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# BRIEFING PAPER

**JULY 10, 2003**

**FOR THE ROUNDTABLE ON
REPORTING ON INTERNAL CONTROL**

On July 29, 2003, the Public Company Accounting Oversight Board (the "Board") will convene a roundtable to discuss issues relating to the independent auditor's report on an issuer's internal control over financial reporting. The roundtable will start at 9:30 a.m. and conclude at 4:00 p.m., with a brief break for lunch. Specifically, the Board seeks the views of interested persons on the responsibilities of registered public accounting firms to report on the assessment of internal controls by issuers. This paper contains the agenda of roundtable issues.

The Board has invited representatives of public companies and accounting firms, as well as U.S. investor groups, to participate in the roundtable. Following the roundtable, the Board will also accept written public comment concerning the issues on the agenda.

## Overview

Section 103(a)(2)(A)(iii) of the Sarbanes-Oxley Act of 2002 (the "Act") directs the Board to establish auditing standards that require registered public accounting firms to describe in audit reports the scope of testing of internal control that has been performed and report on the evaluation of internal control. Section 404(a) requires issuers to file with the SEC an annual report assessing internal controls and Section 404(b) provides that the issuer's auditor must attest to, and report on, the assessment made by management of the issuer. On June 5, 2003, the Securities and Exchange Commission ("SEC") adopted final rules implementing the requirements of Section 404(a). With some exceptions, public companies and their auditors must begin complying with the SEC rule in annual reports for fiscal years ending on or after June 15, 2004.

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The Board has a related responsibility to issue or adopt standards for the auditor's attestation required by Section 404(b). The Board has adopted Interim Auditing and Related Professional Practice Standards that include the pre-existing standard on engagements to issue an examination report on either the effectiveness of an entity's internal control over financial reporting or on management's written assertion concerning internal control effectiveness.[1/]

On March 18, 2003, the Auditing Standards Board of the American Institute of Certified Public Accountants ("AICPA") issued exposure drafts ("EDs") of several related pronouncements on internal control reporting that included the following –

- a proposed SSAE, *Reporting on an Entity's Internal Control Over Financial Reporting*, intended to replace Chapter 5 of SSAE No. 10 with an expanded set of requirements on attestation engagements on the effectiveness of internal control over financial reporting; and

- a proposed new Statement on Auditing Standards ("SAS"), *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction with a Financial Statement Audit.*

The proposed SAS directs auditors of public companies to follow the guidance in the proposed SSAE when performing an audit of internal control and explains the difference between the auditor's attention to internal control in an audit of financial statements and the work necessary to provide a separate opinion on the effectiveness of internal control.

The Act gives the Board the exclusive authority to establish and amend auditing and related professional standards that must be adhered to by all registered public accounting firms in audits of public companies. Because the AICPA no longer has this authority, the AICPA has made a recommendation to the Board, based on the EDs and the comments received by the AICPA during the exposure period.

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[1/] The pre-existing standard is Statement on Standards for Attestation Engagements ("SSAE") No. 10, *Attestation Standards: Revision and Recodification*, Chapter 1, *Attest Engagements,* and Chapter 5, *Reporting on an Entity's Internal Control Over Financial Reporting*. This standard is included in PCAOB Rule 3300T.

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## Roundtable Agenda

## A. Objectives of the Engagement and Standards on Internal Control

Section 404(a) of the Sarbanes-Oxley Act of 2002 requires that annual reports filed with the SEC must be accompanied by a statement by management of the issuer declaring that management is responsible for creating and maintaining adequate internal controls, and presenting management's assessment of the effectiveness of the company's (issuer's) internal control. Section 404(b) requires that the public company's auditor must report on, and attest to, management's assessment. The Act provides that the attestation report on management's assertion is not to be the subject of a separate engagement. In other words, an issuer's financial statement auditor must also perform the internal control attestation.

Standards on considering internal control in a financial statement audit and for reporting on internal control effectiveness have existed for many years. In all financial statement audits, generally accepted auditing standards ("GAAS") require the auditor to obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements, and to determine whether they have been implemented. Existing GAAS also provides guidance on how the auditor may perform tests of controls to obtain evidence about their operating effectiveness and use such evidence to alter the nature, timing, and extent of procedures that the auditor would otherwise perform. However, except for certain financial institutions, auditors have rarely been engaged to separately report on the effectiveness of internal control.

**Discussion Questions –**

1. Are new standards or additional guidance needed for auditors to comply with the requirements of Section 404?

2. What should be the overall objective of an engagement to attest to management's assertion on internal control?

    - Under existing standards, the auditor performs procedures that are sufficient to restrict the risk of issuing an inappropriate opinion on internal control to *an appropriately low level*. The appropriateness of the level of risk necessary to support the auditor's opinion is dependent solely on the auditor's judgment. A *low level of risk* also may be equated with a *high level of assurance*.

- Is there a more objective benchmark for the level of risk (or the level of assurance) that would be preferable?

3. Is reporting on management's assessment about the effectiveness of internal control over financial reporting a substantively different engagement, that would involve considerably less effort, than reporting directly on internal control effectiveness?

   - Does the requirement to attest to and report on management's assessment of internal control mean that the auditor's work should be restricted to evaluating management's assessment process and reviewing documentation prepared by management in its assessment process?

   - Is the amount of work to give an opinion on management's assessment roughly equivalent of the amount of work that would be necessary to give an opinion directly on the effectiveness of internal control?

4. Under the existing standards framework, auditors would need to refer to two different bodies of standards – auditing standards and attestation standards – to satisfy the requirements of the Act. Should the Board retain this approach and issue a separate attestation standard for the auditor's internal control attestation, which likely will require an additional auditing standard to reconcile the work related to the internal control attestation and the financial statement audit, or should there be one, integrated auditing standard to address the internal control attestation?

   - Which approach will provide the most effective guidance for meeting the requirements of Section 404?

## B. Documentation of Internal Control by Management

The SEC's final rules state that "a company must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting." The SEC's final rules include an instruction to remind registrants of the need to maintain such evidential matter.

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**Discussion Questions –**

5. What is the understanding of issuers about the nature and extent of documentation that will be required to support their assessment of the effectiveness of internal control?

6. What are auditors' expectations about the nature and extent of documentation that will be essential to provide an unmodified report on management's assertion about internal control?

    - Do issuers have similar expectations about the nature and extent of required documentation?

7. Should the Board provide specific and detailed criteria that auditors should use to evaluate the sufficiency of management's documentation?

    - Should the Board provide documentation criteria for auditors similar to those applicable to management in the SEC's final rules?

8. Should inadequate documentation of significant controls be a basis for a significant deficiency or a material weakness in internal control?

    - Could it be a basis for a limitation on the scope of the independent auditor's examination?

## C. Framework for Evaluation

The SEC's final rules specified that management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The SEC's final rules do not mandate use of a particular framework, but the Committee of Sponsoring Organizations of the Treadway Commission's (commonly referred to and known as "COSO")[2/] framework is explicitly identified as satisfying the

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[2/] In 1985, the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, was formed to study the financial reporting system in the United States. In 1987, the Treadway Commission issued a report recommending that its sponsoring organizations work together to integrate the various internal control concepts and definitions. Thus, in 1992, COSO published its study of

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SEC's criteria. The SEC recognizes that other evaluation standards exist outside of the United States, and identifies the *Guidance on Assessing Control*, published by the Canadian Institute of Chartered Accountants, and the *Turnbull Report,* published by the Institute of Chartered Accountants in England and Wales, as examples of suitable criteria. Management's report must identify the evaluation framework used to assess the effectiveness of internal control.

**Discussion Questions –**

9. What guidance should be provided on the framework for evaluating internal control?

10. Is a requirement that the evaluation framework must be issued by a group of experts that follow due process procedures sufficient?

11. Should particular frameworks be identified as meeting the requirement?

12. Should particular frameworks be mandated?

### D. Significant Deficiencies and Material Weaknesses in Internal Control

In existing standards, the term "reportable condition" was used to describe the level of deficiency in internal control that had to be communicated to the audit committee. Reportable conditions were defined as matters coming to an auditor's attention that, in the auditor's judgment, represent significant deficiencies in the design or operation of internal control, that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Moreover, a material weakness in internal control was defined as a reportable condition in which the design or operation of a component(s) of internal control does not reduce to a relatively low level the risk that a material misstatement may be contained in the issuer's financial statements. The Act used the term "significant deficiency" and established certain communication requirements concerning them. The term "significant deficiency" is currently understood as substantially the same as "reportable condition." The definitions of "material weakness" and "significant deficiency" are important because the existence of a material weakness precludes an unqualified opinion that internal control is effective, and the existence of a

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internal control to establish a common definition that would serve the needs of issuers, private companies, independent auditors, and regulatory agencies.

significant deficiency must be communicated by management to the auditor and to the audit committee.

**Discussion Questions –**

13. What definitions of significant deficiency and material weakness in internal control should be adopted?

14. For a deficiency to be significant, what should be the likelihood of misstatements not being prevented or detected, and what should be the magnitude of those misstatements?

15. For a weakness to be material, what should be the likelihood of misstatements not being prevented or detected, and what should be the magnitude of those misstatements?

16. What other improvements, if any, should be made in the specificity of the definitions, or the guidance on factors to consider in determining them?

17. If an audit committee is not in compliance with the new security listing requirements under the Securities Exchange Act of 1934 Rule 10A-3,[3/] should there be a presumption of a material weakness in internal control over financial reporting?

## E. Material Weaknesses Corrected During the Period

The Act clearly mandates point-in-time reporting on internal control, but the benefits expected from this reporting are not limited to effectiveness on only one day of the year. The benefits, as with other provisions of the Act, were expected to enhance the quality of financial reporting and increase investor confidence. The SEC's final rules on internal control reporting are not limited to an annual report by management. Management is required to evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. Management is required to disclose in its quarterly certification any such

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[3/] Under this rule, the national securities exchanges and national securities associations are to prohibit the listing of any security of an issuer that is not in compliance with specific standards regarding issuer audit committees (e.g., audit committee members must be independent according to certain criteria).

change in its internal control that occurred during the fiscal quarter covered by the quarterly report, or the last fiscal quarter, in the case of an annual report.

**Discussion Questions –**

18. What, if any, should the auditor's responsibility be with respect to management's disclosure of material weaknesses that existed during the period, but were corrected before the *as of* date of management's annual representation on internal control?

19. What, if any, should the auditor's responsibility be for –

    - advising management on the need to make disclosure of a material weakness existing during a quarter, but corrected by the end of the quarter;

    - advising the audit committee if management fails to make appropriate disclosure;

    - making disclosure outside the company if the audit committee fails to persuade management to make appropriate disclosure; and

    - disclosing in the auditor's annual report on internal control the existence of a material weakness that existed during the period, but was corrected by the *as of* date of management's representation on internal control?

## F. Using the Work of Others, Including Internal Auditors

In many organizations, the internal audit function monitors the effectiveness of internal control. Indeed, an important responsibility of the internal audit function is to monitor the operation of controls. In evaluating whether the monitoring component of internal control is effective, the auditor considers the work performed by internal audit.

**Discussion Questions –**

20. To what extent, and under what circumstances, may the auditor use the work of others, particularly internal auditors, as the principal evidence of the operating effectiveness of controls over significant account balances, classes of transactions, and disclosures?

- What is the extent of testing the independent auditor should perform on the work of others in order to rely upon that work?

- Does the extent of testing differ with respect to assessing the work of internal auditors?

21. Should there be a presumption that internal auditors cannot be considered to be objective if they report to management?

    - For the independent auditor to consider the work of internal auditors, should internal auditors report to the audit committee?

    - If the internal audit function is outsourced, are these internal auditors considered to be more objective than those that are employees of the issuer?

## G. Scope of Testing Controls

Section 103(a)(2)(A)(iii) provides that the Board shall include in the auditing standards it adopts a requirement that the auditor "describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b)." In the audit of a public company, the nature and extent of testing of internal control might still vary considerably because of differences in judgment about the extent of testing that is necessary to report *as of* a point in time, and because some auditors might decide to rely on internal control to a greater extent in connection with the auditor's tests of the financial statement amounts and disclosures. In other words, some auditors might decide to do the minimum testing necessary to give an opinion on effectiveness at a point in time, while other auditors will do considerably more testing because they intend to rely much more on internal control in order to reduce substantive procedures during the course of the audit.

**Discussion Questions –**

22. Should the Board's pronouncement include specific guidance on the nature, timing and extent of tests of controls?

    - For example, should the auditor perform tests of internal control in effect during one or more interim periods covered by the annual financial statements?

23. Should the Board specifically address the issue of rotation of the testing of internal controls? (That is, can the auditor test certain internal controls every three years?)

    - If so, should the rotation of testing be endorsed or prohibited?

24. Does a generic description of work on internal control satisfy the requirement of Section 103 of the Act? (Example of generic description: "Our examination included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances.")

25. Should there be a more extensive explanation of the nature and extent of testing performed?

26. Should the description of testing vary depending on the actual scope of work in the combined engagement, so that a user would know whether the auditor was relying on internal control to reduce the extent of detailed testing of financial statement amounts and disclosures in a particular area?

    - If so, how might this information be disclosed in the auditor's report?

## H. Reporting

The auditor's report on internal control might be a separate report or a combined report on the audited financial statements and the examination of management's assertion on internal control over financial reporting. The audit report on financial statements has not included any warning that misstatements due to error or fraud may occur and not be detected. The auditor is supposed to take into consideration the inherent limitations of internal control, including the possibility of management override, when planning and performing the audit. In contrast, the existing reporting standards for an examination report on internal control contain such warnings.

**Discussion Questions –**

27. Should auditors be free to choose between a combined report and separate reports or should there be no option?

- If there should be no option, should separate reports or a combined report be required?

- Or, should this decision be made by the audit committee?

28. Is an inherent-limitations-of-internal-control paragraph still necessary for reporting on internal control?

    - Should it be required even if management's report on internal control also describes inherent limitations?

    - In a combined report, should it be clarified that the inherent limitations paragraph applies only to the report on internal control?

## I. Auditor Independence

Management might request the auditor to provide a variety of nonaudit services related to its representation on internal control, including making recommendations on improvement to the entity's internal control, or assisting management in preparing or gathering documentation of controls. The Act specifically prohibits registered public accounting firms from providing certain nonaudit services, including bookkeeping services, financial information systems design and implementation, and internal audit outsourcing services, to their audit clients. The Act prohibits these services on the basis that they constitute a fundamental conflict of interest for the auditor because they involve auditing the auditor's own work, functioning as management or an employee, or acting as an advocate for the client.

**Discussion Questions –**

29. If existing independence requirements are insufficient, what additional requirements should the Board impose?

    - Should the auditor be prohibited from providing documentation and testing services to management to assist management in making its assessment of internal control?

    - If an outright prohibition is not warranted, can more explicit guidance than the admonition to avoid performing management functions, or making management decisions be established?

- Should a distinction be made between the auditor assisting in documenting existing internal control procedures versus recommending changes or enhancing internal control?

30. Are there nonaudit services that an auditor might be requested to provide management to assist in management's making the required representations on internal control that should be prohibited because they would impair independence?

31. Do existing independence requirements provide sufficient guidance on the nature of nonaudit services that can be provided to audit clients concerning documentation and testing of internal control?

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