

Defining Issues[®]

KPMG LLP



New PCAOB Auditing Standard on Internal Control Over Financial Reporting

The Public Company Accounting Oversight Board adopted a new auditing standard for an audit of internal control over financial reporting that is integrated with an audit of financial statements. If approved by the SEC, the new standard will supersede the Board's existing standard for these audits.¹ The Board incorporated in the new standard some elements of its proposal on considering and using the work of others, rather than issuing a separate standard as originally proposed.

This edition of *Defining Issues* explains how the new standard might affect the auditor's work in forming an opinion on internal control over financial reporting.

The new standard is designed to focus the audit of internal control on the most important matters, include only requirements necessary for an effective audit, make the audit scalable to fit the size and the complexity of any company, and simplify the requirements.

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The new standard differs from last December's proposal by:

- Revising selected terms and concepts to more closely align them with SEC rules and guidance,
- Emphasizing more prominently the importance of assessing fraud risk and evaluating anti-fraud controls,
- Explaining the effect of different types of entity-level controls on selecting and testing other controls, and
- Requiring auditors to meet the objectives of a properly performed walkthrough, rather than perform walkthroughs in all cases.

¹ PCAOB, Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements, May 24, 2007, and Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements, March 9, 2004, both available at www.pcaobus.org.

Matters Most Important to Internal Control

The new standard requires a top-down approach to selecting the controls to be tested. A top-down approach begins with an understanding of the risks to internal control over financial reporting. The auditor then focuses on entity-level controls, verifies his or her understanding of the risks in the company's processes, and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

Risk assessment is central to the approach in the new standard. It includes identifying significant accounts, disclosures, and relevant assertions, selecting controls to test, and determining the evidence to gather for a given control. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends on the risk associated with the control. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

The results of the auditor's fraud-risk assessment must be taken into account when planning and performing the audit of internal control over financial reporting. The potential for management fraud is identified in the new standard as an area of higher risk that requires commensurately more attention. As part of identifying and testing entity-level controls and selecting other controls to test, the auditor is to evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and of management override of other controls. The new standard provides additional guidance on the types of controls that might address fraud risk.

SEC Guidance for Management

On May 23, 2007, the Securities and Exchange Commission approved interpretive guidance to help public-company managements perform assessments of internal control over financial reporting for purposes of enhancing compliance under Section 404 of the Sarbanes-Oxley Act. The new guidance is intended to focus company management on the internal controls that best protect against the risk of a material financial misstatement and to reduce unnecessary management procedures. The guidance is expected to be posted to the SEC's Web site soon.

Under a top-down, risk-based approach, the auditor should focus on the controls most important to financial reporting. The new standard identifies three broad categories of entity-level controls that vary in nature and precision and explains how each category might affect the performance of tests of other controls:

- Controls, such as control environment controls, that have an indirect effect on the likelihood that a misstatement will be prevented or detected on a timely basis might affect other controls the auditor selects for testing and the nature, timing, and extent of the procedures the auditor performs on other controls, but likely do not operate at a level of precision sufficient to eliminate the need to test other controls in their entirety.
- Controls that monitor the effectiveness of other controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would sufficiently address the assessed risk that misstatements of a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce tests of other controls.
- Controls that when operating effectively at a level of precision sufficient to adequately

prevent or detect on a timely basis misstatements of one or more relevant assertions and may enable the auditor to avoid testing additional controls related to a particular risk of misstatement.

The Board recognized that the auditor generally will need to understand the company's processes to appropriately identify the correct controls to test, but the standard contains no requirement to identify major classes of transactions and significant processes.

The new standard retained the existing framework for evaluating deficiencies under which material weaknesses are identified by assessing the likelihood and magnitude of a potential misstatement. However, some definitions and concepts were clarified. A material weakness is now defined as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." A significant deficiency is now defined as "a deficiency, or 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 the company's financial reporting."

The changes made to the definition of a significant deficiency are intended to focus the auditor on the communication requirement and away from scoping issues. The term “reasonable possibility” replaces the term “more than remote likelihood” within the material weakness definition. This makes the terminology for evaluating the likelihood of a misstatement consistent with the concepts in FASB Statement No. 5, Accounting for Contingencies. Finally, the reference to “significant deficiency” is removed from the definition of material weakness to eliminate the inference that the auditors’ procedures should be detailed enough to detect a significant deficiency.

The new standard includes a list of indicators of a material weakness. A deficiency that is not a listed indicator may be a material weakness. On the other hand, the presence of one of the indicators does not necessitate a conclusion that there is a material weakness. Because the auditor’s focus is on detecting whether any material weaknesses in internal control over financial reporting exist, the new standard does not include a list of areas that ordinarily result in at least significant deficiencies in internal control over financial reporting.

The new standard also clarifies the role of materiality (including interim materiality) in the audit. Auditors are to give account-level materiality the same weight in determining the nature, timing, and extent of their procedures in an audit of internal control as would be given in a financial-statement audit. As before, the reference to interim financial statements in the definitions of material weakness relates only to the evaluation of deficiencies, not to the scope of the auditor’s testing.

Eliminating Certain Procedures

The Board evaluated the procedures required by Auditing Standard No. 2 and eliminated provisions that it concluded were not necessary to achieve the objectives of Auditing Standard No. 5. The eliminated procedures include the requirement to evaluate management’s process for assessing the effectiveness of internal control. The rationale for eliminating this requirement was that in combination with the requirement to provide an opinion on management’s assessment (not assessment process), it could cause confusion and lead to unnecessarily detailed testing of management’s process. Under the new standard, auditors will need to obtain an understanding of management’s process as a starting point in understanding a company’s internal control, in assessing risk, and in determining the extent to which they will use the work of others, but the change may reduce the level of work in this area and enable improved coordination between management and auditors.

The new standard expressly permits auditors to consider the nature, timing, and extent of procedures performed in prior years, and the results of those procedures, when assessing the risk associated with a particular control. This may enable auditors to reduce tests or change their nature in areas of lower risk assessment after considering knowledge gained from audits in prior years. However, the new standard does not permit the results of procedures performed in prior years to be used in lieu of performing some procedures in the current year (“rotation of control testing”).

Scoping decisions in a multi-location environment under the new standard are focused on risk rather than on coverage. The standard omits the requirement to test controls over a

“large portion” of the company and directs auditors to use a risk-based approach to determine the testing strategy for multiple locations. In addition, the guidance on multi-location scoping decisions notes that auditors should vary the nature, timing, and extent of control testing at locations or business units from year to year.

The new standard removes certain barriers to using the work of other parties in the audit of internal control over financial reporting. For example, the new standard allows the auditor performing an integrated audit to use the work of others considered sufficiently competent and objective in testing controls in the control environment. The new standard also allows auditors to use direct assistance from other parties in performing walkthroughs, a change from Auditing Standard No. 2’s prohibition against using others’ work in performing walkthroughs.

The effect of other parties’ work on the auditor’s work depends on the relationship between the risk associated with the control and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases. In areas of higher risk (for example, controls that address specific fraud risks), the need for the auditor to perform his or her own work on the control increases. The Board had proposed a separate auditing standard on using others’ work in an audit that would have replaced the current standard on considering the internal audit function.² However, the Board decided instead to retain the current standard on considering the internal audit function and incorporate additional guidance into new Auditing Standard No. 5.

² PCAOB, Proposed Auditing Standard, Considering and Using the Work of Others in an Audit, December 19, 2006, and Interim Professional Auditing Standard, AU sec. 322, The Auditor’s Consideration of the Internal Audit Function in an Audit of Financial Statements.

The new standard's requirements contrast with Auditing Standard No. 2's requirement for a walkthrough of each major class of transactions within a significant process and with the proposed requirement to perform a walkthrough of each significant process each year. The new standard focuses the auditor on achieving specified objectives related to understanding the likely sources of potential misstatements and to selecting controls to test. It states that a walkthrough frequently will be the best way of achieving the objectives, but that in some cases, other procedures may be equally or more effective ways to achieve them.

Scaling the Audit for Less Complex Companies

The new standard describes how to tailor the audit to the particular circumstances of less complex companies or one or more of a company's less complex business units. The Board believes that focusing on entity-level controls and relying on principles will enable the auditor to scale the audit approach to effectively and efficiently test controls at less complex companies. The new standard states that companies of different sizes and complexity might achieve control objectives differently.

The Board is planning to issue further guidance on auditing internal control in smaller and less complex companies. The guidance is being developed with assistance from a task force of auditors (including KPMG) of smaller and less complex companies, will expand on the principles in the standard, and is intended to provide practical advice about the audit of internal control in a smaller, less complex company.

Simplifying the Requirements

The new standard is intended to simplify the requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal control over financial reporting. The objective was to achieve these three improvements in the requirements:

- Reduce the level of detail and specificity to encourage auditors to apply more professional judgment under the facts and circumstances,
- Organize the standard to better reflect the sequential flow of an audit of internal control, from planning the audit to reporting on the effectiveness of internal control, and
- Articulate the requirements in a more readable manner.

Reporting and Communication Requirements

The auditors' report required by the new standard expresses only one opinion, an opinion on the effectiveness of the company's internal control over financial reporting. No opinion will be expressed by the auditor on whether management's assessment is fairly stated.

Auditors may disclaim an opinion on internal control over financial reporting if and when they conclude that a scope limitation would prevent them from obtaining the reasonable assurance necessary to express an opinion. In these circumstances, the auditor need not perform additional work before disclaiming an opinion.

The auditors' responsibility for communicating material weaknesses, significant deficiencies, and other deficiencies is the same as under the existing standard. Material weaknesses and significant deficiencies identified

during the audit will continue to be communicated in writing to management and the audit committee, and other deficiencies identified during the audit will be communicated in writing to management.

Nonaudit Services

The Board adopted a related new rule on auditors' responsibilities when they seek audit committee pre-approval of internal-control-related nonaudit services.³ New Rule 3525 is intended to ensure that audit committees obtain information sufficient for them to make an informed decision on how performing internal-control-related services might affect audit independence. The new rule requires a registered public accounting firm to take the following steps:

- Describe the scope of the proposed service in writing to the audit committee,
- Discuss with the audit committee the potential effects of the proposed service on the firm's independence, and
- Document the substance of the discussion with the audit committee.

These requirements parallel auditors' responsibilities when seeking audit committee pre-approval to perform tax services for a public-company audit client.

The new rule recognizes that audit committees may pre-approve the provision by their independent auditor of each specific internal-control-related service or may pre-approve such services based on committee-approved policies and procedures.

Effective Date

Assuming approval by the SEC, the new standard and Rule 3525 will be effective for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted at any

³ PCAOB Rule 3525, *Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting*, May 24, 2007, available at www.pcaobus.org.



point after SEC approval. Auditors who elect to comply with the new standard after SEC approval but before its effective date must at the same time comply with Rule 3525 and other PCAOB standards as amended.

Auditors who do not elect to comply with Auditing Standard No. 5 before the effective date must continue to comply with Auditing Standard No. 2 until it is superseded. Those auditors should, however, apply the definition of “material weakness” contained in the new standard, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term “material weakness,” and the definition in the new standard parallels the new SEC definition.

Readers should not treat the descriptive and summary statements above about the PCAOB’s new standard and rules as a substitute for what has been adopted and approved, or for any other SEC or PCAOB requirements. When filing reports with the SEC, registrants should refer to the text of the relevant requirements, consider their particular circumstances, and consult their accounting and legal advisors.

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Contributing authors:

Craig W. Crawford
Walton T. Conn, Jr.
Stephen S. Galbreath
Douglas W. Sweeney

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