SARBANES-OXLEY SECTION 404

A Toolkit for Management and Auditors

Volume 2

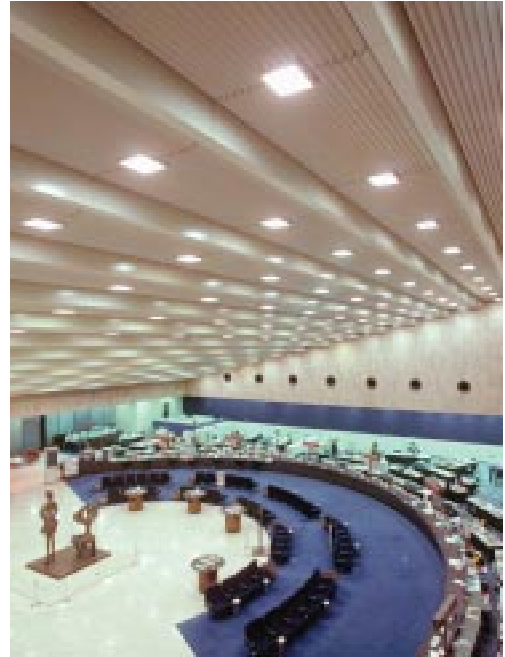
PricewaterhouseCoopers

Public Company Accounting Oversight Board

The Public Company Accounting Oversight Board (PCAOB) was established by Congress under the Sarbanes-Oxley Act of 2002. The five-member Board has been given responsibility for overseeing the audit of public companies, including:

- Registration of public accounting firms;
- Establishing quality control, ethics, independence and other standards relating to public company audits;
- Conducting inspections, investigations and disciplinary proceedings of registered accounting firms; and
- Enforcing compliance with the Act.

In the final Section 404 rules, the PCAOB has reiterated its own responsibility for the setting of attestation standards for registered public accountants (i.e. the Board does not intend to delegate this standard setting to any other body). As an interim measure, the PCAOB adopted existing auditing standards in the United States as of April 16, 2003.



The Public Company Accounting Oversight Board will oversee responsibility for the audit of public companies in the United States.

On October 7, 2003, the PCAOB issued its proposed standard for performing an audit of internal control over financial reporting performed in conjunction with an audit of financial statements for public companies. This is the standard for auditing the required disclosures by management under Section 404 of the Sarbanes-Oxley Act. During the 45-day comment period, the PCAOB is seeking feedback on 31 specific questions that cover a wide range of related topics – from the overall objectives of the internal control audit to detailed performance standards for the attestation. After receiving comments, the PCAOB will submit a final standard to the Securities and Exchange Commission (SEC). The SEC will then expose the standard for comment under its due process, generally 60 days, after which time the standard will be finalized and become the authoritative guidance for practitioners. The timing of the final standard is expected to be in early 2004, since the first audits of internal control will occur for accelerated filers with fiscal years ending on or after June 15, 2004. Companies who are not accelerated filers, including foreign private issuers, will not be required to meet the disclosure standards of Section 404 of the Sarbanes-Oxley Act until fiscal years ending on or after April 15, 2005.

Proposed Auditing Standard

An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements

October 2003

In October 2003, the PCAOB issued a draft standard for Section 404 attestation - a final definitive standard is expected in early 2004.

The Proposed Standard – Responsibilities of Management

The proposed standard of the PCAOB outlines responsibilities of management that are consistent with those previously described by the SEC in the final rule on Section 404. These responsibilities include:

- Accepting responsibility for the effectiveness of the company's internal control over financial reporting;
- Evaluating the effectiveness of the company's internal control over financial reporting using a suitable recognizable control framework, such as COSO;
- Supporting its evaluation with sufficient evidence, including documentation; and
- Presenting a written assessment about the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

In issuing the proposed standard, the Board expressed concern as to its possible effects on small and medium-sized companies. It was recognized that the manner in which the components of internal control will be applied to each company would depend on various factors, including the size of the business, complexity of its operations, methods for processing financial information, and applicable legal and regulatory requirements. Smaller companies will generally have less complex processes and therefore may have less complex and formalized controls. For smaller and less complex companies, 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." The PCAOB included an appendix in the proposed standard to illustrate further how the auditor might evaluate a smaller company's components of internal control.

Internal Control is Not One Size Fits All – *While much of the information in the proposed standard will apply to larger companies (above), the PCAOB has also provided guidance for the auditor of smaller entities and organizations (below).*

The Proposed Standard – Documentation Requirements

Under the proposed PCAOB standard, the documentation prepared by management must include:

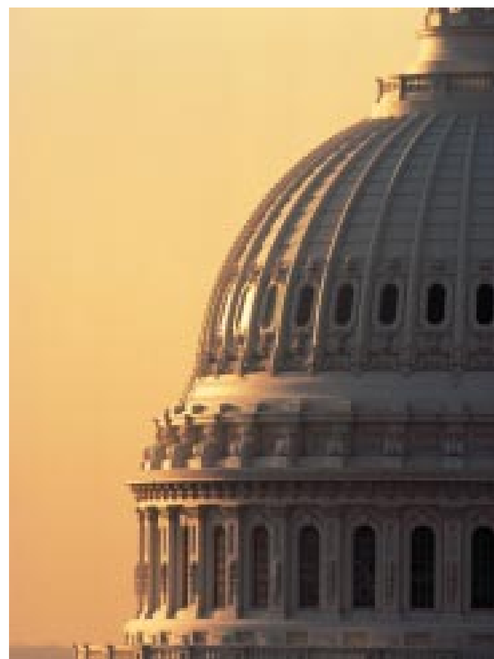
- The design of controls over ***relevant*** assertions related to ***all*** significant accounts and disclosures in the financial statements;
- Information about how significant transactions are initiated, recorded, processed and reported;
- Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur;
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties;
- Controls over the period-end financial reporting process;
- Controls over safeguarding of assets; and
- The results of management's testing and evaluation.

Importantly, the design of controls must include controls to prevent or detect fraud and controls over the safeguarding of assets.

The PCAOB acknowledges in its proposed standard that documentation of controls may take many different forms of presentation and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. No one form of documentation is necessarily required, and the extent of documentation will vary depending on the size, nature, and complexity of the company.

Inadequate management documentation of the design of controls or the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control would be considered an internal control deficiency and may also be a significant deficiency, material weakness or could lead to a scope limitation.

Documentation of controls may take many forms, and in many cases will involve a number of different types of presentation to meet the standard.



Internal Control Deficiencies

An ***internal control deficiency*** is the lowest level of control deficiency defined by the standard. An internal control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in ***design*** exists when a control necessary to meet the control objective is missing or an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met. A deficiency in ***operation*** exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively. An example of an internal control deficiency related to design might be that a reconciliation of intercompany accounts is not in place. If the control was in place but was not occurring on a timely basis, then the deficiency would be one that related to the operation of the control. All internal control deficiencies must be evaluated, both individually and in aggregate, in terms of their likelihood of occurrence and magnitude of potential error, to determine if they rise in level of significance to a significant deficiency or to a material weakness.

A ***significant deficiency*** is an internal control deficiency that adversely affects the company's ability to initiate, record, process or report external financial data reliably in accordance with GAAP. This could represent a single deficiency or a combination of deficiencies that results in more than a remote likelihood (i.e. greater than a slight chance) that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected. The standard emphasizes that the significance of a deficiency in internal control over financial reporting depends on the potential for a misstatement, not on whether a misstatement has actually occurred.

A ***material weakness*** is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The proposed standard provides that the existence of one or more material weaknesses renders internal control ineffective and requires an **adverse** attestation opinion. Circumstances which are presumed to be at least a significant deficiency and a "strong indicator" of a material weakness include the identification by the auditor of a material misstatement in the year-end financial statements that was not identified by the company's internal controls – even if management subsequently corrects the misstatement prior to issuance of the financial statements, and the identification of fraud of "any magnitude on the part of senior management."

Circumstances which result in a significant deficiency and are strong indicators of a material weakness:

- Restatement of previously issued financial statements.
- Identification by the auditor of a material misstatement in the financial statements.
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the Audit Committee.
- Ineffective internal audit or risk assessment function, for more complex entities.
- Ineffective regulatory compliance function for complex entities in highly regulated industries.
- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies communicated to management and the Audit Committee that remain uncorrected after some reasonable period of time.

The Proposed Standard – Responsibilities of the Auditor

The proposed standard puts forth the concept that the audit of the financial statements and the audit of internal control over financial reporting are closely interrelated, and, therefore, should be integrated activities. As a result, an auditor cannot audit internal controls of a public company as required by Section 404 of the Act without also auditing the financial statements.

The standard requires that the auditor evaluate both design and operating effectiveness of controls in order to opine on internal control over financial reporting, including walkthroughs of significant processes and additional testing of controls. The evaluation will include:

- Whether management has properly stated its responsibility;
- Whether the framework used by management is suitable (i.e. COSO or another framework);
- Whether management's assessment of the effectiveness of internal control is free of material misstatement;
- Whether management has expressed its assessment in acceptable form; and
- Whether material weaknesses in internal control have been properly disclosed.

An Integrated Audit *- The proposed PCAOB standard introduces the concept that the audit of internal control over financial reporting and the audit of financial statements are interrelated.*

In this evaluation, the auditor will determine whether or not management has identified significant accounts and relevant financial statement assertions, and will assess the process undertaken by management to develop its conclusions. The auditor's evaluation will include factors related to the effectiveness of the audit committee's oversight function, and controls the company has in place to specifically address the risks of fraud. The standard allows the auditor to issue a separate report or combined report, but, if separate, the reports must be dated the same.

The proposed standard requires the auditor to communicate in writing to the audit committee all significant deficiencies and material weaknesses identified during the audit. The auditor is also required to communicate in writing to management all deficiencies in internal control over financial reporting identified during the audit as well as any identified instances of fraud, and to inform the audit committee when such a communication has been made.

The proposed standard highlights the need for a clear understanding among the audit committee, management and the auditor on what constitutes a significant deficiency and a material weakness. Also, considering management's Section 302 requirements for reporting the existence of significant deficiencies and material weaknesses, a process needs to be in place to ensure that the auditor communicates significant deficiencies and material weaknesses to the audit committee and management during the course of the audit rather than at the end of the engagement. Continuous communication between all parties involved in the Section 404 process is critical.

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