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BOARD CONSIDERS ADOPTING STANDARD FOR AUDITS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

MARCH 9, 2004 PUBLIC MEETING OF THE BOARD

Introduction

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.

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 Public Company Accounting Oversight Board is prepared to adopt the standard for auditors to use when assessing whether managers of a public company have accurately reported on companies' internal controls over financial reporting.

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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.

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 prepared to require 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.

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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.

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 of 2002 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.

Basis for Internal Control Reporting and the Board's Standard

Section 404(a) of the Sarbanes-Oxley Act of 2002 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

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Securities and Exchange Commission 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 Public Company Accounting Oversight Board 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 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 is now prepared to approve PCAOB Auditing Standard No. 2, implementing the requirements of the Sarbanes-Oxley Act and incorporating comments received.

[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].

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This document summarizes some of the significant considerations of the Board when it initially proposed this standard and when it evaluated the comments it received. The Board intends to release a more detailed analysis of the comments received and the Board's responses.

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.

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.

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

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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.

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.

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.

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.

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.

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