Audits of Internal Contro for Public Companies Special Supplement

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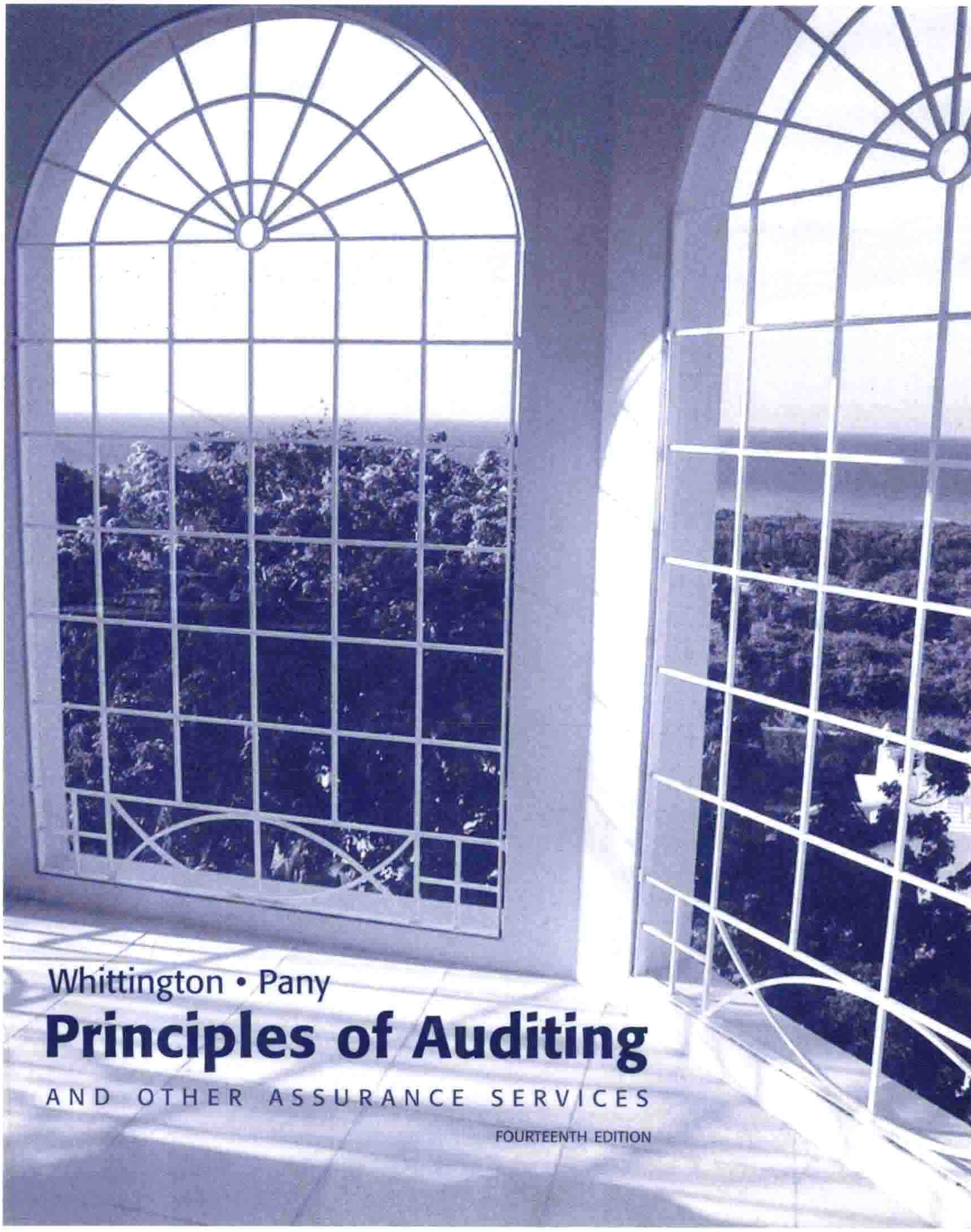


Appendix 7B

Audits of Internal Control for Public Companies

Section 404 of the Sarbanes-Oxley Act requires a publicly traded company's external auditors to audit and report on internal control over financial reporting.[1] In addition, Section 404 requires management to perform an assessment and evaluation of internal control and to issue its own report. While the emphasis of this Appendix is on auditors' responsibility with respect to internal control reporting, we begin with an overview of management's responsibility.

MANAGEMENT'S RESPONSIBILITY FOR INTERNAL CONTROL

Section 404 of the Sarbanes-Oxley Act requires management of public companies to include in their annual reported filed with the SEC a report on the company's internal control over financial reporting (hereafter, internal control). Although exact required wording of the report is not prescribed, the report should:

- State that it is management's responsibility to establish and maintain adequate internal control.
- Identify management's framework for evaluating internal control.
- Include management's assessment of the effectiveness of the company's internal control over financial reporting *as of* the end of the most recent fiscal period, including a statement as to whether internal control over financial reporting is effective.
- Include a statement that the company's auditors have issued an attestation report on management's assessment.

In order to issue such a report, management must understand and carefully evaluate its internal control

[1] Section 103 also presents information on required auditor reporting on internal control that is incorporated in this appendix. In addition, other sections of the Sarbanes-Oxley Act are also relevant to the overall area of audits of financial statements. Section 302 includes a company's principal executive and financial officers each to certify the financial and other information contained in the company's quarterly and annual reports. That certification must indicate that, based on the officer's knowledge, the financial statements (and other financial) information included in the report, fairly present in all material respect the financial condition and results of operations of the company as of, and for, the period presented in the report. Section 906 requires a similar certification requirement but amends the Federal Criminal Code and explicitly includes possible criminal penalties for certifications that do not comply with the requirements.

Management's Assessment and Evaluation Process

For most SEC registrants, passage of Sarbanes-Oxley resulted in a one time major project of assessing, evaluating and subsequently improving internal control so as to increase the likelihood that both management and the auditors will be able to conclude that the company's internal control is effective. This project was performed either by the company itself, or by the company assisted by consultants—often personnel from a CPA firm that did not audit the company's financial statements. Subsequently, each year, results of the evaluation must be updated as management annually must provide a report on internal control in Form 10-K.

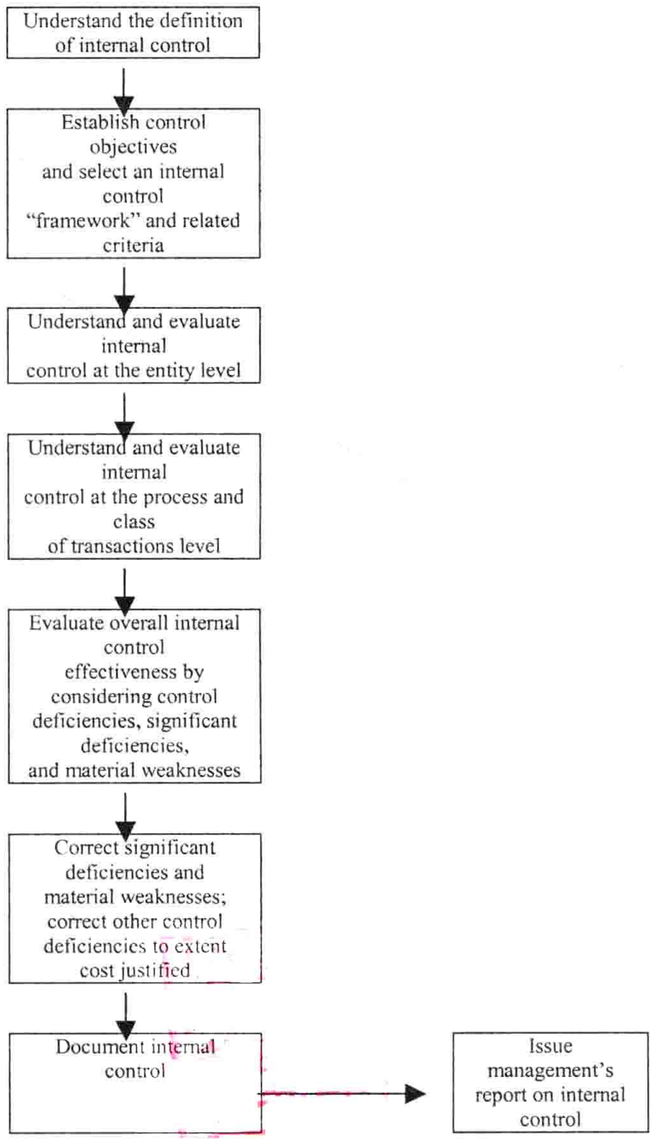
The Company's external auditing firm may provide only very limited assistance to management because the firm must avoid a situation in which its assessment is in essence part of management's assessment, as well as its own. That is, the CPA firm performing the audit should not create a situation in which management relies in any way on the CPA firm's assessment in making its own assessment.

Figure 7B.1 provides one way to consider management's responsibility relating to its assessment process and evaluation of internal control. As a starting point, the Securities and Exchange Commission adopted the following definition for internal control:

> Internal control over financial reporting is
>
> A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
>
> (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
>
> (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Management's report must be based on the preceding definition of internal control and must result from an evaluation using an accepted "control framework." Although not required, the control framework ordinarily used is *Internal Control—Integrated Framework*, created by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The COSO framework is discussed in detail in Chapter 7 as it is the internal control framework commonly used in audits of financial statements.

Figure 7B.1 Management's Assessment Process and Evaluation of Internal Control



To evaluate internal control, the third through fifth steps on Figure 7B.1, management must understand the concepts of control deficiency, significant deficiency, and material weakness.[2] A *control deficiency* exists when the design or operation of a control does not allow management, or employees, in the normal course of performing their functions to prevent or detect misstatements on a timely basis.

A *significant deficiency* is a control deficiency (or a 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 *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 *material weakness* is 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. Figure 7B.2 compares the likelihood of occurrence and the potential amount of misstatement involved for control deficiencies, significant deficiencies, and material weaknesses.

Figure 7B.2 Comparison of Control Deficiency, Significant Deficiency and Material Weakness Definitions

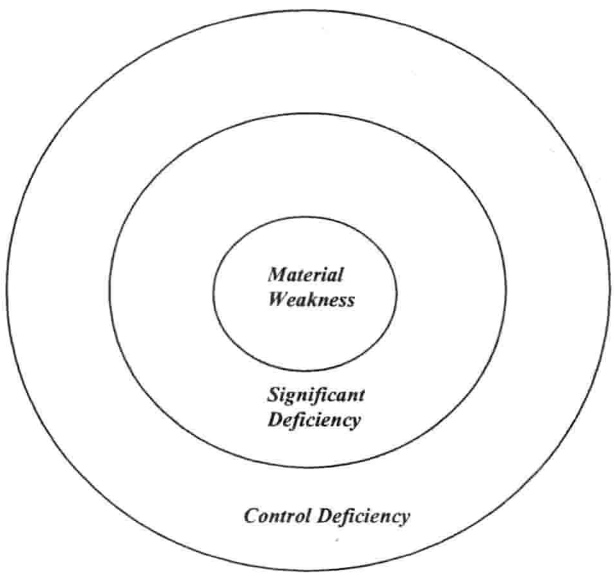
	Likelihood	***Potential Amount Involved***
Control Deficiency	Likelihood not included. Design or operation of control does not allow prevention or timely detection of misstatements.	Any misstatement (immaterial or material)
Significant Deficiency	More than remote	More than inconsequential misstatement
Material Weakness	More than remote	Material misstatement

[2] This categorization is similar, but not identical, to the internal control concepts described in AU 325, and presented in Chapter 7 (see Communication of Control Related Matters, including Figure 7.11). The most significant difference is AU 325's reportable conditions are referred to as significant deficiencies and defined somewhat differently.

In evaluating the significance of identified deficiencies, quantitative and qualitative factors are considered. Quantitative factors address the potential amount of loss. Qualitative factors include consideration of the nature of the accounts and assertions involved and the reasonably possible future consequences of the deficiency. Additionally, the consideration of a control deficiency should also include analysis of whether other compensating controls exist to either prevent or detect possible misstatement.

Figure 7B.3 illustrates the relationships among control deficiencies, significant deficiencies and material weaknesses. As the figure illustrates, all material weaknesses are significant deficiencies, but not all significant deficiencies are material weaknesses.

Figure 7B-3 Relationships Among a Control Deficiency, a Significant Deficiency and a Material Weakness



Management must obtain an understanding of significant accounts in order to identify and evaluate major classes of transactions. Major classes of transactions are those that materially affect significant accounts—either directly through entries in the general ledger or indirectly through the creation of rights or obligations that may or may not be recorded in the general ledger. Processes generate or encompass classes of transactions which are classified as being routine, nonroutine, or estimation transactions. The relationships among the preceding terms is discussed further later in this appendix when we discuss the auditor's responsibility to obtain an understanding internal control.

While management is required to communicate significant deficiencies to the audit committee, it is a material weakness at year-end that causes a modification of the report on internal control. Accordingly, as indicated in Figure 7B.1, when deficiencies are identified, actions are taken to correct them. At a minimum, management attempts to eliminate material weaknesses before the date at which it is required to conclude on its internal control (as discussed later, ordinarily the last day of the fiscal year). Management is well aware that when a material weakness exists at year end, its publicly available internal control report must conclude that the company did not maintain effective internal control over financial reporting.

A required part of management's assessment process is proper documentation of internal control. While this is shown late in the sequence provided in Figure 7B.1, the documentation often occurs throughout the entire assessment and evaluation of internal control. Virtually all of the documentation tools included in Chapters 7 and 8 of this text are relevant for both management's assessment and the external auditors' audit of internal control.

Concerning reporting, when management believes that no material weaknesses exist at year-end, it is able to issue a report concluding that the company maintained effective internal control over financial reporting. An illustration of such a report is included in Figure 7B.4. Finally, as discussed in the next section, the auditors also report on internal control and on management's report

Figure 7B.4 Management Report on Internal Control

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Management is also responsible for reporting on the Company's internal control over financial reporting. We have assessed W Company's internal control over financial reporting based on *criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).* Our assessment revealed no material weaknesses as of December 31, 20X3.

We believe that W Company maintained effective internal control over financial reporting as of December 31, 20X3, in all material respects, based on the COSO Framework. Also, there have been no significant changes in the company's internal control over financial reporting during 20X3 through the date of this report. Willington and Co., CPAs, has attested to and reported on this assessment of internal control over financial reporting and its report follows on page X.

Sally Jones	*John Hankson*
Chief Executive Officer	Chief Financial Officer

February 12, 20X4

AUDITOR RESPONSIBILITY FOR REPORTING ON INTERNAL CONTROL UNDER PCAOB AUDITS

An auditor's objective in an audit of internal control is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To meet this objective, the auditors must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control as of the date specified in management's assessment. Most of the guidance for the audit of internal control is presented in PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (hereafter referred to as Standard No. 2).[3]

The audit of internal control is performed to obtain reasonable assurance that no material weaknesses exist as of the date specified in management assessment—normally the last day of the company's year. That audit may be viewed as having the following six stages:

1. Plan the engagement.
2. Evaluate management's assessment process.
3. Obtain an understanding of internal control over financial reporting (internal control).
4. Test and evaluate design effectiveness of internal control.
5. Test and evaluate operating effectiveness of internal control.
6. Form an opinion on the effectiveness of internal control.

[3] Standard No. 2—which with its accompanying materials is over 200 pages long—is available on the Public Company Accounting Oversight Board website---www.pcaobus.org.

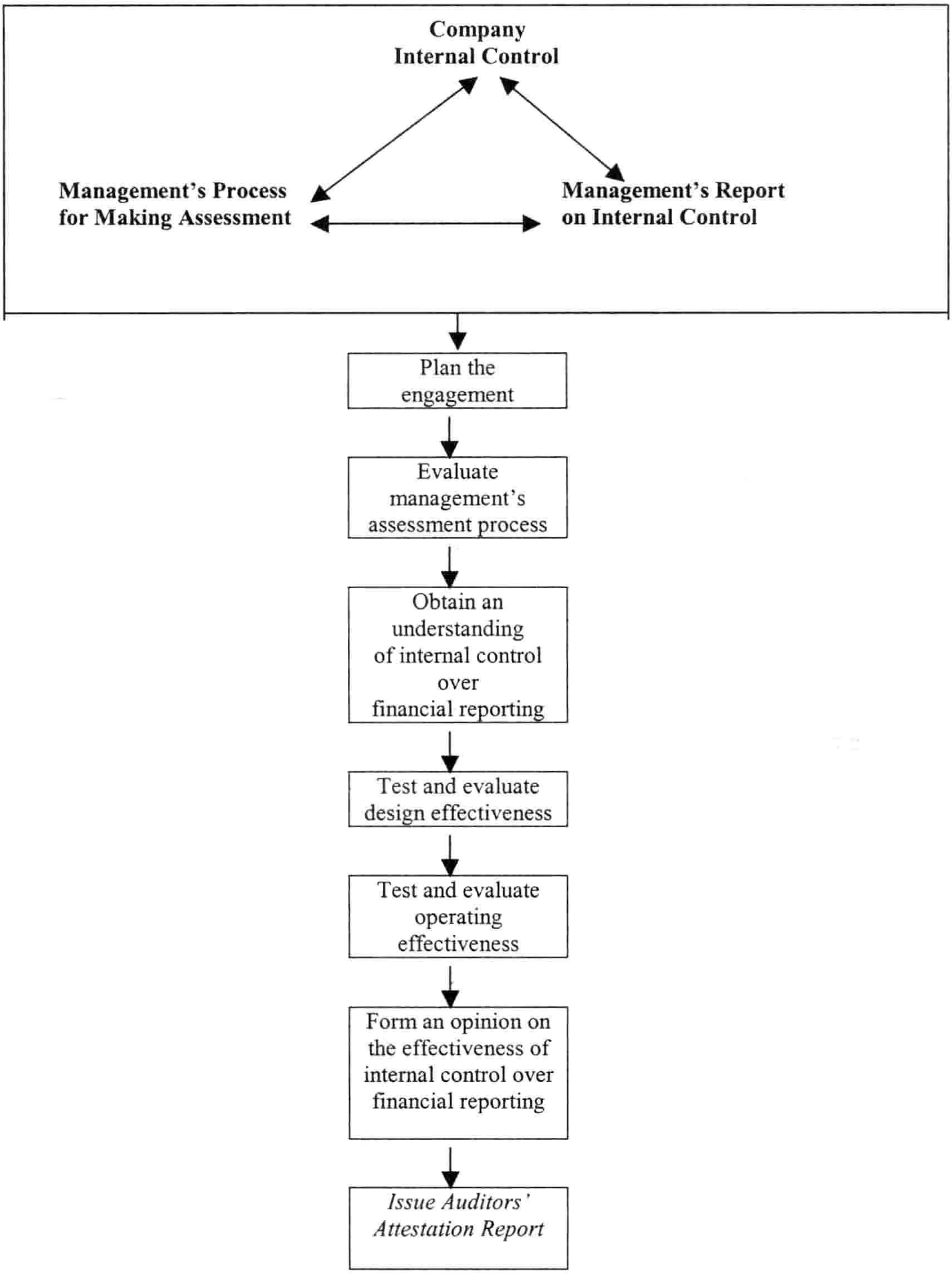
Plan the Engagement

As indicated in Figure 7B.5, the auditors first plan the engagement. This process includes coordinating the planning of the internal control and financial statement audits. For purposes of both audits, the auditors consider matters related to the client's industry, regulatory matters, its business, and any recent changes in the company. The auditors' knowledge of a client's internal control at the planning stage of the engagement may differ significantly depending upon the client involved and the auditor's experience with that client. This will affect the scope of necessary procedures. For example, when financial statement audits have previously been performed for the client, the auditors begin the internal control audit with more information than in a circumstance in which a new audit client is involved.

There is a subtle difference between the auditor's consideration of internal control for the audit of internal control versus the consideration for the audit of financial statements. In the audit of internal control, the focus is on whether internal control is effective as of a point in time—the *as of date*—which is ordinarily the last day of the fiscal period. Thus, to express the internal control opinion, the auditors must obtain evidence on the effectiveness of controls for a sufficient period of time—ordinarily less than the entire year—to assess controls at the as of date. In a financial statement audit, the consideration of internal control is performed to help plan the audit and to assess control risk and is ordinarily based on an evaluation for the entire year

Since the audits of internal control and the financial statements are considered "integrated," it seems obvious that evidence obtained in one audit may affect the performance of the other audit. For example, despite the differences in timing relating to tests of controls, the auditors should evaluate the results of those tests performed as a part of the financial statement audit to determine whether they have implications for the internal control audit. Similarly, when substantive tests performed as a part of the audit of financial statements reveal a misstatement, it must be appropriately considered in the audit of internal control.

Figure 7B.5 An Audit of Internal Control Over Financial Reporting



Evaluate Management's Assessment Process

As indicated in Figure 7B.5, after planning, the auditors obtain an understanding of and evaluate management's process for assessing internal control effectiveness. As a starting point, auditors must determine whether management has addressed the testing of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Those controls are of various types, including controls over:

- Initiating, authorizing, recording, processing, and reporting significant accounts and disclosures.
- Selecting and applying appropriate accounting principles.
- Fraud through antifraud programs (see Appendix 7A) and other controls.[4]
- Various types of significant transactions, including overall company level controls and information technology general controls, and those related to the period-end financial reporting process (e.g., consolidating adjustments, reclassifications, final adjustments).

After identifying the above controls, the auditors must evaluate the likelihood of their failure, the magnitude of any related misstatement due to such a failure, and the degree to which other compensating controls achieve the same control objectives. For example, having an individual who is independent of the cash disbursements function reconcile the bank account may serve as a compensating control that achieves certain control objectives relating to disbursements. The auditors' approach is to consider whether management has addressed both design effectiveness and operating effectiveness of controls and any deficiencies identified. Ultimately, the auditors must consider whether their findings support management's assessment.

Auditors must examine management's documentation of internal control to determine that it provides reasonable support for its assessment. That documentation should include information on:

- Design of controls.
- How significant transactions are initiated, authorized, recorded, processed and reported.
- Flow of transactions that identifies points at which material misstatements could occur.

[4] The Sarbanes-Oxley Act requires that the audit committee establish proper procedures for receiving and acting on confidential and anonymous employee concerns regarding accounting, internal control, or auditing matters. *Whistleblowers*, those who properly report such concerns, must not be penalized by the company for expressing those concerns.

- Controls designed to prevent or detect fraud.
- Controls over the period-end financial reporting process.
- Controls over safeguarding of assets.
- Results of management's testing and evaluation.

A finding by the auditors that management has not adequately documented its assessment process is considered a control deficiency and, possibly, a significant deficiency or a material weakness.

Obtain an Understanding of Internal Control over Financial Reporting

Figure 7B.5 indicates that the auditors obtain an understanding of internal control after evaluating management's assessment process. In actuality the various steps are seldom as distinct as implied by such a figure. For example, the auditors will certainly have obtained a significant amount of information on internal control while evaluating management's assessment process. Regardless, it is while obtaining an understanding that the auditors' emphasis shifts to a greater emphasis on their own tests, including making inquiries of appropriate client personnel, inspecting company documents, observing the application of specific controls and performing *walkthroughs* of transactions.

A walkthrough, a procedure long used in auditing, but particularly emphasized in Standard No. 2, involves literally tracing a transaction though the entire information system from inception to financial reporting. The auditors should perform at least one walkthrough for each major class of transactions. Also, performance of walkthroughs should not be assigned to others (e.g., internal auditors) to perform.

As discussed in Chapter 7, during audits of financial statements auditors must obtain an understanding of the design of controls in each component of internal control—control environment, risk assessment, control activities, information and communication, and monitoring. Audits of internal control include this same requirement. You may wish to review details of the auditors' approach in Chapter 7.

In obtaining an understanding of internal control, auditors should consider the fact that controls differ significantly in their broadness of coverage. Some controls have a pervasive effect on the achievement of overall objectives. Company level controls often fit under the control environment or monitoring components of internal control. For example, *company-level controls* such as portions of the control environment dealing with tone at the top, assignment of authority and responsibility, and corporate codes of conduct have a pervasive effect. Also, many *information technology general controls* over program development program changes, computer operations, and access to programs have a pervasive effect in that they help ensure that specific controls over processing are operating effectively. Other controls are designed to achieve specific objectives—e.g., management may establish *specific controls* such as accounting for all shipping documents to ensure that all sales are recorded; such specific controls often fit under the control activities components of the COSO framework.

Necessary controls relating to the areas of audit committee effectiveness and the period-end financial reporting process receive particular attention in Standard No. 2. Ineffective audit committee oversight by itself is regarded as *at least* a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists. Accordingly, when an ineffective audit committee is identified, the auditors will perform additional analysis to determine whether it represents a material weakness.

The period-end financial reporting process (often referred to as "financial statement close") is always considered significant. It involves the procedures used to enter transactions totals into the general ledger through the end of the financial statement reporting process. Auditors must evaluate the process throughout, including the manner in which financial statements are produced, the extent of information technology involved, who participates from management, locations involved, types of adjusting entries and oversight be appropriate parties, including management, the board of directors, and the audit committee.

How do auditors determine which controls they will test? In general, auditors focus on a combination of general and specific controls to determine whether the objectives of the control criteria have been achieved. More precisely, auditors consider significant accounts, relevant financial statement assertions, significant processes and major classes of transactions, and control objectives to identify controls to test. Figure 7B.6 graphically illustrates the links between significant accounts and controls to be tested.

Figure 7B.6 The Links Between Significant Accounts and Controls to Be Tested

Identify significant accounts and disclosures	→	Identify relevant financial statement assertions	→	Identify significant processes and classes of transactions	→	Identify Control Objectives	→	Identify Controls To Test

Significant accounts

As indicated in Figure 7B.6, identifying significant accounts and disclosures is the beginning of the process of obtaining an understanding of internal control. An account is significant if there is more than a remote likelihood that it could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements. Both the possibility of overstatement and of understatement must be considered. The assessment should be made without giving any consideration to the effectiveness of internal control. Factors auditors should consider in deciding whether an account is significant include its:

- Size and composition.
- Susceptibility of loss due to errors or fraud.
- Volume of activity, complexity and homogeneity of individual transactions.
- Nature.
- Accounting and reporting complexity.
- Exposure to losses.
- Likelihood of significant contingent liabilities
- Existence of related party transactions.
- Changes from the prior period.

A difference may be noted here between the audit of financial statements and the audit of internal control. In the audit of financial statements, as indicated in Chapter 7, control risk may be assessed at a high level simply because it represents part of an efficient audit approach in which tests of controls are minimized as substantive tests are relied upon to restrict audit risk. In an audit of internal control, one would anticipate that control risk would ultimately be assessed as "low" for the various assertions and accounts due to the testing involved. Indeed, if the system does not justify such a "low" assessment, it may well be due to the existence of a material weakness. As an illustration of the differing approaches, consider fixed asset accounts. In a financial statement audit the auditors might decide to perform only substantive procedures for fixed assets because of the low volume and perceived low risk. In an audit of internal control, such accounts are significant because of their materiality to the financial statements. Accordingly, in an audit of internal control, the controls over fixed assets must be tested.

Identifying relevant financial statement assertions

The auditors should determine the relevance of each of the financial statement assertions for significant accounts: (1) existence or occurrence; (2) completeness; (3) valuation or allocation; (4) rights and obligations; and (5) presentation and disclosure. Relevant assertions of an account are those that have a meaningful bearing on whether the account is presented fairly. For example, valuation may be very relevant to determining the net realizable value of receivables, whereas it is not ordinarily relevant to cash unless currency translation is involved.

Identifying significant processes and major classes of transactions

The auditors should identify each significant process over each major class of transactions. Major classes of transactions are those groupings of transactions that are significant to the financial statements. Consider a company whose sales may be initiated by customers either through the Internet, or in a retail store. These types of sales represent two major *classes of transactions* within the sales *process*. Also, for a company with a significant amount of fixed assets, recording depreciation is a major class of transactions.

When auditors consider the major classes of transactions it is helpful to classify them by what Standard No. 2 refers to as "transaction type"—routine, nonroutine, or estimation. *Routine transactions* are for recurring activities, such as sales, purchases, cash receipts and disbursements, and payroll. *Nonroutine transactions* occur only periodically, such as the taking of physical inventory, calculating depreciation expense or adjusting for foreign currencies; nonroutine transactions generally are not a part of the routine flow of transactions. *Estimation transactions* are activities involving management's judgments or assumptions, such as determining the allowance for doubtful accounts, establishing warranty reserves, and assessing assets for impairment.[5]

Throughout the audit of internal control auditors must be concerned about all three transaction types. However, the auditors must be aware that the unique nature of nonroutine transactions, and the subjectivity involved with estimation transactions makes them particularly prone to misstatement unless properly controlled.

For each significant process, the auditors should:

- Understand the flow of transactions (initiation, authorization, recording processing, reporting).
- Identify points at which a misstatement could arise.
- Identify controls to address potential misstatement.
- Identify controls to prevent or timely detect unauthorized acquisition, use or disposition of the company's assets.

Figure 7B.7 provides an illustration of the relationship among significant accounts, processes and transaction types emphasizing inventory processes; it presumes one major class of transactions for each process.

[5] Estimation transactions are referred to as "accounting estimates" in the AICPA Professional Standards.

Figure 7B.7 Relationships among Processes, Transaction types, and Significant Accounts

		Example of Significant Accounts								
Example Processes	**Transaction Types**	Cash	Accounts Receivable	Allowance Doubtful Accounts	Inventories (and I/S)	Inventory Reserves	Prepaid	Property, Plant & Equipment	Other Accounts	Stockholders' Equity
Financial statement close	Non-routine	X	X	X	X	X	X	X	X	X
Cash receipts	Routine	X	X						X	
Cash disbursements	Routine	X							X	
Payroll	Routine									
Inventory costing (CGS)	Routine	X			X					
Estimate commitments	Estimation									
Estimate excess and obsolete inventory	Estimation					X				
Lower of cost or market calculation	Estimation									
LIFO calculation	Non-routine					X				
Physical inventory count	Non-routine					X				
Accounts receivable and sales	Routine		X							
:										
:										

Source: Adapted from Ernst & Young, *Evaluating Internal Control: Considerations for Documenting Controls at the Process, Transaction, or Application Level, 2003.*

Considering control objectives and identifying controls to test

After identifying significant accounts, relevant assertions, processes, and classes of transactions, the auditors should evaluate where errors or fraud could occur. This involves considering control objectives, and the risks of errors creating a situation in which control objectives may not be met. The auditor identifies the controls to be tested by considering the:

- Points at which errors or fraud could occur.
- Nature of the controls implemented by management.
- Significance of each control in achieving the objectives of the control criteria.
- Risk that controls might not be operating effectively.

In determining the risk that controls might not be operating effectively, the auditors consider factors such as changes in the volume or nature of transactions, changes in controls or personnel performing the control, the degree to which controls rely on the effectiveness of other controls, and the automation level and complexity of controls.

The auditors then decide whether to test preventive controls, detective controls, or a combination of both for the various assertions and significant accounts. Preventive controls have the objective of preventing errors or fraud from occurring; detective controls have the objective of detecting errors or fraud that has already occurred. Effective internal control generally involves "levels" of controls composed of a combination of preventive and detective controls. Auditors should determine appropriate control objectives for areas in which misstatements may occur and then test controls that are important to achieving each control objective. It is neither necessary to test all controls nor to test redundant controls (those that duplicate other controls), unless redundancy itself is a control objective.

When a client operates from multiple locations, must the auditors perform tests at all locations? The auditors must perform tests of those locations (or business units) that, individually or when aggregated, could create a material misstatement in the financial statements.

Test and Evaluate Design Effectiveness of Internal Control over Financial Reporting

As do other professional standards on internal control, Standard No. 2 distinguishes between design effectiveness and operating effectiveness. As indicated in Figure 7B.5, the approach is to first test and evaluate the design—if the design seems effective, then it makes sense to test whether the designed controls operate effectively.

To test design, the auditors identify the company's control objectives and risks in each area, and then identify controls that satisfy each control objective. Then they determine whether the controls, if operating properly, can effectively prevent or detect misstatements that could be material. Procedures performed by the auditors include inquiry, observation, walkthroughs, inspection of relevant documentation, and specific evaluation of whether the controls are likely to prevent or detect misstatements. While evaluating management's assessment process, the auditors also obtain evidence on design effectiveness. In addition, while performing walkthroughs auditors ask those involved how they handle errors identified, and whether they have ever been asked to override the process or controls, and if so, to describe the situation. Ordinarily, if there have not been significant changes, auditors may carry documentation of walkthroughs forward each year after updating it for any changes. Figure 7B.8 provides an example of control objectives, risks, and controls taken from the COSO materials. The auditors would specifically consider whether the controls, if functioning, would reduce the risks to an appropriately low level.