

**AUDIT COMMITTEES BEWARE:**

**AUDITORS ARE REQUIRED TO EVALUATE YOUR EFFECTIVENESS UNDER  
PCAOB'S NEW INTERNAL CONTROL AUDITING STANDARD**

**April 7, 2004**

Last month the Public Company Accounting Oversight Board (the "PCAOB") adopted its long-awaited standard on internal control attestation engagements referred to in Section 404 of the Sarbanes-Oxley Act of 2002.

The 185 page standard, designated as "Auditing Standard No. 2 -- An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," is remarkable in its length and complexity.<sup>1</sup> However, of key importance is the Auditing Standard's requirement that, in connection with its audit of management's assessment of the company's internal control over financial reporting, the outside auditor must evaluate the effectiveness of the audit committee's oversight of the company's financial reporting and related internal controls.

Consequently, the audit committee of every public company should be an active participant in the company's effort to comply with new standards applicable to internal control over financial reporting.

**Background**

The series of business failures that began with Enron in late 2001 exposed serious flaws in public company financial reporting. Congress responded to these failures and perceived weaknesses by adopting the Sarbanes-Oxley Act, which imposed a host of new obligations on public companies and their directors, executive officers, audit committees and professional advisers, including their outside auditors.

Chief among these new obligations are those contained in Section 404 of the Sarbanes-Oxley Act. Section 404(a) of the Act requires management of a public company to assess the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year. Section 404(b) of the Act requires the company's auditor to attest to and report on management's assessment and directed the PCAOB to adopt standards for this purpose. The SEC followed up with rules requiring a company to include in its annual report on Form 10-K a report by management concerning the company's internal control over financial

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<sup>1</sup> Auditing Standard No. 2 is subject to approval by the SEC. It is available at <http://www.pcaobus.org/rules/Release-20040308-1.pdf>.

reporting and the outside auditor's attestation.<sup>2</sup> The SEC's new disclosure requirements will apply to annual reports on Form 10-K for fiscal years ending on or after November 15, 2004 for accelerated filers. Other filers must comply beginning for fiscal years ending on or after July 15, 2005.

After much deliberation, the PCAOB in March 2003 adopted Auditing Standard No. 2. In adopting this Auditing Standard, the PCAOB made it clear that it believes "attestation" is an insufficient descriptor for the process an auditor should use to assess management's report on internal controls. Accordingly, throughout the Auditing Standard, the PCAOB refers to the attestation as an "audit" of internal control over financial reporting that must be integrated with an audit of the company's financial statements. Thus, the objective of the auditor in attesting to management's assessment is to form an opinion "as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects." The auditor must form an opinion as to the effectiveness of the company's internal control over financial reporting, as well as consider the adequacy of management's process for determining the effectiveness of the company's internal control.

If an auditor discovers a deficiency, the auditor must communicate it to management and advise the audit committee that the communication has been made. If it rises to the level of a significant deficiency or a material weakness, the auditor must communicate the deficiency or weakness to the audit committee. Management's report on internal control in the company's annual report on Form 10-K must disclose any material weakness. Management's report does not have to disclose a significant deficiency, although multiple significant deficiencies could rise to the level of a material weakness that would have to be disclosed.

### Critical Role of the Audit Committee

The PCAOB believes that effective oversight by the company's board of directors, including the audit committee, is integral to the company's monitoring of internal control. Although management is responsible for maintaining effective internal control over financial reporting, the Auditing Standard emphasizes that the audit committee plays an important role within the control environment, helping to set a positive tone at the top, and that an effective audit committee challenges the company's financial reporting activities.<sup>3</sup> Accordingly, among the circumstances

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<sup>2</sup> See Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) available at <http://www.sec.gov/rules/final/33-8238.htm>.

<sup>3</sup> This emphasis on the audit committee's role is not new. The report on internal controls drafted by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO Report) states that an important element of the company's internal control over financial reporting ". . . is the involvement of the board or audit committee in overseeing the financial reporting process, including assessing the reasonableness of management's accounting judgments and estimates and reviewing key filings with regulatory agencies." See COSO Report at 130. The SEC similarly has stated in the past that both a company's management and board have important roles to play in establishing a supportive control environment. In its 1981 Statement of Policy regarding the FCPA, the Commission stated, "In the last analysis, the key to an adequate 'control environment' is an approach on the part of the board and top management which makes clear what is expected and that conformity to these expectations will be rewarded while breaches will be punished." See Release No. 34-17500 (Jan. 29, 1981).

that are considered significant deficiencies and are strong indicators that a material weakness exists is ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting.

The aspects of the audit committee's effectiveness that are important to the auditor will depend on the circumstances but may focus on the following:

- The independence of the audit committee members from management.
- The clarity of the audit committee's charter and how well the members of the audit committee understand their responsibilities.
- The degree of audit committee involvement and interaction with the outside auditor and with the company's internal auditors.
- The degree of audit committee interaction with key members of financial management, including the chief financial officer and chief accounting officer.
- The extent to which the members of the audit committee demonstrate an understanding of the company's critical accounting policies and judgmental accounting estimates by asking of management and the auditors "the right questions" and pursuing the answers.
- The audit committee's responsiveness to issues raised by the auditor.
- The audit committee's monitoring of the company's code of ethics, especially as the code relates to conflicts of interest, related party transactions and illegal acts.

The Auditing Standard points out that the auditor is not responsible for performing a separate and distinct evaluation of the audit committee. The board of directors still remains ultimately responsible for evaluating the audit committee's performance and effectiveness. However, the auditor must assess the effectiveness of the audit committee as part of the auditor's understanding and evaluating of the role of the audit committee within the control environment.

### Recommendation

In preparing to comply with Section 404 of the Act and the SEC's rules relating to reports on internal control over financial reporting, companies should not ignore the critical role of the audit committee in this process. For management to conclude that the company's internal control over financial reporting is effective, and for the outside auditor to form an opinion that management's opinion is fairly stated, it is essential that the audit committee clearly understand its responsibilities and be active and assertive in discharging them. The board of directors of every public company should evaluate how effectively its audit committee is currently functioning in the context of the Auditing Standard and promptly take any action that is necessary or appropriate to

ensure that the functioning of the audit committee will not lead to a finding of a significant deficiency or a material weakness.

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If you have any questions about the Auditing Standard discussed in this memorandum or if we can be of further assistance, please contact the Womble Carlyle attorney with whom you work or any one of the lawyers listed below.

<u>Garza Baldwin, III</u>	(704) 331-4907	<u>Jane Jeffries Jones</u>	(704) 331-4953
<u>Glenn A. Brown</u>	(404) 962-7515	<u>G. William Joyner III</u>	(336) 721-3579
<u>Meredith P. Burbank</u>	(404) 888-7455	<u>Clifford J. Lawrence</u>	(864) 255-5418
<u>Elizabeth O. Derrick</u>	(404) 888-7433 or	<u>Alonzo L. Llorens</u>	(404) 888-7353
	(864) 255-5415	<u>Keith J. Mendelson</u>	(703) 394-2246
<u>Jeffrey C. Howland</u>	(336) 721-3516	<u>Ross H. Parr</u>	(704) 331-4925
<u>Lisa M. Hudson</u>	(703) 394-2241	<u>Douglas H. Shaver</u>	(336) 721-3564
<u>Leigh R. Johnson</u>	(919) 484-2345	<u>Kenneth N. Shelton</u>	(919) 484-2319

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