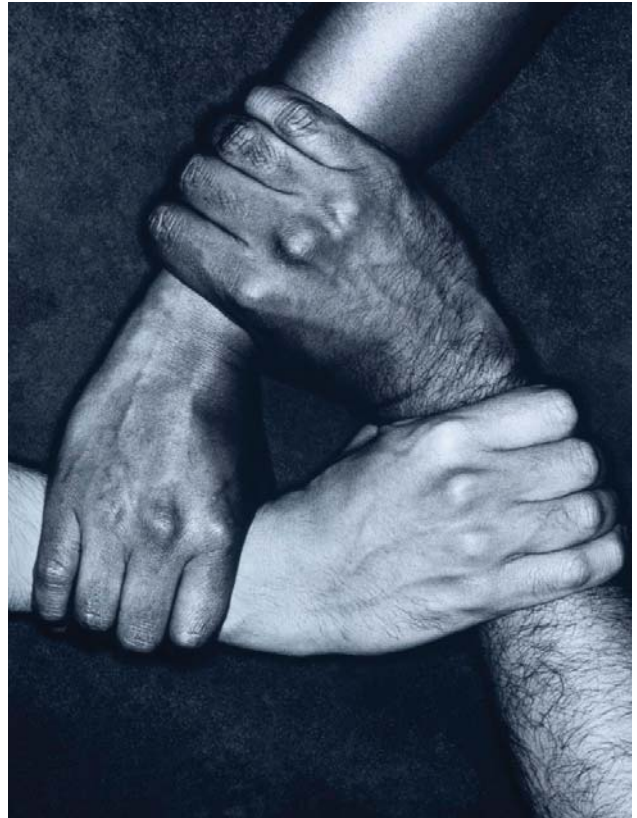


defining issues[®]

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PCAOB Approves Standard for Audits of Internal Control

On March 9, 2004, the Public Company Accounting Oversight Board (PCAOB or Board) approved its Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements. This Standard represents the culmination of a significant undertaking by the PCAOB and its staff directed toward developing an auditing standard that establishes performance and reporting requirements 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 Board received over 190 comment letters on its proposed standard and, as a result, made a number of changes to the proposed standard to enhance its understandability. This edition of *Defining Issues* highlights the more significant provisions of Standard No. 2 and outlines certain changes from the proposed standard.

As required by the Sarbanes-Oxley Act, Standard No. 2 has been submitted to the Securities and Exchange Commission (SEC) for ultimate approval.

OVERVIEW

In its release announcing the adoption of Standard No. 2, the PCAOB repeatedly highlights the importance of an effective internal control structure. Specifically, the Board states that, “Effective internal control over financial reporting is essential for a company to effectively manage its affairs and to fulfill its obligations to 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.”

The Board notes in its release announcing the adoption of Standard No. 2 that an audit of internal control over financial reporting is an extensive process and that maintaining effective internal control over financial reporting, including periodic evaluations, is not without cost. However, the Board notes that the benefits derived from developing, maintaining and improving a system of internal control are numerous, and that, “The primary benefit [of an effective internal control structure]...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.” A number of the changes adopted by the Board in the Standard, when compared to the proposed standard, were designed to enhance the cost-benefit relationship of the requirements to assess and report on internal control over financial reporting.

MANAGEMENT’S RESPONSIBILITIES

Standard No. 2 identifies prerequisites to the auditor’s satisfactory completion of an audit of internal control over financial reporting. As required by the SEC rules implementing Section 404 of the Sarbanes-Oxley Act,¹ 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 (e.g., the COSO criteria),
- Support the 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.

Auditors who conclude that management has not fulfilled the responsibilities noted above, will not be able to complete the audit of internal control over financial reporting and must disclaim an opinion.

MANAGEMENT’S ASSESSMENT PROCESS

A rigorous management process for assessing the effectiveness of a company’s internal control over financial reporting should provide information that helps the auditor understand the company’s internal control and plan the work necessary to complete an audit of internal control over financial reporting. Pursuant to the provisions of Standard No. 2, management’s process for assessing the effectiveness of the company’s internal control over financial reporting should include:

- Determining which controls to test, including controls over all relevant assertions related to all significant accounts and disclosures in the financial statements.
- Evaluating the likelihood that control failure could result in a financial-statement misstatement, the magnitude of such a misstatement, and the degree to which other controls may achieve the same control objectives.
- Determining the specific locations or business units to include in the evaluation (for companies with multiple locations or business units).
- Evaluating the design and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in concluding on effectiveness.
- Determining whether identified deficiencies in internal control over financial reporting constitute significant deficiencies or material weaknesses.
- Communicating findings to the appropriate parties.
- Evaluating whether the findings support its assessment.

(1) See Items 308(a) of Regulation S-B and S-K, 17 C.F.R. 228.308 (a) and 229.308 (a).

While it may be obvious to some, it is important to note that management cannot use the auditors' procedures or related findings in any way to support its assessment of the effectiveness of internal control.

MANAGEMENT'S DOCUMENTATION

The depth and breadth of management's documentation of internal control over financial reporting is a common subject deliberated by management, auditors and internal control advisors. Documentation that is comprehensive and clear facilitates an effective assessment and evaluation of internal control over financial reporting by management and provides a solid platform from which the auditor can launch the audit engagement. When determining whether management's documentation supports its assessment, an auditor should evaluate whether the documentation includes:

- 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 sufficient to identify where material misstatements due to error or fraud could occur;
- Controls designed to prevent or detect fraud;
- Controls over the period-end financial-reporting process;
- Controls over safeguarding of assets; and
- The results of management's testing and evaluation.

Standard No. 2 indicates that management's documentation may be in paper, electronic, or other media form and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, etc. The Standard provides no objective measures for determining the adequacy of management's documentation. It is important to note, however, that inadequate documentation is considered a control deficiency, the severity of which and the possible effect on the auditors' report is subject to auditor judgment.

OBTAINING AN UNDERSTANDING—WALKTHROUGHS

Standard No. 2 directs the auditor to obtain an understanding of internal control over financial reporting by making inquiries of personnel who perform controls, observing them, reviewing documents that are used in applying the controls or result from them, and comparing supporting documents with the resulting accounting records. The Standard further indicates that, "The most effective means of accomplishing this objective is for the auditor to perform 'walkthroughs' of the company's significant processes."

In a walkthrough, the auditor traces transactions and events from their origins to the financial statements, following their course through the company's accounting processes. Standard No. 2 requires that the auditor perform at least one walkthrough for each "major class of transactions" each year and, because of the judgment involved in conducting a walkthrough, the auditor is required to personally perform all walkthroughs. Standard No. 2 defines major classes of transactions as those that are significant to the company's financial statements. The auditor's walkthroughs should encompass the entire transaction process for each significant process over each major class of transactions affecting significant accounts or groups of accounts. Standard No. 2 indicates that an entity's period-end financial-reporting process is always considered a significant process.

EVALUATING THE EFFECTIVENESS OF THE AUDIT COMMITTEE'S OVERSIGHT

In Standard No. 2, the Board clarified its intentions relative to the auditors' responsibility to evaluate the effectiveness of the company's audit committee. Specifically, Standard No. 2 states that, "The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee." The Standard does not call on the auditor to perform a separate, distinct evaluation of the audit committee. This area is one that attracted a great deal of attention from nearly all those that commented on the Board's proposed standard.

Standard No. 2 does, however, recognize the critical role an audit committee fulfills in helping to establish a positive "tone at the top." To that end, Standard No. 2 indicates that the

auditor should assess the effectiveness of an issuer's audit committee as a component of his or her understanding and evaluation of the control environment and monitoring components of internal control over financial reporting, and provides relevant factors for the auditor to consider. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded by the auditor as at least a significant deficiency and a strong indicator of a material weakness in internal control over financial reporting. In addition, Standard No. 2 requires that instances of ineffective audit-committee oversight be communicated in writing to the entity's full board of directors.

Factors that impact the effectiveness of an audit committee's oversight of external financial reporting and internal control over financial reporting include the independence of the members from management, the clarity with which the committee's responsibilities are articulated, how well management and the audit committee understand those responsibilities, and the level of interaction with the independent and internal auditors.

TESTING OPERATING EFFECTIVENESS

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, *every* year. To comply with the provisions of Standard No. 2, the auditor should test the operating effectiveness of those controls that are important to fairly presenting each relevant assertion in the company's financial statements. Each year's audit is to stand on its own.

In determining whether a control is operating effectively, the auditor should evaluate not only whether the control is operating as designed, but also whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In addition, under Standard No. 2, the auditor will be required to obtain evidence about control operating effectiveness over a sufficient period of time. Any tests performed as of an interim date will need to be updated to obtain sufficient evidence that the controls tested during an interim period continue to operate effectively at year-end.

USING THE WORK OF OTHERS

Another area of the proposed standard that attracted significant attention from issuers and auditors involves the extent to which the auditor may use the work of others in performing an audit of internal control over financial reporting. In this regard, Standard No. 2, consistent with the proposed standard, requires that, on an overall basis, the auditor's own work must provide the principal evidence for the auditor's opinion. For purposes of this guidance, other parties' work includes work performed by internal auditors, other company personnel, and third parties working under the direction of management or the audit committee.

Standard No. 2 retains the provisions of the proposed standard indicating that the auditor may not use the work of others in testing controls relative to the control environment, including those established to prevent and detect fraud, and in performing walkthroughs. Standard No. 2 does allow the auditor to use some of the work performed by others in the area of information technology general controls and controls over the period-end financial-reporting process, whereas the proposed standard would have required that all audit work in these areas be performed by the auditor. The Board's concern that the auditor avoid over-reliance on work performed by internal auditors and other parties is clear from the guidance on using the work of others.

The proposed standard also defined three distinct categories of controls and the extent to which the auditor would be allowed to use work performed by others in forming his or her conclusions. This "three-bucket" approach has been replaced in Standard No. 2 with a conceptual framework that focuses on the nature of the controls and the competence and objectivity of the personnel performing the procedures in determining the extent to which the auditor may use the work of others. Standard No. 2 does indicate that if management tests operating effectiveness using a self-assessment process, then the individuals performing the self-assessment are not considered objective and, accordingly, the independent auditor should not use their work.

This framework, combined with the requirement that the auditor obtain the principal evidence on an overall basis, provides flexibility in determining the extent to which the auditor may

use the work performed by others in an audit of internal control over financial reporting.

EVALUATING THE RESULTS OF TESTING

Consistent with the proposed standard, Standard No. 2 requires the auditor to evaluate the severity of all identified-control deficiencies. Considerable debate regarding the Board's proposed definition of significant deficiencies has taken place since release of the proposed standard in October 2003. The Board notes that most commenters objected to the proposed definition of a significant deficiency asserting that such definition established a threshold at an unreasonably low level. Many commenters contended that the proposed definition would result in the vast majority of internal-control deficiencies being identified as at least a significant deficiency.

In Standard No. 2, the Board retained the proposed definitions of a significant deficiency and a material weakness.² In clarifying its intentions regarding these defined terms, the Board indicates that control deficiencies should not be evaluated in isolation, but rather the severity of a particular deficiency should be determined considering the effects of compensating controls. It appears that the Board's clarification of the definition of a significant deficiency in Standard No. 2 has, in part, addressed concerns expressed by many commenters regarding the low threshold thought to be established in the proposed standard. Nevertheless, significant judgment remains in identifying those deficiencies that constitute a significant deficiency or a material weakness.

Under Standard No. 2, a deficiency noted in the following areas ordinarily is at least a significant deficiency:

- Controls over the selection and application of accounting policies,
- Antifraud programs and controls,
- Controls over non-routine and non-systematic transactions, and
- Controls over the period-end financial-reporting process.

In addition, the following circumstances are at least a significant deficiency, and a strong indicator of the existence of a material weakness:

- Restatement of previously issued financial statements to correct a misstatement.
- The auditors' identification of a material misstatement in the current year audit that was not initially identified by the company.
- Ineffective audit-committee oversight.
- An ineffective internal audit or risk assessment function, if those functions are critical to the reliability of the company's financial-reporting process.
- An ineffective regulatory compliance function in a highly regulated company, limited solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.
- Identification of fraud of *any* magnitude on the part of senior management.
- Previously communicated significant deficiencies that remain uncorrected after a reasonable period of time.
- An ineffective control environment.

DEFICIENCIES AND THE AUDITORS' OPINION

Standard No. 2 requires the auditor to issue 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. This is a departure from the proposed standard. While a detailed analysis of the Board's reasoning for adopting this reporting protocol is beyond the scope of this *Defining Issues*, readers should be aware that Standard No. 2 does provide for those instances whereby the "opinion" rendered on management's assessment will differ from the "opinion" rendered on control effectiveness.

(2) Standard No. 2 defines an internal control deficiency to be present if 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. An internal control deficiency (or combination of deficiencies) is defined as significant if it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount. A material weakness in internal control is a significant deficiency or combination of significant deficiencies that results in more than a remote likelihood of a material misstatement in the company's annual or interim financial statements.



Consistent with the proposed standard, Standard No. 2 requires the auditor to issue an adverse opinion on control effectiveness when a material weakness in internal control over financial reporting has been identified.

QUARTERLY CERTIFICATIONS

Standard No. 2 requires the auditor to perform certain procedures each quarter to provide a basis for determining whether he or she has become aware of any material modifications that should be made to disclosures about changes in internal control over financial reporting relative to management's Sarbanes-Oxley Section 302 certifications. In the event the auditor concludes that management's disclosures and certification are not accurate, he or she is required to make certain communications and take certain actions.

EFFECTIVE DATE

As previously noted, Standard No. 2 does not become "final" until it is approved by the SEC. Auditors would then use this standard to audit the written assessment by a public company's management on the effectiveness of the company's internal control over financial reporting. The SEC recently deferred the requirement for managements of companies that are "accelerated filers" as defined in Exchange Act 12b-2, to report on their assessments of internal control over financial reporting for years ending on or after November 15, 2004. Management of non-accelerated filers, including small business and foreign filers, would report beginning with years ending on or after July 15, 2005. Companies must file the auditors' reports on internal control over financial reporting for years ended after these dates.

STAY TUNED

Standard No. 2 provides implementation guidance on a number of matters that have been the subject of extensive deliberation since the release of the proposed standard. However, a number of implementation matters remain unresolved – expected extent of management's documentation and testing, determination of significant financial statement accounts and disclosures, expected auditor coverage in a multi-location environment, use of a service auditor's report, determination of a significant deficiency in internal control over financial reporting, reporting matters when an unqualified report is not warranted, and expected extent of testing of controls over safeguarding of assets. Resolution of these matters will naturally come to pass as issuers and independent auditors continue to work with, and become more familiar with, the provisions of Standard No. 2 and audits of internal control over financial reporting.

The summary statements above describing Standard No. 2 should not be understood as a complete account of the Standard and no statements should be treated as applicable to specific engagements or corporate circumstances. In all matters related to obligations under the Sarbanes-Oxley Act of 2002 and related SEC regulations, companies should consult the relevant, applicable requirements and their accounting and legal advisors.

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