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# AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS

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PCAOB Rulemaking
Docket Matter No. 008

Summary: After public comment, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") has adopted Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements. This standard is the standard on attestation engagements referred to in Section 404(b) as well as Section 103(a)(2)(A) of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act" or "the Act"). The Board will submit this standard to the Securities and Exchange Commission ("Commission" or "SEC") for approval pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act"). This standard will not take effect unless approved by the Commission.

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The series of business failures that began with Enron in late 2001 exposed serious weaknesses in the system of checks and balances that were intended to protect the interests of shareholders, pension beneficiaries and employees of public companies – and to protect the confidence of the American public in the stability and fairness of U.S. capital markets.

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From the boardroom to the executive suite, to the offices of accountants and lawyers, the historic gatekeepers of this confidence were found missing or, worse, complicit in the breaches of the public trust.

Congress responded to the corporate failures with the Sarbanes-Oxley Act of 2002, creating a broad, new oversight regime for auditors of public companies while prescribing specific steps to address specific failures and codifying the responsibilities of corporate executives, corporate directors, lawyers and accountants.

The merits, benefits, cost and wisdom of each of the prescriptions can and will fuel debate. But the context for the passage of the Sarbanes-Oxley Act, and the President's signing it into law on July 30, 2002, cannot be ignored: Corporate leaders and advisors failed. People lost their livelihoods and their life savings. The faith of America and the world in U.S. markets was shaken to the core.

In that context, the PCAOB adopted the standard for auditors to use when assessing whether managers of a public company have accurately reported on companies' internal controls over financial reporting.

Failures in internal control, particularly over financial reporting, were among the specific concerns addressed by Congress in the Sarbanes-Oxley Act. Congress required not just that management report on a company's internal control over financial reporting, but that auditors attest to the accuracy of management's report.

The bottom line for Congress, and for the PCAOB, is the reliability of the company's financial statements – statements relied on by shareholders, management, directors, regulators, lenders, investors and the market at large.

To achieve reliable financial statements, internal controls must be in place to see that records accurately and fairly reflect transactions in and dispositions of a company's assets; to provide assurance that the records of transactions are sufficient to prepare financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures are made only as authorized by management and directors; and to make sure that steps are in place to prevent or detect theft, unauthorized use or disposition of the company's assets of a value that could have a material effect on the financial statements.

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In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it exercises adequate internal control over bookkeeping, the sufficiency of books and records for the preparation of accurate financial statements, adherence to rules about the use of company assets and the possibility of misappropriation of company assets.

The Sarbanes-Oxley Act, in Section 404, requires company management to assess and report on the company's internal control. It also requires a company's independent, outside auditors to issue an "attestation" to management's assessment – in other words, to provide shareholders and the public at large with an independent reason to rely on management's description of the company's internal control over financial reporting.

Reliable financial reporting is too important to relegate an auditor's attestation to a rubber-stamped endorsement of management's report on internal controls. As a result, the PCAOB is requiring that auditors perform an audit of internal control over financial reporting and to perform that audit in conjunction with the audit of a company's financial statements.

The one audit cannot be separated from the other. The information the auditor learns as a result of auditing the company's financial statements has a direct and important bearing on the auditor's conclusion about the effectiveness of the company's internal control over financial reporting.

Section 404 and the Board's requirements will entail extra work and, for companies, extra expense, particularly in the first year of implementation. The PCAOB will be vigilant in its inspections of accounting firms and conversations with issuers, particularly small and medium-sized companies, to see that expense isn't increased for its own sake.

The Board does not underestimate the demands this auditing standard will impose on auditors and public companies. But in the end, the Board, public companies and the accounting profession answer to the higher demand of accuracy, reliability and fairness in the financial statements that provide the basis for trust in our financial markets.

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A. The Benefits of Effective Internal Control Over Financial Reporting

Companies use internal controls as checks on a variety of processes, including financial reporting, operating efficiency and effectiveness, and compliance with applicable laws and regulations. The Sarbanes-Oxley Act focuses on companies' 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 about the reliability of a company's financial reporting and its process for preparing and fairly presenting financial statements in accordance with generally accepted accounting principles. It includes policies and procedures for maintaining accounting records, authorizing receipts and disbursements, and the safeguarding of assets.

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

Strong internal controls also provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that internal control reporting can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), assessments of internal controls over financial reporting should emphasize controls that prevent or detect errors as well as fraud.

Evaluating a company's internal control over financial reporting is not without cost, but it provides many far-reaching benefits. Regular assessments, and reporting on those assessments, can help management develop, maintain and improve existing internal control. Assessments can identify cost-ineffective procedures, reduce costs of processing accounting information, increase productivity of the company's financial function, and simplify financial control systems. It also may result in fewer financial statement restatements and less litigation.

The primary benefit of evaluations, however, is to provide the company, its management, its board and audit committee, and its owners and other stakeholders with a reasonable basis on which to rely on the company's financial reporting. The integrity of financial reporting represents the foundation upon which this country's public markets are built.

As with many endeavors, internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented. As a result, no system of internal control over financial reporting, regardless of how well it is designed and operating, can provide absolute assurance that a company's financial statements are accurate.

Nevertheless, as companies develop processes to assist management in assessing internal control and as auditors perform their evaluations, the assessment process should result in a continuous strengthening of internal control over financial reporting.

B. Basis for Internal Control Reporting and the Board's Standard

Section 404(a) of the Sarbanes-Oxley Act requires 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 and 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. The SEC implemented Section 404(a) in a rule on June 5, 2003.[1/]

Section 404(b) of the Act requires the company's auditor to attest to and report on the assessment made by the company's management. Sections 103(a)(2)(A) and 404(b) of the Act direct the PCAOB to establish professional standards governing the independent auditor's attestation.

In April 2003, the Board adopted pre-existing professional standards as the Board's interim standards, including a standard governing an auditor's attestation on internal control. Mindful of the requirements of the Sarbanes-Oxley Act and the need to evaluate the pre-existing standard, the Board convened a public roundtable discussion

1/ See 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) [68 FR 36636].

on July 29, 2003, to discuss issues and hear views related to reporting on internal control. The participants included representatives from public companies, accounting firms, investor groups, and regulatory organizations.

As a result of comments made at the roundtable, advice from the Board's staff, and other input, the Board determined that the pre-existing standard governing an auditor's attestation on internal control was insufficient for purposes of effectively implementing the requirements of Section 404(b) of the Act and for the Board to appropriately discharge the Board's standard-setting obligations under Section 103 of the Act. In response, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled "An Audit of Internal Control over Financial Reporting in Conjunction with An Audit of Financial Statements."

The Board received 193 comment letters from a variety of interested parties, including auditors, investors, internal auditors, issuers, regulators, and others on a broad array of topics. Those comments led to changes in the proposed standard, intended to make the requirements of the standard clearer and more operational.

The Board has approved PCAOB Auditing Standard No. 2, implementing the requirements of the Sarbanes-Oxley Act and incorporating comments received.

This release summarizes the process involved in conducting an audit of internal control over financial reporting, other significant provisions of PCAOB Auditing Standard No. 2 and some of the significant considerations of the Board when it initially proposed this standard and when it evaluated the comments it received. The Board's detailed analysis of the comments received and the Board's responses are contained in Appendix E to the standard.

## C. The Audit of Internal Control Over Financial Reporting

In preparing PCAOB Auditing Standard No. 2, the Board was guided by a number of broad considerations that have effect throughout the standard. Those broad considerations included: that "attestation" is insufficient to describe the process of assessing management's report on internal controls; that an audit of internal control over financial reporting must be integrated with an audit of the company's financial statements; and that the costs of the internal control audit be appropriate in consideration of the expected benefits to investors of improved internal control over financial reporting.

D. Attestation vs. Audit

Throughout Auditing Standard No. 2, the auditor's attestation of management's assessment of the effectiveness of internal control is referred to as the audit of internal control over financial reporting. The Board has noted, in comment letters and in other communications, that some people have drawn a distinction between an "audit" and an "attestation," suggesting that an attestation is a different type of engagement that involves a lesser amount of work than an audit. This idea is erroneous. An attestation engagement to examine management's assessment of internal control requires the same level of work as an audit of internal control over financial reporting.

The objective of an audit of internal control over financial reporting 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/] Further, Section 103(a)(2)(A)(iii) 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.

An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct. The auditor needs to evaluate management's assessment process to be satisfied that management has an appropriate basis for its conclusion. The auditor, however, also needs to test the effectiveness of internal control to be satisfied that management's conclusion is correct and, therefore, fairly stated. Indeed, as the Board heard at the internal control roundtable and in comment letters, investors expect the independent auditor to test whether the company's internal control over financial reporting is effective, and Auditing Standard No. 2 requires the auditor to do so.

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[2/] See SEC Regulation S-X 2-02(f), 17 C.F.R. 210.2-02(f).

E. Integrated Audit

PCAOB Auditing Standard No. 2 describes an integrated audit of the financial statements and internal control over financial reporting. Accordingly, it is an integrated standard that (1) addresses 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 and (2) refers to the attestation of management's assessment of the effectiveness of the internal control as the audit of internal control over financial reporting.

The Board decided that these audits should be integrated because the objectives of, and work involved in performing, an audit of internal control over financial reporting and an audit of the financial statements are closely related. Furthermore, Section 404(b) of the Sarbanes-Oxley Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement.

Each audit provides the auditor with information relevant to the auditor's evaluation of the results of the other audit. For example, the auditor's discovery of misstatements in the financial statements while performing financial statement auditing procedures indicates that there may be weaknesses in the company's internal control over financial reporting. Because of the significance of this interrelationship, the Board has made it clear that, to conduct and report on the results of an audit of internal control over financial reporting pursuant to Auditing Standard No. 2, the auditor also must audit the company's financial statements.

Notwithstanding the fact that the two audits are interrelated, the integrated audit results in two separate objectives: to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting and to express an opinion on whether the financial statements are fairly stated.

F. Cost

The Board is sensitive to the costs Section 404 and Auditing Standard No. 2 may impose on all companies, particularly some small and medium-sized companies. The

Board anticipates that most companies of all sizes will experience the highest cost of complying with Section 404 during the first year of implementation.

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, for example, are likely to need extensive and sophisticated internal control systems.

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. The Board expects that the auditor will exercise reasonable professional 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.

Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures to develop the framework. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published Internal Control – Integrated Framework. COSO's publication (also referred to simply as COSO) provides a suitable framework for purposes of management's assessment.

The directions in Auditing Standard No. 2 are based on the internal control framework established by COSO because of the frequency with which management of public companies are expected to use that framework for their assessments. Other suitable frameworks have been published in other countries and likely will be published in the future. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass all of COSO's general themes. The auditor should therefore be able to apply the concepts and guidance in Auditing Standard No. 2 in a reasonable manner if management uses a suitable framework other than COSO.

The Board believes that the special considerations for small and medium-sized companies included within COSO provide well for the auditor's use of such judgment, more so than the appendix that the Board's proposed standard originally included. For this reason, the proposed appendix was removed from Auditing Standard No. 2 and replaced with a direct reference to the special considerations within COSO.

The Board also was cognizant of audit costs in its consideration of the appropriate extent to which the auditor may use the work of internal auditors and others to support the auditor's opinion on internal control effectiveness. Auditing Standard No. 2 provides the auditor with significant flexibility in using the relevant work of highly competent and objective personnel, while also requiring the auditor to obtain through his or her own auditing procedures a meaningful portion of the evidence that supports the auditor's opinion. The Board believes it has achieved an appropriate balance of work between the auditor and others that will ensure a high quality audit of internal control and that have the complementary benefit of encouraging companies to invest in competent and objective internal audit functions.

G. The Audit Process

An audit of internal control over financial reporting is an extensive process involving several steps, including 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.

The auditor's objective is to express an opinion about whether management's assessment, or conclusion, on the effectiveness of internal control over financial reporting is stated fairly, in all material respects. To support his or her opinion, the auditor must obtain evidence about whether internal control over financial reporting is effective. The auditor obtains this evidence in several ways, including evaluating and testing management's assessment process; evaluating and testing work on internal control performed by others, such as internal auditors; and testing the effectiveness of the controls himself or herself.

H. Auditor Independence

The Sarbanes-Oxley Act, and the SEC rules implementing Section 404(a) of the Act, require the auditor to be independent to perform an audit of internal control over financial reporting. Under the SEC's Rule 2-01 on auditor independence, an auditor impairs his or her independence if the auditor audits his or her own work, including any work on designing or implementing an audit client's internal control system. PCAOB Auditing Standard No. 2 explicitly prohibits the auditor from accepting an engagement to provide an audit client with an internal control-related service that has not been specifically pre-approved by the audit committee. That is, the audit committee cannot pre-approve internal control-related services as a category, but must approve each service.

I. Key Provisions of Audit Standard No. 2

1. Evaluating Management's Assessment

The natural starting place for the audit of a company's internal control over financial reporting is management's assessment. By evaluating management's assessment, an auditor can have confidence that management has a basis for expressing its conclusion on the effectiveness of internal control. Such an evaluation also 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 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. Auditing Standard No. 2 allows the auditor to use, to a reasonable degree, the work performed by others. The more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

Also, the more clearly management documents its internal control over financial reporting, the process used to assess the effectiveness of the internal control, and the results of that process, the easier it will be for the auditor to understand the internal control, confirm that understanding, evaluate management's assessment, and plan and perform the audit of internal control over financial reporting. This too should translate into reduced professional fees for the audit of internal control over financial reporting.

2. Obtaining an Understanding of Internal Control Over Financial Reporting, Including Performing Walkthroughs

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

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

Auditing Standard No. 2 directs the auditor to confirm his or her understanding by performing procedures that include making inquiries of and observing the personnel who 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. To introduce a powerful efficiency, and because of the importance of several other objectives that walkthroughs accomplish, Auditing Standard No. 2 requires the auditor to perform walkthroughs in each annual audit of internal control over financial reporting.

In a walkthrough, the auditor traces a transaction from each major class of transactions from origination, through the company's accounting and information systems and financial report preparation processes, to it being reported in the company's financial statements. Walkthroughs provide the auditor with audit evidence that supports or refutes his or her understanding of the process flow of transactions, the design of controls, and whether controls are in operation. Walkthroughs also help the auditor to determine whether his or her 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 a walkthrough requires and the significance of the objectives that walkthroughs allow the auditor to achieve, Auditing Standard No. 2 requires the auditor to perform the walkthroughs himself or herself. In other words, Auditing Standard No. 2 does not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs. However, to provide additional evidence, the auditor may also review walkthroughs that have been performed and documented by others.

The walkthroughs also must be done in each annual audit of internal control over financial reporting. Important objectives of walkthroughs are to confirm that the auditor's understanding of the controls is correct and complete. Without actually "walking" transactions through the significant processes each year, there is too high a risk that changes to the processes would go undetected by the auditor.

Because of the significance of the objectives they are intended to achieve, and the judgment necessary to their effective performance, walkthroughs should be performed by appropriately experienced auditors. Inexperienced audit personnel who participate in walkthroughs should be supervised closely so that the conditions encountered in the walkthroughs are considered appropriately and that the information obtained in the walkthroughs is appropriately documented.

3. Identifying Significant Accounts and Relevant Assertions

As a part of obtaining an understanding of internal control, the auditor also determines which controls should be tested, either by the auditor, management, or others. Auditing Standard No. 2 requires that the auditor obtain evidence about the operating effectiveness of internal control over financial reporting for all relevant assertions for all significant accounts or disclosures. This requirement relies heavily on two concepts: significant account and relevant assertion.

Auditing standards implicitly recognize that some accounts are more significant than others. Auditing Standard No. 2 provides additional direction on how to determine significant accounts for purposes of the audit of internal control over financial reporting. In short, the auditor begins by performing a quantitative evaluation of accounts at the financial-statement caption or note-disclosure level. Then the auditor expands the evaluation to include qualitative factors, such as differing risks, company organization structure, and other factors, which would likely result in additional accounts being identified as significant.

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Financial statement amounts and disclosures embody financial statement 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 valued properly? 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? Answering these questions helps the auditor to identify the relevant financial statement assertions for which the company should have controls.

Identifying "relevant" assertions is a familiar process for experienced auditors, and because of the importance relevant assertions play in the required extent of testing, Auditing Standard No. 2 provides additional direction.

Similarly, experienced auditors are familiar with identifying significant processes and major classes of transactions. Major classes of transactions are those groupings of transactions that are significant to the company's financial statements. For example, at a company for which sales may be initiated by customers through personal contract in a retail store or electronically using the Internet, these would be two major classes of transactions within the sales process (if they were both significant to the company's financial statements). Because of the importance of significant processes and major classes of transaction in the design of the auditor's procedures, Auditing Standard No. 2 provides additional direction here, too.

4. Testing and 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 appropriately qualified people who have the authority to implement them. At some point during the internal control audit, the auditor will need to make a determination as to whether the controls would be effective if they were 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 inquiries 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 operate as designed. Auditing Standard No. 2 adopts these methods of testing and evaluating design effectiveness. The last step is especially important because it calls for the auditor to apply professional judgment and knowledge of and experience with internal control over financial reporting to his or her understanding of the company's controls.

5. Testing Operating Effectiveness

Auditing Standard No. 2 requires the auditor to obtain evidence about the operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements.

For this reason, in addition to being satisfied as to the effectiveness of the design of the internal controls, the auditor performs 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.

Auditing Standard No. 2 directs required tests of controls to "relevant assertions" rather than to "significant controls." To comply with the requirements of Auditing Standard No. 2, the auditor would apply tests to those controls that are important to fairly presenting each relevant assertion in the financial statements. It is neither necessary to test all controls nor is it necessary to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). However, the emphasis is better placed on addressing relevant assertions (because those are the points where misstatements could occur) rather than significant controls. This emphasis encourages the auditor to identify and test controls that address the primary areas where misstatements could occur, yet limits the auditor's work to the necessary controls.

Expressing the extent of testing in this manner also resolves the issue of the extent of testing from year to year (the "rotating tests of controls" issue). Auditing Standard No. 2 states that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year.

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At the Board's roundtable, public company representatives and auditors indicated that providing examples of extent-of-testing decisions would be helpful. The proposed auditing standard included several examples, which have been retained in Appendix B of Auditing Standard No. 2.

6. Timing of Testing

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 is neither practical nor appropriate, however. To form a basis to express 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. Auditing Standard No. 2 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 still operated effectively at the end of the company's fiscal year.

7. Using the Work of Others

The auditor must consider other relevant and available information about internal control when evaluating internal control effectiveness. In this regard, Auditing Standard No. 2 requires the auditor to understand the results of procedures performed by others, for example, internal auditors, other company personnel, and third parties working under the direction of management, on internal control over financial reporting.

At a minimum, the auditor should consider the results of those tests in designing the audit approach and ultimately in forming an opinion on the effectiveness of internal control over financial reporting. To this end, Auditing Standard No. 2 requires the auditor to review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address internal controls over financial reporting and evaluate any internal control deficiencies identified in those reports.

Additionally, the auditor may use the results of testing by others to alter the nature, timing, and extent of his or her tests of controls. At the Board's roundtable and in comment letters, public companies indicated their concern that at some point, the

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Board's standard could require an excessive amount of retesting by the auditor in order to use the work of others, especially internal auditors, and would inappropriately restrict the auditor's ability to use the work of internal auditors and others.

Public companies were particularly sensitive to this issue because of its direct bearing on the cost of complying with Section 404. On the other hand, the federal bank regulators indicated that experience with the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), which requires internal control reporting similar to Section 404 of the Act, revealed instances in which the auditor used the work of internal auditors to an inappropriately high degree, where the auditor himself or herself did not perform sufficient work to provide a reasonable basis for his or her opinion.

The directions in Auditing Standard No. 2 for using the work of others are based on the same concepts as Statement on Auditing Standards ("SAS") No. 65, Auditor's Consideration of the Internal Audit Function in an Audit of the Financial Statements.[3/] However, because the subject matter in an audit of internal control – the effectiveness of the controls – is different from the subject matter in an audit of financial statements – the reliability of the financial amounts and disclosures – some adaptation of SAS No. 65 was required.

The competence and objectivity factors described in SAS No. 65 were adapted to the evaluation of persons other than internal auditors, such as members of financial management, and the evaluation of the nature of the items tested by others was adapted to the context of an audit of internal control over financial reporting rather than an audit of financial statements. Additionally, Auditing Standard No. 2 creates an overall boundary on the use of the work of others in an audit of internal control over financial reporting not contained in SAS No. 65 by requiring that the auditor's own work provide the principal evidence for the audit opinion.

Auditing Standard No. 2 describes an evaluation process, focusing on the nature of the controls subject to the work of others and the competence and objectivity of the

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[3/] The Board adopted the generally accepted auditing standards, as described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") SAS No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. SAS No. 65 is one of those standards.

persons who performed the work, that the auditor should use in determining the extent to which he or she may use the work of others.

For example, based on the nature of the controls in the control environment, the auditor should not use the work of others to reduce the amount of work he or she performs on the control environment. On the other hand, the auditor could use the work of others to test controls over the period-end financial reporting process. However, given the nature of these controls, the auditor would normally determine that he or she should perform more of these tests himself or herself, and that for any of the work of others the auditor used, the degree of competence and objectivity of the individuals performing the work should be high. Therefore, the auditor might use the work of internal auditors in this area to some degree but not the work of others within the company. Because of the importance of these decisions, Auditing Standard No. 2 provides additional direction.

Auditing Standard No. 2 also requires that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion. Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment as to whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work performed on pervasive controls and in areas such as the control environment than on other controls such as controls over routine, low-risk transactions. Also, the work the auditor performs in the control environment and walkthroughs provide an important part of the principal evidence the auditor needs to obtain.

These principles interact to provide the auditor with considerable flexibility in using the work of others and also prevent inappropriate over-reliance on the work of others. Although Auditing Standard No. 2 requires that the auditor reperform some of the tests performed by others in order to use their work, it does not set any specific requirement on the extent of the reperformance. For example, the standard does not require that the auditor reperform tests of controls over all significant accounts for which the auditor uses the work of others. Rather, Auditing Standard No. 2 relies on the auditor's judgment, such that the re-testing is sufficient to enable the auditor to evaluate the quality and effectiveness of the work.

This considerable flexibility in using the work of others should translate into a strong encouragement for companies to develop high-quality internal audit, compliance, and other such functions. The more highly competent and objective these functions are, and the more thorough their testing, the more the auditor will be able to use their work.

8. Evaluating the Results of Testing

Both management and the auditor may identify deficiencies in internal control over financial reporting. A 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.

Auditing Standard No. 2 requires the auditor to evaluate the severity of all identified control deficiencies because such deficiencies can have an effect on the auditor's 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 control deficiencies that rise to a certain level of severity.

Under Auditing Standard No. 2, a control deficiency (or a combination of internal control deficiencies) should be classified as a significant deficiency if, by itself or in combination with other control deficiencies, 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 will not be prevented or detected. A significant deficiency should 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.

The definitions of significant deficiency and material weakness focus on likelihood and magnitude as the framework for evaluating deficiencies. The Board anticipates that this framework will bring increased consistency to these evaluations yet preserve an appropriate degree of judgment. Additionally, Auditing Standard No. 2 includes examples of how these definitions would be applied in several different scenarios.

Auditing Standard No. 2 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 to the company's management, in writing, all control deficiencies of which he or she is aware that have not previously been communicated in writing to management and to notify the audit committee that such communication has been made.

9. Identifying Significant Deficiencies

Auditing Standard No. 2 identifies a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists, including –

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee. 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 detrimental effects on the company and its internal control over financial reporting, as well as on the independent audit. Auditing Standard No. 2 requires that, as part of evaluating the control environment and monitoring components of internal control, the auditor assess the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting.

  To be sure, the company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee. Auditing Standard No. 2 does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. If the auditor concludes that oversight by the audit committee is ineffective, however, the auditor must communicate that specific significant deficiency, or material weakness as the case may be, in writing to the board of directors.

Normally, the auditor's interests and the audit committee's interests will be aligned: both should be interested in fairly presented financial statements, effective internal control over financial reporting, and an effective audit process. The Board recognizes that a theoretical conflict of interest results from the audit committee's responsibility to hire and fire the auditor. However, this type of conflict is one that experienced auditors are accustomed to bearing and that investors expect an auditor to address: when the auditor determines that its overseer is ineffective (which significantly impairs the effectiveness of the financial reporting process), the auditor must speak up.

- Material misstatement in the financial statements not initially identified by the company's internal controls. As previously stated, 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 the 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, therefore, a strong indicator that the company's internal control over financial reporting is ineffective.

  Timing might be a concern for some issuers, particularly as it relates to making preliminary drafts of the financial statements available to the auditor. However, changes to the financial statement preparation process that increase the likelihood that the financial information is correct prior to providing it to the auditors likely will result in an improved control environment. The auditor also must exercise judgment when performing this evaluation. For example, if the auditor initially identified a material misstatement in the financial statements but, given the circumstances, determined that management would have found the misstatement on a timely basis before the financial statements were made publicly available, the auditor might appropriately determine that the circumstance was a significant deficiency but not a material weakness.

- Significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after reasonable periods 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, nonetheless, significant, and the auditor should expect the company to correct them. If, however, management fails to correct significant deficiencies within a reasonable period of time, that situation reflects poorly on tone-at-the-top, and directly on the control environment as a whole. Additionally, the significance of the deficiency can change over time (for example, major changes in sales volume or added complexity in sales transaction structures might increase the severity of a significant deficiency affecting sales).

10. Forming an Opinion and Reporting

Auditing Standard No. 2 permits the auditor to express an unqualified opinion if the auditor has identified no material weaknesses in internal control after having performed all of the procedures that the auditor considers necessary in the circumstances. In the event that the auditor cannot perform all of the procedures that the auditor considers necessary in the circumstances, Auditing Standard No. 2 permits the auditor to either qualify or disclaim an opinion. If an overall opinion cannot be expressed, Auditing Standard No. 2 requires the auditor to explain why.[4/]

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[4/] See also SEC Regulation S-X 2-02(f), 17 C.F.R. § 212.2-02(f) ("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.").

In addition, the auditor's report is to include two opinions as a result of the audit of internal control over financial reporting: one on management's assessment and one on the effectiveness of internal control over financial reporting. The Board decided that two opinions will most clearly communicate to report readers the nature and results of the work performed and most closely track with the requirements of Sections 404 and 103 of the Act.

11. No Disclosure of Significant Deficiencies

The auditor's report must follow the same disclosure model as management's assessment. The SEC's final rules implementing Section 404(a) require management's assessment to disclose only material weaknesses, not significant deficiencies. Therefore, because management's assessment will disclose only material weaknesses, the auditor's report may disclose only material weaknesses.[5/]

12. Material Weaknesses Result in Adverse Opinion on Internal Control

The previously existing attestation standard provided that when the auditor 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 might qualify his or her opinion ("except for the effect of the material weakness, internal control was effective") or might express an adverse opinion ("internal control over financial reporting was not effective").

The SEC's final rules implementing Section 404(a) 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 other words, in such a case, management must conclude

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[5/] It should be noted, however, that the final rules indicated that an aggregation of significant deficiencies may constitute a material weakness in a company's internal control over financial reporting, in which case disclosure would be required. See Final Rule: Management's Reports in 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) [68 FR 36636].

that internal control is not effective (i.e., a qualified or "except for" conclusion is not allowed).

Similar to the reporting of significant deficiencies, the reporting model for the auditor must follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion on the effectiveness of internal control over financial reporting must also be adverse; Auditing Standard No. 2 does not permit a qualified opinion in the event of a material weakness. However, Auditing Standard No. 2 also requires an opinion on management's assessment in every audit report.

In the event of a material weakness, the auditor could express an unqualified opinion on management's assessment, so long as management properly identified the material weakness and concluded in their assessment that internal control was not effective.

If the auditor and management disagree about whether a material weakness exists (i.e., the auditor concludes a material weakness exists but management does not and therefore makes the conclusion in its assessment that internal control is effective), then the auditor would render an adverse opinion on management's assessment.

The Board chose for the auditor's report to express two opinions in part because it would be more informative when a material weakness exists.

13. Testing Controls Intended to Prevent or Detect Fraud

Strong internal controls provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that the internal control reporting required by Section 404 can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud), the auditing standard on performing the audit of internal control over financial reporting should emphasize controls that prevent or detect errors as well as fraud. For this reason, Auditing Standard No. 2 specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably possible to result in material misstatement of the financial statements.

**RELEASE**

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On the 9th day of March, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

March 9, 2004

APPENDIX – Auditing Standard No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements