of duties. It is not sufficient to obtain an understanding of the controls in a company when testing the operating effectiveness of the controls in question. Further tests must be undertaken which are presented in ISA 330. When obtaining an understanding of the entity and its environment including the internal control components, the documentation of the audit should contain descriptions of the key elements. Material misstatement caused by error or fraud should be documented as well as assessed risks of material misstatements at the financial statement level, assertion level and in related controls. It is up to the judgement of the auditor which documentation procedures to use but normally techniques like narrative descriptions, questionnaires, checklists and flow charts are utilised throughout the audit process (IFAC 2006a).

Substantive testing procedures and tests of controls to obtain evidence about account balances, classes of transactions, disclosures and assertions regarding the operating effectiveness of controls, can be performed concurrently with risk assessment procedures for an efficient audit procedure. When assessing risks the auditor should perform inquiries of management and other personnel, analytical procedures and observations and inspections. Inquiries with management and people in charge of financial reporting offer a lot of information but communicating with other personnel and functions within the company, for example internal audit and legal functions, can also be informative. By performing analytical procedures, which involve comparison with expected and actual transaction amounts, the auditor can identify unusual transactions or events that have implications on the financial reports. Observations and inspections also help the auditor understand the environment. The activities include observations of operations and visiting company facilities, inspecting documents and tracing transactions through the information system.

## 4.6.2 International Standard on Auditing 330

ISA 330 *The auditor's procedures in response to assessed risks*, describes tests of the operating effectiveness of controls. According to this standard the auditor is required to perform audit procedures and tests regarding the operating effectiveness of controls, which are responsive to assessed risks of material misstatement. When an assessment depends on the internal control to operate effectively, the auditor must perform tests on the controls in order to obtain appropriate audit evidence to see if the controls fulfil their purpose. The evidence should yield information regarding how and by whom controls have been applied and the consistency with which they have been applied. To be efficient the auditor can test the control operating effectiveness and at the same time evaluate its design and obtain evidence of the implementation.

The nature and extent of test procedures depend on the level of assurance required according to the assessed risk level. The tests performed when determining the operating effectiveness of controls are primarily inquiries with management and other personnel. However inquiries are not solely sufficient and should be combined with other test procedures. Inspection and re-performance in combination with inquiries often provide better assurance than audit evidence consisting of only inquiries and observations. Since observations focus at one point in time it is pertinent to utilise other procedures as well, for example inquiries with personnel and inspections of documents. The auditor also plans and performs substantive procedures, which are intended to be responsive to the assessments of risks involved and detect material misstatements at the assertion level. Tests of details of classes of transactions, account balances and disclosures as well as analytical procedures constitute substantive testing. While analytical procedures are appropriate when testing large volumes of transactions, tests of details are generally more applicable when obtaining evidence relevant to assertions on account balances like existence and valuation. If the risk of material misstatement is large, or if the internal controls are not reliable, the substantive procedures will be more extensive. If deviations in the effectiveness of controls are detected, further specific inquiries should be performed to understand the variations and potential consequences. According to this standard the auditor should document responses to assessed risks of material misstatements in the financial statements, the nature, timing and extent of further audit procedures and the results of the audit procedures (IFAC 2006b).

So far in this chapter various regulations has been presented, all of them in one way or another influencing the Swedish requirement of an auditor attestation of the internal control report. In the next section a framework of internal control, adopted by all the above mentioned regulations, will be described. It is defining the internal control concept and is used as a tool both by companies and auditors to achieve a joint understanding of a complex system.

## 4.7 COSO Internal Control Framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) provides a framework of internal control, which is applied by several regulations such as Sarbanes-Oxley Act, IAASBs International Auditing Standards and the Swedish Code of Corporate Governance. Internal controls support company structures and enable companies to reach profitability goals and achieve their mission. The internal control system increases efficiency, reduce risks, and strengthen the reliability of financial statements and compliance with applicable rules, laws and regulations.

Internal control is defined as a process, established and maintained by the board of directors, management and other personnel, with the purpose to offer reasonable assurance of achieving objectives regarding effectiveness of operations, reliability of financial reporting and compliance with laws and regulations. The board of directors and management should also understand to what extent the company's operating objectives are achieved. There are five components in an internal control system, according to COSO, which are related to each other and to the management process.

- The first component is the control environment, which is the foundation of the other components. It sets the tone and influences the culture, discipline and structure of an organisation. The main features of the control environment are management's philosophy, operating style, integrity, ethical values and competence of personnel. Authority and responsibility assignments are also included in the control environment.
- Risk assessment is established to identify and analyse both internal and external risks which constitute threats to the company objectives, as well as to determine what measures should be taken to manage those particular risks. This second component is crucial for companies competing in a constantly changing marketplace.
- The third component is control activities, which are made up of policies and procedures that enable necessary actions to be carried out when addressing risks facing the company. Authorisations, approvals, verifications and reviews of operating performance are all control activities that manage assessed risks.
- Information and communication is the fourth component of the internal control framework. Both external and internal information must be identified, documented and communicated in order to make decisions, distribute responsibility and run the overall business functions. Effective

communication is important when adjusting to changes in other components of the internal control.

- Monitoring is the last component of the five, the internal control systems can be monitored and evaluated continuously or at specific points in time. Deficiencies discovered in the internal control should be reported to management and board of directors. The extent of monitoring depends on how effective the monitoring activities are and the degree of risks involved.

These internal control components should be built into the company's infrastructure where they will create synergies shaping functions that dynamically react to changing circumstances (COSO Framework 1992). The COSO framework can be useful when creating unity in the audit process.

## **4.8 Chapter Summary**

In this chapter we have provided the basic foundation to understand the regulatory environment in which auditors in Sweden operate. The provisions of the Code is most important, but also it is necessary to incorporate laws and regulation which are influential on an international level regarding internal control. To obtain an understanding of the development we have presented the Sarbanes-Oxley Act and the related Auditing Standard issued by PCAOB. Relevant codes and best practice from the UK were also discussed since they provide the leading edge in Europe. Regulations applicable to statutory audits in the EU member states and ISAs concerning internal control recommendations also constitute parts of the regulatory framework relevant to this thesis. The COSO framework has relevance for applications of other regulations since it defines internal control. In the next chapter we will present the empirical findings.

# 5 Empirical Findings

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*Chapter five contains the empirical findings resulting from interviews with six respondents, representing all of the big four audit firms to obtain an auditor perspective on the provisions in the Code regarding internal control. These findings will be structured into four themes in order to obtain an overview perspective on the material. This chapter deals strictly with the empirical data and analysis of the findings will be presented in the next chapter.*

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## 5.1 Chapter Introduction and Definitions

In this chapter the empirical findings<sup>9</sup> will be presented in four separate themes. The first theme concerns methods and audit procedures to obtain an understanding about how the auditors have been working with the internal control previously and what new aspects the provisions in the Code will imply. In the second theme the level of integration between the audit of financial statements and the review of the internal control report will be examined. Possible synergies resulting from performing the new duty in relation to the audit of financial reporting are also included in this theme. In the third theme value creation due to the new requirement and whether the auditor perceives any difficulties in conducting the review of the internal control reports will be examined. In the last theme the subjects in focus are the auditors' perspectives on international influences and frameworks applied when implementing the provisions of the Code regarding internal control. The terms 'most' and 'majority' used in this chapter refer to four or five respondents, while the terms 'some' and 'few' refers to two or three respondents.

## 5.2 Methods and Audit Procedures

This theme will present the methods utilised to review internal controls and further how the respondents perceive that the internal control provisions in the Code will affect the audit procedures. Also the purpose of conducting these procedures prior to implementation of the Code, according to the respondents, will be presented. The effects on the amount of audit work, hours and fees, which the respondents foresee due to the new requirement, are presented. Furthermore the regulations they have relied upon to properly perform the audit of financial reports regarding internal controls will be discussed.

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<sup>9</sup> In appendix A the questionnaire utilised when conducting the interviews with the respondents can be found. Further information on methods applied and the respondents are available in chapter three.

Internal controls have been examined prior to the provisions in the Code and all of our respondents have utilised a methodology based on ISA, which has been incorporated in the audit firms' own working procedures. A few of the respondents stressed that these standards provide more rigorous rules than the Swedish auditing standards, RS (Revisionsstandard), require. In Sweden a management audit (förvaltningsrevision) has been performed. In this the auditor reviews the administration of the company for which the board is responsible. Two respondents argued that this requires the auditor to examine controls, however one of them stressed that they did not have mandate to require any documentation from the company. Another respondent stated that it is "a common misunderstanding that the auditor previously examined all the internal controls, this is not the case". This respondent also explained that the purpose of looking at the control systems is that it is an efficient method when auditing the financial statements. One respondent argued that in the current situation the audit examination of internal controls is limited to when it is the only or the most efficient way to conduct the audit of financial statements. Another respondent stressed that the reliance on this sort of testing also depends on the complexity of the company examined.

While internal control reviews according to all of the respondents have been performed previously, they all seem to agree that a major difference in the future due to the provisions in the Code regarding internal control, will be the quantity of work necessary to give an opinion. All respondents utilised risk analysis to review internal controls when conducting audits of financial statements and this will continue to be an essential method to fulfil the new requirements. The same risks are in focus and in these areas improvements of internal control will be necessary according to one respondent. The auditor will check who performs certain routines and if they are performed internally or externally, which affects the reliability of the controls. The auditor needs to perform more investigation in departments other than the financial department. All respondents argue that there exist no difference in audit methods when conducting the review compared to the methods utilised when performing audits of financial statements. The fact that it is "exactly the same methods and principles that will be utilised as it have been prior to the Code", was especially emphasised by one respondent. There seems to be an agreement among most of our respondents that documentation will be a more essential component in the new context with focus on the internal controls. The organisation and design of internal controls will be in focus according to most of the respondents. The processes in the company generating financial output rather than the output itself is of interest when implementing the new requirements. Previously Sweden had been neglecting the process of obtaining good internal control but the output was still without major deficiencies according to one respondent. One respondent expressed it as "Sweden used to be the backyard of internal control" and further argued that this is about to change. The result from implementing the Code provisions regarding internal control will be an increase in documentation particularly the ability for the auditor to request this service from companies. This was emphasised by most of the respondents. One

respondent argues that the internal control provisions will result in more details being examined than previously. All agree that the new requirement will imply more work and hence increase audit fees, but one respondent considered that much will depend on the amount of work done by companies. If there are deficiencies in the work done by the companies it could result in more difficulties for the auditor. The increase in audit fees is expected to range from 30-50 percent according to the respondents, however it is also mentioned that it might be less for some companies.

Among the respondents there seems to be a consensus that focus on risk areas is of the utmost importance and that materiality is an essential feature of the reviewing process. As one respondent expressed it “the auditor needs to utilise a sniper approach not a cheese slicer” which refers to the necessity to focus on the material risk areas. Furthermore most respondents agree that professional judgement should not be neglected. In the current situation professional judgement determines what constitutes good internal control “the auditors own intuition of what good internal control meant was previously prevailing” according to one respondent who argues that the focus will shift towards the organisation and the effectiveness of internal control systems.

### **5.3 Integration and Synergies**

This theme is concerned with whether the respondents believe that it is possible to integrate the review of the internal control with the audit of financial statements. Also examined is the extent to which the respondents believe it will be possible to rely on the work of others in the review of internal control reports. Possible synergies, described by the respondents, from conducting the new duty in relation to the audit of financial statements are examined.

A majority of the respondents argue that the audit of financial statements and the review of internal control reports do not constitute two separate audits. It is stated that integration of the audits is not only possible but also necessary to be efficient. One respondent with another opinion stated that “to be able to give an opinion it will take some extra effort since it is a separate report”. Internal control functions provide the basis in both the audit of financial statements and the review of the internal control report. Therefore it is necessary to avoid duplication of effort and inefficiency. One respondent stresses that it is two different kinds of reviews and they are to be considered separately. The deviating respondent further argues that the audit of financial reports only requires the internal controls to be sufficient when concluding that the financial statements are reliable. A review of internal control reports implies that all controls related to transactions should not contain any material weaknesses. The respondent does not exclude the possibility of obtaining synergies since the review of internal control reports extends to certain

areas necessary in obtaining reliable financial statements. The internal controls are useful for future accounting quality and this could also affect efficiency.

Regarding the reliance on work of others, two aspects have been brought forward. A majority of the respondents agree that some support could be possibly received from the internal auditors but as one of the respondents stated “the auditor cannot rely on their resources”. When auditors use their work it needs to be tested. Another aspect of reliance on work of others is when external consultants perform the work, which provides a more reliable source of information according to most of the respondents.

The general opinion seems to be that reviewing the internal control report could be utilised when performing the audit of financial reports. The tests performed in the review of the internal control report and the audit of financial statements could be combined. Internal control will function as the basis according to one respondent, which is necessary to obtain efficiency. Synergies due to performing the review seem to be achievable. One respondent particularly believes that obtaining synergies will be easier now that the auditor can demand documentation. Another aspect is an increased understanding of the company due to the new requirement and hence this could lead to increased efficiency in the audit. Most respondents expressed that certain methods utilised to be comfortable with the financial statements could be performed less extensively. On the matter of possible synergies one respondent stated that “when internal controls have been reviewed and there is a positive result, the auditor should be able to rely on the fact that the numbers generated from the processes are correct and hence reduce risk analysis and reviewing”. A couple of the respondents believe that the added requirement to review the internal control report could lead to less substantive testing, and further that it should result in increased audit efficiency. One respondent argues that “the risk will be properly managed if the auditor looks at the design of internal controls”, furthermore he stated that from a control and benefit perspective, testing should be limited.

A perspective put forward by most of the respondents is that testing could be reduced in situations where the auditor can rely on internal controls. If a company has good internal control there is opportunity to obtain positive effects in the audit of financial statements. Good internal control could enhance the efficiency of the audit of financial statements. If a company has well functioning internal controls less substantive testing will be required since the auditor can rely on the controls.

## 5.4 Value Creation and Audit Difficulties

The focus of this theme is the usefulness of the internal control report review and the enhancement of value for stakeholders due to the auditor review. The respondents were asked to evaluate the value creation and whether further material misstatement, mistakes or fraud in the companies' internal controls and in the financial information, can be prevented or detected. This theme is also concerned with the respondents' views and opinions regarding difficulties when reviewing the internal control report and the reason why an exemption of reviewing the internal control report of 2005 was approved.

All of the respondents agree that the internal control of a company is a focal concern and that a positive consequence of the internal control report is that more focus and attention is given to internal control processes in companies. They also acknowledge that the board and the management's new found attention to internal control can result in better and more efficient systems and controls. For the company, value can be created in the control processes when altering the controls to become more appropriate accordingly with the overall structure and organisation of the company. By focusing on the internal control the companies' financial information become more reliable and savings can be achieved from rationalising and enhancing internal control efficiency. When describing the need of having an internal control report and the value it creates when the auditor reviews the report, a majority of the respondents mentioned that the quality and comparability between the companies increase. A continuity of both extent and content can be obtained. Documentation will be more detailed and it will better describe the processes in the company. Most of the respondents declared that it is uncertain to what degree the companies have to document the details of their internal control. A majority of the respondents believe that it is necessary to have a review of the internal control report by the auditors. Without giving an opinion, the report would not be reliable enough to create value for the stakeholders. One of the respondents explains the process when developing the recommendation on audit procedures of the internal control. The first draft of the auditor responsibility regarding the internal control report only suggested 'agreed upon procedures', which does not include an audit opinion. Pressure from representatives of industry and commerce to make it simple and less costly influenced this approach, however they considered the draft to be too general and asked for an audit opinion to be included. The term "Agreed upon procedures" did not deliver much clarity and reliability, the auditor does not draw a conclusion about the report which, according to a few of our respondents, makes the process more or less meaningless.

Now a new proposal is in process and most of the respondents expect that the auditor will be required to conduct a review of the internal control report. A review is more robust than agreed upon procedures but weaker than a full audit, since a review includes a negative assurance opinion. Nearly every one of the

respondents considered this necessary to bring credibility to the internal control report. One of the respondents has a different opinion concerning the value of an auditor review. This respondent believes it to be positive that the companies work with risk management and that norms regarding the internal controls are set, but is sceptical as to whether the auditor review will add more value than the problems it creates. The internal control report would be valuable to investors without a review, and the board signs the report so that must be worth something. He also questions the marginal benefit of the review. There are high costs that must be motivated, and both the audit fee and the costs for the company to examine the internal controls will increase.

Most of the respondents speculate as to whether a review of the internal control report actually results in detection of more misstatements or fraudulent behaviour. They find that the regular audit already focus on the material risks relevant to the company. One respondent argues that it is not in the control routines errors occur but rather in valuation, impairment tests and legal agreements and processes. Another respondent states “I am very sceptical to whether a review of the internal control report would have prevented the corporate scandals. It is not where the major problem exists, the senior management is still able to find opportunities to avoid detection of fraudulent behaviour.” An argument brought forward by another respondent is, “the probability of detecting misstatement and fraud might increase when reviewing the internal control report, but it does not imply that the auditor will actually do that.” A few respondents think that accounting fraud might be easier to discover. Responsibilities are reviewed and it is possible to see when the company is doing, for example, an impairment test by themselves or if they are using external experts. Further this respondent believes that cost-benefit is a challenge that must be taken seriously. The representatives of industry and commerce will demand benefits to make up for the costs. A few respondents bring up the issue of what it would entail if the auditor detects misstatements in the internal control report. None of them believe that it would have much effect on the value of the company on the stock market. However, one concern expressed by a few respondents is that the increased costs for companies registered on the Stockholm Stock Exchange will result in delisting. The companies might choose to register with other stock exchanges that do not have the same strict requirements of a reviewed internal control report. These respondents believe that Sweden with the new Code of Corporate Governance has one of the strictest requirements regarding internal control in Europe, which can have both advantages and disadvantages.

It was not mandatory for auditors to review the internal control report in the first year of implementation, which all the respondents agree is due to the lack of a framework to relate to and the lack of time for the companies to prepare. It is not clear on what level the companies have to analyse and describe the internal control and it is therefore difficult to know how to review the report. This year the companies have issued internal control reports with various ambitions. While

some have made a comprehensive report, many companies have written generic reports which could apply to any company. The companies have not had enough time to prepare for this report and it is likely that some companies will not be ready to issue a statement next year either. Because of the lack of framework for companies on how to prepare the report and the lack of guidelines for the auditor on how to review it, auditors might have difficulties in giving an opinion on the internal control report this year.

Whether there will be difficulties reviewing the internal control report depends on the quality of the report and the companies' risk analysis and documentation. If companies have documented their risk evaluation, test procedures, and the results thoroughly then it will be easier to review. When the framework is in place and the guidelines for auditors are set, most respondents do not think that there will be any problems when reviewing the internal control report. They are confident in the competence of auditors to take on this new responsibility. All of the four big audit firms have experience in auditing Swedish corporations complying with the US Sarbanes-Oxley Act. Those companies have already issued internal control reports which the auditors have reviewed. Although the US requirement differs from the Swedish, knowledge of the internal control report concept already exists in the audit firms.

## **5.5 Perspectives on Framework and International Influences**

In this theme the respondents' perception and opinions of international influences on the Swedish Code of Corporate Governance and the internal control report requirement will be expressed. In addition, the respondents' attitude towards the framing of internal control report requirement and guidance for auditors on this matter will be discussed. Their preferences on the degree of detail in the regulation and auditor guidance, when accomplishing an efficient audit process, are articulated along with their thoughts regarding the 'comply or explain' principle.

When asking the respondents which international regulations have influenced the Swedish Code of Corporate Governance, most answer that the Sarbanes-Oxley Act has been the main influence. Also, the UK Cadbury Report is mentioned by a few respondents. After the scandals in the US and Europe, various corporate governance codes have been developed, but they are all quite similar. However, all respondents are pointing out the differences between the Sarbanes-Oxley Act and the Swedish Code. The US version is a law with very strict requirements while the Swedish Code is self-regulating and a lighter version. One respondent clarifies that the Code as a whole has been influenced by the British framework, but the special requirement regarding the internal control report is mostly inspired by the

Sarbanes-Oxley Act. The corporate scandals put a lot of focus on internal control and those requirements were, according to the respondent, included in the Swedish Code, without reflecting over which consequences they would have. This respondent also states that “it is a short paragraph without further explanation, but it implies more extensive efforts than expected”. A few respondents mentioned that the Code might be redundant in Sweden where the Swedish Company Act requires divided responsibilities between owners, the board and the company.

There exists a fear among many companies that the American framework will be too influential and that it will be very costly, according to a few respondents. Auditors are already influenced by the US and the Sarbanes-Oxley Act since they are auditing Swedish companies registered at the US stock exchange. One respondent believes that the experience auditors have from Swedish companies that follow the US law could potentially result in those methods being used in auditing these companies in Sweden. Further the respondent thinks that auditors can learn from the working methods used applying the Sarbanes-Oxley Act, but it is not certain how similar the recommended Swedish guidance will be compared to the American framework.

The Sarbanes-Oxley Act is, by all respondents, considered to be detailed in its nature. Although one respondent argues it is not the paragraph in the law that is detailed, the internal control section is quite small. It is the interpretation and the guidelines of the law that are very extensive. The Swedish recommendations for auditors, which will be issued by FAR, is according to two of the respondents, not very detailed and is founded on principles like risk assessment and professional judgement. It contains recommendations on how to assess risks, controls, processes and general descriptions of what the auditor should think about when reviewing the report. The internal control framework of COSO permeates all the recommendations. Most of the respondents do not think that the guidelines should be as rule-oriented as the American framework with exact limits. Instead they appreciate the use of professional judgement which is more flexible and adaptable to different kinds of companies. One respondent argues that in the American framework auditors have to work with some less important areas “the degree of detail is very high in the US, they can’t see the forest for the trees”. When evaluating the advantages of more detailed guidelines for auditors most respondents acknowledge the comparability and the uniformity it brings. It could also potentially be easier for the auditor to follow detailed descriptions especially when applying new requirements. The experienced disadvantages are that the same rules do not make sense in every company. Also, a literal interpretation might encourage creative solutions just to avoid certain rules. When evaluating how the work process is affected by a detailed framework one respondent states “it is efficient because it creates a uniform quality but inefficient since it takes a lot of time”.

The 'comply or explain' principle is considered to align well with the self-regulating purpose of the Code. Most of the respondents think that companies will be allowed to explain almost all deviations instead of complying as long as the explanations are satisfactory. All of the respondents argue that in practice most companies will comply with the internal control requirements since it is easier and they avoid criticism. Only details will be explained rather than complied with. The principle will not interfere with the review of the internal control report according to most respondents but it could possibly result in more professional judgement when evaluating the purpose behind the explanations. If a company chooses to explain why it has not complied with the requirements a certain year, a few respondents mention that it would be impossible for the auditor to review the report. This year it is expected that many companies will explain their deviations from the Code by stating their lack of time to prepare the internal control report.

## **5.6 Chapter Summary**

In this chapter we have presented the empirical findings resulting from six interviews with representatives from the four biggest audit firms in Sweden: Deloitte, Ernst&Young, KPMG and Öhrlings PriceWaterhouseCoopers. Their perspectives on methods and audit procedures to review internal controls, the level of integration of audits, possible synergies, implementation difficulties and frameworks and the influences from international regulations have been presented. The theme structure aimed at facilitating an overview perspective on the interview material, will to a certain extent, form the structure in chapter six as well. In the next chapter the empirical findings presented will be utilised to analyse the auditors perspective on internal control provisions in the Code.

# 6 Analysis of Empirical Findings

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*Chapter six is concerned with the analysis of the empirical findings we examined in the previous chapter. We will proceed with the same theme structure utilised in chapter five, hence the analysis will be divided into four parts. This structure is aimed at facilitating understanding of the analysis.*

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## 6.1 Chapter Introduction

In this chapter we will present the analysis of the empirical findings related to the four themes utilised in chapter five. The analysis will primarily be conducted in the theme structure but it will occasionally contain references to information pertaining to a different theme. Some parts of the analysis of each theme might be connected to other themes since the material is complex and interrelated. The pattern discovered in the empirical findings will be analysed and is aimed to obtain an understanding of how different features discussed in the material could affect audit efficiency, when implementing the provisions in the Code regarding internal control. It is the respondents' perceptions and expectations of performing a review of internal control reports that will be analysed in this chapter.

## 6.2 Analysis of Methods and Audit Procedures

Methods and audit procedures could potentially affect audit efficiency when the new requirements to review the internal control report are introduced. Even though the American legislation contains strict rules regarding testing of internal controls which the Swedish Code does not have, the experience from this context is certainly relevant in the Swedish context. One major problem with efficiency in the US was due to an insufficient use of a risk-based audit approach. However risk-assessment seems to be a prioritised focus in the Swedish context according to our empirical findings. Related to this matter is the need to direct attention to areas that could potentially have material errors. This also seems to be an area acknowledged by the respondents as a main feature in the audit procedures when complying with the new provisions. One reason for this might be that many Swedish auditors have experience from implementing Sarbanes-Oxley Act. Therefore it seems conceivable that auditors in Sweden could avoid audit inefficiency resulting from these problems. Problems with audit effectiveness, which refers to how successfully the auditor applies audit procedures and methods to be able to detect misstatements, were also discussed in the US. This is another negative effect due to a lack of risk-based audits, which might have lesser impact in Sweden as a result of auditors utilising this audit approach to a larger extent. Hence, if risk analysis is utilised when actually implementing the new

requirements in Sweden we expect that this factor should not result in negative effects on neither audit efficiency nor effectiveness.

Even though the respondents argued they would not utilise any new methods or audit procedures when reviewing the internal control report, the provisions in the Code effect the ability of the auditor to rely on certain methods to a larger extent than previously. A major difference due to the Code is the increased demand for documentation of internal controls in the companies. This provides the auditor with an opportunity to request improved documentation when it is defective, and further it should result in more documentation created by the companies. Implications of this could be a reduced amount of effort to understand the company when auditing the financial statements and thereby enhancing audit efficiency and reducing audit fees. Too much reliance on one form of documentation might affect audit effectiveness negatively since it might result in internal control deficiencies being overlooked, even though it is used by the auditors to enhance audit efficiency as discussed by Bierstaker and Wright (2004). Hence the audit efficiency of the audit of financial statements and the review of internal control reports could be affected when more documentation is available to the auditors. As stated above the respondents in this study argued that no new methods or audit procedures would be necessary to comply with the new requirements, but it could have effect on the amount of effort spent on existing procedures. For example the auditor would be forced to move beyond the financial department. This could potentially increase the understanding of the company and be useful in the audit of financial statements.

Our respondents stated that the amount of effort spent on reviewing internal controls was previously determined by factors such as judgement by the auditor and the complexity of the examined company. In the new context it might to a larger extent depend on the amount of work already performed by the company. Some respondents thought that it might be easier to review companies that have documented for example the internal control routines, while companies with deficiencies in the documentation might result in difficulties for the auditor. As discussed by Daigle *et al.* (2005) the verification process of asserted controls could be more easily conducted if the controls are well designed and documented. The amount of effort necessary to review internal controls could potentially be reduced. They find in their study that if internal controls are reliable it could imply cost-savings. Thus the audit efficiency might be influenced by factors determined inside the company. However the difference among companies should be more significant in the first years of implementation since it could be expected that compliance with the requirements induce more homogenous effort to improve the design and documentation of internal controls in the companies.

## 6.3 Analysis of Integration and Synergies

To obtain efficiency in the audit process, the review of internal control reports and the audit of financial statements need to be integrated. The implementation of section 404 in the US did not successfully achieve this goal since auditors performed two parallel audits. In this study the respondents perceive the integration between the audit of financial statements and the review of the internal control report as very important. This implies that the audit inefficiencies due to lack of integration, experienced in the US context, are less probable in Sweden. Many auditors have experience from implementing the internal control provisions in section 404 of the Sarbanes-Oxley Act. Therefore it might be possible to avoid this duplication of effort and hence avoid audit inefficiency, already in the first year of implementation in the Swedish context.

Another factor influencing audit efficiency is the extent to which the auditors are willing to rely on the work of others. In the American context this was allowed to a certain degree but the opportunity was not utilised by the auditors in the first year of implementation, which induced audit inefficiencies. According to the empirical findings of this study there seems to be reluctance among auditors to utilise the work of for example internal auditors. This could potentially lead to duplication of effort like in the US experience. Felix *et al.* (2001) found that if the auditor utilises the contribution of the internal audit function and co-ordinates internal and external audit efforts, this could decrease audit fees. Naturally reliance could introduce an independence problem which might be something auditors are keen to avoid. Another aspect of using the work of internal auditors is that internal auditors are less common in Sweden and hence not a major factor in determining audit efficiency. However the respondents seem to be more comfortable to relying on work performed by external sources such as consultants. This should influence audit efficiency in a positive way since it results in less effort to review this work.

A possible synergy resulting from reviewing internal control reports is according to our empirical findings that implementing the internal control provisions might result in fewer substantive tests in the audit of financial statement. This synergy is due to internal controls being examined more extensively, reducing the need for substantive testing. This could affect audit efficiency as discussed by Bierstaker and Wright (2004). They believe that increased reliance on internal controls and thereby reduced substantive testing could improve efficiency in audits. Another aspect of reviewing internal control reports, which could enhance the synergies further, is improved internal control systems in the companies. If implementing the provision in the Code regarding internal control results in better internal control systems, it could indirectly have effect on audit efficiency. The review of the internal control report is thought to result in better internal control than if this had not been done. Better internal controls would induce higher audit efficiency since the auditor might rely on internal controls to a larger extent than previously

and thereby reduce substantive testing. In a study by Smith *et al.* (2000) it is found that substantive testing is less useful than internal control assessment if the systems are strong and in this situation it is cost-efficient for the auditor to direct effort to testing control systems. However neither of the two types of testing results in higher probabilities detecting fraud which is also the view of our respondents. Thus, increased reliance on internal controls might result in synergies, which induce higher audit efficiency. The synergies could partly be due to more attention on internal controls, which can result in reduced substantive testing. Indirectly the efficiency can be increased since the review of the report potentially could improve the internal controls and thereby induce enhanced reliance on these instead of substantive testing.

Audit hours and fees will probably increase despite integration and synergies, according to the views of the respondents. Thus the synergies expected to be obtained when reviewing internal controls in relation to audit of financial statements are not enough to outweigh the extra effort needed to be able to give an opinion on internal control reports.

## **6.4 Analysis of Value Creation and Audit Difficulties**

The cost-benefit perspective is fundamental when analysing affects on audit efficiency due to the internal control report requirement. A main objective of the Code is to strengthen the credibility of the Swedish capital market by offering further transparency towards stakeholders. The representatives of industry and commerce demand benefits to make up for the increased costs due to the internal control report. The question is whether the auditor review of the internal control report can create the value requested and whether this can be done at reasonable costs. In the US compliance cost with section 404 of the Sarbanes-Oxley Act has been higher than expected and a significant part of the costs are due to increased audit fees. However the Swedish compliance costs are not anticipated to increment to the same levels. The respondents acknowledge companies' fear of increased costs and audit fees, since it is estimated the audit fees will increase with 30-50 percent. Hence the auditors perceive that the review of internal control reports will require increased effort by the auditor.

The fact that the representatives for industry and commerce requested an auditor opinion of the internal control report indicates that they perceived the benefits resulting from an auditor review to exceed the costs. However, according to the respondents this can only be achieved by an efficient audit process. Reviewing the internal control report is thought to be necessary to add credibility to the report. Without an auditor review there would be no assurance that the companies would issue a reliable report and the opinion is that the quality of the report is enhanced

when it is reviewed. When implementing section 404 of the Sarbanes-Oxley Act, the aim was to prevent and detect fraud and other weaknesses, however a report by Riise Johansen (2006) who studied the consequences of corporate governance in an auditor context, presents information that only in 14 percent of the reports reviewed were weaknesses discovered and disclosed. Expectations of detecting additional weaknesses in the financial information in the Swedish context indicate a similar tendency. There exists a consensus among the respondents that the audit of financial statements already covers the main risk areas of the internal control. Also in Sweden the Code requires the auditor to review only the report on internal control, not the functions of the internal control systems themselves. The review can potentially increase the probability of detecting weaknesses but the results of this study shows that it is a common opinion that few material misstatements will actually be discovered. The aim in the US, to reduce the threat of corporate scandals and fraud, is in a study by Hsieu Lin and Wu (2006) considered misguided due to a narrow scope of the internal control mainly focusing on the accounting process. Our respondents also argue that the review of the report can not assure that fraudulent behaviour, especially conducted by senior management, is detected. The review of the internal control report is not perceived to directly contribute to adding reliability since detection of additional weaknesses is not expected. However the reliability could indirectly be enhanced due to improved internal controls in the companies.

The primary benefit of an auditor review recognised in our empirical study is not the detection of weaknesses by the auditor, but rather that the quality and reliability of the internal control is enhanced and that the management focuses more on internal control. The board and management are forced to examine the internal control functions and this can result in rationalising of the systems. This is in line with Baker (2005) who presents the opinion that the focus on internal control enhances the senior management's understanding of how effective the control functions really are. A positive consequence of the attention on internal controls, for the company, and hence their stakeholders, is that savings can be made and more reliable information can be produced with more effective internal controls in the company. The improved internal control will in turn increase audit efficiency since reliance in the internal control lead to less effort conducting the audit of financial statements.

One concern expressed by a few respondents is the incentive for companies to delist from the Stockholm Stock Exchange because of the higher costs due to the internal control report. This was also debated in the US when implementing section 404, especially for smaller firms where the compliance cost could be overwhelming. We have not found any studies discussing whether the new regulations actually resulted in delisting in the US, however the dependence of the US capital market might have prevented such action. In Sweden there might be other conceivable alternatives to the Swedish stock exchange, for example Nordic or European stock exchanges with less regulation. However the softer approach

in the Code with a 'comply or explain' principle speaks against such drastic reactions as delisting.

The fact that a review of the internal control is not required this year is due to the lack of framework for both companies and auditors and the lack of time for companies to prepare. Without a framework to lean against and with the varying quality of the internal control reports it would not have been of much value to review the reports this year. When the framework is in place it is not expected that any difficulties reviewing the internal control report will occur. Also efficiency in the audit process is expected to be enhanced when the companies get more experience and issue reports with better quality and improved documentation. A report on the implementation of section 404 issued by the PCAOB indicated that the auditors had difficulties conducting the audits in an efficient and integrated manner. Some Swedish auditors already have experience from reviewing the internal control reports issued by Swedish companies complying with the Sarbanes-Oxley. This could imply that there will be fewer problems in the Swedish context than in the US. Hence the efficiency is only expected to be affected negatively during the first years of implementation. Our study shows no indications of problems in reviewing the internal control reports will continue to affect the efficiency.

## **6.5 Analysis of Perspectives on Framework and International Influences**

The international regulations providing most influence on the Swedish Code of the Corporate Governance are the US Sarbanes-Oxley Act and the UK development of corporate governance regulations. While the UK regulation has inspired the foundation and principles of the Swedish Code, the Sarbanes-Oxley Act has directly influenced the requirements of the internal control report according to our study. It might require more effort than was first expected for the companies to issue a report and for the auditors to review the report.

The framing of the requirements has of course been impacted by international influences. The level of detail in the Sarbanes-Oxley Act is perceived as very high although Schipper (2003), who analysed the effects of rule-based accounting standards, argues that it is not the regulation itself that is detailed but rather the implementation guides. Some of our respondents also confirm with this logic. The Swedish regulations are in general less detailed and encourage professional judgement. According to Schipper (2003) the degree of detail is also a result of requests for further explanation and clarity. This tendency was found in our empirical study as well, a few of the respondents asked for detailed guidance to facilitate the audit process. At the same time though, the same respondents appreciate the principles of professional judgement and risk assessment which are

more flexible and adaptable to different kinds of companies. On one hand a detailed framework can increase the efficiency of the audit process, due to clear instructions and unity of measures which Schipper (2003) argues is a consequence of detailed guidance. Potentially it could also be easier for the auditor to follow detailed descriptions especially when applying new requirements. Our respondents are of the same opinion as Schipper who believes that comparability is enhanced, which is due to that variations in professional judgement are reduced. With the concept of efficiency in mind, uniformity of quality is enhanced when applying a rule-oriented guidance. On the other hand it is inefficient since it could take a lot of time to comply with. Another disadvantage with complying with specific rules is the focus on technicalities according to Satava *et al.* (2006). In a study about ethics and auditing culture he finds that circumvention of rules with the aim to find loopholes is a potential consequence. This is also a major concern among the respondents. A literal interpretation might encourage creative solutions just to avoid certain rules. In a guidance based on principles this conduct can more easily be detected and it also allows more flexibility since alterations in the reviewing procedures can be made based on the different needs. The style of regulation influences audit efficiency due to increased reliability of the financial information since material risks will be considered when professional judgement is utilised.

The recommendations regarding the internal control report review, that in short will be issued by FAR, are not expected to be very extensive. The generally held recommendation indicates a softer approach, which allows free scope for judgement. Cost-savings can be made when allowing professional judgement due to increased focus on the big picture instead of looking at every detail. For those who ask for a clear guidance the recommendations can be perceived as vague and it might lead to difficulties and confusion the first years of reviewing the internal control report. In lack of common rules, the audit firms themselves are however likely to develop their own implementation guides, based on the recommendations from FAR, with more explicit explanations of which methods to use when reviewing the internal control report. This could potentially result in several interpretations of appropriate reviewing methods and procedures, but at the same time create conformity within the audit firms.

The 'comply or explain' principle is not expected to create any difficulties in the reviewing process, contrary to Riise Johansen (2006) who argues that a 'soft law' containing both required and voluntary information will lead to problems for the auditor. Riise Johansen (2006) believes that it would take a lot of effort for the auditor to obtain the high degree of assurance usually required. 'Comply or explain' is a principle that facilitate flexibility and is in line with the softer approach in the Code. The auditor will rely on professional judgement when evaluating the compliance. Very few companies are expected to take advantage of the opportunity to explain instead of comply in the future since it could result in questioning their reliability. Hence audit efficiency should not be influenced by the possibility of explaining deviations.

## **6.6 Chapter Summary**

In this chapter we have presented our analysis based on the empirical findings. In four themes the respondents' opinions and perceptions of the review of the internal control report and its implications on audit efficiency have been examined. Relevant literature was used to support the analysis of the affects on audit methods, synergies, value creation and perspectives on framing. These areas were evaluated to obtain an understanding of the impacts on efficiency in the audit process due to the review of the internal control report. We found that there are many aspects in the audit process that affect efficiency. By applying the right methods, effort can be reduced and efficiency increadsed. If the review of the internal control report and the audit of financial statements can be integrated, efficiency can be increased further. The value created when reviewing the internal control report is mainly the increase of reliability of the internal controls. This analysis is the foundation of the conclusions, which will be presented in the next chapter.

# 7 Conclusions

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*In this chapter we will present the conclusions of our study and we further aim to answer our basic question. Moreover reflections on the conclusions of this thesis will be discussed. In the last section suggestions for future research will be provided.*

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## 7.1 Chapter Introduction

The evolving audit context has introduced a new duty to review internal control reports. This requirement could have implications on the audit process, which is the focus of this thesis. We have chosen the concept of audit efficiency to highlight changes in the audit process due to the internal control provisions in the Code. We will, in this chapter, present the conclusions resulting from the analysis of our empirical findings. These are aimed at fulfilling the purpose of this thesis outlined in chapter one. We also intend to provide an answer to the basic question of this research. Furthermore, reflections on the study and its conclusions will be provided. In the last section suggestions for future research on the matter of the internal control provisions in the Code will be presented.

## 7.2 Conclusions

Our study shows no indication of development of new audit methods or procedures. Nonetheless it is evident that some procedures are likely to attract more attention and be more intensively utilised than before. The new report also requires more work in addition to the efforts auditors previously made to review internal controls in the audit of financial statements. Risk-analysis should not result in problems with efficiency in the Swedish context since the importance of utilising this method is well known and recognised. Previous research has shown that an increased reliance on internally prepared documentation might result in cost-efficiency but it could also result in reduced reliability if auditors rely on it too much. Our study showed some indications of an increased reliance on documentation as a result of implementing the internal control provisions. Thus, due to increased documentation less effort in the audit process might be needed. The auditor could be more or less efficient depending on the amount and quality of documentation produced by the company since it influences the degree that the auditor can rely on the documentation.

A lack of integration of audits affects efficiency negatively, however from our findings we conclude that this should not be the result in the Swedish context. There seems to be a consensus around the importance of integrating the audit of financial statements with the review of internal control reports, therefore no duplication should occur as a result of the new standards. Our study shows

indications that the auditor might reduce substantive testing in favour of testing internal controls. This procedure has the potential to be cost-efficient since it implies less effort when the internal controls are strong, and the procedure should not have any effects on the reliability. The internal control provisions could result in better internal controls which the auditor might rely on when auditing the financial statements. This synergy suggests that audit efficiency will be upheld.

The benefit of an internal control report that is reviewed by auditors is mainly that the reliability in the information in the internal control report is increased. It is not expected that auditors will detect more weaknesses in the internal control and misstatements in the financial information than before. It is believed that the main risk areas regarding internal control are already covered by the audit of financial statements and that the review of the internal control report will not contribute to discovering illegal practices. Instead the primary benefit of introducing a reviewed internal control report originates from the stakeholders' demand for a report of high quality and integrity. The review brings a certain level of assurance to the information in the reports and it adds pressure on the board and management to focus on the internal control of the companies. This attention is expected to improve the quality and effectiveness in the companies' internal control systems. The companies and the stakeholders will then experience benefits such as more reliable internal controls which prevent future misstatements. A well functioning internal control system can affect audit efficiency since the auditor can rely on internal controls to a greater extent when auditing the financial statements. The effort to audit the financial statements could potentially decrease. This implies that the extra effort and resources spent, on reviewing the internal control report could be mitigated by the benefits of more reliable financial statements.

The framing of the guidance available to the auditors regarding the review of the internal control report impacts the efficiency in the work process. The recommendation soon to be issued by FAR is expected to be brief and not include specific details on how to perform the review. The low degree of detail could imply that the work process will require more professional judgement and effort from auditors instead of the clarity and uniformity achieved with a 'check the box mentality', which is perceived as easier to perform. The efficiency could be decreased when general recommendations are applied since more effort is required when professional judgement is encouraged. The advantage with an implementation guide based on general recommendations is flexibility when reviewing different companies and a greater focus on material risks. This approach will better suit the aim of the internal control report to enhance reliability of the financial information since focus on material risks and the bigger picture is encouraged. These generated benefits increase efficiency since more reliable financial information is achieved. Hence, efficiency is affected in both positive and negative directions due the expected general recommendation.

### **7.3 Answer to Basic Question**

More efforts and resources will be required when reviewing internal control reports. However this consequence could be mitigated when synergies are created between the audit of financial statements and the review of internal control reports. There is a lack of evidence that the review of internal control reports will result in additional detection of material misstatements. The main benefit from reviewing the internal control report is achieving more reliable internal controls, which results in prevention of misstatements in the financial statements. This will affect the efficiency in the audit process since the auditor can rely on internal controls when performing audit procedures. Efficiency in the audit process is affected negatively by an increase in effort and positively by an increase in reliability. This implies that the benefits of preventing misstatements could outweigh the efforts and resources spent on reviewing the internal control report.

### **7.4 Reflections on the Study**

Reflections on the results of this study will be discussed in this section. We will further deal with the possible weaknesses in the thesis due to the utilised methodology.

One aspect to consider regarding the empirical findings in this study is that our respondents might have different conceptions of the meaning of words such as efficiency and rule-based regulations, this could result in difficulties to compare the empirical findings. However, we believe the respondents all have an auditor perspective and a homogeneous background due to the fact that they represent the big four audit firms. Some of the respondents do not work as auditors in their current position, however they all have previous experience in auditing. Furthermore we acknowledge the fact that our respondents might not be completely objective, this reflection is essential since it might have influenced our conclusions. For example the respondents might be unwilling to critically evaluate the work they performed previously in comparison to the extended work resulting from the new requirements and the impact this have on detection of material misstatements. Another aspect to consider regarding the empirical findings is that two of the interviews were not recorded, which could have an impact on reliability.

It is difficult to generalise the frequency of a phenomenon in a qualitative research and we have focused on exploring the features of audit efficiency in a contextual environment. The study was aimed at increasing the understanding of the potential implications of reviewing internal control reports on audit efficiency. We believe that the study indeed resulted in an increased comprehension of what to expect from implementing the internal control provisions in the Code. It further

resulted in indications on how efficiency in the audit process will be affected. The study describes different factors that could influence efficiency in the audit process, however it is not possible to draw conclusions on the direction of efficiency as a whole since the study indicates mixed results with regards to efficiency.

The qualitative strategy we utilised in this study to acquire a detailed description of the auditors' perspectives and opinions regarding the new requirements resulted in several new issues which need further research. In this study we have examined an area which will continue to evolve and the actual implications of introducing the new requirements will become evident. These areas and suggestions for future research will be discussed in the next section.

## **7.5 Future Research**

We will present two suggestions for future research regarding the effects on audits due to the new requirement. The qualitative strategy employed in this study has induced a need to quantify the effects due to the internal control provisions in the Code. Since this study is based on the auditors' perceptions on how the new requirement will affect the audit process it is of interest to further examine the effects of the actual implementation.

By conducting quantitative studies on the effects on audit hours and fees, the total influence of the internal control provisions on audit efficiency could be further examined in the first year of implementation. As indicated by the results in this study the efficiency might be enhanced if the companies' internal controls are improved which implies that a long-term perspective, could also be of interest.

Another aspect when introducing the new requirement is whether more material weaknesses will be discovered. This is of interest in the short term, when the effects of first year of implementation are evident and also in a long-term perspective. Possible improvements might have effects on the amount of material weaknesses found in the audits. Hence a quantitative study regarding this issue is necessary to further investigate the effects due to the internal control provisions in the Code.

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## **Interviewees**

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Carlsvi, David, Global Risk Management Solutions, Öhrlings PriceWaterhouseCoopers, Malmö office, 13 April 2006

Hult, Anders, Partner Enterprise Risk Services, Deloitte Stockholm office, 27 April 2006

Enlund, Bertel, Auditor, Ernst&Young Gothenburg office, 24 April 2006

Mårtensson, Tommy, Auditor, Deloitte, Stockholm office, 5 May 2006

Thilström, Joakim, Auditor, KPMG, Stockholm office, 26 April 2006

# Appendix A

## Questionnaire

- How was the internal control reviewed before the introduction of the Swedish Code of Corporate Governance?
  - Which reviewing methods were used?
  - What processes were reviewed? In what purpose?
  - Which regulations or recommendations were used?
  
- How will the companies' report on internal control be audited?
  - Will new work assignments and methods be used?
  - What processes will be reviewed and is judgement of risk an important factor in determining what to focus on?
  - Will it require a lot of extra work to give an opinion regarding the internal control report?
  
- To what extent can the audit of financial statements and the review of internal control report be integrated?
  - Can synergies be created?
  - Can the review of the internal control report be integrated with work of others?
  
- Are there any difficulties in reviewing the internal control report?
  - In the year 2005 the auditor does not need to give an opinion regarding the internal control report, what is the reason for this?
  - Is it necessary to have guidance on how to review the internal control report?
  - Would you prefer a detailed guidance of the review process?
  
- Is an audited internal control report needed in Sweden?
  - Will the international regulations influence the work assignments?
  - How are the international recommendations on internal control different from the Swedish?
  - Which framing of the regulation results in the most efficient work process?
  
- Is the Code and the requirement of the internal control report adopted to Swedish conditions?
  - Is it value enhancing to review the internal control report?
  - Does the probability of detecting material misstatements or fraud increase?
  
- The Code is based on the principle 'comply or explain'.
  - To what degree can the company utilise explanations?
  - Does the principle create any difficulties in the audit process?

# Appendix B

## Underlag för intervjuer

- Anser Ni att kodens regler om intern kontroll är anpassad för svenska förhållanden?
  - Är koden influerad av internationella regelverk?
- När det gäller vägledningen för revisorer angående granskning och avrapportering gällande styrelsens rapport om intern kontroll;
  - Skiljer sig den svenska vägledningen för revisorer från internationella rekommendationer? Detaljstyrd/Principbaserad?
  - Hur påverkar utformningen av reglerna effektiviteten i revisionsarbetet? och reliabiliteten i revisorns uttalande om intern kontroll?
- I vilken utsträckning kan revisionen av finansiella rapporter samordnas med granskningen av rapporten om intern kontroll?
  - Kommer det att skapas synergier? I så fall i vilka arbetsuppgifter?
  - Kan granskningen av rapporten om intern kontroll integreras med andras uppgifter (work of others), tex. internrevisionen?
  - Kommer de nya ansvarsområdena ta i anspråk tid och resurs på bekostnad av revisionen av de finansiella rapporterna?
- Vad finns det för problem med att granska rapporten om intern kontroll?
  - I årsredovisningen för år 2005 behöver inte revisorn uttala sig om den interna kontrollen, vad är anledningen till detta? Hur har osäkerheten om vilka kriterier som ska uppfyllas för att kunna uttala en uppfattning påverkat övergångslösningen?
  - Vilka kontrollsvårigheter kan uppstå?
- Är syftet med vägledningen för revisorer att ge en detaljerad arbetsbeskrivning?
  - Vilka nya arbetsuppgifter tillkommer? Vad kommer att undersökas? Påverkar riskbedömning vad som undersöks?
  - Kommer det kräva merarbete från revisorn? tidsanspråk?
- I koden används följ eller förklara modellen, hur påverkar detta revisorns granskning?
  - Hur granskar revisorn rapporten om intern kontroll i de fall företagen utnyttjar sin rätt att förklara?
- Är det värdefullt att granska rapporten om intern kontroll?
  - Tillför granskningen något värde? För vem?
  - Ökar sannolikheten att väsentliga missförhållanden i företagen? Eller har intern kontroll även tidigare granskats på liknande sätt?

# Appendix C

## Public Company Accounting Oversight Board Bylaws and Rules – Standards – AS2

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### Example A-1

#### **ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING (SEPARATE REPORT)<sup>1/</sup>**

##### Report of Independent Registered Public Accounting Firm

###### *[Introductory paragraph]*

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

###### *[Scope paragraph]*

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

###### *[Definition paragraph]*

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<sup>1/</sup> If the auditor issues separate reports on the audit of internal control over financial reporting and the audit of the financial statements, both reports should include a statement that the audit was conducted in accordance with standards of the Public Company Accounting Oversight Board (United States).

**Public Company Accounting Oversight Board  
Bylaws and Rules – Standards – AS2**

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A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

*[Inherent limitations paragraph]*

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

*[Opinion paragraph]*

In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]*. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]*.

*[Explanatory paragraph]*

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the *[identify financial statements]* of W Company and our report dated *[date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting]* expressed *[include nature of opinion]*.

*[Signature]*

**Public Company Accounting Oversight Board  
Bylaws and Rules – Standards – AS2**

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*[City and State or Country]*

*[Date]*