

## Internal Control Assessment by Management

### KEY ISSUES FOR MANAGEMENT

Prepared on March 13, 2003

**PURPOSE:** The AICPA Business & Industry Team assembled an ad-hoc task force of members to address issues relating to management's responsibility with respect to Section 404 of the Sarbanes-Oxley Act of 2002 titled "Management Assessment of Internal Controls." The ad-hoc task force met via conference call with the ASB Task Force on internal controls to discuss this requirement and the ASB's position with respect to the external auditor's responsibility. After that meeting, the ad-hoc task force assembled this list of key issues to communicate to their peers in other companies that are similarly impacted.

1. The Auditing Standards Board (ASB) is on a fast track to issue a new auditing standard along with revising the existing attestation standard on reporting on the effectiveness of internal control over financial reporting (internal control) with the expectation that they will be effective for audits of public companies for periods ending on or after September 15, 2003. The SEC is not expected to extend deadlines for requiring audits of internal control assertions, at least not past December 15, 2003.
2. Management is required to document the system of internal control over financial reporting. As required by the Sarbanes-Oxley Act of 2002 (SOX), section 404 (Management Assessment of Internal Controls), management will be required to assess the effectiveness of these controls. The ASB believes that the evidence management uses to support its assertion about the effectiveness of its internal control also should be documented. The ASB believes that a failure to document the system of controls or the evidence used in making the assessment should be considered a weakness in internal control.
3. Positive testing of internal control must be performed to make the assessment under SOX section 404; inquiry alone is not adequate testing. Negative evidence, such as proper financial reporting, is not evidence of good internal control. On the other hand, a material misstatement detected by the auditor's procedures that was not identified by management ordinarily is indicative of the existence of a material weakness in internal control.
4. The section 404 assessment must be made using suitable criteria for an effective internal control system. An example of suitable criteria, as well as guidance on the definition of internal control including the five components of internal control (control environment, risk assessment, control activities, information and communication, and monitoring) can be found in *Internal*

*Control-Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO report). You can obtain this report through the AICPA/CPA2Biz.com, product no. 990009. Call AICPA on 1-888-777-7077, or click here, or copy and paste this link you're your browser:

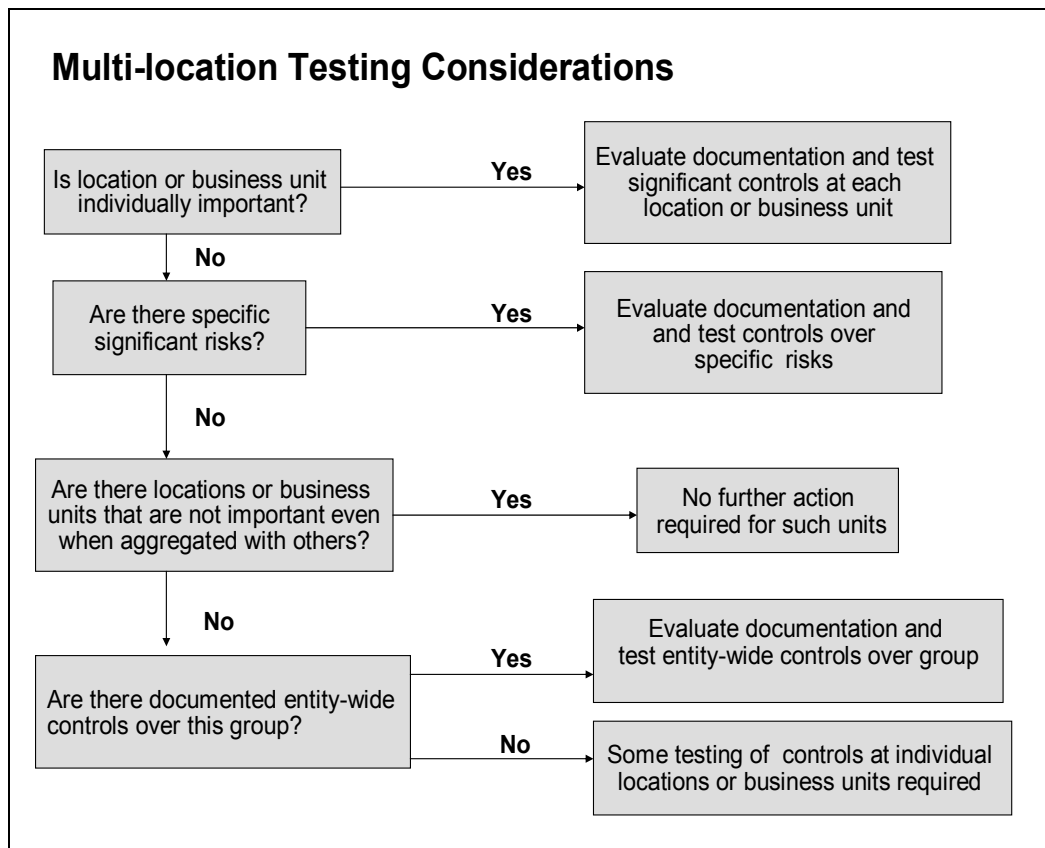
[https://www.cpa2biz.com/CS2000/Products/Product+Detail.htm?cs\\_id=%7B1DC6F23C%2D70C6%2D4816%2DA3CD%2DAE70236B7992%7D&cs\\_catalog=CPA2Biz](https://www.cpa2biz.com/CS2000/Products/Product+Detail.htm?cs_id=%7B1DC6F23C%2D70C6%2D4816%2DA3CD%2DAE70236B7992%7D&cs_catalog=CPA2Biz)

5. Testing and reporting on internal control will be inseparable from the audit of the financial statements. Beginning in 2003 (see possible effective date above), an opinion on audited financial statements cannot be given absent testing and opining on these controls.
6. All significant deficiencies (formerly referred to as reportable conditions) and material weaknesses need to be communicated in writing. The ASB believes that these items should be set forth by management as part of its assessment report. In addition, the existence of a material weakness in internal control precludes an unqualified opinion that internal control is effective.
7. The documentation should encompass all significant account balances and disclosures. The company's auditors may be utilized to help in the documentation of controls; however, management cannot abdicate its responsibility for the documentation.
8. When using outside service organizations (e.g., data processing, payroll processing, etc), management should consider the activities of the service organization when making an assertion about the effectiveness of the company's internal control over financial reporting. A service organization typically engages an auditor to examine and issue a report on certain controls at the service organization, and this report has historically been a tool used by the independent auditor in planning the nature, timing and extent of the auditor's procedures. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, management may consider whether this report provides sufficient evidence to support its assertion. Since the date of the service auditor's report is not likely to correspond with the entity's year end, management will need to consider what changes, if any, have been made at the service organization subsequent to the service auditor's report and the effect of the time lag on their assessment. When significant changes have been made, or a significant time lag exists, management may need to apply their own procedures at the service organization with respect to those subsequent changes or significant time lag.

NOTE: If your organization is a service-provider, you should be prepared for additional inquiries and to provide some information to the organizations that you provide service to about the state of your controls between the date of

your auditor's report on controls at your organization (commonly referred to as SAS 70 reports) and the year-end date of your customer organizations.

9. Companies with multi-locations (in the US and/or internationally), must evaluate all significant controls and all significant locations in connection with each assertion about the effectiveness of internal control. The ASB has developed a draft of a decision tree that could help in planning which locations or controls need to be tested in a given year. This decision tree will be part of the ASB's exposure draft and is subject to change as a result of the ASB's due process procedures.



10. Management must recognize that judgments and estimates are subject to second-guessing, and an assessment can change in a subsequent period if new information becomes available. As a result, the system of internal control over estimates is particularly sensitive because the auditor or a regulator might conclude that the internal control system was either not appropriate or not functioning because it allowed an inappropriate estimate to be booked in the first place. This will be true for any account or control where there is a greater degree of subjectivity.

11. Management should recognize that a restatement of financial statements may provide evidence of an internal control breakdown in the prior period and result in a revision of the auditor's report on management's assessment of internal control.
12. Management must give ample consideration to the timing of implementing significant changes in the internal control system during the year and the impact of those changes on its ability to make an assessment of the system. For example, the timing of outsourcing a key function to an outside service provider (payroll processing, data processing, etc.) could impact management's ability to assess controls at the service provider and thereby, management's assertion. In addition, acquiring another company late in the fiscal year could impair management's ability to assess controls at the new company on a timetable to meet its assertion obligation.
13. An audit (or examination) of the effectiveness of internal control over financial reporting will most likely require significantly more work than what the auditor was doing previously with respect to internal control in a financial statement audit, because an audit of internal control requires testing of a broader range of controls as well as sufficient testing to obtain a high level of assurance about their operating effectiveness. The current auditing standards require that the auditor understand the design of controls and whether they have been placed in operation so that they can properly design audit procedures. In many audits, including smaller public company audits, auditors do not test the effectiveness of controls, but rather perform a substantive audit. The auditor also may choose to perform tests of controls sufficient to provide only moderate or low assurance about their operating effectiveness, and obtain additional assurance from substantive procedures. For the purpose of expressing an opinion on internal control, the tests of controls that the auditor performs should be sufficient to obtain a high level of assurance about their operating effectiveness. As a result, it is possible that audit fees will increase significantly, particularly for those entities that do not presently have a well controlled system.
14. If management relies on the work of the internal auditors as a basis for their assessment of internal control, the independent auditor cannot rely on the internal auditors' work as the principal evidence of the operating effectiveness of controls. The independent auditor may use the internal auditors' results to alter the nature, timing and extent of their own testing, in which case the independent auditor should do some re-performance of the internal auditors' testing and do some independent testing.
15. The SEC has not issued its final rules on section 404 of SOX. Therefore, the final requirements are not known. Additionally, the ASB's proposed standards are subject to change during the exposure period. It is important to note that the SEC has attended some of the ASB's task force meetings as

well as the ASB meetings and has had input into the development of the new SAS and changes to the attestation standards. The PCAOB, as the body charged with setting standards for the audit of public companies, has not yet participated and may also weigh-in with its comments at some point in this process.