Internal Control Over Financial Reporting

SEC and PCAOB Reduce Effort Required for Section 404 Internal Control Assessment and Related Audit

EXECUTIVE SUMMARY

The SEC and the PCAOB have now published their previously announced interpretive guidance and new auditing standard intended to make the application of the internal control assessment and related audit required by Section 404 of the Sarbanes-Oxley Act more efficient and cost-effective. Consistent with the proposals originally made in December 2006, the SEC’s interpretive guidance and the PCAOB’s new auditing standard encourage a top-down, risk-based approach to management’s assessment and the related audit. Both the guidance and the auditing standard encourage management and auditors to tailor their assessment of internal control over financial reporting based on the particular company’s facts and circumstances and in this manner, the guidance and auditing standard are designed to be more flexible and scalable. Whether the changes made by the SEC and the PCAOB will have the intended effect of reducing the effort and expense of complying with the Section 404 internal control process will, of course, depend largely on the way in which the changes are implemented by issuers and their audit firms, particularly those that have already been through several Section 404 audits and may therefore be reluctant to modify processes that have been found to be effective.

The SEC’s interpretive guidance took effect on June 27, 2007. The SEC’s rules relating to the revised definition of material weakness, the new audit report requirements and the creation of a safe harbor for those that follow the interpretive guidance will take effect on August 27, 2007. The PCAOB stated that its new auditing standard would take effect for audits of fiscal years ending on or after November 15, 2007. The SEC, which must still consider whether to approve the PCAOB standard, has indicated that the auditing standard, if approved, will be effective no later than for 2007 calendar year audits.
BUSINESS SUMMARY

SEC Interpretive Guidance Reporting Management’s Assessment

The SEC’s interpretive guidance, which addresses the management assessment aspects of the internal control process, emphasizes a top-down, risk-based approach to evaluating the design and operating effectiveness of internal control over financial reporting. The guidance includes the following:

- **Evaluating Design Effectiveness.** The guidance encourages management to take a risk-based approach to identifying controls to be tested. In applying the guidance, management would begin its assessment by identifying and assessing the company’s risks to reliable financial reporting. Once the financial reporting risks are identified, management should then evaluate whether the company’s controls adequately address these financial reporting risks. Management need not identify all controls that may address financial reporting risks. Rather, management need identify only those that adequately address the applicable financial reporting risks. Similarly, management need not document each control, but instead should focus on those controls that adequately address the identified risks. The SEC guidance also addresses the roles of specific types of controls, such as entity-level controls and information technology controls.

- **Evaluating Operating Effectiveness.** Once management has identified those controls that adequately address the company's financial reporting risks, management should then evaluate the operating effectiveness of those controls. The guidance encourages management to take a risk-based approach in determining the evidence sufficient to support an assessment that internal control over financial reporting is effective. The guidance defines a concept referred to as internal control over financial reporting risk, or ICFR risk, that assesses the risk characteristics of both the individual financial reporting element to which the applicable control relates and the risk that the related control may fail to prevent or timely detect a misstatement relating to that financial reporting element. The higher the assessed ICFR risk, the more evidence management should obtain to support its assessment that internal control over financial reporting is effective. The guidance lists a number of risk factors that management should consider when assessing the risk of control failure. With respect to documentation requirements, the guidance emphasizes that the nature and type of documentation that constitutes reasonable support for management’s assessment will vary based on the nature of the company as well as the nature of the particular control.

- **Evaluating Identified Control Deficiencies.** The guidance sets forth factors that management should consider in assessing the magnitude of an identified control deficiency. The guidance also lists circumstances that are considered indicators of a material weakness. These indicators include: identification of fraud, whether or not material, on the part of senior management; restatement of previously issued financial statements to correct a material misstatement; identification by the auditor of a material misstatement in the current period under circumstances indicating that the misstatement would not have been timely detected by the company; and ineffective audit committee oversight of the company’s financial reporting and internal control.

- **Disclosure Requirements.** The guidance also addresses disclosure of material weaknesses identified by management. The guidance notes that management should consider disclosing the impact of the material weakness on the company’s financial reporting and control environment (with a focus on the extent to which the material weakness has a pervasive impact), as well as any plans for remediating the material weakness. The guidance also addresses issues relating to financial statement restatements as well as limitations on management’s ability to perform its assessment.

The SEC’s interpretive guidance was accompanied by a new safe harbor rule that provides that an evaluation conducted in accordance with the guidance will satisfy the SEC’s management evaluation requirements. On the other hand, a company need not implement the interpretive guidance if it has in place other effective procedures for conducting management’s assessment.
The SEC has also changed the standard for determining whether internal control over financial reporting is effective. Currently, a material weakness exists — and internal control over financial reporting is deemed ineffective — if there is “more than a remote likelihood” that a material misstatement in the financial statements will not be prevented or detected. The SEC has changed this “more than remote” threshold to a “reasonable possibility” standard, a clarification intended to reduce the number of controls that need to be tested and require less evidence to support management’s assessment regarding those controls.

The SEC is also proposing to amend the definition of significant deficiency. The definition, which would be relevant for purposes of management’s internal control certification requirements and related required communications to the auditor and audit committee, would eliminate the probability element in the current definition and instead focus on those control deficiencies that merit attention from the audit committee.

**Summary of Changes from Proposed SEC Guidance**

Differences between the SEC’s proposed interpretive guidance and its final guidance fall generally in five broad areas:

- **Better Alignment of SEC Interpretive Guidance with PCAOB Auditing Standard.** The final guidance is more closely aligned with the PCAOB’s new auditing standard (Auditing Standard No. 5, or AS 5) in a number of areas, including with respect to the definition of material weakness, factors for identifying financial reporting risks, guidance for assessing whether a control adequately addresses a financial reporting risk and indicators of material weaknesses. Some differences between the interpretive guidance and AS 5 remain which, according to the guidance, are attributable to the different roles and responsibilities of management and auditors with respect to evaluating and auditing internal control over financial reporting.

- **Role of Entity-Level Controls.** The final guidance includes an expanded discussion of the role of entity-level controls and their relation to financial reporting elements emphasizing that management’s assessment should address the overall control environment and entity-level controls. The interpretive guidance acknowledges that some entity-level controls may be designed to identify potential breakdowns in lower-level controls. In this instance, where the entity-level control does not by itself adequately address the identified financial reporting risk, management should identify and assess additional controls, such as transaction-level or account balance-level controls that, together with the entity-level control, address the identified risk.

- **Self-Assessment/Ongoing Monitoring Activities.** In response to comments requesting additional guidance, the final guidance clarifies how evidence obtained from self-assessments and ongoing monitoring activities should affect management’s assessment. The guidance recognizes that individuals performing these activities will have varying degrees of objectivity, including based on job function, relationship to the subject matter and status within the organization, and that management need not make an absolute conclusion regarding an individual’s objectivity in order to use evidence gained from those activities. Instead, the guidance directs management to consider the degree of objectivity in relation to the identified risk to financial reporting when determining whether the evidence obtained from these activities is sufficient to support management’s assessment.

- **Risks of Fraud.** The final guidance makes clear that the risk of fraudulent financial reporting exists in nearly all companies, and that identification of a risk of fraud does not mean that fraud has occurred or the controls are inadequate. Conversely, management should not assume that simply because it has not identified incidents of fraud, no fraud risk exists.

- **Indicators of a Material Weakness.** Similar to the existing auditing standard, the proposed guidance sets forth a list of “strong indicators” of a material weakness. The final guidance eliminates
the word “strong” and shortens the list of indicators to emphasize that management should use its judgment in determining whether an identified control deficiency rises to the level of a material weakness.

**PCAOB Auditing Standard**

AS 5 would replace the PCAOB’s current auditing standard relating to internal control over financial reporting (Auditing Standard No. 2, or AS 2), and is designed to facilitate an efficient and effective audit of internal control over financial reporting. AS 5 contains a number of changes from AS 2 that, according to the PCAOB, are designed to meet four primary objectives:

- **Focus the audit on the matters most important to internal control** by directing the auditor’s testing to the most important controls; emphasizing the importance of risk assessment; revising the definitions of material weakness and significant deficiency, as well as the factors that are deemed to be indicators of a material weakness; and clarifying the role of materiality, including interim materiality, in the audit;

- **Eliminate unnecessary procedures** by, among other things, removing the requirement to evaluate management’s process for evaluating internal control; permitting consideration of knowledge obtained during previous audits; refocusing the multi-location testing requirements on risk rather than coverage; removing barriers to using the work of others; and eliminating the specific walkthrough requirement;

- **Scale the audit** by directing the auditor to take into account a company’s particular facts and circumstances, including the size and complexity of a company, business unit or process, when planning and performing an audit; and

- **Simplify the requirements** by, among other things, reducing detail and specificity; better reflecting the sequential flow of an audit of internal control; and improving readability.

The following are the more significant differences between AS 5 as approved by the PCAOB and the proposed auditing standard that the PCAOB issued in December 2006:

- **Better Alignment with the SEC’s Interpretive Guidance.** AS 5 will be better aligned with the SEC’s interpretive guidance and related rules, including with respect to the new definitions of material weakness and significant deficiency, those items that are indicators of a material weakness and the role of entity-level controls.

- **Risks of Fraud.** AS 5 includes an expanded discussion of fraud risk and will emphasize the importance of anti-fraud controls in assessing financial reporting risk.

- **Increased Focus on Top-Down Approach and Auditor Judgment.** In response to comments, the PCAOB has eliminated a number of the mandatory or presumptively mandatory requirements that were set forth in the proposed auditing standard and will encourage auditors to exercise more professional judgment in adopting a top-down, risk-based approach when planning and performing the audit. AS 5 also eliminates the requirement that auditors specifically identify major classes of transactions and significant processes before identifying the controls to test.

- **Role of Entity-Level Controls.** AS 5 contains additional discussion regarding entity-level controls and how these controls can affect an auditor’s assessment process. Similar to the SEC’s guidance, AS 5 provides that entity-level controls that monitor the operation of lower-level controls in a precise manner may reduce the need for testing the underlying controls.

- **Walkthroughs.** In respect of walkthroughs, AS 5 focuses on fulfilling the objectives that walkthroughs were intended to achieve rather than necessarily requiring the performance of a walkthrough in all instances.
Scaling the Audit. The proposed auditing standard contained a stand-alone section addressing the need for auditors to evaluate the size and complexity of a company when planning and performing an audit. AS 5 retains this focus on scalability, encouraging auditors to tailor the audit to the circumstances of smaller or less complex companies, business units and processes. Rather than placing this discussion in a stand-alone section, however, AS 5 integrates the discussion of scalability throughout the auditing standard.

Using the Work of Others. The standards proposed by the PCAOB in December 2006 included a stand-alone auditing standard relating to use of the work of others. This auditing standard was not adopted by the PCAOB. Instead, AS 5 includes a discussion of use of the work of others in the internal control audit. AS 5 permits auditors to use the work of not only personnel in a company’s internal audit function but also that of other company personnel and third parties working under the direction of management or the audit committee.

Implications

While the SEC and PCAOB have made it clear that the changes are intended to reduce the expense and effort of the Section 404 internal control process, the extent to which new efficiencies will be achieved will largely depend on the implementation decisions made by issuers and their audit firms in applying these changes. As a result, the effect of the changes will likely not be known until next year at the earliest. Also, larger companies, which have been through several Section 404 audit processes, may find it more difficult to scale back assessment and audit processes that have already been implemented. Therefore, these changes may result in fewer efficiencies for larger companies than for smaller companies or newly public companies that have not yet been through the internal control audit process.
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I. SEC’S INTERPRETIVE GUIDANCE FOR MANAGEMENT’S ASSESSMENT

A. OVERVIEW

1. Focus on Two General Principles

The SEC’s guidance focuses on two general principles for management to follow when planning and performing its assessment. First, management should evaluate the design of controls to determine whether the controls adequately address identified financial reporting risks. This principle requires management to identify the risks to reliable financial reporting that exist at the company and to identify the controls that adequately address those risks. Second, management’s evaluation of the operating effectiveness of the identified controls should be based on management’s assessment of control risk. As discussed further below, control risk is based on two separate elements — the risk of misstatement of the applicable financial reporting element to which the control relates and the risk that the identified control will fail to prevent or timely detect any misstatements. According to the guidance, a risk-based approach should allow management to “align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting.”

2. Focus on Reasonable Assurance

The SEC guidance reiterates the concepts set forth in the definition of internal control over financial reporting, in particular that its effectiveness should be measured in terms of whether the controls provide reasonable, rather than absolute, assurance regarding the reliability of financial reporting. The guidance incorporates the definition of “reasonable assurance” set forth in Section 13(b)(7) of the Securities Exchange Act of 1934, which defines “reasonable assurance” as the “level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.”

3. Revised Definition of Material Weakness

According to the SEC guidance, the objective of management’s annual evaluation is to provide management with “a reasonable basis for its annual assessment as to whether any material weaknesses in internal control over financial reporting exist as of the end of the fiscal year.” In the event that management conducts its evaluation and identifies no internal control deficiencies that constitute a material weakness, management should conclude that internal control over financial reporting is effective. On the other hand, if management identifies a control deficiency that constitutes a material weakness, management must conclude that internal control over financial reporting is not effective.

Consistent with the focus on reasonable assurance standards in the interpretive guidance, the SEC has adopted a new rule that amends the current definition of “material weakness.” Under the SEC’s current rules and the PCAOB’s current auditing standard, AS 2, “material weakness” is defined as a significant deficiency, or combination of significant deficiencies, that results in “more than a remote likelihood” that a
material misstatement of the annual or interim financial statements will not be prevented or detected. Under the SEC’s new rule, a control deficiency would constitute a material weakness only if there is a “reasonable possibility” (rather than “more than a remote likelihood”) that a material misstatement of the annual or interim financial statements would not be prevented or detected on a timely basis. The SEC guidance states that a “reasonable possibility” of a material misstatement exists when the likelihood is at least “reasonably possible,” as the term is used in Financial Accounting Standard Board Statement No. 5, Accounting for Contingencies (“SFAS 5”). SFAS 5 defines “reasonably possible” as the chance of the future event or events occurring is more than remote but less than likely.

Commenters on the SEC’s proposed guidance have observed that technically under SFAS 5 concepts, “reasonably possible” is equivalent to “more than a remote likelihood” and therefore not a substantive change. The SEC guidance appears to acknowledge this point but nevertheless states that the revised definition is appropriate. The practical effect of the revised definition is therefore unclear.

B. EVALUATING DESIGN EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

1. Identifying Financial Reporting Risks

The guidance first directs management to identify and assess the company’s risks to reliable financial reporting. The SEC expects that once management completes its first annual assessment, management’s efforts in respect of identifying financial reporting risks and related controls will be focused on changes in risks and controls subsequent to the previous evaluation. According to the guidance, management’s first step in identifying financial reporting risks ordinarily is to evaluate how the requirements of GAAP apply to the company’s business, operations and transactions. The guidance notes that management should use its knowledge of the company’s business and operations to consider the sources and potential likelihood of misstatements in financial statement amounts or disclosures (referred to as “financial reporting elements”) and identify those that could result in a material misstatement to the financial statements (referred to as “financial reporting risks”).

The manner in which management identifies financial reporting risks would be based on characteristics such as the size, complexity and organizational structure of the company as well as its financial reporting environment. The guidance provides that in the case of smaller companies, management’s day-to-day

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1 As defined in AS 5, a control is considered deficient in the event that its design or operation “does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.”

2 The SEC retained the reference to interim financial statements noting that although “annual materiality considerations are appropriate when making judgments about the nature and extent of evaluation procedures”, judgments about the effectiveness of a control “should consider the requirement to provide investors reliable annual and quarterly financial reports.”
interactions may enable management to directly identify financial reporting risks. In the case of larger and more complex companies, management may require assistance from employees who are knowledgeable about GAAP and the manner in which the company’s business transactions are initiated, authorized, recorded and processed.

The guidance notes that management’s risk assessment should include consideration of the vulnerability of the organization to fraudulent activity and the effect of any fraud risk on financial reporting risk. The guidance reminds management that the risk of material misstatement due to fraud ordinarily exists at every company and that although the identification of fraud risk does not necessarily indicate that fraud has occurred, the absence of the identification of fraud does not mean that fraud risk does not exist.

2. Identifying Controls that Adequately Address Financial Reporting Risks
   a. General

   Once management has identified the relevant financial reporting risks, it should then evaluate whether the company has in place controls that adequately address those risks (that is, management must evaluate whether internal control over financial reporting is effective in its design). The guidance emphasizes that management need not identify all controls that address the relevant financial reporting risks. So long as the identified controls adequately address the financial reporting risks, management would be permitted to evaluate those controls for which evidence of operating effectiveness is most efficiently obtained.

For purposes of management’s evaluation of internal control over financial reporting, a control is not deemed adequate if its design is such that there is a "reasonable possibility that a misstatement in the related financial reporting element that could result in a material misstatement of the annual or interim financial statements will not be prevented or detected on a timely basis." According to the proposed guidance, a design deficiency exists either when the company lacks necessary controls or when "existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed."

b. Guidance Relating to Specific Types of Controls
   i. Entity-Level Controls

   The guidance addresses the role of "entity-level controls," which are those aspects of a system of internal control that have a pervasive effect on the entity’s system of internal control. According to the guidance,

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3 The guidance notes as an example that in the case of general information technology controls, management may determine that automated, rather than manual, controls are more efficiently evaluated.

4 According to the guidance, entity-level controls include those controls related to the control environment; controls over management override; the company’s risk assessment process; centralized processing and controls, including shared service environments; controls to monitor (footnote continued on next page)
whether an entity-level control adequately addresses a financial reporting risk will depend on the nature of the financial reporting element to which the risk relates and the extent to which the entity-level control directly relates to the financial reporting element. The guidance addresses three types of entity-level controls. First, certain controls have an indirect effect on financial reporting risk. The guidance notes that although these controls play a role in management’s assessment of internal control over financial reporting, it is unlikely that management would identify a control of this type as, by itself, adequately addressing an identified control risk. A second category of entity-level controls is those controls designed to identify possible breakdowns in lower-level controls, but that are not by themselves adequate to address identified financial reporting risks. Lastly, there are certain entity-level controls that may operate at the process, application, transaction or account level that by themselves may be sufficient to address the identified financial reporting risk.

ii. General Information Technology Controls

The guidance emphasizes that the relevance of general IT controls will depend on a company’s particular facts and circumstances and that management need only evaluate those IT general controls that "are necessary for the proper and consistent operation of other controls designed to adequately address financial reporting risks." Identification and evaluation of general IT controls may be relevant in evaluating the design and operating effectiveness of a specific automated or IT dependent control, especially those IT general controls that are necessary for the proper and consistent operation of other controls. In this regard, the guidance notes that management might consider IT general control areas such as program development, program changes, computer operations and access to programs and data in its internal control evaluation.

3. Documenting Management’s Assessment of the Design Effectiveness of Controls

The SEC’s rules require management to maintain “reasonable support” for its annual assessment. The guidance emphasizes that the extent to which management documents its assessment of the design effectiveness of controls, as well as the form that the documentation may take (such as memoranda or flow charts), will likely vary based on a company’s particular circumstances. As is the case with management’s identification and evaluation of controls, management need not document each control that exists, but instead should focus on documenting those controls that adequately address the applicable financial reporting risks. The guidance notes, however, that documenting the design of controls may itself contribute to the company’s overall control environment (and consequently promote effective

(footnote continued)

results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices.
internal control over financial reporting) by serving as evidence that management is able to appropriately identify and monitor controls.

C. EVALUATING OPERATING EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

1. Determining the Evidence Needed to Support Management’s Assessment

In determining the nature and extent of the evidence needed to support management’s assessment of the operating effectiveness of a particular control, the guidance directs management to evaluate the internal control over financial reporting risk, or ICFR risk, associated with the relevant control. “ICFR risk,” as defined by the guidance, includes the risk characteristics of both the individual financial reporting element and the control that addresses the risk associated with that element. According to the guidance, as management’s risk assessment of the likelihood of a misstatement relating to the financial reporting element\(^5\) and the likelihood that the control designed to detect or prevent the misstatement will fail increases, more evidence is required to support management’s assessment that internal control over financial reporting is effective. On the other hand, in the case of a financial reporting element that has a relatively high risk characteristic but the associated control has a very low risk of failure (that is, it is likely that the control will operate effectively to prevent or timely detect the error), the required level of evidence may be lower.

In assessing the level of risk associated with a financial reporting element, the guidance encourages management to consider, among other things, the extent to which the element involves judgment in determining recorded amounts, is susceptible to fraud, has complex accounting requirements, experiences change in the nature or volume of the underlying transactions or is subject to environmental factors, such as technological or economic developments. In assessing the risk of control failure, the guidance directs management to assess various factors, including:

- the type of control and the frequency with which it operates;
- the complexity of the control;
- the risk of management override;
- the judgment required to operate the control;
- the competence of the personnel who perform the control or monitor its performance;
- whether there have been changes in key personnel who either perform the control or monitor its performance;
- the nature and materiality of misstatements that the control is intended to prevent or detect;
- the degree to which the control relies on the effectiveness of other controls; and

\(^5\) Risk relating to a financial reporting element includes both the materiality of the financial reporting element and the susceptibility of the underlying account balances and other information to material misstatement.
the evidence of the operation of the control from prior years.

The guidance specifically notes that financial reporting elements involving related party transactions, critical accounting policies, and related critical accounting estimates would generally be assessed as having higher risk of material misstatement and, where they are subject to the risk of management override, involve significant judgment or are complex, higher ICFR risk.

The guidance also notes that strong entity-level controls will not eliminate the need to obtain evidence about operating effectiveness of a particular control but may influence the amount of evidence that is necessary to provide reasonable support for management’s assessment. Similarly, entity-level controls also can play a role in management’s risk assessment of particular controls.

2. Procedures for Collecting Evidence of Operating Effectiveness

Support for management’s assessment may come from a variety of activities, including day-to-day management of the business, direct testing and activities that are performed to meet the monitoring objectives of the control framework. Direct testing, which typically is performed on a periodic basis by individuals with a high degree of objectivity relative to the control being tested, provides evidence about a control as of a point in time and may also provide insight into the effectiveness of ongoing monitoring activities. Ongoing monitoring activities include management’s normal, recurring activities and may include self-assessment procedures. According to the guidance, self-assessment procedures include assessments made by the personnel who operate the particular control as well as members of management who are not responsible for operating the control. The usefulness of evidence gained from self-assessment procedures will depend on the objectivity of the person performing the self-assessment as well as the ICFR risk of the control.

The guidance notes that the type and degree of evidence needed to support management’s assessment will vary based on the nature of the control being tested and the related ICFR risk. In the case of a higher assessed risk, management may need to rely more heavily on direct testing. In addition, management should take into account both the quantity (for example, sample size) and quality of the evidence that it has obtained. Qualitative factors would include the period of time during which the testing occurred, the objectivity of those individuals testing the controls and evidence obtained from direct testing. In the case of smaller and less complex companies, management’s daily interaction with the company’s controls,
including through direct supervision of control operation, may provide management with evidence sufficient to support its assessment. On the other hand, in the case of companies with multiple layers of management or operating segments, daily interaction generally would not be sufficient.

3. Documentation Requirements

According to the guidance, “reasonable support” for management’s assessment of operating effectiveness includes evidence of the basis for management’s assessment, including “documentation of the methods and procedures it utilizes to gather and evaluate evidence.” According to the guidance, one approach would be a comprehensive memorandum documenting management’s evaluation approach and procedures, as well as its basis for management’s conclusions for each financial reporting element and the entity-level and other pervasive elements important to an assessment of internal control over financial reporting. In instances in which management’s daily interactions with controls form the basis for management’s assessment, the guidance acknowledges that management may have limited documentation to support its assessment. In these instances, management should consider “whether reasonable support for its assessment would include documentation of how its interaction provided it with sufficient evidence”; this documentation could include memoranda, emails and correspondence between management and employees documenting interactions with controls.

The guidance also provides that management may determine not to maintain separately copies of evidence that it evaluates; however, the company’s books and records should contain sufficient evidence to provide reasonable support for management’s assessment. The guidance notes, however, that separately maintained documentation may assist the audit committee in exercising its oversight of the company’s financial reporting.

4. Controls Operating at Multiple Locations

The guidance also addresses controls that operate at multiple locations or business units. The guidance indicates that management generally must evaluate evidence of the operation of controls at each business unit or location in which the control operates. However, management should adopt a risk-based approach and in instances in which the ICFR risk of the controls that operate at individual locations or business units is low, management may determine that evidence obtained from self-assessments or other ongoing monitoring activities, taken together with evidence regarding the operation of centralized controls that monitor individual locations or business units, is sufficient. On the other hand, where the operation of a control is complex or requires judgment at the individual location, the ICFR risk would be higher, and more evidence would be required regarding the control’s operation at the individual location.

D. EVALUATING CONTROL DEFICIENCIES

1. Determinations Relating to Material Weaknesses

Management is required to evaluate each identified control deficiency and to determine whether the control deficiency (or a combination of control deficiencies) constitutes a material weakness that must be
disclosed in management’s report on internal control over financial reporting. The guidance emphasizes that management should evaluate individual control deficiencies that affect the same financial statement amount or disclosure or internal control component to determine whether individual control deficiencies in combination constitute a material weakness. In evaluating the severity of a control deficiency, management should evaluate both the likelihood that a misstatement will be prevented or detected and the magnitude of the potential misstatement.

The guidance sets forth certain risk factors that affect whether there is a reasonable possibility that a deficiency or combination of deficiencies would result in a misstatement to the financial statements not being prevented or detected in a timely manner (and therefore affect the likelihood that the deficiency constitutes a material weakness):

- the nature of the financial reporting elements involved (such as suspense accounts and related party transactions);
- the susceptibility of the related asset or liability to loss or fraud;
- the subjectivity, complexity or extent of judgment required to determine the amount involved;
- the interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- the interaction of the deficiencies; and
- the possible future consequences of the deficiency.

In considering the magnitude of a misstatement that may arise from a deficiency, management should consider, among other factors, the size of the financial statement amounts or total of transactions that are exposed to the deficiency as well as the volume of activity in the account balance or class of transactions that may be exposed to the deficiencies. The guidance also discusses certain principles that management should bear in mind when evaluating the magnitude of the potential financial statement misstatement and the risk that the misstatement will not be prevented or identified in a timely manner. Management should recognize that the maximum amount that a balance can be overstated is the amount recorded on the financial statements; the maximum amount that a balance can be understated is of course much larger. In addition, the guidance notes that the probability of a large error not being investigated or detected in a timely manner is much less than that for a smaller error. Management also should evaluate the existence of any compensating controls that may counteract the identified deficiency.

The guidance directs management to evaluate whether the following situations indicate a deficiency in internal control over financial reporting and if so, whether they represent a material weakness:

7 This list of factors to be evaluated replaces the list of “strong indicators” of a material weakness in the proposed guidance.
• identification of fraud, whether or not material, on the part of senior management;\(^8\)
• restatement of previously issued financial statements to reflect the correction of a material misstatement;
• identification (presumably by the auditor) of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company’s internal control over financial reporting; and
• ineffective oversight of the company’s external financial reporting and internal control over financial reporting by the company’s audit committee.

E. DISCLOSURE CONSIDERATIONS

1. Reporting on a Material Weakness

The guidance notes that management should clearly disclose its assessment of internal control effectiveness and may not qualify its assessment by a statement that internal control over financial reporting is effective subject to certain qualifications or exceptions. On the other hand, management may state that internal control over financial reporting is ineffective for specific reasons.\(^9\)

The guidance notes that when disclosing a material weakness, management should consider disclosing the impact of the material weakness on the company’s financial reporting and internal control over financial reporting (including the extent to which the material weakness may have a pervasive impact on the company’s internal control over financial reporting) as well as any plans for remediating the material weakness.

2. Effect of a Restatement on Management’s Report

In the event a company is required to restate its financial statements as a result of a material misstatement in the financial statements, management is not necessarily required to reassess or revise its previous conclusion regarding the effectiveness of internal control over financial reporting. Although, the circumstances in which the conclusion need not be modified will be rare. The guidance encourages management to consider whether its previous disclosures and report need to be modified or supplemented to include any material information that is necessary to prevent the disclosure from being

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\(^8\) According to the guidance, “senior management” includes the principal executive and financial officers signing the Sarbanes-Oxley Act CEO and CFO certifications as well as other members of senior management who play a significant role in the company’s financial reporting process.

\(^9\) The final guidance eliminates a statement in the proposed guidance that would have permitted management to state that internal control over financial reporting is ineffective solely to the extent of the identified material weakness. The SEC eliminated this provision on the basis that it could be viewed as permitting something similar to a qualified opinion on internal control over financial reporting.
misleading in light of the restatement.\textsuperscript{10} The guidance also reminds management that it is required to disclose any material changes to internal control over financial reporting on a quarterly basis.

3. Scope Limitations

The guidance does not contain an accommodation for limitations on the ability of management to perform its assessment, such as when management outsources a significant process to a service organization and is unable to assess the effectiveness of those controls (including in the event the organization fails to deliver a Type 2 SAS 70 report). The guidance reminds issuers that management is not permitted to issue a report on internal control over financial reporting with a scope limitation; rather, management is required to report that internal control over financial reporting is either effective or ineffective.

F. SAFE HARBOR

The SEC also has adopted a rule that provides that an evaluation conducted in accordance with the SEC’s interpretive guidance will satisfy the SEC’s management evaluation requirements. The SEC staff acknowledged at the public meeting at which it adopted the rule that many companies are already subject to the SEC’s internal control requirements and have established effective procedures to comply with the SEC’s rules. The SEC staff noted that there is no requirement that companies implement the interpretive guidance if they have otherwise established effective procedures for conducting management’s assessment.

G. CHANGES TO AUDIT OPINION

Under current rules, the auditors must express an opinion both on management’s assessment and on the underlying internal control over financial reporting. The SEC has adopted revisions to Regulation S-X requiring auditors to express only a single opinion directly on the effectiveness of internal control over financial reporting, eliminating the requirement for an additional opinion on management’s assessment. The SEC’s adopting release notes that an opinion on internal control over financial reporting necessarily conveys whether management’s assessment is fairly stated. The SEC’s adopting release also notes that although auditors are no longer required to specifically report on management’s assessment, AS 5 requires auditors to modify their reports if they believe that management’s assessment is not fairly stated or does not contain all of the elements required by the SEC’s rules. The SEC’s revisions to Regulation S-X require auditors to provide either an unqualified or adverse opinion on the effectiveness of internal control over financial reporting except “in the rare circumstance of a scope limitation” that cannot be overcome by the issuer or the accounting firm. In this instance, the auditor may disclaim an opinion.

\textsuperscript{10} The guidance also indicates that management should consider whether its previous disclosures regarding its conclusions on the effectiveness of disclosure controls and procedures need to be modified or supplemented.
**H. UPCOMING GUIDANCE**

The SEC indicated in its adopting release relating to the final interpretive guidance that the SEC staff guidance previously issued in May 2005 remains relevant.\(^{11}\) The SEC staff also is reviewing its existing frequently asked questions regarding management’s assessment with a view to updating them as appropriate. In addition, the SEC staff is considering issuing a set of frequently asked questions to address internal control-related issues specific to non-U.S. SEC-reporting issuers.

**I. PROPOSED DEFINITION OF SIGNIFICANT DEFICIENCY**

In addition to adopting the interpretive guidance and related rules, the SEC also has proposed a new rule that would define the term “significant deficiency.” The definition, which would be relevant for purposes of management’s internal control certification requirements and related required communications with the audit committee and auditors, would eliminate the probability of misstatement concept in the current definition of significant deficiency.\(^ {12}\) Under the SEC’s current rules and AS 2, “significant deficiency” is defined as a “control deficiency, or combination of control deficiencies, that adversely affects the company’s ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles such that there is a more than 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.” The SEC’s proposed rule would define “significant deficiency” as “a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of a registrant’s financial reporting.”

**II. THE PCAOB’S NEW AUDITING STANDARD RELATING TO INTERNAL CONTROL OVER FINANCIAL REPORTING**

The PCAOB’s new auditing standard, *Auditing Standard No. 5 — An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements*, will supersede PCAOB Auditing Standard No. 2, the PCAOB’s current auditing standard relating to internal control over financial reporting.

**A. SIGNIFICANT CHANGES FROM AS 2**

As highlighted by the PCAOB when it issued proposed AS 5 in December 2006, the standard is designed to meet four primary objectives: focus the audit on those matters most important to internal control over financial reporting.

\(^{11}\) This guidance is discussed in our Memorandum, dated May 23, 2005, entitled “SEC and PCAOB Publish Staff Guidance to Reduce Burdens from Internal Control Over Financial Reporting.”

\(^{12}\) Under AS 5, auditors are required to report any significant deficiencies they identify to the audit committee.
internal control over financial reporting, eliminate unnecessary procedures, make the audit scalable for smaller companies and simplify the audit requirements. The significant changes in AS 5 are:

- **Focus on Most Important Controls.**
  - **Focus on Risk Assessment.** AS 5 focuses on implementing the top-down, risk-based approach to planning and performing the internal control audit. AS 5 encourages auditors to focus on control risk throughout the audit process, including when identifying controls to test as well as when determining the nature and extent of evidence necessary to support a conclusion regarding the effectiveness of internal control over financial reporting.
  - **Revised Definition of Material Weakness.** In conformity with the SEC’s new definition, AS 5 changes the definition of “material weakness” from a “more than a remote likelihood” standard to a “reasonable possibility” standard and eliminates the reference to “significant deficiency” in the definition of material weakness. While it appears the change is intended to reduce the number of controls to be evaluated, the practical effect of the change is unclear. AS 5 also modifies the list of circumstances that are strong indicators of a material weakness and eliminates the language in AS 2 that provides that any item that is a strong indicator of a material weakness is, by definition, a significant deficiency. Furthermore, AS 5 eliminates the use of the word “strong” before indicators to enable auditors to use more professional judgment in determining whether a particular identified control deficiency constitutes a material weakness.
  - **Revised Definition of Significant Deficiency.** Under AS 2, a “significant deficiency” exists when there is “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.” AS 5 changes this definition of “significant deficiency” to eliminate the probability element and also focuses the definition on those items of which the audit committee and others in a financial reporting oversight role should be made aware. These changes are consistent with the purpose of the term significant deficiency, which is to define those identified control deficiencies that must be communicated to the audit committee.
  - **Role of Materiality.** AS 2 relies on the materiality concept applied under federal securities laws. In order to mitigate concerns that auditors have interpreted the materiality standard as requiring that they identify all potential defects in internal control, regardless of the effect on financial reporting, AS 5 clarifies that in planning and performing the internal control audit, auditors should use the same materiality measures that the auditor uses in the annual financial statement audit. The PCAOB’s proposing release relating to AS 5 clarified that the reference to interim financial statements in the definition of material weakness is intended to relate to the evaluation of deficiencies and not to the scope of the auditor’s testing.
  - **Eliminating Unnecessary Procedures.** AS 5 eliminates a number of procedures contained in AS 2 that the PCAOB has concluded are unnecessary to an effective audit of internal control. Among other things, AS 5 eliminates the requirement to separately evaluate and report on management’s process to evaluate internal control, eliminates the requirement in AS 2 that each year’s audit must stand on

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14 The PCAOB’s proposing release noted that the reference to “significant deficiency” in AS 2’s definition of material weakness may lead auditors to believe that they must perform their audits in such a manner to ensure that all significant deficiencies are identified, whereas the objective of an internal control audit is to provide reasonable assurance regarding whether a material weakness exists.
its own, refocuses the multi-location testing requirements, removes barriers to using the work of others and eliminates the specific walkthrough requirement.

- **Scaling the Audit.** AS 5 encourages auditors to take into account a company’s particular facts and circumstances, including the size and complexity of a company, business unit or process, when planning and performing an audit.

- **Simplifying the Audit Requirements.** AS 5 is shorter and more streamlined than AS 2 and organized in a manner intended to better reflect the sequential flow of the internal control audit. These changes are designed to make the auditing standard more readable and understandable to both auditors and audit clients and to encourage auditors to better exercise their professional judgment when planning and performing the audit based on the audit client’s particular facts and circumstances.

**B. SUMMARY OF AUDITING STANDARD NO. 5**

1. **Objective of the Audit**

According to AS 5, the auditor’s objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company’s internal control over financial reporting. In order to form a basis for expressing its opinion, an auditor must plan and perform the audit to obtain “competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management’s assessment.” Consistent with AS 2, AS 5 provides that the internal control over financial reporting audit should be integrated with the financial statement audit.

2. **Considerations When Planning and Performing the Audit**

   a. **Planning the Audit**

AS 5 directs auditors to evaluate a number of matters to determine whether they are important to the company’s financial statements and internal control over financial reporting and if so, how they affect the auditor’s audit procedures. These include:

   - knowledge of the company’s internal control over financial reporting obtained in other engagements;
   - matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations and technological changes;
   - the extent of recent changes in the company, its operations or internal control over financial reporting;
   - control deficiencies previously communicated to the audit committee or management; and
   - the relative complexity of the company’s operations.

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15 “Audit of internal control over financial reporting” is defined as an “audit of management’s assessment of the effectiveness of internal control over financial reporting.” Although an auditor is not required to specifically evaluate management’s internal control assessment, this definition is presumably designed to conform to the express statutory requirements of Section 404 of the Sarbanes-Oxley Act, which specifically directs auditors to report on management’s assessment.

16 In determining how and to what extent an auditor can use knowledge gained in prior years’ audits, the auditor should consider (1) the nature, timing and extent of procedures performed in previous audits; (2) the results of the previous years’ testing of the relevant control; and (3) whether there have been changes in the relevant control or the process in which it operates since the previous audit.
AS 5 encourages auditors to take into account a company’s particular facts and circumstances including the complexity of the company or a particular business unit or process. Factors that may indicate a lesser degree of complexity include fewer business lines, less complex business processes and financial reporting systems, more centralized accounting functions, extensive involvement by senior management in day-to-day activities and fewer levels of management, each with a wide span of control.

b. Role of Risk Assessment
AS 5 emphasizes that risk assessment underlies all aspects of the audit process and that a direct relationship exists between the degree of risk that a material weakness could exist in a particular area and the amount of attention that should be devoted to that area. Conversely, AS 5 provides that an auditor need not test audit controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

c. Risk of Fraud
AS 5 directs auditors to consider whether a company’s controls sufficiently address identified fraud risks and the risk of management override. Controls that may address these risks include:

- controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- controls over journal entries and adjustments made in the period-end financial reporting process;
- controls over related party transactions;
- controls related to significant management estimates; and
- controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

AS 5 reminds auditors that deficiencies in controls designed to prevent or detect fraud should be considered when planning and performing the financial statement audit.

d. Using the Work of Others
AS 5 permits auditors to use the work of others, including work performed by internal auditors, other company personnel and third parties working under the direction of management or the audit committee. In determining the extent to which an auditor uses the work of a third person, the auditor should assess the competence and objectivity of that person. AS 5 notes that personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, are generally expected to have a higher degree of competence and objectivity in performing the type of work that will be useful to the auditor. In addition to competence and objectivity, risk assessment will also play a role in determining how and to what extent an auditor may use the work of others, with the need for the auditor to perform his or her own work increasing with the level of risk associated with the particular control.
e. Top-Down Approach

AS 5 notes that a top-down approach begins at the financial statement level and with the auditor’s understanding of the overall risks to internal control over financial reporting. Next, the auditor focuses on entity-level controls and then on significant accounts and disclosures17 and their relevant assertions. These procedures are used to identify those accounts, disclosures and assertions that create a financial reporting risk. The auditor then verifies his or her understanding of the risks in the company’s processes and selects for testing those controls that sufficiently address the identified risk of misstatement to each relevant assertion.

i. Identifying and Assessing Entity-Level Controls

AS 5 directs auditors to test those entity-level controls that are important to an auditor’s conclusion regarding a company’s internal control over financial reporting. According to AS 5, an evaluation of entity-level controls can result in increasing or decreasing the testing that an auditor performs on other controls. AS 5 divides entity-level controls into three broad categories and describes the effect these controls may have on the audit:

- **Indirect controls**: Certain entity-level controls, such as control environment controls, have an indirect effect on the likelihood of a misstatement being prevented or detected on a timely basis. These controls may, however, affect the nature, timing and extent of procedures performed on other controls.
- **Monitoring controls**: Certain entity-level controls monitor the effectiveness of other controls and might be designed to identify possible breakdowns in particular lower-level controls, but do not operate at a level of precision that by themselves adequately address the relevant risk. These controls may enable an auditor to perform less testing on the particular lower-level controls, but do not eliminate the need for testing those lower-level controls.
- **Direct controls**: Certain entity-level controls may be designed to operate at a level of precision such that they themselves may adequately prevent or detect misstatements on a timely basis. In this instance, an auditor need not test additional controls relating to that risk.

AS 5 specifically requires auditors to evaluate both the control environment and controls over the period-end financial reporting process. In evaluating the control environment, auditors are directed to assess:

- whether management’s philosophy and operating style promote effective internal control over financial reporting;
- whether sound integrity and ethical values, particularly of top management, are developed and understood; and

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17 An account or disclosure is a significant account or disclosure if “there is a reasonable possibility that the account or disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account or disclosure is significant is based on inherent risk, without regard to the effect of controls.”

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whether the board of directors or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

In evaluating the period-end financial reporting process, auditors are directed to assess:

- inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- the extent of IT involvement in the period-end financial reporting process;
- who participates from management;
- the locations involved in the period-end financial reporting process;
- the types of adjusting and consolidating entries; and
- the nature and extent of the oversight of the process by management, the board of directors and the audit committee.

### ii. Guidance in Identifying Significant Accounts and Disclosures and their Relevant Assertions

AS 5 provides that in identifying significant accounts and disclosures and their relevant assertions, auditors should evaluate the risk factors related to the financial statement line items and disclosures. Relevant risk factors include:

- size and composition of the account;
- susceptibility to misstatement due to errors or fraud;
- volume of activity, complexity and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- nature of the account or disclosure;
- accounting and reporting complexities associated with the account or disclosure;
- exposure to losses in the account;
- possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;
- existence of related party transactions in the account; and
- changes from the prior period in account or disclosure characteristics.

### f. Understanding Likely Sources of Misstatement and Walkthroughs

AS 5 provides that to understand further the likely sources of potential misstatements, and as part of selecting the controls to test, the auditor should achieve the following objectives when planning and performing the audit:

- understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed and recorded;
- verify that the auditor has identified the points within the company’s processes at which a material misstatement could arise;
- identify the controls that management has implemented to address the potential misstatements; and
- identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use or disposition of the company’s assists that could result in a material misstatement.
According to AS 5, performing walkthroughs will frequently be the most effective way of achieving these objectives. A walkthrough will provide auditors an opportunity to ask questions of the company’s personnel about their understanding of the company’s prescribed procedures and controls and allows auditors to gain an understanding of the process and to be able to identify those points at which a necessary control may be missing or designed ineffectively. AS 5 does not, however, require walkthroughs if the auditor is able to achieve the objectives listed above in another manner.

3. Testing Controls
   a. Testing Design and Operating Effectiveness

AS 5 directs auditors to test the design effectiveness of controls by determining “whether the company’s controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, satisfy the company’s control objectives and can effectively prevent or detect errors or fraud” that could result in a material misstatement. Procedures to test design effectiveness would include inquiry of appropriate personnel, observation of the company’s operations and inspection of relevant documents. According to AS 5, walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness. AS 5 requires auditors to test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Procedures to test operating effectiveness include inquiry of appropriate personnel, observation of the company’s operations, inspection of relevant documentation and re-performance of the control.

   b. Risk-Based Approach to Gathering Evidence

Under AS 5 the level of evidence required to support the auditor’s conclusion regarding effectiveness is directly affected by the risk associated with the control. Factors that affect the risk associated with a specific control include:

- the nature and materiality of errors that the control is intended to prevent or detect;
- the inherent risk associated with the related accounts and assertions;
- whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- whether the account has a history of errors;
- the effectiveness of entity-level controls;
- the nature of the control and the frequency with which the control operates;
- the degree to which the control relies on the effectiveness of other controls;
- the competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;
- whether the control relies on individual performance or is automated; and
- the complexity of the control and the significance of any judgments that must be made in operation of the control.
c. Timing of Tests of Controls

When determining when to test controls, auditors must balance the need to test closer to the as-of date (i.e., the date as of which management renders its conclusion regarding internal control over financial reporting) with the need to test controls over a sufficient period of time to obtain adequate evidence of operating effectiveness. AS 5 acknowledges that management may make improvements to controls prior to the as-of date of management’s assessment. If the auditor determines that the new controls achieve the related objectives and have been in effect for a sufficient period of time to permit an adequate assessment, the auditor will not need to test the superseded controls for purposes of the internal control over financial reporting opinion.

4. Evaluating Identified Deficiencies

In assessing the severity of a control deficiency, an auditor should evaluate:

- whether there is a reasonable possibility that the company’s controls will fail to prevent or detect a misstatement of an account balance or disclosure; \(^{18}\) and
- the magnitude of the potential misstatement resulting from the deficiency or deficiencies.\(^ {19}\)

Similar to the SEC’s guidance in evaluating the potential magnitude of a potential misstatement, AS 5 provides that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. In addition, the probability of a small misstatement will generally be greater than the probability of a large misstatement. Finally, auditors are directed to evaluate the impact of compensating controls. According to AS 5, to have a mitigating effect, the compensating control must operate at a level of precision that would prevent or detect a misstatement that could be material.

a. Indicators of a Material Weakness

AS 5 sets forth the same four indicators of a material weakness that are set forth in the SEC’s guidance. AS 5 also notes that when evaluating the severity of a deficiency, the auditor should determine “the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles.” If the auditor determines that a deficiency might prevent “prudent officials in the conduct of their own affairs..."
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from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles," then the auditor should treat the deficiency as an indicator of a material weakness.

5. Considerations Regarding Multiple Locations and Business Units

AS 5 directs auditors to use a risk-based approach in determining the business locations or units at which to perform tests of controls. Auditors need not test those business units or locations that, individually or in the aggregate, do not present a reasonable possibility of a material misstatement in the financial statements. AS 5 notes that at lower-risk locations or business units, an auditor may first determine whether entity-level controls provide the auditor with sufficient evidence. Auditors also may use work performed by others on behalf of management and may also coordinate work with the internal audit function.

6. Audit Opinion

Consistent with AS 2, the internal control over financial reporting audit report may be combined with the financial statement audit report or issued in a separate report. The audit report should be dated no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. The financial statement and internal control over financial reporting audit reports should be dated the same date. As discussed above, the auditor need only express an opinion on the effectiveness on internal control over financial reporting, rather than also separately reporting on management’s assessment.

a. Material Weaknesses

In the event that the auditor identifies a material weakness, the auditor must express an adverse opinion on the effectiveness of internal control over financial reporting. In this instance, the audit report must include an identification of the material weakness described in management’s assessment. If the material weakness is not described in management’s assessment (for example, due to a disagreement between management and the auditors as to whether a material weakness exists), the audit report must note that a material weakness has been identified but not included in management’s assessment. In this instance, the report should include a description of the material weakness. If the material weakness is disclosed in management's report but is not, in the auditor’s opinion, fairly presented in all material respects, the auditor’s report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

b. Additional Report Modifications

Similar to AS 2, AS 5 requires auditors to modify their report if any of the following conditions exists:

- *Elements of management’s annual internal control report are incomplete or improperly presented.* If the auditor determines that the required elements of management’s report are
incomplete or improperly presented, auditors should include an explanatory paragraph describing the reasons for this determination.

- **Scope limitations.** AS 5 directs auditors to withdraw from the engagement or disclaim an opinion if there are restrictions on the scope of the engagement. If the auditor disclaims an opinion but identified material weaknesses, those material weaknesses must be identified in the report.

- **The auditor refers to the report of other auditors as the basis, in part, for the auditor’s own report.** AS 5 provides guidance for when a principal auditor may determine to reference the work of another auditor in the report. AS 5 notes that due to the integrated audit, only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting.

- **There is other information contained in management’s annual report.** The auditor should disclaim an opinion on any additional information contained in management’s annual internal control over financial reporting report that is not required by the SEC’s rules. If the auditor believes that the additional information contains a material misstatement, the auditor should discuss the matter with management and, if necessary, take additional steps required by other auditing standards relating to illegal acts of clients.

- **Management’s annual certification is misstated.** If matters come to the auditor’s attention that lead the auditor to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in the fourth quarter) are necessary for the annual certification to be accurate, the auditor should communicate this matter to management and the audit committee. If management and the audit committee do not respond appropriately, the auditor should include an explanatory paragraph in the audit report describing the reasons the auditor believes management’s disclosures should be modified.

### 7. Required Communications

AS 5 directs an auditor to communicate, in writing, to management and the audit committee all material weaknesses identified during the audit. Any significant deficiencies identified in the audit also must be communicated to the audit committee. The auditor also must communicate in writing to management all deficiencies that were identified and inform the audit committee when such communication has been made. The auditor need not make a written communication regarding deficiencies that have already been identified in writing to management, such as written communications made to management by the internal audit function.

### 8. Subsequent Events

AS 5 acknowledges that changes in internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but prior to the issue date of the report. If the auditor obtains knowledge about subsequent events that did not exist at the date specified in the assessment but arose before the issuance of the auditor’s report, and if this event has a material effect on internal control over financial reporting, the auditor should include an explanatory paragraph in its report.

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20 If the auditor determines that oversight of the company’s external financial reporting and internal control over financial reporting by the audit committee is ineffective, the auditor must communicate this fact to the board of directors.
9. Special Situations

In June 2004, the PCAOB and the SEC issued guidance regarding the treatment of certain situations in connection with the internal control audit and management's assessment, including issues pertaining to equity investees and recently acquired companies. Consistent with current guidance under AS 2, AS 5 provides that for equity method investments, the scope of the internal control audit should include controls over the reporting of the company’s portion of the investee’s income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. AS 5 provides that the internal control audit ordinarily would not extend to controls at the equity investee.

In other instances in which the SEC permits management to limit its internal control assessment, including certain instances relating to recently acquired entities and certain variable interest entities, auditors may similarly limit their review. AS 5 directs auditors to include an explanatory note in their audit report addressing the limitation. AS 5 also directs auditors to evaluate the reasonableness of management’s conclusion that the particular circumstance meets the criteria of the SEC’s allowed exclusion.

C. PRE-APPROVAL OF INTERNAL CONTROL NON-AUDIT SERVICES

Concurrently with the adoption of AS 5, the PCAOB has adopted a new rule to specify the auditor’s responsibility when seeking audit committee pre-approval of non-audit services that relate to internal control. The new rule, which remains subject to SEC approval, requires the auditor to take the following specific steps:

- describe, in writing, to the audit committee the scope of the proposed service;
- discuss with the audit committee the potential effects of the proposed service on the firm’s independence; and
- document the substance of the firm’s discussion with the audit committee.

These requirements are similar to the PCAOB’s rules governing the auditor’s responsibility in seeking audit committee pre-approval to perform tax services for an audit client.

The rule also removes the express requirement for the auditor to obtain specific pre-approval from the audit committee to perform an engagement to provide internal control-related services. Consistent with the PCAOB’s tax service pre-approval rule, the rule does not specify that the pre-approval must be specific but is neutral as to whether an audit committee pre-approves a non-audit service on an ad hoc basis or on the basis of policies and procedures (for example, as part of the audit committee’s annual pre-approval process). The rule would also remind auditors that their independence would be impaired by

21 These exclusions are discussed in our Memorandum, dated June 29, 2004, entitled “SEC and PCAOB Staff Publish Interpretations Regarding Internal Control Reporting.”
providing services that result in management delegating its responsibility for internal control over financial reporting or that result in the auditor designing or implementing a company's internal control over financial reporting.

IMPLEMENTATION SCHEDULE
The SEC's interpretive guidance took effect on June 27, 2007. The related amendments (including the definition of material weakness, the safe harbor rule and the revisions to Regulation S-X) will take effect on August 27, 2007. If approved by the SEC, AS 5 will take effect for audits of fiscal years ending on or after November 15, 2007, with earlier adoption permitted. The PCAOB has noted that following approval of AS 5 by the SEC but prior to the time when the auditing standard becomes effective (i.e., at that time when an auditor has a choice whether to operate under AS 2 or AS 5), auditors should use the definition of material weakness as set forth in AS 5, even if they are performing an audit under AS 2, to avoid a conflict with the SEC's new definition, which will already have gone into effect. According to an SEC press release, AS 5 is subject to SEC approval in the coming months and, if approved, is expected to be effective no later than for calendar year 2007 audits, with early adoption encouraged.

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