March 26, 2004

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A New Standard for Auditing Internal Control Over Financial Reporting

Public Company auditors now have a new standard for auditing internal control over financial reporting. The Public Company Accounting Oversight Board recently adopted this standard, [1] which although largely consistent with the original proposal,[2] has a number of helpful changes, including the following:

- more flexibility to rely on the work of others and a narrower scope for required transaction tracing, or walkthroughs;
- clarifications to the reporting threshold for internal control problems; and
- refinement of how the auditor must assess the effectiveness of the audit committee.

Background

To implement Section 404(a) of the Sarbanes-Oxley Act of 2002, the SEC adopted rules requiring annual management assessments of the effectiveness of public companies' internal control over financial reporting and reports by independent auditors addressing those assessments.[3] Also under the Sarbanes-Oxley Act, the Public Company Accounting Oversight Board, generally charged with establishing professional standards for public company auditors, was to establish professional standards governing the audit of management's assessment of the effectiveness of internal control over financial reporting.[4] The final standard adopted by the Board responds to this statutory requirement.[5]

The Board received over 190 comment letters on the proposed standard, covering a wide list of topics. In its adopting release, the Board stated that the comment

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[1] The Board has codified the standard as Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements. *See* Public Company Accounting Oversight Board Release No. 2004-001 (Mar. 9, 2004) http://www.pcaobus.org/rules/Release-20040308-1a.pdf. The new standard must be approved by the SEC before becoming effective, which the SEC's Chief Accountant, Donald Nicolaisen, has said should happen in April.

[2] *See* Public Company Accounting Oversight Board Release No. 2003-017 (Oct. 7, 2003) http://www.pcaobus.org/rules/Release2003-017.pdf.

[3] *See* the SEC Release No. 33-8238 (Jun. 5, 2003) http://www.sec.gov/rules/final/33-8238.htm. The SEC extended the compliance date for these rules in February 2004. Under the new compliance schedule, an "accelerated filer" must begin to comply with the new rules for its first fiscal year ending on or after November 15, 2004, and any other filer must begin to comply for its first fiscal year ending on or after July 15, 2005.

[4] *See* Sections 103(a)(2)(A) and 404(b) of the Sarbanes-Oxley Act.

[5] The standard refers to the attestation required by Section 404(b) of the Sarbanes-Oxley Act as the *audit* of internal control over financial reporting instead of an *attestation* of management's assessment. The Board decided this approach was appropriate for two reasons. First, the auditor's objective is to express an opinion on management's assessment of the effectiveness of internal control over financial reporting, just as the auditor's objective in an audit of the financial statements is to express an opinion on the company's presentation of its financial statements. Second, the level of assurance obtained by the auditor is the same in both cases. Consistent with this approach, the standard describes an *integrated* audit of the financial statements and internal control over financial reporting.

letters led the Board to make changes in the standard, primarily to make the requirements set forth in the standard clearer and more operational.

While much of the standard is more directly relevant to independent auditors than public companies, there are a number of topics in the standard that should interest public companies and their employees and officers involved in financial reporting, internal control and disclosure generally. Sections 302 and 404 of the Sarbanes-Oxley Act and the SEC's implementing rules impose an increased duty on public company management for internal control over financial reporting. This includes quarterly identification of "significant deficiencies" and "material weaknesses", in and annual assessments of, internal control. The new audit standard bears directly on how the outside auditor will evaluate management's response to this new internal control mandate.

Overview of the Audit

The standard provides that an auditor's objective in an audit of internal control over financial reporting is to express an opinion about whether management's assessment about the effectiveness of internal control over financial reporting is stated fairly, in all material respects. [6] The Board determined that, in order to provide an opinion on management's assessment of internal control effectiveness, the auditor must obtain a high level of assurance that the conclusion expressed in management's assessment is correct. Further, to obtain such assurance, the Board concluded that the auditor must test internal control over financial reporting directly. The Board noted that an audit process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct.

The standard outlines an extensive process for the conduct of an audit of internal control over financial reporting. Set forth below is a brief summary of the key elements of the audit process as described in the standard.

Planning the Engagement. In planning the engagement, the auditor should consider a full range of factors. Starting with an understanding of a company's current internal control over financial reporting, the auditor should plan the engagement based on industry-specific factors, company-specific matters and preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses. The auditor should review previous control deficiencies, relevant legal or regulatory matters, the number of significant business locations or units, and the type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting.

Evaluating Management's Assessment Process. The auditor must evaluate management's process for assessing the effectiveness of internal control over financial reporting. The auditor should determine whether management has addressed a number of specific elements described in the standard. In addition, the auditor must evaluate the sufficiency of management's documentation prepared in connection with management's assessment.

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[6] "Internal control over financial reporting" is defined in the standard consistently with the definition of the same in Rules 13a-15(f) and 15d-15(f) under the Exchange Act.

Obtaining an Understanding of Internal Control Over Financial Reporting. This is really the core of the audit process. The new standard outlines a number of steps that the auditor must take to obtain this understanding, including the following:

- identify company-level (pervasive) controls;
- evaluate the effectiveness of the audit committee's oversight of financial reporting and internal control;
- identify significant accounts and components of disclosure, using both quantitative and qualitative factors;
- for each significant account, identify assertions that have a meaningful bearing on whether the account is fairly stated, e.g., assertions regarding existence, completeness and valuation;
- identify significant processes (e.g., capturing, sorting and merging data) over each major class of transactions affecting significant accounts or groups of accounts;
- understand the period-end financial reporting process;
- perform walkthroughs for each major class of transactions by tracing transactions from origination through the company's information systems until it is reflected in the financial reports; and
- identify controls to be tested.

Testing and Evaluating Design Effectiveness. The standard provides that internal control over financial reporting is designed effectively if it would be expected to prevent or detect errors or fraud that could result in material misstatements in the financial statements. To evaluate design effectiveness, the auditor must identify the company's control objectives and the elements of such control that satisfy each objective and determine whether the elements, if operating properly, can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

Testing and Evaluating Operating Effectiveness. The auditor must evaluate the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. The standard provides detailed guidance to assist the auditor with respect to the nature, timing and extent of tests of controls.

Using the Work of Others. Although the standard requires the auditor to perform enough of the testing itself so that the auditor's own work provides the principal evidence for the auditor's opinion, the auditor may use the work of others, such as internal auditors and other company employees, in some circumstances. The final standard provides auditors with more flexibility in this area than did the proposed standard, as discussed below.

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting. The standard actually requires the auditor to form two opinions - one on management's assessment and one on the actual effectiveness of internal control over financial reporting. The proposed standard had a confusing "mixed model" approach.

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The final standard is more closely aligned with the two sections of the Sarbanes-Oxley Act (Sections 103 and 404) from which authority in this area is drawn. These opinions should be based on evidence obtained from all sources, including the adequacy of the assessment performed by management, the results of the auditor's evaluation of the design and tests of operating effectiveness of controls, the negative results of substantive procedures performed during the financial statement audit, and any identified control deficiencies.

Integration with Audit of Financial Statements

The standard requires an integrated engagement, i.e., when performing an audit of internal control over financial reporting, the auditor also must audit the company's financial statements as of the date specified in management's assessment regarding internal control. The Board based this requirement on its determination that the information to be obtained during a financial statement audit is relevant to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting.[7] The standard allows the auditor to express its opinions on the financial statements and on the effectiveness of internal control in separate reports or in a single, combined report.

Using the Work of Others

The proposed standard generated significant comment among both auditors and public companies regarding the circumstances in which the auditor could rely on the work of others in performing its audit of internal control. The proposed standard generally laid out two principles that limited the auditor's ability to use of the work of others. First, the proposed standard required that, on an overall basis, the auditor's own work must provide the "principal evidence" for the audit opinion. Second, the proposed standard defined three categories of control and the extent to which the auditor was permitted to use the work of others in each of those categories. The first of these three categories included controls for which the auditor should not rely on the work of others, such as the overall control environment and control elements specifically intended to prevent or detect fraud reasonably likely to have a material effect on the company's financial statements. Thus, the proposed standard effectively ruled out using the work of others in specified areas.

Many commenters, particularly issuers, voiced concern that the categories in the proposed standard were too restrictive, and that the auditor's judgment in determining how to use the work of others would be unduly limited. Other commenters found the proposed standard to place not enough emphasis on the work of the internal auditor who, it was argued, generally should have sufficient competence and objectivity to review the work performed by others in the organization, such as management.[8]

In response to these concerns, the Board modified the standard to remove the categorical framework contained in the proposed standard. While the final standard still requires that the auditor's own work provide the "principal evidence" for the audit opinion,

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[7] It is noteworthy that this mandatory integration of the two audits applies even in cases where a company might need to obtain an opinion on the effectiveness of internal control as of an interim date. Note, nonetheless, that it *is* permissible for an auditor to perform an audit of financial statements without also performing an audit with respect to internal control over financial reporting.

[8] Other commenters suggested that the proposed standard might undermine the authority of AU sec. 322 (*The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements)* ("AU sec. 322"), as it relates to the auditor's use of the work of the internal auditor in an audit of financial statements.

the auditor is given substantially more discretion than under the proposed standard in determining whether it is appropriate to use the work of others. In making this judgment, the auditor should (i) evaluate the nature of the controls subjected to the work of others, (ii) evaluate the competence and objectivity of the individuals who performed the work, and (iii) test some of the work performed by others to evaluate the quality and effectiveness of their work.[9] This is a qualitative, versus quantitative, judgment.[10]

Notwithstanding the greater flexibility afforded by the final standard, there are two areas where the auditor's ability to use the work of others is significantly limited. First, the standard provides that the auditor should not use the work of others to reduce the amount of work it performs to assess the quality of the overall control environment. Second, the auditor is required to perform "walkthroughs" itself because of the degree of judgment required in performing this work.

Walkthroughs

Commenters voiced concerns about the potential significant costs and burdens associated with the new requirement for auditor walkthroughs in the proposed standard. Walkthroughs involve tracing transactions from origination through the company's information systems to the financial reports. The proposed standard stated that the auditor should perform a walkthrough of significant processes (i.e., processes for such things as capturing, sorting and merging data) for *all* types of transactions and events, a scope that drew criticism as too broad. Based on the concerns of commenters, the Board narrowed the scope of transactions subjected to walkthroughs from "all types of transactions and events" to "each *major class* of transactions." Major classes of transactions are defined as those that are significant to the company's financial statements, based on the auditor's consideration of risk and materiality.

Definitions of Significant Deficiency and Material Weakness

The definitions of "significant deficiency" and "material weakness" are key elements of the new standard and of special interest to public companies and their principal executive and financial officers. Such companies and officers are required to make certain disclosures and certifications with their quarterly and annual SEC reports addressing internal control over financial reporting, including whether such officers have disclosed to the company's auditors and audit committee certain significant deficiencies and material weaknesses.[11] In addition, management may not conclude that the company's internal control over financial reporting is effective if there is a material weakness, and such material weakness must be specifically disclosed.

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[9] The standard explicitly confirms that AU sec. 322 applies to the use of others' work in an audit of the financial statements. The auditor may apply the relevant concepts described in that section to using the work of others in the audit of internal control over financial reporting.

[10] The Board noted that an auditor should be able to rely to a greater extent on the work of a highly competent and objective internal auditor than on work performed by others within the company. However, if the internal audit function reports solely to management, or if the company allocates limited resources to the internal audit function, the auditor should rely less on the internal audit function and more on its own testing.

[11] *See* Exhibit 31 of Item 601 of Regulation S-K. The certification required by Exhibit 31, along with the disclosure called for by Item 308(c) of Regulation S-K, also requires disclosure of any change in internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

The new standard modifies the definitions of significant deficiency and material weakness under current auditing standards.[12] The existing auditing standards define a material weakness using a framework focused on likelihood and magnitude. While the Board decided that this framework would facilitate effective implementation of the Sarbanes-Oxley Act's internal control reporting requirements, the Board decided that likelihood and magnitude needed to be defined in terms that would encourage more consistent application. Thus, for example, in the existing definition of material weakness, the Board decided that the definition of likelihood would be improved if it used "more than remote" instead of "relatively low level," because auditors were more familiar with that formulation of the likelihood definition.[13] The Board also determined that it would be appropriate to use the same general framework for defining significant deficiency as it adopted for defining material weakness. (Please see the ***Annex*** for the full definitions of the terms significant deficiency and material weakness under the new standard.)

When the Board proposed them, the changes to the definitions of significant deficiency and material weakness engendered significant objection from commenters. The main complaint was that these definitions set too low a threshold for the reporting of significant deficiencies. This was not a uniform view, however, and it is not entirely clear that the different formulation of the definitions actually represented a meaningful shift toward catching more control weaknesses within the concept of significant deficiency or material weakness. Partly to address concerns voiced by commenters, however, the Board added clarifying language to the standard to emphasize the importance of considering compensating controls when evaluating the likelihood of a misstatement occurring.[14] In its adopting release, the Board explained that the intent of the standard is that control deficiencies should first be evaluated individually. The determination as to whether they are significant deficiencies or material weaknesses should then be made considering the effects of compensating controls, and the effect of compensating controls should be taken into account when assessing the likelihood of a misstatement occurring and not being prevented or detected.

Evaluation of Effectiveness of Audit Committee

The standard requires the auditor to evaluate the effectiveness of the audit committee's oversight of the financial reporting process and internal control over financial reporting. The standard also states that ineffective oversight of internal control by the audit committee is a significant deficiency as well as a strong indicator of a material weakness.

A number of commenters objected to the auditor being required to evaluate the effectiveness of the audit committee. Such evaluation could pose an unacceptable conflict of interest, because the audit committee is charged with responsibility for appointing the independent auditor. Despite these concerns, the Board concluded that the requirement for evaluating the audit committee should be retained, observing in the process that the perceived conflict of interest is, to some extent, inherent in the duties that society expects of auditors. The Board did modify the final standard in this area in

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[12] The term "material weakness" is currently defined in the Board's interim auditing standards, which incorporate AU sec. 325 (*Communication of Internal Control Related Matters Noted in an Audit*). Such standard also defines the term "reportable condition," which the SEC has stated is equivalent to "significant deficiency." *See* fn. 73 to SEC Release No. 33-8238 (Jun. 5, 2003).

[13] FASB Statement No. 5 (*Accounting for Contingencies*) ("FAS No. 5") defines "remote." At the meeting in which the Board adopted the new standard, the staff confirmed that under FAS No. 5, "more than remote" means the same as "reasonably possible."

[14] *See* Note to paragraph 10 of the standard.

several respects, however. First, it clarified the standard to state explicitly that the auditor's evaluation of the audit committee is not a separate evaluation but, rather, is part of the auditor's overall evaluation of the control environment and monitoring components of internal control. Second, the factors for evaluating the effectiveness of the audit committee were modified, with some factors from the proposed standard discarded and several new factors added.

The final standard acknowledges that the board of directors is primarily responsible for monitoring the effectiveness of the audit committee's oversight of internal control. However, the auditor is now explicitly required to communicate with the board of directors if it finds that the audit committee's oversight of internal control is ineffective.

The standard also addresses circumstances in which the company may not have an audit committee comprised solely of independent directors. (For example, a company whose securities are not listed on a national securities exchange or automated inter-dealer quotation system such as the New York Stock Exchange, American Stock Exchange, or Nasdaq is not required to have an independent audit committee.) The standard states that in such circumstances, the auditor should not consider the lack of independent directors indicative, by itself, of a control deficiency. Of course, in practice, the auditor is likely to consider the degree to which audit committee members are independent from management a key factor in assessing whether the company has an effective control environment. The standard also includes language accommodating the special circumstances of issuers of non-equity securities of a consolidated or at least 50% beneficially owned subsidiary of a listed company that is subject to the requirements of Rule 10A-3(c)(2) under the Exchange Act.[15]

Requirement for Adverse Opinion When a Material Weakness Exists

Under existing auditing standards, when a material weakness is identified, the auditor may, depending on the significance of the material weakness, either qualify its opinion (using the phrase "except for the effect of the material weakness, internal control over financial reporting was effective") or express an adverse opinion ("internal control over financial reporting was not effective"). Because the SEC's rules implementing Section 404 of the Sarbanes-Oxley Act do not allow management to conclude that internal control over financial reporting is effective if there is a material weakness, the standard requires an adverse audit opinion, and does not allow for a so-called "qualified" opinion, when such a material weakness is identified.

Small Business Issuers

Although the proposed standard contained a separate appendix discussing considerations applicable to small and medium-sized companies, the Board decided to delete this appendix in the final standard. This was based on a concern that by separately discussing small and medium-sized businesses, the standard might create an expectation that the internal control over financial reporting for such companies would not necessarily need to be as strong as for larger companies. The Board also noted that the COSO framework[16] currently provides management of the company, and the auditor, with

[15] *See* the second Note to paragraph 55 of the standard.

[16] The COSO framework refers to the internal control framework outlined in Internal Control - Integrated Framework (1992, as supplemented in 1994) published by the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission.

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greater guidance and more flexibility regarding small and medium-sized companies than the Board had provided in the proposed appendix. Consequently, in the final standard, the Board eliminated the proposed appendix and replaced it with a brief statement that the COSO report discusses special considerations with regard to internal control over financial reporting for small and medium-sized companies.

Costs

> ***"Requiring auditors to audit a company's internal controls over financial reporting will…result in increased audit fees. These additional costs, when coupled with the resources which companies are having to directly dedicate to perform their own assessments of (and improvements in) internal controls, are not insignificant. However, we firmly believe that these costs are more than offset by the benefits that strong and effective internal controls provide to increase the reliability of financial reports. …Before I leave the subject of costs, let me be clear about another point: the work that auditors must now perform with respect to internal controls is not an excuse to price gouge. I urge any company that believes its auditor is overcharging for this work to contact us."***
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> ***From Statement of Board Member Kayla Gillan March 9, 2004***

Many commenters on the proposed standard worried about the increased costs likely to be incurred by companies to enable their auditors to perform the audit of internal control over financial reporting. Nonetheless, the Board noted, correctly, that the primary factor contributing to such costs is not the new auditing standard itself or any particular provision of that standard, but, rather, the statutorily mandated requirement for a management report and auditor attestation. The Board acknowledged that the standard's requirements will entail extra work and, for companies, extra expense, particularly in the first year of implementation. In its adopting release, the Board also stated that it will be "vigilant" in inspecting registered accounting firms to ensure that such firms do not take advantage of the potential opportunity and increase expense for its own sake.

Conclusion

Since the adoption of the SEC's rules under Section 404 of the Sarbanes-Oxley Act, public companies and their independent auditors have begun to prepare themselves for the substantial amount of work that will be necessary for management to deliver its report on the effectiveness of internal control and for the auditor to perform the related audit. As part of this preparation, many companies familiarized themselves with the ins and outs of the proposed standard. Although the SEC had originally expressed its desire for the Board to adopt a standard by the end of 2003, the complexity of the issues involved and the need to address the large volume of comments prevented the Board from meeting this aggressive timetable. Despite this delay, public companies can take comfort in the fact that the final standard is generally quite consistent with the version of the standard first proposed by the Board. Accordingly, preparatory steps that may have been taken based on such proposed standard should generally be useful for purposes of compliance with the requirements of the final standard.

Since the release of the proposed standard, auditors, too, clearly have begun to view internal control deficiency issues through the prism of both existing auditing standards as well as the proposed standard. This, combined with an overall increase in intensity of focus on internal control, has presented challenges for companies as deficiencies that might previously have been viewed as not significant have come under the microscope and been characterized as either significant deficiencies or even material weaknesses. Evidence suggests that the volume of such deficiencies and weaknesses disclosed by public companies has been increasing. It is likely that this trend will continue.

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Annex

Set forth below are the definitions of "significant deficiency" and "material weakness" contained in Auditing Standard No. 2.

Significant deficiency

A "significant deficiency" is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (below) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5 (*Accounting for Contingencies*) ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:
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> a. *Probable*. The future event or events are likely to occur.
>
> b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
>
> c. *Remote*. The chance of the future events or events occurring is slight.
>
> Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

Note: A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential*.

Material weakness

A "material weakness" is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 8, 9 and 10 [of the standard], and the directions in paragraphs 130 through 137 [of the standard]. As explained in paragraph 23 [of the standard], the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.