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BRIEFING PAPER

PROPOSED AUDITING STANDARD –

AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS

OCTOBER 7, 2003 PUBLIC MEETING OF THE BOARD

At its public meeting on October 7, 2003, the Public Company Accounting Oversight Board voted unanimously to propose, and seek comment on, an auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.* This briefing paper describes the significant requirements in the proposed auditing standard as well as important, related concepts.

Introduction

Section 404(a) of the Sarbanes-Oxley Act of 2002, and the Securities and Exchange Commission's related implementing rules,[1/] require the management of a public company to assess the effectiveness of the company's internal control over financial reporting, as of the end of the company's most recent fiscal year. Section 404 of the Act also requires management to include in the company's annual report to shareholders, management's conclusion as a result of that assessment about whether the company's internal control is effective. Section 404 of the Act, as well as Section 103, direct the PCAOB to establish professional standards governing the independent auditor's attestation, and reporting on, management's assessment of the effectiveness of internal control.

An attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion. For example, a financial statement

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[1/] See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (Securities and Exchange Commission Release No. 33-8238, June 5, 2003).

audit is a form of attestation. Specifically, the auditor attests to the fairness of a company's financial statements, which are assertions by management regarding the financial performance and condition of the company. To accomplish this task, the auditor evaluates the process management uses to prepare the company's financial statements and gathers evidence either supporting or refuting the assertions. Similarly, an auditor's attestation on management's assessment of the effectiveness of the company's internal control involves evaluating management's assessment process and gathering evidence regarding the design and operating effectiveness of the company's internal control, determining whether that evidence supports or refutes management's assessment, and opining as to whether management's assessment is fair.

Section 404(b) of the Act states that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. Because the objectives of and work involved in performing both an audit of internal control and an audit of the financial statements are closely interrelated, the proposed auditing standard introduces an integrated audit of internal control and financial statements. The proposed auditing standard is an integrated standard, addressing both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. The integrated audit results in two audit opinions: one on internal control over financial reporting and one on the financial statements.

Internal Control Over Financial Reporting

Internal control is a process designed to provide reasonable assurance regarding the achievement of a company's objectives in the areas of financial reporting reliability, operating efficiency and effectiveness, and compliance with laws and regulations. The SEC's rules implementing Section 404(a) of the Act, and the proposed auditing standard, focus on those objectives related to the reliability of a company's external financial reporting. This subset of internal control is commonly referred to as *internal control over financial reporting*.

Internal control over financial reporting consists of company policies and procedures that are designed and operated to provide reasonable assurance – a high, but not absolute, level of assurance – about the reliability of a company's financial reporting and its process for preparing financial statements in accordance with generally accepted accounting principles. It also includes policies and procedures that pertain to the maintenance of accounting records, the authorization of receipts and disbursements, and the safeguarding of assets.

Regardless of how well any system of internal control over financial reporting is designed and operating, it cannot provide absolute assurance of achieving financial

reporting objectives because of inherent limitations. These inherent limitations exist because internal control over financial reporting is a process that involves human diligence and compliance and can be intentionally circumvented.

The Costs and Benefits of Internal Control

Effective internal control over financial reporting is essential for a company to effectively manage its affairs to fulfill its obligation to its investors. A company's management and its owners – public investors – and others must be able to rely on the financial information reported by companies to make decisions.

Reliable financial reporting adds value and also can offset risks in a manner that is cost-beneficial to a company. Evaluating a company's internal control over financial reporting is sometimes costly, but also has many far-reaching benefits. Some of the benefits of a company developing, maintaining, and improving its system of internal control include identifying cost-ineffective procedures, reducing costs of processing accounting information, increasing productivity of the company's financial function, and simplifying financial control systems. The primary benefit, however, is to provide the company, its management, its board and audit committee, and its owners, and other stakeholders with a reasonable basis to rely on the company's financial reporting.

The Board is sensitive to the possible effects of the proposed standard on small and medium-sized companies. Internal control is not "one-size-fits-all," and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company. Large, complex, multi-national companies are likely to need extensive and sophisticated systems of internal control. In smaller companies, or in companies with less complex operations, the ethical behavior and core values of a senior management group that is directly involved in daily interactions with both internal and external parties might reduce the need for elaborate internal control systems. For a smaller, less complex company, the Board expects that the auditor will exercise reasonable judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.

The Audit of Internal Control Over Financial Reporting

An audit of internal control over financial reporting is an extensive process, integrated with the audit of the financial statements. It involves several steps. In the proposed auditing standard, these steps would include planning the audit, evaluating the process management used to perform its assessment of internal control effectiveness, obtaining an understanding of the internal control, evaluating the

effectiveness of both the design and operation of the internal control, and forming an opinion about whether internal control over financial reporting is effective.

Evaluating Management's Assessment

A natural starting place for the audit of a company's internal control over financial reporting is an evaluation of management's assessment. This evaluation provides the auditor with confidence that management has a basis for expressing its opinion on the effectiveness of internal control, provides information that will help the auditor understand the company's internal control, helps the auditor plan the work necessary to complete the audit, and provides some of the evidence the auditor will use to support his or her opinion.

The objective of an audit of internal control is to form an opinion "as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects."[2/] In addition, Section 103 of the Act requires the auditor's report to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary, among other requirements. Importantly, the auditor's conclusion will pertain directly to whether the auditor can agree with management that internal control is effective, not just to the adequacy of management's process for determining whether internal control is effective. Indeed, investors expect the independent auditor to test whether the company's internal control over financial reporting is effective. The proposed auditing standard would require the auditor to do so.

Nevertheless, the work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. The proposed auditing standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management. Thus, the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

The proposed auditing standard also would allow the auditor to incorporate into the audit of internal control over financial reporting some of the work performed by others, such as internal auditors or third parties who have performed work under the direction of management. To use that work, however, the auditor would need to assess the competence and objectivity of the persons who have performed it. The proposed auditing standard also would limit the auditor's ability to rely on the work of others in

[2/] *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (Securities and Exchange Commission Release No. 33-8238, § 210.2-02(f), June 5, 2003).

some key respects. That is, the standard would establish certain categories of work that the auditor must perform, such as work related to company-wide anti-fraud programs and controls and work related to other controls that have a pervasive effect on the company, such as general controls over the company's electronic data processing. The proposed auditing standard also would require that, overall, the auditor obtain directly the "principal evidence" about the effectiveness of internal control over financial reporting.

Planning the Audit

Planning the audit of internal control over financial reporting allows the auditor to develop an overall strategy for the audit. Many factors enter into audit planning, and the proposed auditing standard includes among them the auditor's knowledge of the company obtained during other engagements, matters affecting the company's industry, matters relating to the company's business, and the extent of recent changes in the company's operations or internal control over financial reporting. Armed with a good understanding of these types of factors, the auditor is in a position to effectively design the nature, timing, and scope of the planned audit.

Obtaining an Understanding of Internal Control Over Financial Reporting

To evaluate and test its effectiveness, the auditor must understand how the internal control over financial reporting is designed and operates. The auditor obtains a substantial amount of this understanding when evaluating management's assessment process.

The auditor also must be satisfied, however, that the controls *actually* have been implemented and are operating as they were designed to operate. Thus, while inquiry of company personnel and a review of management's assessment provide the auditor with an understanding of how the system of internal control is designed and operates, other procedures are necessary for the auditor to confirm his or her understanding.

The proposed auditing standard would have the auditor to confirm his or her understanding by performing procedures that include making inquiries of and observing the personnel that actually perform the controls; reviewing documents that are used in, and that result from, the application of the controls; and comparing supporting documents (for example, sales invoices, contracts, and bills of lading) to the accounting records. The most effective means of accomplishing this objective is for the auditor to perform "walkthroughs" of the company's significant processes. For this reason, and because of the importance of several other objectives that walkthroughs accomplish, the proposed auditing standard would require the auditor to perform walkthroughs.

In a walkthrough, the auditor traces all types of company transactions and events – both those that are routine and recurring and those that are unusual – from origination, through the company's accounting and information systems and financial report preparation processes, to their being reported in the company's financial statements. Walkthroughs provide the auditor with evidence that confirms his or her understanding of the process flow of transactions, the design of controls, and whether controls actually have been placed in operation. Walkthroughs also confirm that the auditor's understanding is complete and provide information necessary for the auditor to evaluate the effectiveness of the design of the internal control over financial reporting.

Because of the judgment that walkthroughs require and the significance of the objectives that walkthroughs allow the auditor to achieve, the proposed auditing standard would require the auditor to perform the walkthroughs himself or herself. In other words, the proposed auditing standard would not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs.

As a part of obtaining an understanding of internal control, the auditor also determines which controls should be tested, either by the auditor or by management or others. The proposed auditing standard, therefore, would require the auditor to identify those financial statement accounts and company processes that are significant.

The proposed standard would also require the auditor to identify relevant assertions. Does the asset exist, or did the transaction occur? Has the company included all loans outstanding in its loans payable account? Have marketable investments been properly valued? Does the company have the rights to the accounts receivable, and are the loans payable the proper obligation of the company? Are the amounts in the financial statements appropriately presented, and is there adequate disclosure about them? This process will allow the auditor to identify financial statement assertions that are relevant and for which the company should have controls.

Evaluating the Effectiveness of the Design of Controls

To be effective, internal controls must be designed properly and all the controls necessary to provide reasonable assurance about the fairness of a company's financial statements should be in place and performed by qualified people who have the authority to implement them. At some point during the internal control audit, the auditor will need to determine whether the controls would be effective if they are operated as designed, and whether all the necessary controls are in place. This is known as *design effectiveness*.

The procedures the auditor performs to test and evaluate design effectiveness include inquiry of company personnel, observation of internal controls, walkthroughs, and a specific evaluation of whether the controls are likely to prevent or detect financial statement misstatements if they are operated as designed. The proposed auditing standard would adopt these methods of testing and evaluating design effectiveness. The last step is particularly important. This evaluation calls for the auditor to apply his or her professional judgment and knowledge of and experience with internal control over financial reporting to his or her understanding of the company's controls.

Testing Operating Effectiveness

To express an opinion on internal control, the auditor must obtain evidence about whether the controls actually operate effectively. This is distinct and apart from design effectiveness.

The Act requires management's assessment and the auditor's opinion to address whether internal control was effective as of the end of the company's most recent fiscal year, in other words, as of a point-in-time. Performing all of the testing on December 31, however, is neither practical nor appropriate. To form a basis for expressing an opinion about whether internal control was effective as of a point in time requires the auditor to obtain evidence that the internal control operated effectively over an appropriate period of time. The proposed auditing standard recognizes this and allows the auditor to obtain evidence about operating effectiveness at different times throughout the year, provided that the auditor updates those tests or obtains other evidence that the controls continued to operate effectively at the end of the company's fiscal year.

The auditor should perform tests of controls to obtain evidence about the operating effectiveness of the controls. These tests include a mix of inquiries of appropriate company personnel, inspection of relevant documentation, such as sales orders and invoices, observation of the controls in operation, and reperformance of the application of the control. As indicated earlier, the auditor may use the results of tests performed by management and others, including internal auditors and third parties working under the supervision of management, provided that the auditor is satisfied that these persons are competent and performed their work in an objective manner. Therefore, the more testing management and others perform, and the better that work is, the less work will be necessary for the auditor to perform.

Tests of the effectiveness of internal control performed by management, internal auditors, or others are very important to the continued effective functioning of internal control over financial reporting and are a part of monitoring any effective system of internal control. The proposed auditing standard requires the auditor to read reports of

internal auditors and others (such as the loan review function in a financial institution) that address internal control over financial reporting.

Evaluating the Results and Forming an Opinion

Both management and the auditor may identify deficiencies in the internal control over financial reporting. An internal control deficiency exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

The proposed auditing standard would require the auditor to evaluate the severity of all identified internal control deficiencies because such deficiencies can have an effect on his or her overall conclusion about whether internal control is effective. The auditor also has a responsibility to make sure that certain parties, such as the audit committee, are aware of internal control deficiencies that rise to a certain level of severity.

In the proposed auditing standard, an internal control deficiency (or a combination of internal control deficiencies) should be classified as a *significant deficiency* if it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount. A significant deficiency should be classified as a *material weakness* if, by itself or in combination with other internal control deficiencies, it results in more than a remote likelihood of a material misstatement in the company's annual or interim financial statements.

Most importantly, if a material weakness exists as of the end of the company's most recent fiscal year, management and the auditor must conclude that the internal control is ineffective.

The proposed auditing standard requires the auditor to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor also is required to communicate in writing to the company's management all internal control deficiencies of which he or she is aware and to notify the audit committee that such communication has been made.

Inadequate documentation by management is a deficiency in internal control over financial reporting. The documentation that management prepares is important to the effective functioning of the internal control over financial reporting and to the auditor's internal control audit. This includes documentation about the design of the controls, including how the controls are supposed to operate; the objectives they are designed to

achieve; and the necessary qualifications of the people performing the control for the control to function effectively. This documentation also includes information about the process management used to assess the effectiveness of the internal control over financial reporting, including the nature and results of the tests performed and management's evaluation. As with other internal control deficiencies, the auditor should evaluate the severity of documentation deficiencies and determine whether they rise to the level of a significant deficiency or material weakness.

The proposed auditing standard identifies a number of circumstances that would be, by definition, significant deficiencies and that also would be a strong indicator that a material weakness exists. The following paragraphs describe several of these circumstances.

- *Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.* The proposed auditing standard requires the auditor to evaluate factors related to whether the audit committee is effective, including whether audit committee members act independently from management. Effective oversight by the company's board of directors, including its audit committee, is essential to the company's achievement of its objectives and is an integral part of a company's monitoring of internal control. In addition to requiring the audit committee to oversee the company's external financial reporting and internal control over financial reporting, the Act makes the audit committee directly responsible for the appointment, compensation, and oversight of the work of the auditor. Thus, an ineffective audit committee can have serious detrimental effects on the company and its internal control over financial reporting as well as on the independent audit.

- *Material misstatement in the financial statements not initially identified by the company's internal controls.* The audit of internal control over financial reporting and the audit of the company's financial statements are an integrated activity and are required by the Act to be a single engagement. The results of the work performed in a financial statement audit provide evidence to support the auditor's conclusions on the effectiveness of internal control, and vice-versa. Therefore, if the auditor discovers a material misstatement in the financial statements as a part of his or her audit of the financial statements, the auditor should consider whether internal control over financial reporting is effective. That the company's internal controls did not first detect the misstatement is a strong indicator that the company's internal control over financial reporting is not effective.

- *Significant deficiencies that have been communicated to management and the audit committee but that remain uncorrected after a reasonable period of time.* Significant deficiencies in internal control that are not also determined to be material weaknesses, as defined in the proposed auditing standard, are not so severe as to require the auditor to conclude that internal control is ineffective. However, these deficiencies are significant, and the company should correct them. If management does not correct significant deficiencies within a reasonable period of time, that reflects poorly on tone-at-the-top and the control environment. Additionally, the significance of the deficiency can change over time (for example, increases in sales volume or added complexity in sales transaction structures would increase the severity of a significant deficiency affecting sales).

If, after having performed all of the procedures that the auditor considers necessary in the circumstances, the auditor has not identified any material weaknesses in internal control, then the proposed standard would permit the auditor to express an unqualified opinion that management's assessment of the effectiveness of internal control over financial reporting is fairly stated in all material respects. In the event that the auditor could not perform all of the procedures that the auditor considers necessary in the circumstances, then the proposed standard would permit the auditor to either qualify the opinion or disclaim an opinion. If an overall opinion cannot be expressed, the proposed auditing standard would require the auditor to explain why.[3/]

Auditor's Responsibilities for Quarterly Reporting

Along with the auditor's work related to the annual audit of internal control over financial reporting, he or she has quarterly and annual responsibilities related to the certifications required by Section 302 of the Act.

[3/] See also *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (Securities and Exchange Commission Release No. 33-8328, § 210.2-02 (f), June 5, 2003) that indicates, "The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and clearly state the opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects, or must include an opinion to the effect that an overall opinion cannot be expressed. If an overall opinion cannot be expressed, explain why."

A company's principal executive and financial officers are responsible for internal control over financial reporting. Section 302 of the Act emphasizes this responsibility by requiring these parties to certify, quarterly and annually, their responsibility, among others, for establishing and maintaining internal control over financial reporting and for disclosing changes in the company's internal control over financial reporting that occurred during the most recent quarter that have materially affected, or are likely to materially affect, the company's internal control over financial reporting.

The proposed standard also requires the auditor to play a role related to management's certifications. The auditor performs limited procedures, quarterly and annually, to identify any matters requiring modifications to management's certifications. Based on the procedures performed, if the auditor becomes aware of any matters leading to the belief that modifications to the quarterly certifications or associated disclosures about material changes in internal controls are necessary, then the proposed auditing standard would require the auditor to communicate the matters to management.

The proposed auditing standard would require certain additional actions of the auditor, depending on management's response. These actions range from communicating with the audit committee to reach an appropriate resolution to considering resigning from the engagement.

Effective Date of the Proposed Standard

Companies considered accelerated filers (seasoned U.S. companies with public float exceeding $75 million) are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act for fiscal years ending on or after June 15, 2004. Accordingly, auditors engaged to audit the financial statements of such companies for fiscal years ending on or after June 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. Other companies (including smaller companies, foreign private issuers and companies with only registered debt securities) have until fiscal years ending on or after April 15, 2005, to comply with these internal control reporting and disclosure requirements and the requirement for audit reporting on internal control is similarly delayed.

Public Comment

If the Board issues the proposed standard, it will seek comment on the proposed standard for a 45-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted

by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 008 in the subject or reference line and should be received by the Board no later than 5:00 p.m. (EST) on November 21, 2003.

The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt a final standard, with or without amendments. Any final standard adopted will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are deemed to be rules under the Act.

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