Internal Controls over Financial Reporting

General Information
- SOX 404: 4 paragraphs! Mgt Assesses, Auditor Attests – I/Cs over financial reporting for PUBLIC COMPANIES, PCAOB
- PCAOB: AS 2: 161 pages! Application of SOX 404. From general (definitions) to specific (rec of A/R subledger to G/L).
- Criteria – COSO Framework
- SEC: Effective dates Biggest 12/31/04 to smallest (moving target date).

Auditor’s Objectives
- Express an opinion on management’s assessment of the effectiveness of the company’s internal control over financial reporting (404 report)
- Note: To express such an opinion the auditor must also perform an audit of the financial statements
- Obtain reasonable assurance that no material weaknesses exist as of the date specified in management’s assessment

Internal Control over Financial Reporting
- Policies and procedures that:
  - Pertain to the maintenance of records that reflect the transactions and dispositions of assets
  - Provide assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are authorized
  - Provide assurance regarding prevention or detection of unauthorized acquisition, use or disposition of assets that could have a material effect

Deficiencies
- AS2 distinguishes control and significant deficiencies
  - 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 assigned functions, to prevent or detect misstatements on a timely basis.
  - A significant deficiency is a control deficiency ...such that there is more than a remote likelihood that a misstatement that is more than inconsequential will not be prevented or detected.

Material Weaknesses
- Relationship between deficiencies and material weaknesses
  - 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 financial statements will not be prevented or detected.
Management’s Responsibilities
- Accept responsibility for the effectiveness of the internal control over financial reporting.
- Evaluate the effectiveness of the internal control over financial reporting using suitable control criteria.
- Support its evaluation with sufficient evidence, including documentation.
- Present a written assessment of the effectiveness of the internal control over financial reporting as of the end of the most recent fiscal year.

Obtaining an Understanding
- Auditors must evaluate management’s assessment process, including whether management considered which controls should be tested, the design effectiveness of controls, the operating effectiveness of controls, and the deficiencies in internal control over financial reporting.
- Auditors should also obtain an understanding of the results of procedures performed by others (IA, other CPA firm, etc.).

Obtaining an Understanding
- Auditors must obtain an understanding of:
  - Control environment
  - Risk assessment
  - Control activities
  - Information and communication
  - Monitoring
- AS2 emphasizes company-level controls.
- Understanding of the audit committee.

Identifying Controls to Test
- Important factors in selecting controls to test include:
  - Points at which errors or fraud could occur.
  - Nature of the controls implemented by management.
  - The significance of each control in achieving the objectives of the control criteria and control redundancy.
  - The risk that controls might not be operating effectively.
- Note that TOC apply to each of the five elements of internal control.

Testing & Evaluating Design Effectiveness
- IC over financial reporting is effectively designed when the controls complied with would be expected to prevent or detect errors or fraud.
- Appropriate procedures:
  - Inquiry
  - Observation
  - Walkthroughs
  - Inspection of relevant documentation.

Testing & Evaluating Operating Effectiveness
- Focus is on whether a control is operating as designed and whether the person performing the control possesses the necessary authority and qualifications.
- Appropriate procedures:
  - Inquiries (not sufficient by itself)
  - Inspection of relevant documentation
  - Observation
  - Reperformance.
Timing and Extent of TOC

- **Timing**

- **Extent depends on:**
  - Degree of automation
  - Complexity and judgment
  - Frequency of control occurrence
  - Importance of control

Using the Work of Others

- Auditors exercise considerable discretion on using the work (i.e., tests of controls) of others

- Auditors may not use the work of others related to the (to reduce the amount of work performed)
  - Control environment
  - Walkthroughs

- Relying on others hinges on their
  - Competence
  - Objectivity

Arriving at an Opinion on IC

- Auditor should evaluate:
  - The adequacy of management’s assessment and the results of the auditor’s evaluation of the design and tests of operating effectiveness
  - The negative results of substantive procedures performed during the financial statement audit
  - Any identified control deficiencies
  - Reports issued by IA relevant to IC over financial reporting

- Unqualified opinions can be issued only when there are no material weaknesses and there are no scope restrictions

Evaluating Deficiencies

- Auditor should assess the likelihood and potential magnitude of a deficiency

- Certain deficiencies are to be treated as significant
  - Controls over the selection and application of accounting policies that are in conformity with GAAP
  - Antifraud programs and controls
  - Controls over non-routine and non-systematic transactions
  - Controls over the period-end financial reporting process

Relationship to Audit of F/S

- Auditors wish to reduce CR to below maximum to lead to a reduction in substantive testing

- Extent of testing – entire period

- Assessing CR as other than low
  - If CR is assessed as other than low, the auditor should document the reasons for that conclusion

Reporting

- Management
  - Required to include an assessment of the effectiveness of internal control over financial reporting in its annual report
  - May not conclude that internal control over financial reporting is effective if one or more material weaknesses is present at EOU
  - Must disclose all material weaknesses as of the EOU
Reporting

- Auditor’s Evaluation of Management’s Report
  - Management’s acceptance of responsibility
  - Suitability of IC framework
  - Whether management’s assessment is free of material misstatement
  - Whether management has expressed its assessment in an acceptable form
  - Whether material weaknesses identified in the company’s internal control over financial reporting, if any, have been properly disclosed, including material weaknesses corrected during the period

- Report on Management’s Assessment has multiple elements including
  - Management’s conclusion about the effectiveness of the company’s internal control over financial reporting
  - Statement that the audit was conducted in accordance with the standards of the PCAOB (US)
  - Auditor’s opinion on whether management’s assessment of the effectiveness of the internal control over financial reporting is fairly stated, in all material respects, based on the control criteria
  - Auditor’s opinion on whether the company maintained, in all material respects, effective internal control

One Year Later – Lessons Learned

- Challenges:
  - limited time frame/moving target
  - shortage of staff and competence
  - extent of I/C improvements
  - Mini-COSO?
  - Guidance to companies

- Areas for improvement:
  - Integration
  - Top-down approach
  - Risk-based approach
  - Single transaction → All relevant controls
  - Use of others

- Two top material weaknesses – System access and competency of financial reporting personnel
- Empirical data suggests little user reaction to adverse I/C reports, why?
- Are smallest companies using extensions to get ready or procrastinating
- Delistings, Closely held companies
- So – what are the positives and negatives associated with AS 2 / SOX 404? Should it be recalled? Will it prevent the next Enron?