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What Management and the Audit Committee Need to Know About PCAOB Auditing Standard No. 2 for Audits of Internal Control over Financial Reporting

In accordance with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act"), the PCAOB adopted Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (the "Standard"). The Standard was approved by the SEC on June 17, 2004. On June 23, 2004, the PCAOB staff issued a set of responses to frequently asked questions on the Standard.

This memorandum summarizes the key elements of the Standard, and also reflects the recent PCAOB guidance. It focuses on the elements of the audit process that should be of particular importance to management and audit committee members, so as to give such persons an overview of the process and an of idea of what will be expected of management during the process. It also highlights the PCAOB's (and indirectly the SEC's) views with respect to:

- the oversight responsibilities of the audit committee and the implications of ineffective oversight;
- the advantages to establishing an effective, competent and objective internal control function;
- the implications of disagreements as to whether management has made appropriate public disclosure of changes in internal control over financial reporting;
- the disclosure implications of a finding of a material weakness; and
- alternatives available to management to provide additional disclosure (over and above that required in its report) concerning internal control over financial reporting.

When will the Standard be used?

The Standard establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting. The standard applies to registered public accounting firms, as well as their associated persons.

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As a practical matter, the Standard will apply to audit engagements for fiscal years ending after November 15, 2004 (in the case of "accelerated filers") or July 15, 2005 (in the case of other reporting companies, including foreign private issuers).

Section 404 of the Act referred to an attestation; what is the difference between an attestation and an audit?

The Standard clarifies that the terms "audit of internal control over financial reporting" (the term used throughout the standard) and "attestation of management's assessment of the effectiveness of internal control over financial reporting" (the term used in the Act) refer to the same professional service. The first term refers to the process, and the second term refers to the result of that process. Hereinafter we refer to the audit of internal control over financial reporting as an "Audit."

What are the objectives of the Audit?

The Standard states that the auditor's objective in an Audit is to express an opinion as to whether "management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects" as of the date specified in management's assessment. The auditor also must audit the company's financial statements as of the date specified in management's assessment because the information the auditor obtains during a financial statement audit is relevant to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting. Maintaining effective control over financial reporting means that no "material weaknesses" (discussed below) exist; therefore, the objective of the Audit is to obtain "reasonable assurance" (discussed below) that no material weaknesses exist as of the date specified in management's assessment.

The auditor's report is also to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary, among other requirements.

In effect, the auditor's conclusion will pertain directly to whether the auditor can agree with management that internal control over financial reporting is effective and not just to the adequacy of management's process for determining whether internal control over financial reporting is effective. To do this, the auditor will evaluate management's assessment process to be satisfied that management has an appropriate basis for its conclusion. The auditor, however, also needs to test effectiveness to be satisfied that management's conclusion is correct and, therefore, fairly stated.

At the conclusion of its review but prior to the issuance of its report, the auditor is to communicate in writing to the company's management and audit committee all "significant deficiencies" (discussed below) and material weaknesses of which the auditor is aware. The Standard also requires the auditor to communicate in writing to the company's management all internal control deficiencies of which it is aware and to notify the audit committee that it has done so. If the auditor believes the significant deficiency or material weakness exists because of ineffective oversight by the audit committee over internal control over financial reporting, the auditor must communicate that specific deficiency or material weakness to the entire board.

Reasonable Assurance. The concept of **reasonable assurance** reflects an understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis.

The objective of the Audit is limited to reasonable assurance because of the limitations on the amount of assurance that the auditor can obtain as a result of performing his or her audit procedures. These limitations arise because an Audit is conducted on a test basis and requires the exercise of professional judgment. Nevertheless, the Audit includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective.

Materiality. The Standard provides that, as in an audit of financial reporting, an auditor is to apply a materiality standard in performing an Audit. The Standard further states that the same materiality standard that applies to financial reporting applies also to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.

Depending on the specific procedure, an auditor is to apply the materiality standard either at the financial-statement level or at the individual account-balance level. (Materiality at the account-balance level is lower than materiality at the financial-statement level.) For example, an auditor must apply materiality at the financial-statement level in evaluating whether a deficiency, or combination of deficiencies, in controls is a significant deficiency or a material weakness. In planning the Audit and designing its procedures, an auditor applies materiality at both levels.

What is the scope and extent of the Audit?

An Audit extends to the company's controls over the preparation of its financial statements and notes as presented in accordance with accounting principles generally accepted in the United States. Similarly, an Audit covers (in the case of foreign private issuers reporting in accordance with a comprehensive body of accounting principles other than US GAAP) the primary financial statements as well as the US GAAP reconciliation.

In addition, unless excluded from management's internal control report in accordance with SEC guidance (for example, certain entities consolidated pursuant to FIN 46 and EITF 00-1 and entities acquired late in the year), an Audit would generally extend to controls over the preparation of financial statements of all consolidated entities and acquired businesses, as well as control over outsourced activities (discussed below). An Audit would not ordinarily extend to controls at equity method investees.

The scope of an Audit does not cover control over the preparation of management's discussion and analysis (MD&A) or other similar financial information outside the financial statements. This financial information (including MD&A) is management's responsibility and is subject to the company’s disclosure controls and procedures the effectiveness of which is certified by the company’s chief executive officer and chief financial officer pursuant to Section 302 of the Act.

What steps will the auditor take as part of its review?

The Standard outlines the steps an auditor must take in conducting its review, including:

- planning the Audit;
- evaluating the process management used to perform its assessment of internal control effectiveness;
- obtaining an understanding of the internal control over financial reporting;
- testing and evaluating the effectiveness of both the design and operation of the internal control; and
- forming an opinion on whether internal control over financing reporting is effective.

Planning the Audit

The first step is for an auditor to develop a strategy for the Audit (i.e. nature, timing and scope), based among other things on the auditor's knowledge of the company; 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.

Evaluating Management's Assessment

Next, the auditor must obtain an understanding of, and evaluate, management's process for assessing the effectiveness of the company’s internal control over financial reporting. In obtaining an understanding of management’s process, the Standard requires an auditor to determine whether management has addressed the following elements:

- determining which controls are to be tested, including controls over all relevant assertions related to all significant accounts and disclosures in the financial statements; generally, such controls include: controls over initiating, authorizing, recording, processing and reporting significant accounts and disclosures and related assertions embodied in the financial statements; controls over the selection and application of accounting policies; anti-fraud programs and controls; controls, including information technology general controls, on which other controls are dependent; controls over significant non-routine and non-systematic transactions, such as accounts involving judgments and estimates; and company level controls, including the control environment, and controls over the period-end financial reporting process;

- evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such misstatements, and the degree to which other controls, if effective, achieve the same control objectives;

- determining the locations or business units to include in the evaluation for a company with multiple locations or business units;

- evaluating the design effectiveness of controls;

- evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness;

- determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute "significant deficiencies" or "material weaknesses;"

- communicating findings to the auditor and to others; and

- evaluating whether findings are reasonable and support management's assessment.

The Standard requires an auditor to obtain an understanding of the results of procedures performed by others, including internal audit and third parties working under the direction of management. Inquiry of management and others is the starting point but inquire alone is not adequate for reaching a conclusion.

Management cannot use an auditor's procedures as part of the basis for its assessment of the effectiveness of internal control over financial reporting.

Identifying Controls to Test. As part of its review, an auditor should obtain evidence about the effectiveness of the company's controls for all significant processes and relevant assertions related to all significant accounts and disclosures in the company's financial statements. The auditor can obtain such evidence either by performing tests of controls himself or herself, or by using the work of others.

Identifying specific controls to test begins with identifying **significant accounts** and disclosures within the company's financial statements. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually, or together with other misstatements, could have a material effect on the financial statements, considering the risks of both overstatement and understatement. Significant accounts are first determined at the financial statement level and then at the account or disclosure component level. When identifying significant accounts, an auditor should evaluate both quantitative and qualitative factors.

As a next step, an auditor is required to identify **relevant assertions** for each significant account. Relevant assertions are assertions that have a meaningful bearing on whether the account is fairly stated. In identifying relevant assertions, an auditor is required to determine the source of likely potential misstatements in each significant account. The Standard provides a non-exclusive list of five financial statement assertions that should be assessed for relevance (existence or occurrence; completeness; valuation or allocation; rights and obligations; and presentation and disclosure). Management or the auditor may base his or her work on different assertions. However, if different assertions are used, the auditor would be required to determine that he or she had identified and tested controls over all sources of likely potential misstatements in each significant account and over all representation by management that have a meaningful bearing on whether the account is fairly stated.

Finally, an auditor must identify each **significant process over each major class of transactions** affecting significant accounts or groups of accounts. Major classes of transactions are those that are significant to the company's financial statements.

The period-end financial reporting process is always a significant process because of its importance to financial reporting and to the auditor's opinions on internal control and the financial statements. The period-end financial reporting process includes the following:

- the procedures used to enter transaction totals into the general ledger;
- the procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- other procedures used to record recurring and nonrecurring adjustments (such as consolidating adjustments, report combinations, and classifications); and
- procedures for drafting annual and (for domestic issuers) quarterly financial statements and related disclosures.

The Standard indicates that deficiencies in the period-end financial reporting process are ordinarily at least significant deficiencies. Because much of the process occurs after the "as of" date of management's assessment of internal controls, management should carefully consider all aspects of the period-end financial reporting process well before year-end to minimize the risk that internal control deficiencies are identified too late for remediation.

After the auditor has identified significant accounts, relevant assertions, and significant processes, the auditor is to identify controls to be tested. Controls are selected for testing primarily on the basis of the likelihood of error or fraud, their nature and significance and the risk that they may not be operating effectively. The auditor is to evaluate whether to test preventive controls, detective controls or a combination of both. As the significance of an account balance or disclosure increases, the importance of testing both a preventive and a detective control increases.

The auditor must clearly link individual controls with the significant accounts and assertions to which they relate. To allow the auditor to do that, management should identify in its documentation and assessment of internal controls the relevant financial statement assertions and determine the controls that address such relevant assertions.

If a company has multiple locations or business units, the Standard provides auditors with guidance on how to select controls to test. The auditor should test controls over a *large portion* of the company's operations and financial position (at the overall level, not the individual significant account level). The Standard leaves to the auditor's judgment the determination of what exactly constitutes a large portion and, in circumstances where a company has a very large number of individually insignificant locations or business units, would allow an auditor to test a representative sample of the company's locations or business units to satisfy the large portion requirement. However, if the auditor would encounter non-negligible testing exceptions within the sample, the Standard suggests that testing controls over a very large number of individual locations or business units may be necessary in order to support an audit opinion.

Management's Documentation. When determining whether management's documentation provides reasonable support for its assessment, the Standard requires an auditor to evaluate whether such documentation includes the following:

- the design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements;
- information about how significant transactions are initiated, authorized, recorded, processed and reported;
- sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur;
- controls over the period-end financial reporting process;
- controls over safeguarding of assets; and
- the results of management's testing and evaluation.

The form and extent of documentation will vary depending on the size, nature, and complexity of the company. Documentation may take many forms, including paper, electronic files, or other media and can include a variety of information, such as policy manuals, process models, flowcharts, job descriptions, documents and forms.

The Standard requires management to document internal control over financial reporting in sufficient detail to allow for the identification of controls related to each relevant assertion for all significant accounts and disclosures in the company's financial statements. Management's documentation should include information about how transactions are initiated, authorized, recorded, processed and reported.

Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting. Inadequate documentation also could cause an auditor to conclude that there is a limitation on the scope of the Audit.

Walkthroughs (discussed below) are a valuable tool for use by management to ensure that its documentation is complete and accurate.

Obtaining an Understanding of Internal Control Over Financial Reporting

The Standard requires an auditor to obtain an understanding of how specific controls of a company's internal control over financial reporting are designed and operate. A substantial amount of this understanding is obtained during the evaluation of management's assessment process. An auditor is also required to become satisfied that the controls have been implemented and are operating as they were designed to operate.

In confirming his or her understanding, an auditor must perform certain procedures, including:

- making inquiries of appropriate management, supervisory and staff personnel;
- inspecting company documents;
- observing the application of specific controls; and
- performing "walkthroughs" of the company's significant processes.

Walkthroughs. The walkthrough requirement is viewed as the most effective of the above procedures and an auditor would not be allowed to rely on the work of management or others in satisfying the walkthrough requirement. In a **walkthrough**, an auditor is to trace both routine and unusual company transactions from origination, through a company's accounting and information systems and financial reporting processes to their reporting in the financial statements. Because of the judgment that a walkthrough requires and the significance of the objectives of the walkthrough, the auditor must perform the walkthrough itself. Although the auditor may review walkthroughs performed and documented by others as *additional* evidence, the auditor may not use the work performed by management or others to satisfy his or her requirement to perform walkthroughs. The Standard requires that at least one walkthrough is performed for each major class of transactions (discussed below) in each annual Audit.

Company-level Controls. Because controls that exist at the company level often have a pervasive impact on internal controls, an auditor should test and evaluate the effectiveness of company-level controls first. Company-level controls include controls within the control environment, such as the proper tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide compliance programs that apply to all locations and business units.

Fraud Considerations. The Standard specifically requires an auditor to test and evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. The Standard identifies those controls that an auditor is to evaluate (some of which may be outside the area management would normally associate with internal control over financial reporting) as follows:

- controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements;
- risk assessment processes;
- code of ethics provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board;
- adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit;
- adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters; and
- board approved policies that address significant business control and risk management practices.

The Standard requires an auditor to perform the work himself or herself relating to the evaluation of controls specifically intended to address fraud. Although an auditor should not use the work of others in this situation, the auditor should consider the results of work performed by others because this may indicate the need for the auditor to increase his or her work in this area.

Effectiveness of Audit Committee's Oversight. The audit committee plays an important role within the control environment and, in obtaining an understanding of internal control over financial reporting, the auditor will evaluate the effectiveness of audit committee oversight. The auditor will focus on how well the audit committee and management understand the audit committee's responsibilities. The auditor may focus on the committee's involvement and interaction with the external and internal auditor, as well as the committee's interaction with key members of financial management. The auditor may evaluate whether the right questions are asked and pursued with management and the auditor, including questions that indicate an understanding of critical accounting policies and judgmental accounting estimates. As noted below, ineffective oversight by the audit committee is a strong indicator of a material weakness in internal control over financial reporting.

Testing and Evaluating Design Effectiveness

The Standard requires an auditor to evaluate a company's "design effectiveness," or whether the controls would be effective if they were operated as designed and meet the objectives of the control criteria, and whether all the necessary controls are in place. An auditor must evaluate **design effectiveness** by:

- identifying the company's control objectives in each area;

- identifying the controls that satisfy each objective; and
- determining whether the controls, if operating properly, can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

An auditor may use a variety of procedures to test and evaluate design effectiveness, including:

- inquiries of company personnel;
- observation of internal control over financial reporting;
- walkthroughs; and
- a specific evaluation of whether the controls are likely to prevent or detect financial statement misstatements if they operate as designed.

Testing and Evaluating Operating Effectiveness

The Standard requires an auditor to 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. An auditor is to use a mix of the following procedures to test controls over **operating effectiveness**:

- inquiries of appropriate company personnel;
- inspection of relevant documentation;
- observation of the controls in operation; and
- re-performance of the application of the control.

In determining the extent of procedures to perform, an auditor is required to design its procedures to provide a high level of assurance that the control being tested is operating effectively. In making this determination, an auditor must assess the following factors: the nature of the control; the frequency of operation; and the importance of the control.

Management's assessment and the auditor's opinion on internal controls must be given as of the end of the company's fiscal year. However, performing all of the testing as of year end is neither practical nor appropriate. The Standard allows an auditor to perform tests of controls over a period of time as long as that is adequate to determine whether, as of the year-end, the controls are operating effectively. The period of time varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously (for example, control over sales), while others operate only at certain times (for example, controls over the preparation of monthly or quarterly financial statements). The longer the time period between when the tests were performed and the company's fiscal year-end, the more extensive the updates required by both management and the auditor will be. For example, tests should be performed closer to the year-end with respect to controls over significant non-routine transactions, controls over accounts or processes with a high degree of judgement in measurement, or controls over the recording of period-end adjustments.

An auditor is required to vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company.

The auditor is required to test controls directly, regardless of the results of management's assessment or the auditor's earlier identification of a material weakness.

If management implements, late in the year, a new accounting system that significantly affects the processing of transactions for significant accounts, an auditor must test controls over the new system (as it is in operation as of the date of management's assessment) before it can issue its opinion. Although an auditor would not be required to test controls over the old system with respect to its audit of internal controls, the old system remains relevant to the audit of the financial statements.

Can the auditor rely on the work of others?

The Standard requires an auditor to perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the audit opinion (any testing conducted for the purpose of assessing the quality and effectiveness of the work of others is not considered to be part of the principal evidence). However, the standard allows an auditor to use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed.

The work of others that an auditor may use includes relevant work performed by internal auditors, company personnel, and third parties working under the direction of management or the audit committee. Thus, 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 auditor will need to perform. The more extensive and reliable management's assessment is, the less extensive the auditor's work will need to be.

To determine the extent to which an auditor may use the work of others, the Standard requires an auditor to: evaluate the nature of the controls subjected to the work of others; evaluate the competence and objectivity of the individuals who performed the work; and test some of the work performed by others to evaluate the quality and effectiveness of their work. Within this framework, the amount of testing of the work of others should be sufficient to enable the auditor to evaluate the overall quality and effectiveness of their work; testing the work of others in every significant account in which the auditor plans to use their work is not required. In fact, if the auditor feels the need to test the work of others to a high degree, that would raise questions about the auditor's initial assessment of the competence and objectivity of the other party.

The Standard provides more specific and definitive direction on how an auditor is to make the determination as to whether he or she can use the work of others, but the directions allow the auditor significant flexibility to use his or her judgment to make that determination. Regardless of the auditor's determination of the work that he or she must perform himself or herself, the auditor's responsibility to report on the effectiveness of internal control over financial reporting rests solely with the auditor; this responsibility cannot be shared with the other individuals whose work the auditor uses.

As noted above, an auditor should not use the work of others for the performance of walkthroughs and the evaluation of controls specifically intended to address fraud. However, the auditor should consider the results of work performed by others in these areas because that may indicate the need for the auditor to increase his or her work.

The auditor must understand the results of procedures performed by others, such as internal auditors. In fact, the auditor will be required to review internal control reports. The considerable flexibility in using the work of others should encourage reporting companies to develop high-quality internal audit, compliance and other such functions. The greater the competence and objectivity of these functions, and the more thorough their testing, the more the auditor will be able to use their work. This will be particularly true of internal auditors who follow the International Standards for the Professional Practice of Internal Auditing (issued by the Institute of Internal Auditors). On the other hand, if internal audit reports solely to management, which reduces objectivity, or has limited resources, or has limited competence, the auditor would use their work to a much lesser extent and perform more of the testing itself.

What are the types of deficiencies that may be identified?

Both management and the auditor may identify deficiencies in 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. Auditors must consider deficiencies in internal controls individually and in isolation; therefore, the existence of compensating controls does not affect the determination whether a control deficiency exists. The Standard requires the auditor to evaluate the severity of all identified internal control deficiencies and classify them as significant deficiencies or material weaknesses as noted below.

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. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or together with other misstatements, would *clearly be immaterial* to the financial statements.

The Standard identifies a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are deemed significant deficiencies as well as strong indicators that a material weakness exists, including:

- restatement of previously issued financial statements to reflect the correction of a misstatement;
- material misstatement in the financial statements not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement);
- ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee;
- for larger, more complex companies, ineffective internal audit function or ineffective risk management function;
- for complex companies in highly regulated industries, an ineffective regulatory compliance function (in areas where violations could have a material effect on the reliability of financial reporting);
- fraud of any magnitude on the part of senior management;
- significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after some reasonable period of time; and
- an ineffective control environment.

Material Weakness. A significant deficiency is to be classified as a **material weakness** if, by itself, or in combination with other control deficiencies, it results in more than a *remote likelihood* that a material misstatement in the company's annual or interim financial statements will not be prevented or detected. Remote likelihood as used in the definitions of significant deficiency and material weakness has the same meaning as the term "remote" in FAS No. 5, *Accounting for Contingencies*, defined as "the chance of the future event or events occurring is slight."

Materiality Standard. In their determination whether a significant deficiency or material weakness exists, auditors are to apply both quantitative and qualitative factors of the materiality standard, each at the financial statement level.

When evaluating whether a deficiency, or combination of deficiencies, in controls is a significant deficiency or a material weakness, an auditor should consider compensating controls and whether such compensating controls are effective. To have a mitigating effect, compensating controls should operate at a level of precision that would prevent or detect a material misstatement constituting either a significant deficiency or material weakness.

The auditor's report is required to disclose material weaknesses but not significant deficiencies.

On what basis can the auditor provide an unqualified opinion?

If the auditor has identified no material weaknesses in internal control over financial reporting after having performed all of the procedures that the auditor considers necessary in the circumstances, then the auditor is permitted 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. If the auditor could not perform all of the procedures considered necessary, then the auditor is permitted to qualify or disclaim the opinion. If an overall opinion cannot be expressed, the auditor is required to explain why.

The SEC's final rules implementing Section 404 of the Act state that "management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In such a case, management must conclude that internal control over financial reporting is not effective. As the reporting model for the auditor is to follow the required reporting model for management, the auditor is required to express an "adverse" conclusion in the event a material weakness exists. This is a change from the existing attestation standard for auditors, which provides that when the auditor has identified a material weakness in internal control, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion or may express an adverse opinion.

As noted above, in certain situations, management may exclude certain entities from the scope of its assessment of the company's internal control over financial reporting (for example, certain consolidated entities (FIN 46 and EITF 00-1) and acquired businesses). In these situations, the auditor's opinion on internal control would not be affected. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, disclosure similar to management's regarding the exclusion of an entity or entities from the scope of both management's assessment and the auditor's Audit.

As noted above, at the conclusion of its review the auditor will communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor will also communicate in writing to the company's management all internal control deficiencies and notify the audit committee that it has done so. To comply with the communication requirements of the Standard and the Act, clear lines of communication should be established among management, the audit committee and the auditor to ensure regular and timely communication of significant deficiencies and material weaknesses during the course of the Audit.

What aspects of management's report will the auditor evaluate?

As part of the Audit, an auditor is to evaluate the following matters with respect to management's report on internal control over financial reporting (the form of management's report is dictated by Item 308 of Regulation S-K):

- whether management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting;

- whether the framework used by management to conduct the evaluation is suitable (for example, the COSO framework is a suitable framework);

- whether management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year, is free of material misstatement;

- whether management has expressed its assessment in an acceptable form:

    - management is required to state whether the company's internal control over financial reporting is effective. (The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms; however, management is required to state a direct conclusion about whether the company's internal control over financial reporting is effective.)

    - a negative assurance type statement is not acceptable.

    - qualifications or exceptions to the statement are not acceptable.

    - management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses.

- whether material weaknesses, if any, have been properly disclosed, including material weaknesses corrected during the reporting period.

What will the auditor's report cover?

The Standard requires an auditor's report to include the following elements:

- a title that includes the word "independent;"

- an identification of management's conclusion about the effectiveness of the company's internal control over financial reporting;

- an identification of the title of the management report that includes management's assessment;

- a statement that the assessment is the responsibility of management;

- a statement that the auditor's responsibility is to express an opinion on the assessment and an opinion on the company's internal control over financial reporting based on his or her Audit;

- a definition of internal control over financial reporting (provided by the Standard);

- a statement that the Audit was conducted in accordance with the standards of the PCAOB;

- a statement that the standards of the PCAOB require that the auditor plan and perform the Audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

- a statement that an Audit includes 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 the auditor considered necessary in the circumstances;

- a statement that the auditor believes the Audit provides a reasonable basis for his or her opinions;

- a paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that 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;

- the auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria;

- the auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

- the manual or printed signature of the auditor's firm;

- the city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

- the date of the audit report.

Under what circumstances will the auditor be required to modify its report?

The auditor's report must be modified if any of the following conditions exist.

- Management's assessment is inadequate (in which case it is to be modified for a scope limitation) or management's report is inappropriate (in which case it is to be modified to include a description of the reasons).

- There is a material weakness in the company's internal control over financial reporting, in which case the auditor must express an adverse opinion and describe the material weakness (which is to include information about the specific nature of the material weakness and its actual and potential effect on the presentation of the financial statements).

- There is a restriction on the scope of the engagement, in which case the auditor may withdraw, disclaim an opinion or express a qualified opinion).

- The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report.

- A significant subsequent event has occurred since the date being reported on.

- There is other information contained in management's report on internal control over financial reporting (such as disclosures about corrective actions taken by the company after the date of management's assessment, plans for new controls or a statement that management believes the cost of correcting a material weakness would exceed the benefits of implementing new controls), in which case the auditor would disclaim an opinion on the additional information. (If management makes additional disclosures outside its internal control report (i.e., elsewhere in the annual report), no disclaimer is required.)

Note that in the event the auditor believes that the additional information contains material misstatements of fact, it should discuss the matter with management. The matter would be elevated to the audit committee if the auditor concludes there remains a valid basis for concern after discussions with management (and other third parties "whose advice might be useful").

How will the Audit report relate to the audit report on the financial statements?

The Standard requires that an auditor who conducts an Audit must also audit the company's financial statements. The rationale for this requirement is that information obtained during the financial statement audit may be significant to the evaluation of the effectiveness of internal control. The integrated audit will result in two opinions, one on internal control over financial reporting and one on the financial statements, each dated as of the same date. It is likely that as a result of the combined report, the auditor's report will be issued at a later date than current practice due to the work involved in the internal control audit and the time required for communication with the audit committee and the board of directors.

An auditor may be engaged to audit financial statements without also auditing internal control over financial reporting (for example, where the company is conducting a public offering and needs an audit of an interim period).

In the case of registered offerings, the auditor is directed to AU section 711 for its responsibilities before its report on the Audit can be included in a registration statement. Its consent will refer to both the audit on the financial statements and the Audit.

Every proposed engagement by an auditor to provide any internal control related service must be pre-approved by the company's audit committee to ensure the performance of services would not impair the auditor's independence (discussed below).

What are management's responsibilities in connection with the Audit?

For an auditor to complete satisfactorily an Audit, management must:

- accept responsibility for the effectiveness of the company's internal control over financial reporting;
- evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria;
- support its evaluation with sufficient evidence, including documentation; and
- present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

If an auditor concludes that management has not fulfilled these responsibilities, the Standard requires the auditor to communicate, in writing, to management and the audit committee that the Audit cannot be satisfactorily completed and that an opinion will be disclaimed.

Management is required to fulfil the same responsibilities noted above under Items 308(a) and (c) of Regulation S-K. To the extent management has willfully decided not to fulfill these responsibilities, the auditor may have responsibilities under AU 317, *Illegal Acts by Clients*, and Section 10A of the Exchange Act.

As a pre-requisite to issuing its report on the Audit, the Standard requires an auditor to obtain written representations from management:

- acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;
- stating that management has performed an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;
- stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting of the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;
- stating management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

- stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's assessment, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

- describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

- stating whether control deficiencies identified and communicated to the audit committee during previous engagements have been resolved, and specifically identifying any that have not; and

- stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the Audit sufficient to preclude an unqualified opinion.

What are the auditor's responsibilities for evaluating 302 certifications?

The Standard provides that, if a company reports a change in internal control over financial reporting (as confirmed by a 302 certification), and the change is to correct a material weakness, management has the responsibility to determine, and the auditor is to evaluate, whether the reasons for the change and the surrounding circumstances are material and necessary to make the disclosure of the change not misleading (see Rule 12b-20 of the Exchange Act).

The Standard also provides that, in the case of quarterly certifications (for domestic registrants), the auditor's responsibilities differ from the annual Audit exercise. The auditor is to perform limited procedures to provide a basis for determining whether it has become aware of material modifications that, in its judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate. The auditor is directed, if it concludes that modification of the disclosure concerning changes in internal control over financial reporting is necessary for the certification to be accurate, to communicate with the appropriate level of management. If the auditor believes that management has not responded properly, the auditor is to inform the audit committee and, if there is no timely and appropriate response, it is to evaluate whether to resign. As a result of these requirements, the evaluation of internal control deficiencies and communications with management and the audit committee will be an ongoing, continuous process.

The same procedures are to be followed in connection concerns about the annual certification (i.e., in respect of the fourth quarter for a domestic registrant and for the full year for a foreign private issuer), but in the absence of an appropriate and timely response, the auditor is to modify the audit report to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Auditor Independence – What form of assistance can auditors provide regarding internal control without compromising their independence?

Companies turning to others for assistance in meeting the internal control requirements should be mindful that use of the external auditor could create independence issues.

The Standard prohibits an auditor from accepting an engagement to provide any internal control-related service to an audit client that has not been specifically pre-approved by the audit committee. The effect of this is that the audit committee will not be able to pre-approve internal control-related services as a category. Rather, each specific engagement is required to be specifically pre-approved (regardless of whether the services to be rendered are classified as audit or non-audit services).

The Standard also requires that management be actively involved in, and not delegate its responsibility for, the design and operation of internal control, and that management's involvement be substantive and extensive. Management's acceptance of responsibility for documentation and testing performed by the auditor does not, in and of itself, satisfy the independence requirements.

Moreover, the auditor and the audit committee must be diligent in evaluating the nature and extend of services provided so as to avoid an impairment of independence, in fact or in appearance. The test for independence, in fact, according to the Standard is whether the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements and of internal control. The test for independence in appearance is based on whether a reasonable investor would perceive a conflict of interest that would jeopardize the exercise of objective and impartial judgments.

The Standard notes that the auditor thus cannot design or implement controls. The auditor however can make substantive recommendations as to how management may improve the design and operation of internal control as a by-product of an Audit. An auditor should also be able to assist an audit client with the documentation of its internal control over financial reporting.

Auditor Independence – Are engagements that were pre-approved prior to the effective date of the Standard exempt from the new requirements?

No, if the provision of internal control related services is ongoing, and the auditor's engagement was pre-approved by the audit committee in a manner that does not satisfy the requirements of the Standard, the auditor should request the audit committee to specifically evaluate the independence implications of the continuation of those services as soon as practicable.

If the auditor identifies a misstatement in a preliminary draft of the financial statements, does this represent a significant deficiency and a strong indication of a material weakness?

Yes, it may, depending on how management communicates the preliminary draft to the auditor.

The Standard provides that a material misstatement in the financial statements not initially identified by the company's internal control is deemed a significant deficiency and a strong indicator that a material weakness exists (even if management subsequently corrects the misstatement). The purpose of this provision is to ensure that a company has effective internal control over financial reporting on its own and does not rely on the results of auditing procedures to identify gaps in its internal controls.

Although a company may feel forced to provide only a single draft of the financial statements to its auditor once management is comfortable that the internal controls are effective, that outcome is not the declared intention of the PCAOB.

Management may continue to share interim drafts of the financial statements with the auditor, but it should be careful how it communicates (written or oral) with the auditor about the following:

- state of completion of the financial statements;
- extent of controls that had (or had not) operated at the time; and
- purpose for which the draft financial statements are given to the auditor.

For example, if management provides the auditor with a draft that does not contain two specific required notes to the financial statements without any further explanation, the auditor may conclude on the face of the incomplete draft that there is a significant deficiency in the company's internal control over financial reporting. If, however, management tells the auditor that the draft does not include the two specific notes but that they will be provided at a later time, the auditor would not consider the draft materially deficient. As another example, management may provide the auditor with a partially completed note making it clear that the numerical information (provided in a separate table) is final but that the related text of the note is not.

The analysis on draft financial statements also applies to auditor involvement in the auditing process. Although the increased focus on the effectiveness of the company's internal control should not require auditors to become so far removed from the process that the quality of the audit is impaired, some aspects of the traditional audit process may need to be adjusted as a consequence.

For example, it should be permissible for the auditor to provide the company with a blank accounting disclosure checklist that the company completes on its own as part of the preparation of the financial statements. (If the same checklist is completed by the auditor as a result of which the auditor finds that material required disclosure was missing, the auditor may conclude that a significant deficiency is present.) It should also be permissible for the auditor to discuss with management an emerging accounting issue or the application of a complex and highly technical accounting pronouncement in the company's particular circumstances.

What types of outsourcing activities form part of a company's internal control over financial reporting?

Companies regularly outsource certain functions (such as payroll or information technology) to third party service providers. These situations present special issues with respect to internal control reporting. If services that are outsourced by a company form part of the company's information system, management's assessment of the company's internal control over financial reporting must extend to such services. Similarly, those services must also form part of an auditor's work relating to an Audit.

AU sec. 324 provides guidance as to when services that are outsourced by a company to third party service organizations are a part of the company's information system. Those services are part of the company's information system if they affect:

- significant classes of transactions;
- procedures (automated or manual) by which transactions are initiated, authorized, recorded, processed and reported;
- related accounting records (electronic or manual);
- the way in which the company records other events and conditions; or
- the financial reporting process, including significant accounting estimates and disclosures.

AU sec. 324 provides examples of situations in which a service organization's services affect a company's information system. Banks often act as custodians for a company's benefit plan assets that involves them making investment decisions and taking responsibility for administration and record keeping of accounts. These types of services affect a company's information system. If services are limited to executing transactions that the client specifically authorizes they would not form part of the information system of the company.

If outsourced services are a part of the company's information system, management should consider the activities of the service organization in making an assessment of internal control over financial reporting, and the auditor should consider the activities of the service organization in determining the evidence required to support his or her opinion. In its assessment of internal controls over the outsourced services, management may rely on a Type 2 SAS 70, *Service Organizations* report performed by the auditors of the third party service provider, even if the auditors for both companies were the same (however, management may not engage the company's audit firm to prepare such report on the third party service provider). (Type 2 reports assess both design and operating effectiveness while Type 1 reports only cover design effectiveness.) Similarly, the Standard allows an auditor to use a Type 2 report in its own Audit if the report fits within the general accommodation of the Standard allowing an auditor to use the work of others.

The Standard does not require that the auditor of the third party service provider be a registered public accounting firm. However, care should be taken to ensure that the auditor's reliance on such report in arriving at its own audit opinion does not trigger the "substantial role" threshold of the PCAOB's registration requirements. (Rule 1001(p) of the PCAOB requires that any public accounting firm that plays a substantial role in the preparation or furnishing of an audit report register with the PCAOB.)

As a practical matter, in preparing for its assessment of the company's internal control over financial reporting, management should

- identify all situations where an outside service organization provides services that affect the company's information systems;
- determine whether service auditor's reports exist that provide evidence about the effectiveness of controls at the service provider;
- review those reports to evaluate whether they provide sufficient evidence to support management's assessment; and
- consider requesting the service provider to provide a Type 2 report if it does not exist.

* * *

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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