PCAOB APPROVES FINAL STANDARD FOR AUDITOR ATTESTATIONS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

The Public Company Accounting Oversight Board (the "PCAOB") recently approved a final standard for auditor attestations of a company's internal control over financial reporting. These attestations are required under Section 404 of the Sarbanes-Oxley Act of 2002 in connection with management's assessment of such internal control.

Management Assessment of Internal Control Over Financial Reporting

Pursuant to Section 404 of the Sarbanes-Oxley Act, on June 5, 2003, the Securities and Exchange Commission (the "SEC") adopted final rules requiring management of a reporting company to assess the effectiveness of the company's internal control over financial reporting[1] as of the end of the company's most recent fiscal year and to describe in the company's annual report management's conclusion, as a result of that assessment, whether the company's internal control is effective. The rules require that management's internal control report state that the registered public accounting firm that audited the company's financial statements has issued an attestation report as to whether management's assessment of the company's internal control over financial reporting is "fairly stated in all material respects." The company must then file the attestation report as part of its annual report.

Companies that are "accelerated filers" (generally Form S-3 eligible companies) must comply with these requirements in their annual reports for their first fiscal year ending on or after November 15, 2004; non-accelerated filers and foreign private issuers must comply with these requirements in their annual reports for their first fiscal year ending on or after July 15, 2005.

The Sarbanes-Oxley Act further directed the PCAOB to establish professional standards governing the independent auditors' attestation report. Accordingly, on March 9, 2004, following a previously proposed version, the PCAOB adopted *Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("Auditing Standard No. 2"). This Standard has been submitted to the SEC for its approval.

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[1] The SEC defines "internal control over financial reporting" as a "process designed by, or under the supervision of, the issuer's principal executive and principal financial officers . . . to provide *reasonable assurance* regarding the reliability of financial reporting and the preparation of financial statements" in accordance with GAAP. It includes policies and procedures for maintaining accounting records, recording transactions, authorizing receipts and expenditures and safeguarding assets.

Audit of Internal Control Over Financial Reporting

Although the work required to be performed by the independent auditors is referred to as an "attestation," the PCAOB has stated that the attestation engagement requires the same level of work as an audit of internal control over financial reporting. Consequently, Auditing Standard No. 2 requires that the auditors not just evaluate the adequacy of management's processes for assessing the effectiveness of the company's internal control over financial reporting, but that the auditors independently test the effectiveness of the internal control itself.

Because of the similar objectives and work involved in audits of internal control over financial reporting and audits of financial statements, the PCAOB decided that these two audits should be integrated. Accordingly, the auditors who conduct the audit of internal control over financial reporting must also audit the company's financial statements. The two audit reports may be separate or combined, but should be dated the same date.

The requirements in Auditing Standard No. 2 are based on the internal control framework established by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). However, Auditing Standard No. 2 allows companies flexibility in choosing an alternative framework that encompasses all of COSO's general themes.

Commentary:

- The COSO framework consists of five interrelated components: control environment (so-called "tone at the top"), risk assessment, control activities to ensure that management directives are carried out, capture and communication of information and monitoring activities.

- Although the COSO framework addresses the effectiveness and efficiency of operations and compliance with applicable law as well as the reliability of financial reporting, the SEC's requirements regarding internal control over financial reporting focus on the latter category. However, controls on operations and compliance with law, to the extent they may affect financial reporting, are also part of the SEC's requirements.

- Auditing Standard No. 2 provides the auditors with some flexibility to use work performed by others, including the internal auditors and management's assessment. The more extensive and reliable the work is, and the better documented it is, the less extensive and costly the independent auditors' work will need to be. Still, the independent auditors' own work must constitute the principal evidence, both quantitative and qualitative, for their audit opinion.

- Embedded in the SEC definition of "internal control over financial reporting" is that management's assessment of the company's internal control must provide "reasonable assurance" of its effectiveness. The definition recognizes that the control processes will reduce, but not eliminate, the risk of financial reporting issues.

Management's Responsibilities

For the auditors to perform their audit of the internal control, management must:

- accept responsibility for the effectiveness of the company's internal control over financial reporting;
- evaluate the effectiveness of the internal control using acceptable criteria;
- support its evaluation with sufficient evidence, including documentation; and
- present its written assessment of the effectiveness of the company's internal control as of the end of the fiscal year.

If the auditors conclude that management has not satisfied these responsibilities, they should communicate, in writing, to management and the audit committee that the audit cannot be completed.

The Audit Process

The audit of internal control over financial reporting is an extensive process involving multiple steps. These steps include planning the audit, evaluating the process that management used to perform its assessment of the effectiveness of the internal control, evaluating the effectiveness of both the design and operation of the internal control and forming an opinion about whether the internal control is effective.

In addition to testing management's assessment process and the work on internal control by others, such as the internal auditors, the auditors must test the internal control directly. For example, the auditors are required to perform walkthroughs in each annual audit to trace transactions from origination, through the company's accounting and information systems and financial report preparation processes, to their being reported in the company's financial statements.

Auditing Standard No. 2 emphasizes the importance of controls over possible fraud and requires the auditors to test controls specifically intended to prevent, deter and detect fraud. These controls start with the "tone at the top" and include, for example, controls to prevent the misappropriation of assets, risk assessment processes, codes of ethics, internal audit activities and audit committee oversight and whistleblower procedures.

Commentary:

- More limited procedures are required to be performed by the auditors in connection with management's quarterly certifications regarding internal control required under Section 302 of the Sarbanes-Oxley Act.

Auditor Independence

Under Rule 2-01 of Regulation S-X, the auditors' independence is compromised if the auditors audit their own work or act as management, such as by designing or implementing the internal control. These restrictions, however, do not preclude the auditors from making recommendations as to how management may improve the design or operation of the internal control as a by-product of an audit.

Auditing Standard No. 2 prohibits the auditors from providing *any* internal control-related service, unless the service has been specifically pre-approved by the audit committee (rather than through a general categorical approval). At all times, management must be actively involved and retain responsibility for the control matters.

Timing of Testing

The Sarbanes-Oxley Act requires management's assessment and the auditor's opinion to address whether the internal control was effective as of the end of the company's most recent fiscal year. Obviously, performing all of the testing on December 31 is neither practical nor appropriate. Auditing Standard No. 2 recognizes that to express an opinion about whether the internal control was effective *as of* a point in time the auditors must obtain evidence that the internal control operated effectively *over* an appropriate period of time. Accordingly, the Standard provides that the auditors should obtain evidence about operating effectiveness at different times throughout the year and then update those tests at the end of the year.

Commentary:

- Controls "as of" a specific date include controls relevant to financial reporting "as of" that date, even if they may not operate until later. For example, certain controls over the period-end financial reporting process normally operate only after the end of the period.

Evaluating the Results of Testing

Auditing Standard No. 2 differentiates among a control deficiency, a significant deficiency and a material weakness:

- 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.

- A control deficiency is classified as a ***significant deficiency*** if, by itself or in combination with other control deficiencies, it results in more than a remote likelihood that 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 is 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 auditors must evaluate the severity of all control deficiencies, communicate such deficiencies in writing to management and notify the audit committee that such communication has been made. All significant deficiencies and material weaknesses must also be communicated in writing to the audit committee.

Auditing Standard No. 2 provides examples of circumstances that are significant deficiencies, as well as strong indicators of the existence of a material weakness, including:

- ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee;

  Commentary:

  - Ironically, this means that the independent auditors, who are hired and supervised by the audit committee, must evaluate the effectiveness of their overseers.

- any material misstatement in the financial statements not initially identified by the company's internal control;

- significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after reasonable periods of time;

- ineffective internal audit or risk assessment functions, particularly for large or complex companies;

- an ineffective regulatory compliance function in regulated companies, where violations of applicable law could have a material effect on financial reporting; and

- identification of fraud of any magnitude by senior management.

Forming an Opinion and Reporting

Similar to management's internal control report, only material weaknesses are required to be disclosed in the auditors' report on the effectiveness of the control. If the auditors have identified a material weakness, they must conclude that the company's internal control is not effective; a qualified opinion is not permitted if there is a material weakness.

Auditing Standard No. 2 permits the auditors to express an unqualified opinion only if the auditors have not identified any material weaknesses in the internal control after having performed *all* of the procedures that the auditors consider necessary under the circumstances. If

the auditors cannot perform all necessary procedures, they are required to qualify or disclaim their opinion.

Auditing Standard No. 2 further requires that the auditors report on management's assessment of the internal control. In the event of a material weakness, the auditors could express an unqualified opinion on management's assessment so long as management properly identified the material weakness and concluded in its assessment that the internal control was not effective. If the auditors and management disagree about the existence of a material weakness, then the auditors must render an adverse opinion on management's assessment.

Implementation

Given the extensive amount of time required to evaluate a company's internal control procedures and then design, implement and test any additional procedures that may be required, companies should already be well on their way in evaluating and implementing these requirements and preparing for management's internal control report and the related auditors' attestation report.

Commentary:

- Even though the independent auditors do not need to provide their attestation report until after year-end, make sure to involve them in the ongoing evaluation and testing processes to help ensure that there are no last minute surprises.

- Pay attention to these requirements in connection with any business acquisition, particularly at the end of the year and particularly of private companies, which may not have the controls required of public companies. With no transition period for newly acquired entities, any acquisition will need to be included as part of the review of internal controls for the year in which the acquisition is consummated. If necessary, consider adjusting the closing date.

- Companies will need to obtain the auditors' consent to the incorporation by reference of their attestation report in connection with any registration statement filed under the Securities Act, similar to auditor consents to the incorporation of their report on the financial statements. As with the auditor consent regarding their report on the financial statements, this consent regarding their attestation report will require that management deliver an updated representation letter to the auditors.

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If you wish to obtain additional information regarding this new PCAOB standard and related SEC regulations regarding management's internal control report, please contact Serge Benchetrit, John S. D'Alimonte, Steven J. Gartner, Yaacov M. Gross, Jeffrey S. Hochman or the corporate partner with whom you regularly work. For help with a current investigative or regulatory issue, feel free to call litigators Stephen W. Greiner, Richard L. Posen or Michael R. Young of our Accounting Irregularities Practice Group.

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March 30, 2004

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