Paul|Weiss

October 2003

PCAOB Proposes Standard for Review of Internal Control Over Financial Reporting

In accordance with the requirements of Section 404(b) of the Sarbanes-Oxley Act of 2002 (the "Act") and related implementing rules, the Public Company Accounting Oversight Board (the "PCAOB") has released for public comment an auditing standard (the "Standard") for auditor's reviews of internal control over financial reporting. The public comment period for the Standard expires on November 21, 2003. Once the PCAOB has finalized the Standard, it will be submitted to the SEC for approval.

"Accelerated filers" are required to comply with the requirements relating to internal control over financial reporting beginning with the first fiscal year ending after June 15, 2004, and the Standard will need to be in place by that date. All other reporting companies, including foreign private issuers, are required to comply with the new requirements beginning with the first fiscal year ending after April 15, 2005.

I. Background

Section 404(b) of the Act requires every registered public accounting firm that prepares or issues an audit report for an issuer (other than a registered investment company) to attest to, and report on, management's assessment of the issuer's internal control over financial reporting. The attestation and report required by Section 404(b) must be made in accordance with standards for attestation engagements "issued or adopted" by the PCAOB. The Standard is the PCAOB's proposal for such standard. Key elements of the Standard are discussed below.

A more detailed discussion of the requirements of Section 404 of the Act is included in our June 18, 2003 memorandum "SEC Adopts Rules Regarding Internal Control Over Financial Reporting" which is available on our website (www.paulweiss.com) under Securities Group publications.

II. Objective

The objective of the review by the auditor is for the auditor 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's report is also to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary, among other requirements.

At the conclusion of its review, the auditor would communicate in writing to the company's audit committee all significant deficiencies and material weaknesses (discussed below) of which the auditor is aware. The Standard also requires the auditor to communicate in writing to the company's management all internal control deficiencies and to notify the audit committee that it has done so.

III. Review Procedures

The Standard outlines the steps auditors would take in conducting their review, including:

- planning the audit;
- evaluating the process management used to perform its assessment of internal control effectiveness;
- obtaining an understanding of the internal control;
- evaluating the effectiveness of both the design and operation of the internal control; and
- forming an opinion about whether internal control over financing reporting is effective.

Planning the Audit

The first step would be for the auditor to develop a strategy for the audit (i.e. nature, timing and scope), based on the following factors, among others:

- auditor's knowledge of the company;
- matters affecting the company's industry;
- matters relating to the company's business; and
- the extent of recent changes in the company's operations or internal control over financial reporting.

Evaluating Management's Assessment

Next, the auditor would evaluate management's assessment. The Standard states that evaluating management's assessment:

- provides the auditor with confidence that management has a basis for expressing its opinion;
- provides information that will help the auditor understand the company's internal control;
- helps the auditor plan the work necessary to complete the audit; and
- provides some of the evidence the auditor will use to support his or her opinion.

The Standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management, in conducting its review of management's assessment.

Obtaining an Understanding of Internal Control Over Financial Reporting

The auditor is expected to understand how a company's internal control over financial reporting is designed and operates. A substantial amount of this understanding would be obtained during the evaluation of management's assessment process. The auditor should also be satisfied that the controls have been implemented and are operating as they were designed to operate.

The auditor would confirm his or her understanding by performing certain procedures, including:

- making inquiries of and observing the personnel who actually perform the controls;
- reviewing documents that are used in, and that result from, the application of the controls;
- comparing supporting documents (sales invoices, contracts, bills of lading, etc.) to the accounting records; and
- performing "walkthroughs" of the company's significant processes.

The walkthrough requirement is viewed as the most effective of the above procedures and the auditor would not be allowed to rely on the work of management or others in satisfying the walkthrough requirement. In a walkthrough, the auditor is to trace both routine and unusual company transactions from origination, through a company's accounting and information systems and financial reporting processes to their reporting in the financial statements.

Testing and Evaluating the Effectiveness of the Design of Controls

The auditor would evaluate a company's "design effectiveness," or whether the controls would be effective if they were operated as designed, and whether all the necessary controls are in place. The procedures the auditor would perform to evaluate design effectiveness include:

- inquiries of company personnel;
- observation of internal controls;
- walkthroughs; and
- a specific evaluation of whether the controls are likely to prevent or detect financial statement misstatements if they operate as designed.

Testing Operating Effectiveness

In addition to evaluating the design effectiveness of internal controls, the auditor would be required to evaluate the operating effectiveness of the internal controls. These tests would include:

- inquiries of appropriate company personnel;
- inspection of relevant documentation;
- observation of the controls in operation; and
- re-performance of the application of the control.

The Standard would allow the auditor to obtain evidence about operating effectiveness at different times throughout the year, provided that the auditor updates those tests or obtains other evidence that the controls still operated effectively at the end of the company's fiscal year.

The Standard specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably likely to result in material misstatement of the financial statements.

Using the Work of Management and Others

The Standard proposes an evaluation process that the auditor should use in determining the extent to which he or she may use the work of others in evaluating internal control effectiveness. The intention is to allow the auditor flexibility in using the work of others but prevent over-reliance on the work of others. Ultimately, the Standard relies on the judgement of the auditor to determine when and to what extent re-performance of the work of others is necessary. The Standard requires that on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion.

The Standard sets forth three categories of controls and the extent to which the auditor may use the work of others for each category.

Controls for which the auditor should not rely on the work of others:

- controls in the control environment and controls specifically intended to prevent or detect fraud that is reasonably likely to have a material effect on the company's financial statements.

Controls for which the auditor may rely on the work of others but his or her reliance on the work of others should be limited:

- controls over nonroutine transactions that are considered high risk because they involve judgments and estimates.

Controls for which the auditor's reliance on the work of others is not specifically limited:

- controls over routine processing of significant accounts.

Evaluating the Results

Both management and the auditor may identify deficiencies in internal control over financial reporting. An internal control deficiency exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. The Standard would require the auditor to evaluate the severity of all identified internal control deficiencies and classify them as significant deficiencies or material weaknesses as discussed below.

Significant Deficiency

A significant deficiency is an internal control deficiency that adversely affects the company’s ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.

The Standard identifies a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, would be deemed significant deficiencies as well as strong indicators that a material weakness exists, including:

- ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee;
- material misstatement in the financial statements not initially identified by the company's internal controls; and
- significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after some reasonable period of time.

Material Weakness

A material weakness is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The auditor's report is required to disclose material weaknesses but not significant deficiencies.

Forming an Opinion and Reporting

If the auditor has identified no material weaknesses in internal control after having performed all of the procedures that the auditor considers necessary in the circumstances, then the auditor would be permitted to express an unqualified opinion that management's assessment of the effectiveness of internal control over financial reporting is fairly stated in all material respects. If the auditor could not perform all of the procedures considered necessary, then the auditor would be permitted to qualify or disclaim the opinion. If an overall opinion cannot be expressed, the auditor would be required to explain why.

The SEC's final rules implementing Section 404 of the Act state that "management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In such a case, management must conclude that internal control is not effective. As the reporting model for the auditor is to follow the required reporting model for management, the auditor is required to express an "adverse" conclusion in the event a material weakness exists. This is a change from the existing attestation standard for auditors, which provides that when the auditor has identified a material weakness in internal control, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion or may express an adverse opinion.

As noted above, at the conclusion of its review the auditor would communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor would also communicate in writing to the company's management all internal control deficiencies and notify the audit committee that it has done so.

IV. Integrated Audit

The Standard requires that an auditor who conducts an audit of internal control over financial reporting must also audit the company's financial statements. The rationale for this requirement is that information obtained during the financial statement audit may be significant to the evaluation of the effectiveness of internal control. The integrated audit will result in two opinions, one on internal control over financial reporting and one on the financial statements.

The Standard prohibits the auditor from accepting an engagement to provide an internal control-related non-audit service to an audit client that has not been specifically pre-approved by the audit committee. The effect of this is that the audit committee would not be able to pre-approve internal control-related non-audit services as a category. Rather, each specific engagement would be required to be specifically pre-approved.

V. Small and Medium Sized Companies

In the Standard, the Board notes that it is "sensitive" to the possible effects of the Standard on small and medium sized companies. For smaller companies, the Board expects that the auditor will "exercise reasonable professional judgement" in determining the extent of the audit of internal control over financial reports that is appropriate.

VI. Inherent Limitations

The Standard notes that internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because it is a process that "involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures." It also states that internal control over financial reporting can be circumvented by collusion or improper management override.

* * *

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

Mark S. Bergman	(44 20) 7367-1601	John C. Kennedy	(212) 373-3025
Richard S. Borisoff	(212) 373-3153	Edwin S. Maynard	(212) 373-3034
Andrew J. Foley	(212) 373-3078	Raphael M. Russo	(212) 373-3309
Paul D. Ginsberg	(212) 373-3131		

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP