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BYLAWS and RULES

OF THE

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

As of June 18, 2004

BYLAWS AND RULES

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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BYLAWS AND RULES

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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BYLAWS

ARTICLE I
NAME

1. The name of the Corporation shall be the Public Company Accounting Oversight Board, Inc.

ARTICLE II
OBJECT

2. The Corporation is organized pursuant to, and shall be operated for such purposes as are set forth in, Title I of the Sarbanes-Oxley Act of 2002 (the "Act").

ARTICLE III
OFFICES

3.1. Principal Office. The principal office of the Corporation shall be in the City of Washington, District of Columbia.

3.2. Other Offices. The Governing Board of the Corporation ("Governing Board") may designate other office locations, outside of the District of Columbia, as the Governing Board may determine are necessary or appropriate to meet the Corporation's objectives.

ARTICLE IV
GOVERNING BOARD

4.1. Composition. The Governing Board shall consist of those persons appointed thereto by the Securities and Exchange Commission, pursuant to Section 101 of the Act.

4.2. Powers and Duties. The Governing Board shall have such powers and duties as are provided in Title I of the Act.

4.3. Quorum and Majority. A majority of the members of the Governing Board shall constitute a quorum. An act approved by majority vote of the members of the Governing Board present at a meeting of the Board at which a quorum is present shall be the act of the Board. If a Board member has recused himself or herself from a decision, and a quorum of otherwise qualified Board members cannot be assembled in time to meet the exigencies of that particular situation, the recused Board member may be counted for quorum purposes only. As used in this section, "the exigencies of that particular situation" shall be defined to require circumstances in which the Board is required to act within a limited period of time or in which the public interest or the protection of investors otherwise prevent the deferral of action until a quorum of non-recused Board members is available.

4.4. Compensation and Expenses. The Governing Board shall set the compensation for its Members. Members of the Governing Board shall be reimbursed by the Board for reasonable expenses incurred in the discharge of their duties.

ARTICLE V
BOARD MEETINGS

5.1. General. As soon as practical after the adoption of these bylaws, the Governing Board shall adopt a written policy defining the circumstances under which meetings of the Board will be open to the public (the "Open Meeting Policy").

5.2. Regular Public Meetings. The Governing Board shall hold at least one public meeting each month, which meeting shall take place on the first Tuesday of each month (the "Regular Public Meeting"), or at such other time as the Chair shall determine. The Board shall ensure that, under procedures defined in its Open Meeting Policy, the public is informed, at least five (5) calendar days in advance, of the time, location, and general topics scheduled for discussion of each Regular Public Meeting.

5.3. Special Meetings. The Governing Board may hold additional meetings ("Special Meetings"), which may be public or non-public (in accordance with the Open Meeting Policy) as it deems necessary or appropriate to further the purposes of the Act. The Open Meeting Policy shall set forth procedures for providing the public with reasonable notice of public Special Meetings.

5.4. Telephonic Participation. The Governing Board may meet via telephone or teleconference, and any member may participate in a meeting by telephone, provided that, in the case of a meeting that is open to the public, at least one Board member shall be present at the location specified in the meeting notice.

ARTICLE VI
OFFICERS

6.1. General. The Chair of the Governing Board shall also be the President and Chief Executive Officer of the Corporation. All other Governing Board members shall also be Vice Presidents of the Corporation. Board members shall serve as officers of the Corporation without additional compensation.

6.2. Other Officers. The other officers of the Corporation shall include a Secretary, Treasurer, General Counsel, Chief Auditor, Chief Administrative Officer, Director of Inspections and Registration, Director of Investigations and Enforcement, and such other officers as the Governing Board may establish in accordance with such rules of the Board as may be adopted for establishing officers.

6.3. Powers of the Chief Executive Officer.

(a) The Chief Executive Officer is responsible for, and has authority over, the management and administration of the Corporation, including responsibility and authority for the appointment, dismissal, and supervision of personnel (other than Board members and personnel employed regularly and full-time within the immediate offices of the Board members), the distribution of business among such personnel and among organizational units of the Corporation, the use and expenditure of funds (including the procurement of goods and services), and the development (for Board review) of strategic policy initiatives.

(b) (1) In carrying out any of the responsibilities under the provisions of this section 6.3, the Chief Executive Officer shall be governed by the general policies of the Governing Board and by such rules and decisions as the Governing Board may lawfully make.

(2) The appointment by the Chief Executive Officer of the officers of the Corporation designated in and established under section 6.2

shall be subject to the approval of, and made in consultation with, the Governing Board, and the dismissal of the officers of the Corporation designated in and established under section 6.2 shall be made in consultation with the Governing Board, except that when the Board determines that the dismissal arises out of a conflict regarding the general policies of the Governing Board, it is also subject to the approval of the Governing Board.

(3) Each Governing Board member has responsibility and authority for the appointment, dismissal, and supervision of personnel employed regularly and full-time within the immediate office of the Board member, subject to the Governing Board's overall personnel policies.

(4) The Chief Executive Officer has the responsibility and authority to develop, and present to the Board for approval, an annual budget as well as mid-year adjustments, if any. There is reserved to the Governing Board its responsibility and authority with respect to determining the distribution of funds according to major programs and purposes, including those related to salary schedules and other conditions of employment.

ARTICLE VII
LIABILITY AND INDEMNIFICATION

7.1. No Personal Liability. No contract entered into by or on behalf of the Corporation shall personally obligate any employee, officer, or Governing Board member of the Corporation, including the employee, officer or Governing Board member authorizing such contract or executing same.

7.2. Indemnification.

(a) Unless otherwise prohibited by law and as provided in section 7.2(b), the Corporation shall indemnify any employee, officer, or Governing Board member, or any former employee, officer, or Governing Board member, against any and all expenses and liabilities actually and necessarily incurred by him or her, or imposed on him or her, in connection with any claim, action, suit, or proceeding (whether actual or threatened, civil, criminal, administrative, or investigative, including appeals), to which he or she may be or is made a party by reason of being or having been such employee, officer, or Board member.

(b) Notwithstanding section 7.2(a), there shall be no indemnification in relation to matters as to which the Board finds that the employee, officer, or Board member acted in bad faith or engaged in willful misconduct in the performance of a duty to the Corporation.

(c) Amounts paid in indemnification of expenses and liabilities may include, but shall not be limited to, counsel and other related fees; costs and disbursements; and judgments, fines, and penalties against, and amounts paid in settlement by, such employee, officer, or Board member.

(d) The Corporation may advance expenses to, or where appropriate may itself, at its expense, undertake the defense of any employee, officer, or Board member; provided, however, that such employee, officer, or Board member shall undertake to repay or to reimburse such expense if it should be ultimately determined that he or she is not entitled to indemnification under this Article.

(e) The provisions of this Article shall be applicable to claims, actions, suits, or proceedings made or commenced after the adoption hereof, whether arising from acts or omissions to act occurring before or after adoption hereof.

(f) The indemnification provided by this Article shall not be deemed exclusive of any other rights to which such employee, officer, or Board member may be entitled under any applicable law.

(g) The indemnification provided by this Article shall not restrict the power of the Governing Board to provide any additional indemnification permitted by law.

7.3. Insurance. The Governing Board may purchase insurance on behalf of any employee, officer, or Governing Board member against any liability which may be asserted against or incurred by him or her which arises out of such person's status as an employee, officer, or Board member or out of acts taken in such capacity, whether or not the Corporation would have the power to indemnify such person against that liability under law. To the extent that any applicable insurance is available to respond to any claim addressed in this Article, such insurance shall be exhausted before any payment is made pursuant to the indemnification provisions in this Article.

7.4. Severability. If any part of this Article shall be found in any action, suit, or proceeding to be invalid or ineffective, the validity and effectiveness of the remaining parts shall not be affected.

ARTICLE VIII
BYLAW AMENDMENTS AND RULES OF THE CORPORATION

8.1. Amendments to Bylaws. The Governing Board may from time to time amend, repeal, or supplement these bylaws.

8.2. Rules. In addition to, and separate from, these bylaws, the Governing Board may adopt such rules of the Corporation as it deems necessary or appropriate to discharge its responsibilities under the Act.

ARTICLE IX
MISCELLANEOUS PROVISIONS

9.1. Fiscal Year. The Corporation's fiscal year shall be the calendar year.

9.2. Capital Expenditures. Except as expressly delegated by the Governing Board, no capital expenditure or investment shall be made without the approval of the Board.

9.3. Selection of Auditor. The Governing Board shall retain an accounting firm to annually audit the Corporation's financial records, which firm shall not perform any other services, except tax services, for the Corporation.

ETHICS CODE

EC1. Application of Code

The provisions of this Ethics Code apply, according to their terms, to –

(a) present and former Board members and staff;

(b) the spouse, spousal equivalent, and dependents of Board members and staff; and

(c) designated contractors and consultants to the Board.

Note: Rule 3700(e) requires members of a Board advisory group to comply with certain provisions of the Ethics Code.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC2. Definitions

(a) Reference to Rules of the Board

Unless the context requires otherwise, the definitions provided in Section 1001 of the Rules of the Board apply to the words and terms contained in this Ethics Code.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

(b) Code

The term "Code" means this Ethics Code, as it may be amended from time to time.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

(c) Dependent

The term "dependent" of a Board member or staff means a person who receives more than half of his or her support for the most recent calendar year from the Board member or staff.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

(d) Designated Contractors and Consultants

The term "designated contractors and consultants" means certain persons or business organizations

(1) with which the Board enters into contracts for services, including contracts that provide for both goods and services;

(2) which the Board, or its designate, has determined should be subject to this Code, in whole or in part; and

(3) for which the contract contains a provision expressly incorporating this Code, in whole or in part.

Note: The Board will maintain a list of designated contractors and consultants, which will be available to the public. Nothing in this provision will restrict the Board's right to impose additional contractual restrictions and limitations on any contractor or consultant. The Board is committed not to use its contracting authority to convert a person who would ordinarily be an employee to a contractor or consultant, as a means of allowing that person to be excluded from the provisions of this Code.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

(e) Honoraria

The term "honoraria" means anything with more than a nominal value, whether provided in cash or otherwise, and which is provided in exchange for a speech, panel participation, publication or lecture. Neither the waiver of conference fees nor acceptance of a modest speakers-only meal constitutes "honoraria."

Note: Items which are provided to all conference participants, including speakers, are not provided "in exchange for" a speech and thus not considered to be "honoraria."

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

(f) Practice

The term "practice" means –

(1) knowingly acting as an agent or attorney for, or otherwise representing any other person in any formal or informal appearance before the Board or Commission with respect to Board-related matters; or

(2) making any oral or written communication on behalf of any other person to, and with the intent to influence, the Board or Commission with respect to Board-related matters.

Note: For purposes of this definition, participating in the financial reporting process as the officer or director of an issuer or participating in an audit of an issuer's financial statements does not, in and of itself, constitute practice before the Board or the Commission.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

(g) Professional Staff or Professional Staff of the Board

The terms "professional staff" or "professional staff of the Board" mean those persons who are employed by the Board and who are exempt, pursuant to Section 13(a)(1) of the Fair Labor Standards Act (29 USC § 201 et sec.), from Sections 6 and 7 (minimum wage and overtime provisions) of that act.

Note: These terms may, according to the context, alternatively be used to refer to a single such employee, or to all such employees.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

(h) Staff or Staff of the Board

The terms "staff" or "staff of the Board" mean those persons who are employed by the Board.

Note: These terms may, according to the context, alternatively be used to refer to a single such employee, or to all such employees.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC3. General Principles

(a) The purpose of this Code is to maintain the highest standards of ethical conduct among Board members and staff, and to provide the public with confidence in the objectivity of the Board's decisions by seeking to avoid both actual and perceived conflicts of interest among Board members and staff. The general principles within this section form the basis for the ethics rules and standards of conduct contained in the Code. When a situation is not covered by the Code's specific standards, Board members and staff shall apply the principles set forth in this section in determining whether their conduct is proper.

(1) Board members and staff should at all times be mindful of their responsibilities to the Board, the sensitivity of their positions, and the need for public confidence in the objectivity and deliberative process of the Board.

(2) Board members and staff should take great care to conduct themselves and all of their activities in such a manner so that their personal investments or other personal activities will not affect their professional independence or objectivity, or otherwise hinder the interests or reputation of the Board.

(3) Board members and staff should recognize that the degree of public confidence in the function and activities of the Board depends heavily upon the observance of both the letter and spirit of this Code.

(b) No Board member or staff shall act in a manner, regardless of whether specifically prohibited by this Code, which might reasonably result in or reasonably create the appearance that the employee is –

(1) using his or her official position with the Board, or confidential information obtained through service for the Board, for the private gain of any person;

(2) giving preferential treatment to any person with respect to the Board member or employee's work for the Board;

(3) losing independence or objectivity with respect to his or her work for the Board;

(4) adversely affecting the public confidence in, or the integrity, independence or objectivity of the Board; or

(5) otherwise hindering the interests or reputation of the Board.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC4. Financial and Employment Interests

(a) While employed by the Board, no Board member or professional staff shall –

(1) be owed, directly or indirectly, any financial or other obligation by any former employer, business partner, client, or publisher except –

(A) routine banking and other routine commercial relationships;

(B) securities and other investments permitted by this Code;

(C) benefits under a bona fide pension, retirement, group life, health or accident insurance, or other employee welfare or benefit plan maintained by a former employer and related to prior services for the former employer, business partner or client;

(D) profit-sharing, stock bonus or other payments related to prior services for the former employer, business partner or client;

(E) royalties or other like payments with respect to writings and recordings completed prior to commencement of employment with the Board; or

(F) such other obligations permitted by this Code, or as may be specifically and expressly approved by the Board; or

(2) owe, directly or indirectly, any financial or other obligation to any former employer, business partner or client, except –

(A) routine banking and other routine commercial relationships;

(B) covenants not to compete;

(C) non-disclosure agreements; or

(D) such other obligations permitted by this Code, or as may be specifically and expressly approved by the Board.

(b) Notwithstanding any other provision of this Code, no member of the Board or his or her spouse, spousal equivalent, or dependents may share in any of the profits of, or receive payments from, a public accounting firm, other than fixed continuing payments under standard arrangements for retirement from public accounting firms.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC5. Investments

(a) Except as provided in this Section, nothing in this Code prohibits Board members and staff, or their spouses, spousal equivalents, or dependents, from owning and holding securities (including futures), real estate, commodities (including futures), exchange-traded options and other investments held for personal investment purposes, except that no Board member or staff may have any financial interest in a public accounting firm.

(b) Board members and staff should at all times be mindful of their responsibilities to the Board and shall avoid personal financial activities which might affect or reasonably create the appearance of affecting their independence or objectivity.

(c) Board members and staff should at all times be mindful that, in the course and scope of their employment activities, they may obtain knowledge of confidential, non-public information which, if disclosed, might affect the value of particular securities or investments. Accordingly, Board members and staff may not –

(1) disseminate or otherwise disclose any confidential, non-public information obtained by virtue of their position with the Board, regardless of whether that information may be considered to be "material" under the securities laws; or

(2) use such information for the financial gain of themselves or others.

Note: Concurrent restrictions on disclosure of non-public information are provided in EC9.

(d) Board members and professional staff shall annually disclose their holdings, and the holdings of their spouses, spousal equivalents, and dependents, in securities of issuers (including exchange-traded options and futures).

(1) For initial disclosures, statements shall be filed with the Ethics Officer within the first 60 days of commencement of service with the Board, or 60 days from the effective date of this Code, whichever is later.

(2) Subsequent disclosures shall be filed with the Ethics Officer on May 1, commencing the first year following the initial disclosure.

(3) Disclosure statements by Board Members shall be made available to the public.

(4) Disclosure statements by professional staff shall remain confidential.

Note: The form and content of this disclosure statement shall be included in the Board's ethics manual.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC6. Outside Activities

(a) No member of the Board may undertake any employment or other activity for compensation outside of service to the Board.

(b) Staff of the Board may only undertake other employment or other activity for compensation with the express and specific approval of the Board or such person to whom the Board may delegate such approval authority.

(c) No Board member or staff of the Board shall engage in any outside activity, whether or not for compensation, which –

(1) affects or reasonably creates the appearance of affecting his or her independence or objectivity;

(2) interferes with his or her responsibilities to the Board; or

(3) otherwise hinders the interests or reputation of the Board.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC7. Gifts, Reimbursements, Honoraria and Other Things of Value

(a) No Board member or professional staff shall, directly or indirectly, solicit or accept any gift, reimbursement, honoraria or anything of monetary value from any source, which might reasonably be viewed as –

(1) interfering with his or her independence, objectivity or responsibilities to the Board; or

(2) otherwise hindering the interests or reputation of the Board.

Note: Although this provision does not extend to non-professional staff, such staff should remain cognizant of corresponding duties imposed by EC3 and EC5.

(b) No Board member or staff shall accept payment for or reimbursement of official travel-related expenses from any organization, except –

(1) for travel that is in direct connection with the employee's participation in an educational forum; and

(2) the educational forum is principally sponsored by and the travel-related expenses are paid or reimbursed by –

(A) a federal, state or local governmental body, or an association of such bodies,

(B) an accredited institution of higher learning,

(C) an organization exempt from taxation under 501(c)(3) of the Internal Revenue Code, provided such organization is not principally funded from one or more public accounting firms or issuers, or

(D) institutions equivalent to those in EC 7(b)(2)(A) – (C) outside the United States.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC8. Disqualification

(a) If a Board member or professional staff becomes, or reasonably should become, aware of facts which would lead a reasonable person to believe that he or she, or his or her spouse, spousal equivalent, or dependents, may have a financial interest or other similar relationship which might affect or reasonably create the appearance of affecting his or her independence or objectivity with respect to the Board's function or activities, then he or she shall, at the earliest possible date –

(1) disclose such circumstances and facts, as set forth in subsection (b); and

(2) recuse himself or herself from further Board functions or activities involving or affecting the financial interest or relationship.

Note 1: For the purposes of applying this provision to members of an advisory group convened by the Board, those members shall not be considered to lack independence or objectivity with regard to advisory group matters merely because they (or their employer, business partners or clients) are subject to the direct or indirect oversight of the Board.

Note 2: Although this provision does not extend to non-professional staff, such staff facing circumstances that may affect their ability to perform their functions should seek advice from the Board's Ethics Officer.

(b) For a member of the Board, disclosure shall be made to all other members of the Board. For professional staff of the Board, disclosure shall be made to the Board Chair, or his or her designee.

(c) For a period of 12 months commencing on date of appointment or employment, no Board member or professional staff may participate in the making of a decision which is reasonably likely to have a material effect, direct or indirect, on the Board or professional staff member's former employer, business partner or client, when such prior employment terminated within five years from the date of appointment or employment with the Board. For purposes of this section, participating in the making of a decision which affects a former employer, business partner or client to the same degree as similarly situated people or business organizations, does not constitute an "indirect" effect.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC9. Non-Public Information

(a) Unless authorized by the Board, no Board member or staff shall disseminate or otherwise disclose any information obtained in the course and scope of his or her employment, and which has not been released, announced, or otherwise made available publicly.

(b) The provisions of this Section shall continue in effect after the termination of employment or Board membership.

Note: Concurrent restrictions on disclosure of non-public information are provided in EC5(c).

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC10. Speaking for the Board

Unless authorized to speak on behalf of the Board, Board members and professional staff shall include a disclaimer for any private publication or public statement by indicating that the views expressed are those of the author or speaker and do not necessarily reflect the view of the Board or other Board members or staff.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC11. Ethics Officer

The Board shall designate an Ethics Officer who shall be empowered to –

(a) counsel Board members and staff regarding compliance with or potential violation of this Code;

(b) issue advisory opinions, as deemed necessary, to Board members and staff regarding potential violations of this Code; and

(c) make recommendations to the Board regarding waiver requests and potential violations of, or amendments to, this Code.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC12. Post-Employment Restrictions

(a) Negotiating Prospective Employment

(1) Board members and professional staff may not negotiate prospective employment with a public accounting firm or issuer, without first disclosing (pursuant to the procedures in Section EC8(b)) the identity of the prospective employer and recusing himself or herself from all Board matters directly affecting that prospective employer.

(2) For purposes of this section, "negotiating prospective employment" means participating in an employment interview; discussing an offer of employment; or accepting an offer of employment, even if the precise terms are still to be developed. Submitting a resume or job application to a group of employers or receiving an unsolicited inquiry of interest that is rejected, do not alone constitute "negotiating prospective employment."

(b) Prohibition on Practice Before the Board or Commission

(1) Board members and professional staff shall be restricted from practice before the Board, and the Commission with respect to Board-related matters, for one year following termination of employment or Board membership.

(2) Former Board members and professional staff shall not practice before the Board, or the Commission with respect to Board-related matters, on a particular matter in which the Board member or professional staff participated personally and substantially as a Board or staff member and which involved a specific party or specific parties at the time of such participation.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC13. Waiver

Unless otherwise prohibited by law, the Board (or person to whom the Board may delegate this responsibility as to staff) may grant a request for waiver of any provision of this Code. Such waivers must be requested in writing by the Board member or staff, and evaluated by the Ethics Officer. The Board will only grant waiver requests after a finding that the waiver would not otherwise hinder the interests or reputation of the Board. Waivers will be made available to the public, subject to the withholding of information that would constitute a clearly unwarranted invasion of personal privacy.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

EC14. Certification

Board members, staff and designated contractors and consultants agree to comply with this Code at the commencement of their service or contract with the Board and shall, throughout the term of their appointment, employment or contract, certify annually in writing their continuing compliance with it.

[Effective pursuant to SEC Release No. 34-48755; File No. PCAOB-2003-04; November 7, 2003]

RULES

SECTION 1. GENERAL PROVISIONS

Rule 1000. [Reserved]

[Reserved]

Rule 1001. Definitions of Terms Employed in Rules.

When used in the Rules, unless the context otherwise requires:

(a)(i) Accounting Support Fee

The term "accounting support fee" means the fee described in Rule 7100.

[Effective pursuant to SEC Release No. 34-48278; File No. PCAOB-2003-02; August 1, 2003]

(a)(ii) Accountant

The term "accountant" means a natural person –

(1) who is a certified public accountant, or

(2) who holds –

(i) a college, university, or higher professional degree in accounting, or

(ii) a license or certification authorizing him or her to engage in the business of auditing or accounting, or

(3) who –

(i) holds a college, university, or higher professional degree in a field, other than accounting, and

(ii) participates in audits;

provided, however, that the term "accountant" does not include a person engaged only in clerical or ministerial tasks.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(a)(iii) Act

The term "Act" means the Sarbanes-Oxley Act of 2002.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(a)(iv) Associated Entity

The term "associated entity" means, with respect to a public accounting firm –

(1) any entity that directly, indirectly, or through one or more intermediaries, controls, or is controlled by, or is under common control with, such public accounting firm; or

(2) any "associated entity," as used in Rule 2-01(f)(2) of Regulation S-X, 17 C.F.R. 210.2-01(f)(2), that would be considered part of that firm for purposes of the Commission's auditor independence rules.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(a)(v) Audit

The term "audit" means an examination of the financial statements of any issuer by an independent public accounting firm in accordance with the rules of the Board or the Commission (or, for the period preceding the adoption of applicable Rules of the Board under Section 103 of the Act, in accordance with then applicable generally accepted auditing standards for such purposes), for the purpose of expressing an opinion on such statements.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(a)(vi) Audit Report

The term "audit report" means a document or other record –

(1) prepared following an audit performed for purposes of compliance by an issuer with the requirements of the securities laws; and

(2) in which a public accounting firm either –

(i) sets forth the opinion of that firm regarding a financial statement, report or other document; or
(ii) asserts no such opinion can be expressed.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(a)(vii) Audit Services

The term "audit services" means –

(1) subject to paragraph (a)(vii)(2) of this Rule, professional services rendered for the audit of an issuer's annual financial statements, and (if applicable) for the reviews of an issuer's financial statements included in the issuer's quarterly reports.

(2) effective after December 15, 2003, professional services rendered for the audit of an issuer's annual financial statements, and (if applicable) for the reviews of an issuer's financial statements included in the issuer's quarterly reports or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements for those fiscal years.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(a)(viii) Auditing and Related Professional Practice Standards.

The term "auditing and related professional practice standards" means the auditing standards, related attestation standards, quality control standards, ethical standards, and independence standards (including any rules implementing Title II of the Act), and any other professional standards, that are established or adopted by the Board under Section 103 of the Act.

[Effective pursuant to SEC Release No. 34-48730; File No. PCAOB-2003-05; October 31, 2003]

(a)(ix) Accounting Board Demand

The term "accounting board demand" means a command to produce documents and/or to appear at a certain time and place to give testimony.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(a)(x) Accounting Board Request

The term "accounting board request" means a request to produce documents and/or to appear at a certain time and place to give testimony.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(a)(xi) Appropriate State Regulatory Authority

The term "appropriate state regulatory authority" means the State agency or other authority responsible for the licensure or other regulation of the practice of accounting in the State or States having jurisdiction over a registered public accounting firm or associated person thereof, with respect to the matter in question.

[Effective pursuant to SEC Release No. 34-49787; File No. PCAOB-2003-08, June 1, 2004]

(b)(i) Board

The term "Board" means the Public Company Accounting Oversight Board.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(b)(ii) Bar

The term "bar" means a permanent disciplinary sanction prohibiting a person from being associated with a registered public accounting firm.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(c)(i) Commission

The term "Commission" means the Securities and Exchange Commission.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(c)(ii) Counsel

The term "counsel" means an attorney at law admitted to practice, and in good standing, before the Supreme Court of the United States or the highest court of any state.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(d)(i) Disciplinary Proceeding

The term "disciplinary proceeding" means a proceeding initiated by an order instituting proceedings, held for the purpose of determining whether or not a registered public accounting firm, or any person associated with a registered public accounting firm, has engaged in any act or practice, or omitted to act, in violation of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards; or has failed reasonably to supervise an associated person in connection with any such violation by that person; or has failed to cooperate with the Board in connection with an investigation; and whether to impose a sanction pursuant to Rule 5300.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(d)(ii) Document

The term "document" is synonymous in meaning and equal in scope to its usage in Federal Rule of Civil Procedure 34(a), including, without limitation, electronic or computerized data compilations. A draft or non-identical copy is a separate document within the meaning of this term. In no event shall the term "document" be construed to be limited to audit work papers.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(e)(i) Exchange Act

The term "Exchange Act" means the Securities Exchange Act of 1934, as amended.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(f)(i) Foreign Public Accounting Firm

The term "foreign public accounting firm" means a public accounting firm that is organized and operates under the laws of a non-U.S. jurisdiction, government or political subdivision thereof.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(h)(i) Hearing Officer

The term "hearing officer" means a person, other than a Board member or staff of the interested division, duly authorized by the Board to preside at a hearing.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(i)(i) Issuer Market Capitalization

The terms "issuer market capitalization" and "market capitalization of an issuer" mean –

(1) Except as provided in paragraph (i)(i)(2) of this rule, the aggregate market value of all classes of an issuer's common stock that trade in the United States; or

(2) With respect to an issuer: (i) that is registered under Section 8 of the Investment Company Act or has elected to be regulated as a business development company pursuant to Section 54 of the Investment Company

Act, and (ii) whose securities are not traded on a national securities exchange or quoted on Nasdaq, the issuer's net asset value.

[Effective pursuant to SEC Release No. 34-48278; File No. PCAOB-2003-02; August 1, 2003]

(i)(ii) Investment Company Act

The term "Investment Company Act" means the Investment Company Act of 1940, as amended.

[Effective pursuant to SEC Release No. 34-48278; File No. PCAOB-2003-02; August 1, 2003]

(i)(iii) Issuer

The term "issuer" means an issuer (as defined in Section 3 of the Exchange Act), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(i)(iv) Interested Division

The term "interested division" means a division or office of the Board assigned primary responsibility by the Board to participate in a particular proceeding.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(n)(i) Notice

The term "notice" means the document sent by the Board to an issuer, pursuant to Rule 7102, setting forth such issuer's share of the accounting support fee under Section 109 of the Act and Rules 7101 and 7102.

[Effective pursuant to SEC Release No. 34-48278; File No. PCAOB-2003-02; August 1, 2003]

(n)(ii) Non-Audit Services

The term "non-audit services" means –

(1) subject to paragraph (n)(ii)(2) of this Rule, services related to financial information systems design and implementation as defined in Rule 2-01(c)(4)(ii) of Regulation S-X, 17 C.F.R. 2-01(c)(4)(ii), and all other services, other than audit services or other accounting services.

(2) effective after December 15, 2003, all other services other than audit services, other accounting services, and tax services.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(o)(i) Other Accounting Services

The term "other accounting services" means –

(1) subject to paragraph (o)(i)(2) of this Rule, services that are normally provided by the public accounting firm that audits the issuer's financial statements in connection with statutory and regulatory filings or engagements and assurance and related services that are reasonably related to the performance of the audit or review of the issuer's financial statements, other than audit services.

(2) effective after December 15, 2003, assurance and related services that are reasonably related to the performance of the audit or review of the issuer's financial statements, other than audit services.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(o)(ii) Order Instituting Proceedings

The term "order instituting proceedings" means an order issued by the Board commencing a disciplinary proceeding.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(p)(i) Person Associated With a Public Accounting Firm (and Related Terms)

The terms "person associated with a public accounting firm" (or with a "registered public accounting firm" or "applicant") and "associated person of a public accounting firm" (or of a "registered public accounting firm" or "applicant") mean any individual proprietor, partner, shareholder, principal, accountant, or professional employee of a public accounting firm, or any independent contractor that, in connection with the preparation or issuance of any audit report –

(1) shares in the profits of, or receives compensation in any other form from, that firm; or

(2) participates as agent on behalf of such accounting firm in any activity of that firm;

provided, however, that these terms do not include a person engaged only in clerical or ministerial tasks or a person whom the public accounting firm reasonably believes is a person primarily associated with another registered public accounting firm.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(p)(ii) Play a Substantial Role in the Preparation or Furnishing of an Audit Report

The phrase "play a substantial role in the preparation or furnishing of an audit report" means –

(1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, or

(2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer.

Note 1: For purposes of paragraph (1) of this definition, the term "material services" means services, for which the engagement hours or fees constitute 20% or more of the total engagement hours or fees, respectively, provided by the principal accountant in connection with the issuance of all or part of its audit report with respect to any issuer. The term does not include non-audit services provided to non-audit clients.

Note 2: For purposes of paragraph (2) of this definition, the phrase "subsidiary or component" is meant to include any subsidiary, division, branch, office or other component of an issuer, regardless of its form of organization and/or control relationship with the issuer.

Note 3: For purposes of determining "20% or more of the consolidated assets or revenues" under paragraph (2) of this Rule, this determination should be made at the beginning of the issuer's fiscal year using prior year information and should be made only once during the issuer's fiscal year.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(p)(iii) Public Accounting Firm

The term "public accounting firm" means a proprietorship, partnership, incorporated association, corporation, limited liability company, limited liability partnership, or other legal entity that is engaged in the practice of public accounting or preparing or issuing audit reports.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(p)(iii) Party

The term "party" means the interested division, any person named as a respondent in an order instituting proceedings or notice of a hearing, any applicant named in the caption of any order, or any person seeking Board review of a decision.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(p)(iv) Person

The term "person" means any natural person or any business, legal or governmental entity or association.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(p)(vi) Professional Standards

The term "professional standards" means –

(A) accounting principles that are –

(i) established by the standard setting body described in section 19(b) of the Securities Act of 1933, as amended by the Act, or prescribed by the Commission under section 19(a) of the Securities Act of 1933 or section 13(b) of the Securities Exchange Act of 1934; and

(ii) relevant to audit reports for particular issuers, or dealt with in the quality control system of a particular registered public accounting firm; and

(B) auditing standards, standards for attestation engagements, quality control policies and procedures, ethical and competency standards, and independence standards (including rules implementing Title II of the Act) that the Board or the Commission determines –

(i) relate to the preparation or issuance of audit reports for issuers; and

(ii) are established or adopted by the Board under section 103(a) of the Act, or are promulgated as rules of the Commission.

[Effective pursuant to SEC Release No. 34-49787; File No. PCAOB-2003-08, June 1, 2004]

(r)(i) Registered Public Accounting Firm

The term "registered public accounting firm" means a public accounting firm registered with the Board.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(r)(ii) Rules or Rules of the Board

The terms "Rules" or "Rules of the Board" mean the bylaws and rules of the Board (as submitted to and approved, modified, or amended by the Commission in accordance with Section 107 of the Act) and those stated policies, practices, and interpretations of the Board that the Commission, by rule, may deem to be rules of the Board, as necessary or appropriate in the public interest or for the protection of investors.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

(r)(iii) Revocation

The term "revocation" means a permanent disciplinary sanction terminating a firm's registration.

[Effective pursuant to SEC Release No. 34-49704; File No. PCAOB-2003-07, May 14, 2004]

(s)(i) Securities Act

The term "Securities Act" means the Securities Act of 1933, as amended.

[Effective pursuant to SEC Release No. 34-48278; File No. PCAOB-2003-02; August 1, 2003]

(s)(ii) Securities Laws

The term "securities laws" means the provisions of the law referred to in Section 3(a)(47) of the Exchange Act, as amended by the Act, and includes the rules, regulations, and orders issued by the Commission thereunder.

[Effective pursuant to SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

Example A-1

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING (SEPARATE REPORT)[1/]

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

[1/] If the auditor issues separate reports on the audit of internal control over financial reporting and the audit of the financial statements, both reports should include a statement that the audit was conducted in accordance with standards of the Public Company Accounting Oversight Board (United States).

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-2

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

<u>Report of Independent Registered Public Accounting Firm</u>

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, because of the effect of [*material weakness identified in management's assessment*], based on [*Identify criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that 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 following material weakness has been identified and included in management's assessment. [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.[1/]

[*Opinion paragraph*]

In our opinion, management's assessment that W Company did not maintain effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control*

[1/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting, as described in paragraph 196.

criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-3

ILLUSTRATIVE REPORT EXPRESSING A QUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND A QUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

Except as described below, we conducted our audit in accordance the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Explanatory paragraph that describes scope limitation*]

A material weakness is a control deficiency, or combination of control deficiencies, that 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 following material weakness has been identified and included in management's assessment.[1/] Prior to December 20, 20X3, W Company had an inadequate system for recording cash receipts, which could have prevented the Company from recording cash receipts on accounts receivable completely and properly. Therefore, cash received could have been diverted for unauthorized use, lost, or otherwise not properly recorded to accounts receivable. We believe this condition was a material weakness in the design or operation of the internal control of W Company in effect prior to December 20, 20X3. Although the Company implemented a new cash receipts system on December 20, 20X3, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

[1/] If the auditor has identified a material weakness that is not included in management's assessment, add the following wording to the report: "In addition, we have identified the following material weakness that has not been identified as a material weakness in management's assessment."

In our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, except for the effect of matters we might have discovered had we been able to examine evidence about the effectiveness of the new cash receipts system, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-4

ILLUSTRATIVE REPORT DISCLAIMING AN OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND DISCLAIMING AN OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We were engaged to audit management's assessment included in the accompanying [*title of management's report*] that W Company maintained effective internal control over financial reporting as of December 31, 20X3 based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting.

[*Omit scope paragraph*]

[*Explanatory paragraph that describes scope limitation*][1/]

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or

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1/ If, through the limited procedures performed, the auditor concludes that a material weakness exists, the auditor should add the definition of material weakness (as provided in paragraph 10) to the explanatory paragraph. In addition, the auditor should include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.

timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

Since management [*describe scope restrictions*] and we were unable to apply other procedures to satisfy ourselves as to the effectiveness of the company's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion either on management's assessment or on the effectiveness of the company's internal control over financial reporting.

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-5

ILLUSTRATIVE REPORT EXPRESSING AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT REFERS TO THE REPORT OF OTHER AUDITORS AS A BASIS, IN PART, FOR THE AUDITOR'S OPINION AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20X3. The effectiveness of B Company's internal control over financial reporting was audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, based on our audit and the report of the other auditors, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, based on our audit and the report of the other auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Explanatory paragraph*]

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting*] expressed [*include nature of opinion*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-6

ILLUSTRATIVE REPORT EXPRESSING AN ADVERSE OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN ADVERSE OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF THE EXISTENCE OF A MATERIAL WEAKNESS

<u>Report of Independent Registered Public Accounting Firm</u>

[*Introductory paragraph*]

We have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[*Scope paragraph*]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Explanatory paragraph*]

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We have identified the following material weakness that has not been identified as a material weakness in management's assessment [*Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.*] This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of this report on internal control*] on those financial statements.[1/]

[*Opinion paragraph*]

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is not fairly stated, in all material respects, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on

[1/] Modify this sentence when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting.

[*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-7

ILLUSTRATIVE COMBINED REPORT EXPRESSING AN UNQUALIFIED OPINION ON FINANCIAL STATEMENTS, AN UNQUALIFIED OPINION ON MANAGEMENT'S ASSESSMENT OF THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING AND AN UNQUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X3 and 20X2, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X3. We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X3 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. Furthermore, in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*Identify control criteria,* f*or example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

APPENDIX B

Additional Performance Requirements and Directions; Extent-of-Testing Examples

Tests to be Performed When a Company Has Multiple Locations or Business Units

B1. To determine the locations or business units for performing audit procedures, the auditor should evaluate their relative financial significance and the risk of material misstatement arising from them. In making this evaluation, the auditor should identify the locations or business units that are individually important, evaluate their documentation of controls, and test controls over significant accounts and disclosures. For locations or business units that contain specific risks that, by themselves, could create a material misstatement, the auditor should evaluate their documentation of controls and test controls over the specific risks.

B2. The auditor should determine the other locations or business units that, when aggregated, represent a group with a level of financial significance that could create a material misstatement in the financial statements. For that group, the auditor should determine whether there are company-level controls in place. If so, the auditor should evaluate the documentation and test such company-level controls. If not, the auditor should perform tests of controls at some of the locations or business units.

B3. No further work is necessary on the remaining locations or businesses, provided that they are not able to create, either individually or in the aggregate, a material misstatement in the financial statements.

Locations or Business Units That Are Financially Significant

B4. Because of the importance of financially significant locations or business units, the auditor should evaluate management's documentation of and perform tests of controls over all relevant assertions related to significant accounts and disclosures at each financially significant location or business unit, as discussed in paragraphs 83 through 105. Generally, a relatively small number of locations or business units will encompass a large portion of a company's operations and financial position, making them financially significant.

B5. In determining the nature, timing, and extent of testing at the individual locations or business units, the auditor should evaluate each entity's involvement, if any, with a central processing or shared service environment.

Locations or Business Units That Involve Specific Risks

B6. Although a location or business unit might not be individually financially significant, it might present specific risks that, by themselves, could create a material misstatement in the company's financial statements. The auditor should test the controls over the specific risks that could create a material misstatement in the company's financial statements. The auditor need not test controls over all relevant assertions related to all significant accounts at these locations or business units. For example, a business unit responsible for foreign exchange trading could expose the company to the risk of material misstatement, even though the relative financial significance of such transactions is low.

Locations or Business Units That Are Significant Only When Aggregated with Other Locations and Business Units

B7. In determining the nature, timing, and extent of testing, the auditor should determine whether management has documented and placed in operation company-level controls (See paragraph 53) over individually unimportant locations and business units that, when aggregated with other locations or business units, might have a high level of financial significance. A high level of financial significance could create a greater than remote risk of material misstatement of the financial statements.

B8. For the purposes of this evaluation, company-level controls are controls management has in place to provide assurance that appropriate controls exist throughout the organization, including at individual locations or business units.

B9. The auditor should perform tests of company-level controls to determine whether such controls are operating effectively. The auditor might conclude that he or she cannot evaluate the operating effectiveness of such controls without visiting some or all of the locations or business units.

B10. If management does not have company-level controls operating at these locations and business units, the auditor should determine the nature, timing, and extent of procedures to be performed at each location, business unit, or combination of locations and business units. When determining the locations or business units to visit and the controls to test, the auditor should evaluate the following factors:

- The relative financial significance of each location or business unit.
- The risk of material misstatement arising from each location or business unit.
- The similarity of business operations and internal control over financial reporting at the various locations or business units.
- The degree of centralization of processes and financial reporting applications.

- The effectiveness of the control environment, particularly management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations or business units. An ineffective control environment over the locations or business units might constitute a material weakness.

- The nature and amount of transactions executed and related assets at the various locations or business units.

- The potential for material unrecognized obligations to exist at a location or business unit and the degree to which the location or business unit could create an obligation on the part of the company.

- Management's risk assessment process and analysis for excluding a location or business unit from its assessment of internal control over financial reporting.

B11. Testing company-level controls is not a substitute for the auditor's testing of controls over a large portion of the company's operations or financial position. If the auditor cannot test a large portion of the company's operations and financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting.

> Note: The evaluation of whether controls over a large portion of the company's operations or financial position have been tested should be made at the overall level, not at the individual significant account level.

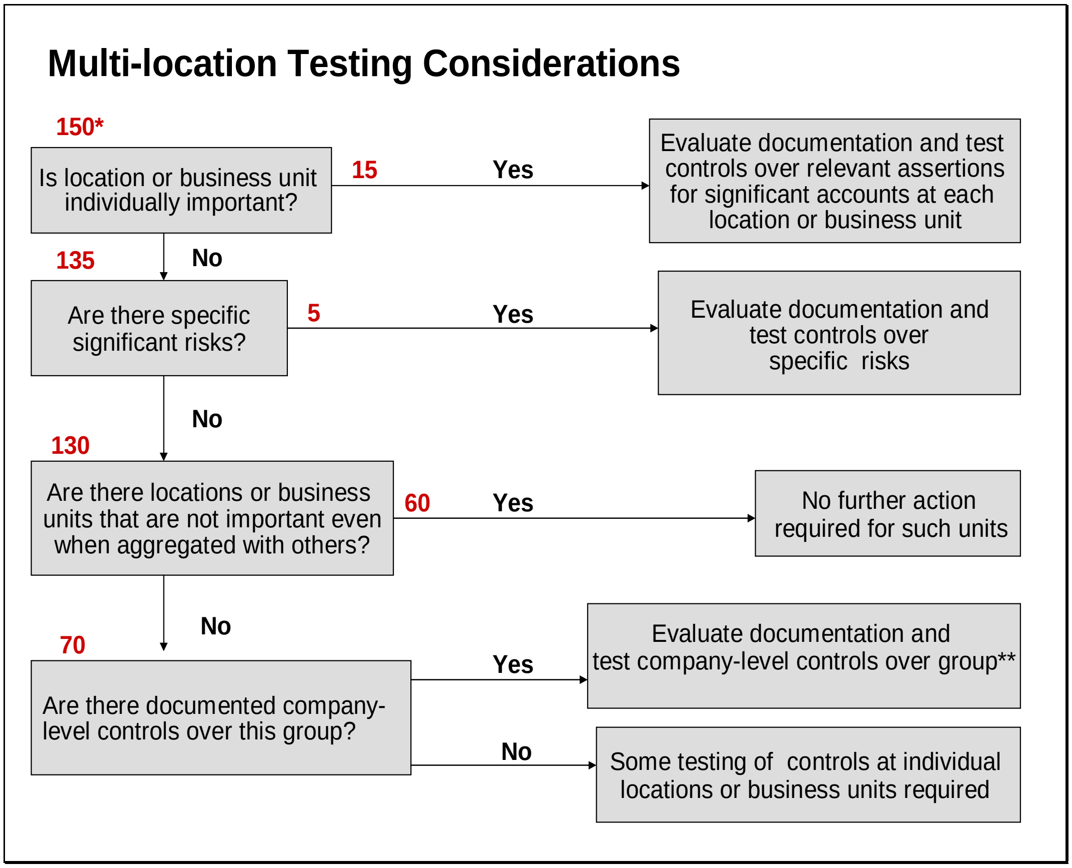
Locations and Business Units That Do Not Require Testing

B12. No testing is required for locations or business units that individually, and when aggregated with others, could not result in a material misstatement to the financial statements.

Multi-Location Testing Considerations Flowchart

B13. Illustration B-1 depicts how to apply the directions in this section to a hypothetical company with 150 locations or business units, along with the auditor's testing considerations for those locations or business units.

Illustration B-1



* Numbers represent number of locations affected.
** See paragraph B7.

Special Situations

B14. The scope of the evaluation of the company's internal control over financial reporting should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The auditor should consider this multiple locations discussion in determining whether it will be necessary to test controls at these entities or operations.

B15. For equity method investments, the evaluation of the company's internal control over financial reporting should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The evaluation ordinarily would not extend to controls at the equity method investee.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner and report without reference to the limitation in scope. However, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure should be modified.

B17. For example, for entities that are consolidated or proportionately consolidated, the evaluation of the company's internal control over financial reporting should include controls over significant accounts and processes that exist at the consolidated or proportionately consolidated entity. In some instances, however, such as for some variable interest entities as defined in Financial Accounting Standards Board Interpretation No. 46, *Consolidation of Variable Interest Entities,* management might not be able to obtain the information necessary to make an assessment because it does not have the ability to control the entity. If management is allowed to limit its assessment by excluding such entities,[1/] the auditor may limit the audit in the same manner and report without reference to the limitation in scope. In this case, the evaluation of the company's internal control over financial reporting should include evaluation of controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the entity's income or loss, the investment balance, adjustments to the income or loss and investment balances, and related disclosures. However, the auditor should evaluate the reasonableness of management's conclusion that it does not have the ability to obtain the necessary

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[1/] It is our understanding that the SEC Staff may conclude that management can limit the scope of its assessment if it does not have the authority to affect, and therefore cannot assess, the controls in place over certain amounts. This would relate to entities that are consolidated or proportionately consolidated when the issuer does not have sufficient control over the entity to assess and affect controls. If management's report on its assessment of the effectiveness of internal control over financial reporting is limited in that manner, the SEC staff may permit the company to disclose this fact as well as information about the magnitude of the amounts included in the financial statements from entities whose controls cannot be assessed. This disclosure would be required in each filing, but outside of management's report on its assessment of the effectiveness of internal control over financial reporting.

information as well as the appropriateness of any required disclosure related to such a limitation.

Use of Service Organizations

B18. AU sec. 324, *Service Organizations,* applies to the audit of financial statements of a company that obtains services from another organization that are part of its information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting. Further, although AU sec. 324 was designed to address auditor-to-auditor communications as part of the audit of financial statements, it also is appropriate for management to apply the relevant concepts described in that standard to its assessment of internal control over financial reporting.

B19. Paragraph .03 of AU sec. 324 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, management should consider the activities of the service organization in making its assessment of internal control over financial reporting, and the auditor should consider the activities of the service organization in determining the evidence required to support his or her opinion.

> Note: The use of a service organization does not reduce management's responsibility to maintain effective internal control over financial reporting.

B20. Paragraphs .07 through .16 in AU sec. 324 describe the procedures that management and the auditor should perform with respect to the activities performed by the service organization. The procedures include:

a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and

b. Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively.

B21. Evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively may be obtained by following the procedures described in paragraph .12 of AU sec. 324. These procedures include:

a. Performing tests of the user organization's controls over the activities of the service organization (for example, testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).

b. Performing tests of controls at the service organization.

c. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

   Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in paragraph .24b of AU sec. 324). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in paragraph .24a of AU sec. 324) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, management and the auditor should evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

B22. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, management and the auditor may evaluate whether this report provides sufficient evidence to support the assessment and opinion, respectively. In evaluating whether such a service auditor's report provides sufficient evidence, management and the auditor should consider the following factors:

- The time period covered by the tests of controls and its relation to the date of management's assessment,

- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls,

- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements as described in paragraph .16 of AU sec. 324.

B23. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures. For example, completeness of processing payroll transactions might depend on the company's validation that all payroll records sent to the service organization were processed by checking a control total.

B24. In determining whether the service auditor's report provides sufficient evidence to support management's assessment and the auditor's opinion, management and the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors.*

B25. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should determine whether management has performed procedures to evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should consider whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization that management has not identified.

B26. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following factors. As these factors increase in significance, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment,
- The significance of the activities of the service organization,

- Whether there are errors that have been identified in the service organization's processing, and

- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

B27. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures may include:

- Evaluating the procedures performed by management and the results of those procedures.

- Contacting the service organization, through the user organization, to obtain specific information.

- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.

- Visiting the service organization and performing such procedures.

B28. Based on the evidence obtained, management and the auditor should determine whether they have obtained sufficient evidence to obtain the reasonable assurance necessary for their assessment and opinion, respectively.

B29. The auditor should not refer to the service auditor's report when expressing an opinion on internal control over financial reporting.

Examples of Extent-of-Testing Decisions

B30. As discussed throughout this standard, determining the effectiveness of a company's internal control over financial reporting includes evaluating the design and operating effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Paragraphs 88 through 107 provide the auditor with directions about the nature, timing, and extent of testing of the design and operating effectiveness of internal control over financial reporting.

B31. Examples B-1 through B-4 illustrate how to apply this information in various situations. These examples are for illustrative purposes only.

Example B-1 – ***Daily Programmed Application Control and Daily Information Technology-Dependent Manual Control***

The auditor has determined that cash and accounts receivable are significant accounts to the audit of XYZ Company's internal control over financial reporting. Based on discussions with company personnel and review of company documentation, the auditor learned that the company had the following procedures in place to account for cash received in the lockbox:

a. The company receives a download of cash receipts from the banks.

b. The information technology system applies cash received in the lockbox to individual customer accounts.

c. Any cash received in the lockbox and not applied to a customer's account is listed on an exception report (Unapplied Cash Exception Report).

- Therefore, the application of cash to a customer's account is a programmed application control, while the review and follow-up of unapplied cash from the exception report is a manual control.

To determine whether misstatements in cash (existence assertion) and accounts receivable (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the controls provided by the system in the daily reconciliation of lock box receipts to customer accounts, as well as the control over reviewing and resolving unapplied cash in the Unapplied Cash Exception Report.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

- Identified, through discussion with company personnel, the software used to receive the download from the banks and to process the transactions and determined that the banks supply the download software.

  -- The company uses accounting software acquired from a third-party supplier. The software consists of a number of modules. The client modifies the software only for upgrades supplied by the supplier.

- Determined, through further discussion with company personnel, that the cash module operates the lockbox functionality and the posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agreed this information to the supplier's documentation.

- Identified, through discussions with company personnel and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of these programs and agreed them to the original installation date of the application.

- Identified the objectives of the programs to be tested. The auditor wanted to determine whether only appropriate cash items are posted to customers' accounts and matched to customer number, invoice number, amount, etc., and that there is a listing of inappropriate cash items (that is, any of the above items not matching) on the exception report.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken) and logical access (for example, data file access to the file downloaded from the banks and user access to the cash and accounts receivable modules) and concluded that they were operating effectively.

To determine whether such programmed controls were operating effectively, the auditor performed a walkthrough in the month of July. The computer controls operate in a systematic manner, therefore, the auditor concluded that it was sufficient to perform a walkthrough for only the one item. During the walkthrough, the auditor performed and documented the following items:

a. Selected one customer and agreed the amount billed to the customer to the cash received in the lockbox.

b. Agreed the total of the lockbox report to the posting of cash receipts in the general ledger.

c. Agreed the total of the cash receipt download from the bank to the lockbox report and supporting documentation.

d. Selected one customer's remittance and agreed amount posted to the customer's account in the accounts receivable subsidiary ledger.

To test the detective control of review and follow up on the Daily Unapplied Cash Exception Report, the auditor:

a. Made inquiries of company personnel. To understand the procedures in place to ensure that all unapplied items are resolved, the time frame in which such resolution takes place, and whether unapplied items are handled properly within the system, the auditor discussed these matters with the employee responsible for reviewing and resolving the Daily Unapplied Cash Exception Reports. The auditor learned that, when items appear on the Daily-Unapplied Cash Exception Report, the employee must manually enter the correction into the system. The employee typically performs the resolution procedures the next business day. Items that typically appear on the Daily Unapplied Cash Exception Report relate to payments made by a customer without reference to an invoice number/purchase order number or to underpayments of an invoice due to quantity or pricing discrepancies.

b. Observed personnel performing the control**.** The auditor then observed the employee reviewing and resolving a Daily Unapplied Cash Exception Report. The day selected contained four exceptions – three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy.

- For the pricing discrepancy, the employee determined, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer's invoice. The employee resolved the pricing discrepancy, determined which invoices were being paid, and entered a correction into the system to properly apply cash to the customer's account and reduce accounts receivable and sales accounts for the amount of the price break.

c. Reperformed the control. Finally, the auditor selected 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperformed the follow-up procedures that the employee performed. For instance, the auditor inspected the documents and sources of information used in the follow-up and determined that the transaction was properly corrected in the system. The auditor also scanned other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

Because the tests of controls were performed at an interim date, the auditor had to determine whether there were any significant changes in the controls from interim to year-end. Therefore, the auditor asked company personnel about the procedures in place at year-end. Such procedures had not changed from the interim period, therefore, the auditor observed that the controls were still in place by scanning Daily Unapplied Cash Exception Reports to determine the control was performed on a timely basis during the period from September to year-end.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

Example B-2 – ***Monthly Manual Reconciliation***

The auditor determined that accounts receivable is a significant account to the audit of XYZ Company's internal control over financial reporting. Through discussions with company personnel and review of company documentation, the auditor learned that company personnel reconcile the accounts receivable subsidiary ledger to the general ledger on a monthly basis. To determine whether misstatements in accounts receivable (existence, valuation, and completeness) would be detected on a timely basis, the auditor decided to test the control provided by the monthly reconciliation process.

Nature, Timing, and Extent of Procedures. The auditor tested the company's reconciliation control by selecting a sample of reconciliations based upon the number of accounts, the dollar value of the accounts, and the volume of transactions affecting the account. Because the auditor considered all other receivable accounts immaterial, and because such accounts had only minimal transactions flowing through them, the auditor decided to test only the reconciliation for the trade accounts receivable account. The auditor elected to perform the tests of controls over the reconciliation process in conjunction with the auditor's substantive procedures over the accounts receivable confirmation procedures, which were performed in July.

To test the reconciliation process, the auditor:

a. Made inquiries of personnel performing the control. The auditor asked the employee performing the reconciliation a number of questions, including the following:

- What documentation describes the account reconciliation process?
- How long have you been performing the reconciliation work?
- What is the reconciliation process for resolving reconciling items?
- How often are the reconciliations formally reviewed and signed off?
- If significant issues or reconciliation problems are noticed, to whose attention do you bring them?
- On average, how many reconciling items are there?
- How are old reconciling items treated?
- If need be, how is the system corrected for reconciling items?
- What is the general nature of these reconciling items?

b. Observed the employee performing the control**.** The auditor observed the employee performing the reconciliation procedures. For nonrecurring reconciling items, the auditor observed whether each item included a clear explanation as to its nature, the action that had been taken to resolve it, and whether it had been resolved on a timely basis.

c. Reperformed the control**.** Finally, the auditor inspected the reconciliations and reperfomed the reconciliation procedures. For the May and July reconciliations, the auditor traced the reconciling amounts to the source documents on a test basis. The only reconciling item that appeared on these reconciliations was cash received in the lockbox the previous day that had not been applied yet to the customer's account. The auditor pursued the items in each month's reconciliation to determine that the reconciling item cleared the following business day. The auditor also scanned through the file of all reconciliations prepared during the year and noted that they had been performed on a timely basis. To determine that the company had not made significant changes in its reconciliation control procedures from interim to year-end, the auditor made inquiries of company personnel and determined that such procedures had not changed from interim to year-end. Therefore, the auditor verified that controls were still in place by scanning the monthly account reconciliations to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the reconciliation control was operating effectively as of year-end.

Example B-3 – ***Daily Manual Preventive Control***

The auditor determined that cash and accounts payable were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that company personnel make a cash disbursement only after they have matched the vendor invoice to the receiver and purchase order. To determine whether misstatements in cash (existence) and accounts payable (existence, valuation, and completeness) would be prevented on a timely basis, the auditor tested the control over making a cash disbursement only after matching the invoice with the receiver and purchase.

Nature, Timing, and Extent of Procedures. On a haphazard basis, the auditor selected 25 disbursements from the cash disbursement registers from January through September. In this example, the auditor deemed a test of 25 cash disbursement transactions an appropriate sample size because the auditor was testing a manual control performed as part of the routine processing of cash disbursement transactions through the system. Furthermore, the auditor expected no errors based on the results of company-level tests performed earlier. [If, however, the auditor had encountered a control exception, the auditor would have attempted to identify the root cause of the exception and tested an additional number of items. If another control exception had been noted, the auditor would have decided that this control was not effective. As a result, the auditor would have decided to increase the extent of substantive procedures to be performed in connection with the financial statement audit of the cash and accounts payable accounts.]

a. After obtaining the related voucher package, the auditor examined the invoice to see if it included the signature or initials of the accounts payable clerk, evidencing the clerk's performance of the matching control. However, a signature on a voucher package to indicate signor approval does not necessarily mean that the person carefully reviewed it before signing. The voucher package may have been signed based on only a cursory review, or without any review.

b. The auditor decided that the quality of the evidence regarding the effective operation of the control evidenced by a signature or initials was not sufficiently persuasive to ensure that the control operated effectively during the test period. In order to obtain additional evidence, the auditor reperformed the matching control corresponding to the signature, which included examining the invoice to determine that (a) its items matched to the receiver and purchase order and (b) it was mathematically accurate.

Because the auditor performed the tests of controls at an interim date, the auditor updated the testing through the end of the year (initial tests are through September to December) by asking the accounts payable clerk whether the control was still in place and operating effectively. The auditor confirmed that understanding by performing a walkthrough of one transaction in December.

Based on the auditor's procedures, the auditor concluded that the control over making a cash disbursement only after matching the invoice with the receiver and purchase was operating effectively as of year-end.

Example B-4 – ***Programmed Prevent Control and Weekly Information Technology-Dependent Manual Detective Control***

The auditor determined that cash, accounts payable, and inventory were significant accounts to the audit of the company's internal control over financial reporting. Through discussions with company personnel, the auditor learned that the company's computer system performs a three-way match of the receiver, purchase order, and invoice. If there are any exceptions, the system produces a list of unmatched items that employees review and follow up on weekly.

In this case, the computer match is a programmed application control, and the review and follow-up of the unmatched items report is a detective control. To determine whether misstatements in cash (existence) and accounts payable/inventory (existence, valuation, and completeness) would be prevented or detected on a timely basis, the auditor decided to test the programmed application control of matching the receiver, purchase order, and invoice as well as the review and follow-up control over unmatched items.

Nature, Timing, and Extent of Procedures. To test the programmed application control, the auditor:

a. Identified, through discussion with company personnel, the software used to process receipts and purchase invoices. The software used was a third-party package consisting of a number of modules.

b. Determined, through further discussion with company personnel, that they do not modify the core functionality of the software, but sometimes make personalized changes to reports to meet the changing needs of the business. From previous experience with the company's information technology environment, the auditor believes that such changes are infrequent and that information technology process controls are well established.

c. Established, through further discussion, that the inventory module operated the receiving functionality, including the matching of receipts to open purchase orders. Purchase invoices were processed in the accounts payable module, which matched them to an approved purchase order against which a valid receipt has been made. That module also produced the Unmatched Items Report, a standard report supplied with the package to which the company has not made any modifications. That information was agreed to the supplier's documentation and to documentation within the information technology department.

d. Identified, through discussions with the client and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of the programs and agreed them to the original installation date of the application. The compilation date of the report code was agreed to documentation held within the information technology department relating to the last change made to that report (a change in formatting).

e. Identified the objectives of the programs to be tested. The auditor wanted to determine whether appropriate items are received (for example, match a valid purchase order), appropriate purchase invoices are posted (for example, match a valid receipt and purchase order, non-duplicate reference numbers) and unmatched items (for example, receipts, orders or invoices) are listed on the exception report. The auditor then reperformed all those variations in the packages on a test-of-one basis to determine that the programs operated as described.

In addition, the auditor had evaluated and tested general computer controls, including program changes (for example, confirmation that no unauthorized changes are undertaken to the functionality and that changes to reports are appropriately authorized, tested, and approved before being applied) and logical access (for example, user access to the inventory and accounts payable modules and access to the area on the system where report code is maintained), and concluded that they were operating effectively. (Since the computer is deemed to operate in a systematic manner, the auditor concluded that it was sufficient to perform a walkthrough for only the one item.)

To determine whether the programmed control was operating effectively, the auditor performed a walkthrough in the month of July. As a result of the walkthrough, the auditor performed and documented the following items:

a. Receiving cannot record the receipt of goods without matching the receipt to a purchase order on the system. The auditor tested that control by attempting to record the receipt of goods into the system without a purchase order. However, the system did not allow the auditor to do that. Rather, the system produced an error message stating that the goods could not be recorded as received without an active purchase order.

b. An invoice will not be paid unless the system can match the receipt and vendor invoice to an approved purchase order. The auditor tested that control by attempting to approve an invoice for payment in the system. The system did not allow the auditor to do that. Rather, it produced an error message indicating that invoices could not be paid without an active purchase order and receiver.

c. The system disallows the processing of invoices with identical vendor and identical invoice numbers. In addition, the system will not allow two invoices to be processed against the same purchase order unless the sum of the invoices is less than the amount approved on the purchase order. The auditor tested that control by attempting to process duplicate invoices. However, the system produced an error message indicating that the invoice had already been processed.

d. The system compares the invoice amounts to the purchase order. If there are differences in quantity/extended price, and such differences fall outside a pre-approved tolerance, the system does not allow the invoice to be processed. The auditor tested that control by attempting to process an invoice that had quantity/price differences outside the tolerance level of 10 pieces, or $1,000. The system produced an error message indicating that the invoice could not be processed because of such differences.

e. The system processes payments only for vendors established in the vendor master file. The auditor tested that control by attempting to process an invoice for a vendor that was not established in the vendor master file. However, the system did not allow the payment to be processed.

f. The auditor tested user access to the vendor file and whether such users can make modifications to such file by attempting to access and make changes to the vendor tables. However, the system did not allow the auditor to perform that function and produced an error message stating that the user was not authorized to perform that function.

g. The auditor verified the completeness and accuracy of the Unmatched Items Report by verifying that one unmatched item was on the report and one matched item was not on the report.

Note: It is inadvisable for the auditor to have uncontrolled access to the company's systems in his or her attempts described above to record the receipt of goods without a purchase order, approve an invoice for payment, process duplicate invoices, etc. These procedures ordinarily are performed in the presence of appropriate company personnel so that they can be notified immediately of any breach to their systems.

To test the detect control of review and follow up on the Unmatched Items Report, the auditor performed the following procedures in the month of July for the period January to July:

a. Made inquiries of company personnel. To gain an understanding of the procedures in place to ensure that all unmatched items are followed-up properly and that corrections are made on a timely basis, the auditor made inquiries of the employee who follows up on the weekly-unmatched items reports. On a weekly basis, the control required the employee to review the Unmatched Items Report to determine why items appear on it. The employee's review includes proper follow-up on items, including determining whether:

- All open purchase orders are either closed or voided within an acceptable amount of time.
- The requesting party is notified periodically of the status of the purchase order and the reason for its current status.
- The reason the purchase order remains open is due to incomplete shipment of goods and, if so, whether the vendor has been notified.
- There are quantity problems that should be discussed with purchasing.

b. Observed the performance of the control. The auditor observed the employee performing the control for the Unmatched Items Reports generated during the first week in July.

c. Reperformed the control. The auditor selected five weekly Unmatched Items Reports, selected several items from each, and reperformed the procedures that the employee performed. The auditor also scanned other Unmatched Items Reports to determine that the control was performed throughout the period of intended reliance.

To determine that the company had not made significant changes in their controls from interim to year-end, the auditor discussed with company personnel the procedures in place for making such changes. Since the procedures had not changed from interim to year-end, the auditor observed that the controls were still in place by scanning the weekly Unmatched Items Reports to determine that the control was performed on a timely basis during the interim to year-end period.

Based on the auditor's procedures, the auditor concluded that the employee was clearing exceptions in a timely manner and that the control was operating effectively as of year-end.

APPENDIX C

Safeguarding of Assets

C1. *Safeguarding of assets* is defined in paragraph 7 as those policies and procedures that "provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements." This definition is consistent with the definition provided in the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's Addendum, *Reporting to External Parties*, which provides the following definition of internal control over safeguarding of assets:

> Internal control over safeguarding of assets against unauthorized acquisition, use or disposition is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements. Such internal control can be judged effective if the board of directors and management have reasonable assurance that unauthorized acquisition, use or disposition of the entity's assets that could have a material effect on the financial statements is being prevented or detected on a timely basis.

C2. For example, a company has safeguarding controls over inventory tags (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its quarterly and annual financial reporting dates. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely.

C3. Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. The COSO Addendum also indicates that to the extent that such losses might occur, controls over financial reporting are effective if they provide reasonable assurance that those losses are properly reflected in the financial statements, thereby alerting financial statement users to consider the need for action.

> Note: *Properly reflected* in the financial statements includes both correctly recording the loss and adequately disclosing the loss.

C4. Material weaknesses relating to controls over the safeguarding of assets would only exist when the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

C5. Furthermore, management's plans that could potentially affect financial reporting in future periods are not controls. For example, a company's business continuity or contingency planning has no effect on the company's current abilities to initiate, authorize, record, process, or report financial data. Therefore, a company's business continuity or contingency planning is not part of internal control over financial reporting.

C6. The COSO Addendum provides further information about safeguarding of assets as it relates to internal control over financial reporting.

APPENDIX D

Examples of Significant Deficiencies and Material Weaknesses

D1. Paragraph 8 of this standard defines a control deficiency. Paragraphs 9 and 10 go on to define a significant deficiency and a material weakness, respectively.

- Paragraphs 22 through 23 of this standard discuss materiality in an audit of internal control over financial reporting, and paragraphs 130 through 140 provide additional direction on evaluating deficiencies in internal control over financial reporting.

- The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only.

Example D-1***— Reconciliations of Intercompany Accounts Are Not Performed on a Timely Basis***

Scenario A – Significant Deficiency. The company processes a significant number of routine intercompany transactions on a monthly basis. Individual intercompany transactions are not material and primarily relate to balance sheet activity, for example, cash transfers between business units to finance normal operations.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure performance of these procedures. As a result, detailed reconciliations of intercompany accounts are not performed on a timely basis. Management does perform monthly procedures to investigate selected large-dollar intercompany account differences. In addition, management prepares a detailed monthly variance analysis of operating expenses to assess their reasonableness.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual intercompany transactions are not material, and the compensating controls operating monthly should detect a material misstatement. Furthermore, the transactions are primarily restricted to balance sheet accounts. However, the compensating detective controls are designed only to detect material misstatements. The controls do not address the detection of misstatements that are more than inconsequential but less than material. Therefore, the likelihood that a misstatement that was more than inconsequential, but less than material, could occur is more than remote.

Scenario B - Material Weakness. The company processes a significant number of intercompany transactions on a monthly basis. Intercompany transactions relate to a wide range of activities, including transfers of inventory with intercompany profit between business units, allocation of research and development costs to business units and corporate charges. Individual intercompany transactions are frequently material.

A formal management policy requires monthly reconciliation of intercompany accounts and confirmation of balances between business units. However, there is not a process in place to ensure that these procedures are performed on a consistent basis. As a result, reconciliations of intercompany accounts are not performed on a timely basis, and differences in intercompany accounts are frequent and significant. Management does not perform any alternative controls to investigate significant intercompany account differences.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual intercompany transactions are frequently material and relate to a wide range of activities. Additionally, actual unreconciled differences in intercompany accounts have been, and are, material. The likelihood of such a misstatement is more than remote because such misstatements have frequently occurred and compensating controls are not effective, either because they are not properly designed or not operating effectively. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Example D-2***—Modifications to Standard Sales Contract Terms Not Reviewed To Evaluate Impact on Timing and Amount of Revenue Recognition***

Scenario A – Significant Deficiency. The company uses a standard sales contract for most transactions. Individual sales transactions are not material to the entity. Sales personnel are allowed to modify sales contract terms. The company's accounting function reviews significant or unusual modifications to the sales contract terms, but does not review changes in the standard shipping terms. The changes in the standard shipping terms could require a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. The entity has experienced limited situations in which revenue has been inappropriately recorded in advance of shipment, but amounts have not been material.

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be more than inconsequential, but less than material, because individual sales transactions are not material and the compensating detective controls operating monthly and at the end of each financial reporting period should reduce the likelihood of a material misstatement going undetected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition. However, the compensating detective controls are only designed to detect material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur.

Scenario B - Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. The nature of the modifications can affect the timing and amount of revenue recognized. Individual sales transactions are frequently material to the entity, and the gross margin can vary significantly for each transaction.

The company does not have procedures in place for the accounting function to regularly review modifications to sales contract terms. Although management reviews gross margins on a monthly basis, the significant differences in gross margins on individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred, and the amounts have been material.

Based only on these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating detective controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is more than remote. Taken together, the magnitude and likelihood of misstatement of the financial statements resulting from this internal control deficiency meet the definition of a material weakness.

Scenario C – Material Weakness. The company has a standard sales contract, but sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These amounts are deducted by customers in paying their invoices and are recorded as outstanding balances on the accounts receivable aging. Although these amounts are individually insignificant, they are material in the aggregate and have occurred consistently over the past few years.

Based on only these facts, the auditor should determine that this deficiency represents a material weakness for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. The likelihood of material misstatement of the financial statements resulting from this internal control deficiency is more than remote (even assuming that the amounts were fully reserved for in the company's allowance for uncollectible accounts) due to the likelihood of material misstatement of the gross accounts receivable balance. Therefore, this internal control deficiency meets the definition of a material weakness.

Example D-3***—Identification of Several Deficiencies***

Scenario A – Material Weakness. During its assessment of internal control over financial reporting, management identified the following deficiencies. Based on the context in which the deficiencies occur, management and the auditor agree that these deficiencies individually represent significant deficiencies:

- Inadequate segregation of duties over certain information system access controls.
- Several instances of transactions that were not properly recorded in subsidiary ledgers; transactions were not material, either individually or in the aggregate.
- A lack of timely reconciliations of the account balances affected by the improperly recorded transactions.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons: Individually, these deficiencies were evaluated as representing a more than remote likelihood that a misstatement that is more than inconsequential, but less than material, could occur. However, each of these significant deficiencies affects the same set of accounts. Taken together, these significant deficiencies represent a more than remote likelihood that a material misstatement could occur and not be prevented or detected. Therefore, in combination, these significant deficiencies represent a material weakness.

Scenario B – Material Weakness. During its assessment of internal control over financial reporting, management of a financial institution identifies deficiencies in: the design of controls over the estimation of credit losses (a critical accounting estimate); the operating effectiveness of controls for initiating, processing, and reviewing adjustments to the allowance for credit losses; and the operating effectiveness of controls designed to prevent and detect the improper recognition of interest income. Management and the auditor agree that, in their overall context, each of these deficiencies individually represent a significant deficiency.

In addition, during the past year, the company experienced a significant level of growth in the loan balances that were subjected to the controls governing credit loss estimation and revenue recognition, and further growth is expected in the upcoming year.

Based only on these facts, the auditor should determine that the combination of these significant deficiencies represents a material weakness for the following reasons:

- The balances of the loan accounts affected by these significant deficiencies have increased over the past year and are expected to increase in the future.
- This growth in loan balances, coupled with the combined effect of the significant deficiencies described, results in a more than remote likelihood that a material misstatement of the allowance for credit losses or interest income could occur.

Therefore, in combination, these deficiencies meet the definition of a material weakness.

APPENDIX E

BACKGROUND AND BASIS FOR CONCLUSIONS

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Introduction

E1. This appendix summarizes factors that the Public Company Accounting Oversight Board (the "Board") deemed significant in reaching the conclusions in the standard. This appendix includes reasons for accepting certain views and rejecting others.

Background

E2. Section 404(a) of the Sarbanes-Oxley Act of 2002 (the "Act"), and the Securities and Exchange Commission's (SEC) related implementing rules, require the 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(a) of the Act also requires management to include in the company's annual report to shareholders management's conclusion as a result of that assessment of whether the company's internal control over financial reporting is effective.

E3. Sections 103(a)(2)(A) and 404(b) of the Act direct the Board to establish professional standards governing the independent auditor's attestation and reporting on management's assessment of the effectiveness of internal control over financial reporting.

E4. The backdrop for the development of the Board's first major auditing standard was, of course, the spectacular audit failures and corporate malfeasance that led to the passage of the Act. Although all of the various components of the Act work together to help restore investor confidence and help prevent the types of financial reporting breakdowns that lead to the loss of investor confidence, Section 404 of the Act is certainly one of the most visible and tangible changes required by the Act.

E5. The Board believes that effective controls provide the foundation for reliable financial reporting. Congress believed this too, which is why the new reporting by management and the auditor on the effectiveness of internal control over financial reporting received such prominent attention in the Act. Internal control over financial reporting enhances a company's ability to produce fair and complete financial reports. Without reliable financial reports, making good judgments and decisions about a company becomes very difficult for anyone, including the board of directors, management, employees, investors, lenders, customers, and regulators. The auditor's reporting on management's assessment of the effectiveness of internal control over financial reporting provides users of that report with important assurance about the reliability of the company's financial reporting.

E6. The Board's efforts to develop this standard were an outward expression of the Board's mission, "to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports." As part of fulfilling that mission as it relates to this standard, the Board considered the advice that respected groups had offered to other auditing standards setters in the past. For example, the Public Oversight Board's Panel on Audit Effectiveness recommended that "auditing standards need to provide clear, concise and definitive imperatives for auditors to follow."[1/] As another example, the International Organization of Securities Commissioners advised the International Auditing and Assurance Standards Board "that the IAASB must take care to avoid language that could inadvertently encourage inappropriate shortcuts in audits, at a time when rigorous audits are needed more than ever to restore investor confidence."[2/]

E7. The Board understood that, to effectively fulfill its mission and for this standard to achieve its ultimate goal of restoring investor confidence by increasing the reliability of public company financial reporting, the Board's standard must contain clear directions to the auditor consistent with investor's expectations that the reliability of financial reporting be significantly improved. Just as important, the Board recognized that this standard must appropriately balance the costs to implement the standard's directions with the benefits of achieving these important goals. As a result, all of the Board's decisions about this standard were guided by the additional objective of creating a rational relationship between costs and benefits.

E8. When the Board adopted its interim attestation standards in Rule 3300T on an initial, transitional basis, the Board adopted a pre-existing standard governing an auditor's attestation on internal control over financial reporting.[3/] As part of the Board's process of evaluating that pre-existing standard, the Board convened a public roundtable discussion on July 29, 2003 to discuss issues and hear views related to

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[1/] Panel on Audit Effectiveness, *Report and Recommendations,* sec. 2.228 (August 31, 2000).

[2/] April 8, 2003 comment letter from the International Organization of Securities Commissions to the International Auditing and Assurance Standards Board regarding the proposed international standards on audit risk (Amendment to ISA 200, "Objective and Principles Governing an Audit of Financial Statements;" proposed ISAs, "Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement;" "Auditor's Procedures in Response to Assessed Risks;" and "Audit Evidence").

[3/] The pre-existing standard is Chapter 5, "*Reporting on an Entity's Internal Control Over Financial Reporting*" of Statement on Standards for Attestation Engagements (SSAE) No. 10*, Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards,* Vol. 1, AT sec. 501). SSAE No. 10 has been codified into AICPA *Professional Standards*, Volume 1, as AT sections 101 through 701.

reporting on internal control over financial reporting. The participants at the roundtable included representatives from public companies, accounting firms, investor groups, and regulatory organizations. Based on comments made at the roundtable, advice from the Board's staff, and other input the Board received, the Board determined that the pre-existing standard governing an auditor's attestation on internal control over financial reporting was insufficient for effectively implementing the requirements of Section 404 of the Act and for the Board to appropriately discharge its standard-setting obligations under Section 103(a) of the Act. In response, the Board developed and issued, on October 7, 2003, a proposed auditing standard titled, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements.*

E9. The Board received 189 comment letters on a broad array of topics from a variety of commenters, including auditors, investors, internal auditors, issuers, regulators, and others. Those comments led to changes in the standard, intended to make the requirements of the standard clearer and more operational. This appendix summarizes significant views expressed in those comment letters and the Board's responses.

Fundamental Scope of the Auditor's Work in an Audit of Internal Control over Financial Reporting

E10. The proposed standard stated that the auditor's objective in an audit of internal control over financial reporting was to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To render such an opinion, the proposed standard required the auditor to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's report. To obtain reasonable assurance, the auditor was required to evaluate both management's process for making its assessment and the effectiveness of internal control over financial reporting.

E11. Virtually all investors and auditors who submitted comment letters expressed support for this approach. Other commenters, primarily issuers, expressed concerns that this approach was contrary to the intent of Congress and, therefore, beyond what was specifically required by Section 404 of the Act. Further, issuers stated their views that this approach would lead to unnecessary and excessive costs. Some commenters in this group suggested the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and internal audit. Others acknowledged that the auditor would need to test at least some controls directly in addition to evaluating and testing management's assessment process. However, these commenters described various ways in which the auditor's own testing could be significantly reduced from the scope expressed in the proposed standard. For instance, they proposed that the auditor could be permitted to use the work of management and others to a much greater degree; that the auditor could use a "risk analysis" to identify only a few controls to be tested; and a variety of other methods to curtail the extent of the auditor's work. Of those opposed to the scope, most cited their belief that the scope of work embodied in the standard would lead to a duplication of effort between management and the auditor which would needlessly increase costs without adding significant value.

E12. After considering the comments, the Board retained the approach described in the proposed standard. The Board concluded that the approach taken in the standard is consistent with the intent of Congress. Also, to provide the type of report, at the level of assurance called for in Sections 103 and 404, the Board concluded that the auditor must evaluate both management's assessment process and the effectiveness of internal control over financial reporting. Finally, the Board noted the majority of the cost to be borne by companies (and ultimately investors) results directly from the work the company will have to perform to maintain effective internal control over financial reporting and to comply with Section 404(a) of the Act. The cost of the auditor's work as described in this standard ultimately will represent a smaller portion of the total cost to companies of implementing Section 404.

E13. The Board noted that large, federally insured financial institutions have had a similar internal control reporting requirement for over ten years. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) has required, since 1993, managements of large financial institutions to make an assessment of internal control over financial reporting effectiveness and the institution's independent auditor to issue an attestation report on management's assessment.

E14. The attestation standards under which FDICIA engagements are currently performed are clear that, when performing an examination of management's assertion on the effectiveness of internal control over financial reporting (management's report on the assessment required by Section 404(a) of the Act must include a statement as to whether the company's internal control over financial reporting is effective), the auditor may express an opinion either on management's assertion (that is, whether management's assessment about the effectiveness of the internal control over financial reporting is fairly stated) or directly on the subject matter (that is, whether the internal control over financial reporting is effective) because the level of work that must be performed is the same in either case.

E15. The Board observed that Congress indicated an intent to require an examination level of work in Section 103(a) of the Act, which states, in part, that each registered public accounting firm shall:

> describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by Section 404(b), and present (in such report or in a separate report)—
>
> (I) the findings of the auditor from such testing;

(II) an evaluation of whether such internal control structure and procedures—

(aa) include maintenance of records that in reasonable detail accurately reflect the transactions and dispositions of the assets of the issuer;

(bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing. [emphasis added].

E16. The Board concluded that the auditor must test internal control over financial reporting directly, in the manner and extent described in the standard, to make the evaluation described in Section 103. The Board also interpreted Section 103 to provide further support that the intent of Congress was to require an opinion on the effectiveness of internal control over financial reporting.

E17. The Board concluded that the auditor must obtain a high level of assurance that the conclusion expressed in management's assessment is correct to provide an opinion on management's assessment. An auditing process restricted to evaluating what management has done would not provide the auditor with a sufficiently high level of assurance that management's conclusion is correct. Instead, it is necessary for the auditor to evaluate management's assessment process to be satisfied that management has an appropriate basis for its statement, or assertion, about the effectiveness of the company's internal control over financial reporting. It also is necessary for the auditor to directly test the effectiveness of internal control over financial reporting to be satisfied that management's conclusion is correct, and that management's assertion is fairly stated.

E18. This testing takes on added importance with the public nature of the internal control reporting. Because of the auditor's association with a statement by management that internal control over financial reporting is effective, it is reasonable for a user of the auditor's report to expect that the auditor tested the effectiveness of internal control over financial reporting. For the auditor to do otherwise would create an expectation gap, in which the assurance that the auditor obtained is less than what users reasonably expect.

E19. Auditors, investors, and the Federal bank regulators reaffirmed in their comment letters on the proposed auditing standard that the fundamental approach taken by the

Board was appropriate and necessary. Investors were explicit in their expectation that the auditor must test the effectiveness of controls directly in addition to evaluating management's assessment process. Investors further recognized that this kind of assurance would come at a price and expressed their belief that the cost of the anticipated benefits was reasonable. The federal banking regulators, based on their experience examining financial institutions' internal control assessments and independent auditors' attestation reports under FDICIA, commented that the proposed auditing standard was a significant improvement over the existing attestation standard.

Reference to Audit vs. Attestation

E20. The proposed standard referred to the attestation required by Section 404(b) of the Act as the *audit* of internal control over financial reporting instead of an *attestation* of management's assessment. The proposed standard took that approach both because the auditor's objective is to express an opinion on management's assessment of the effectiveness of internal control over financial reporting, just as the auditor's objective in an audit of the financial statements is to express an opinion on the fair presentation of the financial statements, and because the level of assurance obtained by the auditor is the same in both cases. Furthermore, the proposed standard described an *integrated* audit of the financial statements and internal control over financial reporting and allowed the auditor to express his or her opinions on the financial statements and on the effectiveness of internal control in separate reports or in a single, combined report.

E21. Commenters' views on this matter frequently were related to their views on whether the proposed scope of the audit was appropriate. Those who agreed that the scope in the proposed standard was appropriate generally agreed that referring to the engagement as an *audit* was appropriate. On the other hand, commenters who objected to the scope of work described in the proposed standard often drew an important distinction between an *audit* and an *attestation.* Because Section 404 calls for an *attestation*, they believed it was inappropriate to call the engagement anything else (or to mandate a scope that called for a more extensive level of work).

E22. Based, in part, on the Board's decisions about the scope of the audit of internal control over financial reporting, the Board concluded that the engagement should continue to be referred to as an "audit." This term emphasizes the nature of the auditor's objective and communicates that objective most clearly to report users. Use of this term also is consistent with the integrated approach described in the standard and the requirement in Section 404 of the Act that this reporting not be subject to a separate engagement.

E23. Because the Board's standard on internal control is an auditing standard, it is preferable to use the term *audit* to describe the engagement rather than the term *examination*, which is used in the attestation standards to describe an engagement designed to provide a high level of assurance.

E24. Finally, the Board believes that using the term *audit* helps dispel the misconception that an audit of internal control over financial reporting is a different level of service than an attestation of management's assessment of internal control over financial reporting.

Form of the Auditor's Opinion

E25. The proposed auditing standard required that the auditor's opinion in his or her report state whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria. However, the proposed standard also stated that nothing precluded the auditor from auditing management's assessment and opining directly on the effectiveness of internal control over financial reporting. This is because the scope of the work, as defined by the proposed standard, was the same, regardless of whether the auditor reports on management's assessment or directly on the effectiveness of internal control over financial reporting. The form of the opinion was essentially interchangeable between the two.

E26. However, if the auditor planned to issue other than an unqualified opinion, the proposed standard required the auditor to report directly on the effectiveness of the company's internal control over financial reporting rather than on management's assessment. The Board initially concluded that expressing an opinion on management's assessment, in these circumstances, did not most effectively communicate the auditor's conclusion that internal control was not effective. For example, if management expresses an adverse assessment because a material weakness exists at the date of management's assessment ("…internal control over financial reporting is not effective…") and the auditor expresses his or her opinion on management's assessment ("…management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects…"), a reader might not be clear about the results of the auditor's testing and about the auditor's conclusions. The Board initially decided that reporting directly on the effectiveness of the company's internal control over financial reporting better communicates to report users the effect of such conditions, because direct reporting more clearly states the auditor's conclusions about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described…, the Company's internal control over financial reporting is not effective.").

E27. A number of commenters were supportive of the model described in the previous paragraph, as they agreed with the Board's reasoning. However, several commenters believed that report users would be confused as to why the form of the auditor's opinion would be different in various circumstances. These commenters thought that the auditor's opinion should be consistently expressed in all reports. Several auditors recommended that auditors always report directly on the effectiveness of the company's internal control over financial reporting. They reasoned that the scope of the audit—which always would require the auditor to obtain reasonable assurance about whether the internal control over financial reporting was effective—would be more clearly communicated, in all cases, by the auditor reporting directly on the effectiveness of internal control over financial reporting. Other commenters suggested that the auditor always should express two opinions: one on management's assessment and one directly on the effectiveness of internal control over financial reporting. They believed the Act called for two opinions: Section 404 calls for an opinion on management's assessment, while Section 103 calls for an opinion directly on the effectiveness of internal control over financial reporting.

E28. The Board believes that the reporting model in the proposed standard is appropriate. However, the Board concluded that the expression of two opinions—one on management's assessment and one on the effectiveness of internal control over financial reporting—in all reports is a superior approach that balances the concerns of many different interested parties. This approach is consistent with the scope of the audit, results in more consistent reporting in differing circumstances, and makes the reports more easily understood by report users. Therefore, the standard requires that the auditor express two opinions in all reports on internal control over financial reporting.

Use of the Work of Others

E29. After giving serious consideration to a rational relationship between costs and benefits, the Board decided to change the provisions in the proposed standard regarding using the work of others. The proposed standard required the auditor to evaluate whether to use the work of others, such as internal auditors and others working under the direction of management, and described an evaluation process focused on the competence and objectivity of the persons who performed the work that the auditor was required to use when determining the extent to which he or she could use the work of others.

E30. The proposed standard also described two principles that limited the auditor's ability to use of the work of others. First, the proposed standard defined three categories of controls and the extent to which the auditor could use the work of others in each of those categories:

- Controls for which the auditor should not rely on the work of others, such as 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, such as controls over nonroutine transactions that are considered high risk because they involve judgments and estimates, and

- Controls for which the auditor's reliance on the work of others is not specifically limited, such as controls over routine processing of significant accounts.

E31. Second, the proposed standard required that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion (this is referred to as the *principal evidence provision*).

E32. In the proposed standard, these two principles provided the auditor with flexibility in using the work of others while preventing him or her from placing inappropriate over-reliance on the work of others. Although the proposed standard required the auditor to reperform some of the tests performed by others to use their work, it did not establish specific requirements for the extent of the reperformance. Rather, it allowed the auditor to use his or her judgment and the directions provided by the two principles discussed in the previous two paragraphs to determine the appropriate extent of reperformance.

E33. The Board received a number of comments that agreed with the proposed three categories of controls and the principal evidence provision. However, most commenters expressed some level of concern with the categories, the principal evidence provision, or both.

E34. Comments opposing or criticizing the categories of controls varied from general to very specific. In general terms, many commenters (particularly issuers) expressed concern that the categories described in the proposed standard were too restrictive. They believed the auditor should be able to use his or her judgment to determine in which areas and to what extent to rely on the work of others. Other commenters indicated that the proposed standard did not place enough emphasis on the work of internal auditors whose competence and objectivity, as well as adherence to professional standards of internal auditing, should clearly set their work apart from the work performed by others in the organization (such as management or third parties working under management's direction). Further, these commenters believed that the standard should clarify that the auditor should be able to use work performed by internal auditors extensively. In that case, their concerns about excessive cost also would be partially alleviated.

E35. Other commenters expressed their belief that the proposed standard repudiated the approach established in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements,* for the auditor's use of the work of internal auditors in a financial statement audit. Commenters also expressed very specific and pointed views on the three categories of controls. As defined in the proposed standard, the first category (in which the auditor should not use the work of others at all) included:

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements.

- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

- Controls that have a pervasive effect on the financial statements, such as certain information technology general controls on which the operating effectiveness of other controls depend.

- Walkthroughs.

E36. Commenters expressed concern that the prohibition on using the work of others in these areas would (a) drive unnecessary and excessive costs, (b) not give appropriate recognition to those instances in which the auditor evaluated internal audit as having a high degree of competence and objectivity, and (c) be impractical due to resource constraints at audit firms. Although each individual area was mentioned, the strongest and most frequent objections were to the restrictions imposed over the inclusion in the first category of walkthroughs, controls over the period-end financial reporting process, and information technology general controls. Some commenters suggested the Board should consider moving these areas from the first category to the second category (in which using the work of others would be limited, rather than prohibited); others suggested removing any limitation on using the work of others in these areas altogether.

E37. Commenters also expressed other concerns with respect to the three control categories. Several commenters asked for clarification on what constituted *limited* use of the work of others for areas included in the second category. Some commenters asked for clarification about the extent of reperformance necessary for the auditor to use the work of others. Other commenters questioned the meaning of the term *without specific limitation* in the third category by asking, did this mean that the auditor could use the work of others in these areas without performing *or* reperforming *any* work in those areas?

E38. Although most commenters suggested that the principal evidence threshold for the auditor's own work be retained, some commenters objected to the principal evidence provision. Although many commenters identified the broad array of areas identified in the first category (in which the auditor should not use the work of others at all) as the key driver of excessive costs, others identified the principal evidence provision as the real source of their excessive cost concerns. Even if the categories were redefined in such a way as to permit the auditor to use the work of others in more areas, any associated decrease in audit cost would be limited by the principal evidence provision which, if retained, would still require significant original work on the part of the auditor. On the other hand, both investors and auditors generally supported retaining the principal evidence provision as playing an important role in ensuring the independence of the auditor's opinion and preventing inappropriate overreliance on the work of internal auditors and others.

E39. Commenters who both supported and opposed the principal evidence provision indicated that implementing it would be problematic because the nature of the work in an audit of internal control over financial reporting does not lend itself to a purely quantitative measurement. Thus, auditors would be forced to use judgment when determining whether the principal evidence provision has been satisfied.

E40. In response to the comments, the Board decided that some changes to the guidance on using the work of others were necessary. The Board did not intend to reject the concepts in AU sec. 322 and replace them with a different model. Although AU sec. 322 is designed to apply to an audit of financial statements, the Board concluded that the concepts contained in AU sec. 322 are sound and should be used in an audit of internal control over financial reporting, with appropriate modification to take into account the differences in the nature of the evidence necessary to support an opinion on financial statements and the evidence necessary to support an opinion on internal control effectiveness. The Board also wanted to make clear that the concepts in AU sec. 322 also may be applied, with appropriate auditor judgment, to the relevant work of others.

E41. The Board remained concerned, however, with the possibility that auditors might overrely on the work of internal auditors and others. Inappropriate overreliance can occur in a variety of ways. For example, an auditor might rely on the work of a highly competent and objective internal audit function for proportionately too much of the evidence that provided the basis for the auditor's opinion. Inappropriate overreliance also occurs when the auditor incorrectly concludes that internal auditors have a high degree of competence and objectivity when they do not, perhaps because the auditor did not exercise professional skepticism or due professional care when making his or her evaluation. In either case, the result is the same: unacceptable risk that the auditor's conclusion that internal control over financial reporting is effective is incorrect. For example, federal bank regulators commented that, in their experience with FDICIA, auditors have a tendency to rely too heavily on the work of management and others, further noting that this situation diminishes the independence of the auditor's opinion on control effectiveness.

E42. The Board decided to revise the categories of controls by focusing on the nature of the controls being tested, evaluating the competence and objectivity of the individuals performing the work, and testing the work of others. This allows the auditor to exercise substantial judgment based on the outcome of this work as to the extent to which he or she can make use of the work of internal auditors or others who are suitably qualified.

E43. This standard emphasizes the direct relationship between the assessed level of competence and objectivity and the extent to which the auditor may use the work of others. The Board included this clarification to highlight the special status that a highly competent and objective internal auditor has in the auditor's work as well as to caution against inappropriate overreliance on the work of management and others who would be expected to have lower degrees of competence and objectivity in assessing controls.

Indeed, the Board noted that, with regard to internal control over financial reporting, internal auditors would normally be assessed as having a higher degree of competence and objectivity than management or others and that an auditor will be able to rely to a greater extent on the work of a highly competent and objective internal auditor than on work performed by others within the company.

E44. The Board concluded that the principal evidence provision is critical to preventing overreliance on the work of others in an audit of internal control over financial reporting. The requirement for the auditor to perform enough of the control testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion is of paramount importance to the auditor's assurance providing the level of reliability that investors expect. However, the Board also decided that the final standard should articulate clearly that the auditor's judgment about whether he or she has obtained the principal evidence required is qualitative as well as quantitative. Therefore, the standard now states, "Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions."

E45. The Board also concluded that a better balance could be achieved in the standard by instructing the auditor to factor into the determination of the extent to which to use the work of others an evaluation of the nature of the controls on which others performed their procedures.

E46. Paragraph 112 of the standard provides the following factors the auditor should consider when evaluating the nature of the controls subjected to the work of others:

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.

- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).

- The pervasiveness of the control.

- The level of judgment or estimation required in the account or disclosure.

- The potential for management override of the control.

E47. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the auditor may rely more on the work of others. Because of the nature of controls in the control environment, however, the standard does not allow the auditor to use the work of others to reduce the amount of work he or she performs on such controls. In addition, the standard also does not allow the auditor to use the work of others in connection with the performance of walkthroughs of major classes of transactions because of the high degree of judgment required when performing them (See separate discussion in paragraphs E51 through E57).

E48. The Board decided that this approach was responsive to those who believed that the auditor should be able to use his or her judgment in determining the extent to which to use the work of others. The Board designed the requirement that the auditor's own work must provide the principal evidence for the auditor's opinion as one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. The other instructions about using the work of others provide more specific direction about how the auditor makes this determination, but allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence, and to determine when the auditor can use the work of others rather than perform the work himself or herself. Although some of the directions are specific and definitive, such as the directions for the auditor to perform tests of controls in the control environment and walkthroughs himself or herself, the Board decided that these areas were of such audit importance that the auditor should always perform this testing as part of obtaining the principal evidence for his or her opinion. The Board concluded that this approach appropriately balances the use of auditor judgment and the risk of inappropriate overreliance.

E49. The Board was particularly concerned by comments that issuers might choose to reduce their internal audit staff or the extent of internal audit testing in the absence of a significant change in the proposed standard that would significantly increase the extent to which the auditor may use the work of internal auditors. The Board believes the standard makes clear that an effective internal audit function does permit the auditor to reduce the work that otherwise would be necessary.

E50. Finally, as part of clarifying the linkage between the degree of competence and objectivity of the others and the ability to use their work, the Board decided that additional clarification should be provided on the extent of testing that should be required of the work of others. The Board noted that the interaction of the auditor performing walkthroughs of every significant process and the retention of the principal evidence provision precluded the need for the auditor to test the work of others in every significant account. However, testing the work of others is an important part of an ongoing assessment of their competence and objectivity. Therefore, as part of the emphasis on the direct relationship between the assessed level of competence and objectivity to the extent of the use of the work of others, additional provisions were added discussing how the results of the testing of the work of others might affect the auditor's assessment of competence and objectivity. The Board also concluded that testing the work of others should be clearly linked to an evaluation of the quality and effectiveness of their work.

Walkthroughs

E51. The proposed standard included a requirement that the auditor perform walkthroughs, stating that the auditor should perform a walkthrough for all of the company's significant processes. In the walkthrough, the auditor was to trace all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they were included in the company's financial reports. As stated in the proposed standard, walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;
- Confirm the auditor's understanding of the design of controls identified for all five components of internal control over financial reporting, including those related to the prevention or detection of fraud;
- Confirm that the auditor's understanding of the process is complete by determining whether all points in the process at which misstatements related to each relevant financial statement assertion that could occur have been identified;
- Evaluate the effectiveness of the design of controls; and
- Confirm whether controls have been placed in operation.

E52. A number of commenters expressed strong support for the requirement for the auditor to perform walkthroughs as described in the proposed standard. They agreed that auditors who did not already perform the type of walkthrough described in the proposed standard should perform them as a matter of good practice. These commenters further recognized that the first-hand understanding an auditor obtains from performing these walkthroughs puts the auditor in a much better position to design an effective audit and to evaluate the quality and effectiveness of the work of others. They considered the walkthrough requirement part of "getting back to basics," which they viewed as a positive development.

E53. Some commenters expressed general support for walkthroughs as required procedures, but had concerns about the scope of the work. A number of commenters suggested that requiring walkthroughs of *all* significant processes and *all* types of transactions would result in an overwhelming and unreasonable number of walkthroughs required. Commenters made various suggestions for alleviating this problem, including permitting the auditor to determine, using broad auditor judgment, which classes of transactions to walk through or refining the scope of "all types of transactions" to include some kind of consideration of risk and materiality.

E54. Other commenters believed that required walkthroughs would result in excessive cost if the auditor were prohibited from using the work of others. These commenters suggested that the only way that required walkthroughs would be a reasonable procedure is to permit the auditor to use the work of others. Although commenters varied on whether the auditor's use of the work of others for walkthroughs should be liberal or limited, and whether it should include management or be limited to internal auditors, a large number of commenters suggested that limiting walkthroughs to only the auditor himself or herself was impractical.

E55. The Board concluded that the objectives of the walkthroughs cannot be achieved second-hand. For the objectives to be effectively achieved, the auditor must perform the walkthroughs himself or herself. Several commenters who objected to the prohibition on using the work of internal auditors for walkthroughs described situations in which internal auditors would be better able to effectively perform walkthroughs because internal auditors understood the company's business and controls better than the external auditor and because the external auditor would struggle in performing walkthroughs due to a lack of understanding. The Board observed that these commenters' perspectives support the importance of requiring the external auditor to perform walkthroughs. If auditors struggle to initially perform walkthroughs because their knowledge of the company and its controls is weak, then that situation would only emphasize the necessity for the auditor to increase his or her level of understanding. After considering the nature and extent of the procedures that would be required to achieve these objectives, the Board concluded that performing walkthroughs would be the most efficient means of doing so. The first-hand understanding the auditor will obtain of the company's processes and its controls through the walkthroughs will translate into increased effectiveness and quality throughout the rest of the audit, in a way that cannot be achieved otherwise.

E56. The Board also decided that the scope of the transactions that should be subjected to walkthroughs should be more narrowly defined. To achieve the objectives the Board intended for walkthroughs to accomplish, the auditor should not be forced to perform walkthroughs on what many commenters reasoned was an unreasonably large population. The Board decided that the auditor should be able to use judgment in considering risk and materiality to determine which transactions and events within a given significant process to walk through. As a result, the directions in the standard on determining significant processes and major classes of transactions were expanded, and the population of transactions for which auditors will be required to walk through narrowed by replacing "all types of transactions" with "major classes of transactions."

E57. Although judgments of risk and materiality are inherent in identifying major classes of transactions, the Board decided to also remove from the standard the statement, "walkthroughs are required procedures" as a means of further clarifying that auditor judgment plays an important role in determining the major classes of transactions for which to perform a walkthrough. The Board observed that leading off the discussion of walkthroughs in the standard with such a sentence could be read as setting a tone that diminished the role of judgment in selecting the transactions to walk through. As a result, the directions in the standard on performing walkthroughs begin with, "The auditor should perform at least one walkthrough for each major class of transactions…" The Board's decision to eliminate the statement "walkthroughs are required procedures" should not be viewed as an indication that performing walkthroughs are optional under the standard's directions. The Board believes the auditor might be able to achieve the objectives of a walkthrough by performing a combination of procedures, including inquiry, inspection, observation, and reperformance; however, performing a walkthrough represents the most efficient and effective means of doing so. The auditor's work on the control environment and walkthroughs is an important part of the principal evidence that the auditor must obtain himself or herself.

Small Business Issues

E58. Appendix E of the proposed standard discussed small and medium-sized company considerations. Comments were widely distributed on this topic. A number of commenters indicated that the proposed standard gave adequate consideration to how internal control is implemented in, and how the audit of internal control over financial reporting should be conducted at, small and medium-sized companies. Other commenters, particularly smaller issuers and smaller audit firms, indicated that the proposed standard needed to provide much more detail on how internal control over financial reporting could be different at a small or medium-sized issuer and how the auditor's approach could differ. Some of these commenters indicated that the concepts articulated in the Board's proposing release concerning accommodations for small and medium-sized companies were not carried through to the proposed standard itself.

E59. On the other hand, other commenters, particularly large audit firms and investors, expressed views that the proposed standard went too far in creating too much of an accommodation for small and medium-sized issuers. In fact, many believed that the proposed standard permitted those issuers to have less effective internal control over financial reporting than larger issuers, while providing guidance to auditors permitting them to perform less extensive testing at those small and medium-sized issuers than they might have at larger issuers. These commenters stressed that effective internal control over financial reporting is equally important at small and medium-sized issuers. Some commenters also expressed concerns that the guidance in proposed Appendix E appeared to emphasize that the actions of senior management, if carried out with integrity, could offset deficiencies in internal control over financial reporting, such as the lack of written policies and procedures. Because the risk of management override of controls is higher in these types of environments, such commenters were concerned that the guidance in proposed Appendix E might result in an increased fraud risk at small and medium-sized issuers. At a minimum, they argued, the interpretation of Appendix E might result in a dangerous expectation gap for users of their internal control reports. Some commenters who were of this view suggested that Appendix E be deleted altogether or replaced with a reference to the report of the

Committee of Sponsoring Organizations (COSO) of the Treadway Commission, *Internal Control—Integrated Framework*, which they felt contained sufficient guidance on small and medium-sized company considerations.

E60. Striking an appropriate balance regarding the needs of smaller issuers is particularly challenging. The Board considered cautionary views about the difficulty in expressing accommodations for small and medium-sized companies without creating an inappropriate second class of internal control effectiveness and audit assurance. Further, the Board noted that the COSO framework currently provides management and the auditor with more guidance and flexibility regarding small and medium-sized companies than the Board had provided in the proposed Appendix E. As a result, the Board eliminated proposed Appendix E and replaced the appendix with a reference to COSO in paragraph 15 of the standard. The Board believes providing internal control criteria for small and medium-sized companies within the internal control framework is more appropriately within the purview of COSO. Furthermore, the COSO report was already tailored for special small and medium-sized company considerations. The Board decided that emphasizing the existing guidance within COSO was the best way of recognizing the special considerations that can and should be given to small and medium-sized companies without inappropriately weakening the standard to which these smaller entities should, nonetheless, be held. If additional tailored guidance on the internal control framework for small and medium-sized companies is needed, the Board encourages COSO, or some other appropriate body, to develop this guidance.

Evaluation of the Effectiveness of the Audit Committee

E61. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as *strong indicators* that a material weakness exists. A particularly notable significant deficiency and strong indicator of a material weakness was the ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting. In addition, the proposed standard required the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting.

E62. This provision related to evaluating the effectiveness of the audit committee was included in the proposed standard for two primary reasons. First, the Board initially decided that, because of the significant role that the audit committee has in the control environment and monitoring components of internal control over financial reporting, an ineffective audit committee is a gravely serious control weakness that is strongly indicative of a material weakness. Most auditors should have already been reaching this conclusion when confronted with an obviously ineffective audit committee. Second, highlighting the adverse consequences of an ineffective audit committee would, perhaps, further encourage weak audit committees to improve.

E63. Investors supported this provision. They expressed an expectation that the auditor would evaluate the audit committee's effectiveness and speak up if the audit committee was determined to be ineffective. Investors drew a link among restoring their confidence, audit committees having new and enhanced responsibilities, and the need for assurance that audit committees are, in fact, meeting their responsibilities.

E64. Auditors also were generally supportive of such an evaluation. However, many requested that the proposed standard be refined to clearly indicate that the auditor's responsibility to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is not a separate and distinct evaluation. Rather, the evaluation is one element of the auditor's overall understanding and assessment of the company's control environment and monitoring components. Some commenters suggested that, in addition to needing clarification of the auditor's responsibility, the auditor would have difficulty in evaluating all of the factors listed in the proposed standard, because the auditor's normal interaction with the audit committee would not provide sufficient basis to conclude on some of those factors.

E65. Issuers and some others were opposed to the auditor evaluating the effectiveness of the audit committee on the fundamental grounds that such an evaluation would represent an unacceptable conflict of interest. Several commenters shared the view that this provision would reverse an important improvement in governance and audit quality. Whereas the auditor was formerly retained and compensated by management, the Act made clear that these responsibilities should now be those of the audit committee. In this way, commenters saw a conflict of interest being remedied. Requiring the auditor to evaluate the effectiveness of the audit committee led commenters to conclude that the same kind of conflict of interest was being reestablished. These commenters also believed that the auditor would not have a sufficient basis on which to evaluate the effectiveness of the audit committee because the auditor does not have complete and free access to the audit committee, does not have appropriate expertise to evaluate audit committee members (who frequently are more experienced businesspeople than the auditor), does not have the legal expertise to make determinations about some of the specific factors listed in the proposed standard, and other shortcomings. These commenters also emphasized that the board of directors' evaluation of the audit committee is important and that the proposed standard could be read to supplant this important evaluation with that of the auditor's.

E66. The Board concluded that this provision should be retained but decided that clarification was needed to emphasize that the auditor's evaluation of the audit committee was not a separate evaluation but, rather, was made as part of the auditor's evaluation of the control environment and monitoring components of internal control over financial reporting. The Board reasoned that clarifying both this context and limitation on the auditor's evaluation of the audit committee would also address, to some degree, the conflict-of-interest concerns raised by other commenters. The Board also observed, however, that conflict is, to some extent, inherent in the duties that society expects of auditors. Just as auditors were expected in the past to challenge management when the auditor believed a material misstatement of the financial statements or material weakness in internal control over financial reporting existed, the auditor similarly is expected to speak up when he or she believes the audit committee is ineffective in its oversight.

E67. The Board decided that when the auditor is evaluating the control environment and monitoring components, if the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, the auditor should be strongly encouraged to consider that situation a material weakness and, at a minimum, a significant deficiency. The objective of the evaluation is not to grade the effectiveness of the audit committee along a scale. Rather, in the course of performing procedures related to evaluating the effectiveness of the control environment and monitoring components, including evaluating factors related to the effectiveness of the audit committee's oversight, if the auditor concludes that the audit committee's oversight of the external financial reporting and internal control over financial reporting is ineffective, then the auditor should consider that a strong indicator of a material weakness.

E68. The Board concluded that several refinements should be made to this provision. As part of emphasizing that the auditor's evaluation of the audit committee is to be made as part of evaluating the control environment and not as a separate evaluation, the Board determined that the evaluation factors should be modified. The factors that addressed compliance with listing standards and sections of the Act were deleted, because those factors were specifically criticized in comment letters as being either outside the scope of the auditor's expertise or outside the scope of internal control over financial reporting. The Board also believed that those factors were not significant to the type of evaluation the auditor was expected to make of the audit committee. The Board decided to add the following factors, which are based closely on factors described in COSO, as relevant to evaluating those who govern, including the audit committee:

- Extent of direct and independent interaction with key members of financial management, including the chief financial officer and chief accounting officer.
- Degree to which difficult questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates.
- Level of responsiveness to issues raised by the auditor, including those required to be communicated by the auditor to the audit committee.

E69. The Board also concluded that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor's evaluation of the control environment is not intended to supplant those evaluations. In addition, the Board concluded that, in the event the auditor determines that the audit committee's oversight is ineffective, the auditor should communicate that finding to the full board of directors. This communication should occur regardless of whether the auditor concludes that the condition represents a significant deficiency or a material weakness, and the communication should take place in addition to the normal communication requirements that attach to those deficiencies.

Definitions of Significant Deficiency and Material Weakness

E70. As part of developing the proposed standard, the Board evaluated the existing definitions of significant deficiency (which the SEC defined as being the same as a reportable condition) and material weakness to determine whether they would permit the most effective implementation of the internal control reporting requirements of the Act.

E71. AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit*, defined a material weakness as follows:

> A *material weakness* in internal control is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a *relatively low level* the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

E72. The framework that defined a material weakness focused on likelihood of and magnitude for evaluating a weakness. The Board decided that this framework would facilitate effective implementation of the Act's internal control reporting requirements; therefore, the Board's proposed definitions focused on likelihood and magnitude. However, as part of these deliberations, the Board decided that likelihood and magnitude needed to be defined in terms that would encourage more consistent application.

E73. Within the existing definition of material weakness, the magnitude of "material in relation to the financial statements" was well supported by the professional standards, SEC rules and guidance, and other literature. However, the Board decided that the definition of likelihood would be improved if it used "more than remote" instead of "relatively low level." FASB Statement No. 5, *Accounting for Contingencies* (FAS No. 5) defines "remote." The Board decided that, because auditors were familiar with the application of the likelihood definitions in FAS No. 5, using "more than remote" in the definition of material weakness would infuse the evaluation of whether a control deficiency was a material weakness with the additional consistency that the Board wanted to encourage.

E74. AU sec. 325 defined *reportable conditions* as follows:

> …matters coming to the auditor's attention that, in his judgment, should be communicated to the audit committee because they represent significant deficiencies in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.

E75. The Board observed that this definition makes the determination of whether a condition is reportable solely a matter of the auditor's judgment. The Board believed that this definition was insufficient for purposes of the Act because management also needs a definition to determine whether a deficiency is significant and that the definition should be the same as the definition used by the auditor. Furthermore, using this existing definition, the auditor's judgment could never be questioned.

E76. The Board decided that the same framework that represented an appropriate framework for defining a material weakness also should be used for defining a significant deficiency. Although auditor judgment is integral and essential to the audit process (including in determining the severity of control weaknesses), auditors, nonetheless, must be accountable for their judgments. Increasing the accountability of auditors for their judgments about whether a condition represents a significant deficiency and increasing the consistency with which those judgments are made are interrelated. Hence, the same framework of likelihood and magnitude were applied in the Board's proposed definition of significant deficiency.

E77. In applying the likelihood and magnitude framework to defining a significant deficiency, the Board decided that the "more than remote" likelihood of occurrence used in the definition of material weakness was the best benchmark. In terms of magnitude, the Board decided that "more than inconsequential" should be the threshold for a significant deficiency.

E78. A number of commenters were supportive of the definitions in the proposed standard. These commenters believed the definitions were an improvement over the previous definitions, used terms familiar to auditors, and would promote increased consistency in evaluations.

E79. Most commenters, however, objected to these definitions. The primary, over-arching objection was that these definitions set too low a threshold for the reporting of significant deficiencies. Some commenters focused on "more than remote" likelihood as the driver of an unreasonably low threshold, while others believed "more than inconsequential" in the definition of significant deficiency was the main culprit. While some commenters understood "more than inconsequential" well enough, others indicated significant concerns that this represented a new term of art that needed to be accompanied by a clear definition of "inconsequential" as well as supporting examples. Several commenters suggested retaining the likelihood and magnitude approach to a definition but suggested alternatives for likelihood (such as reasonably likely, reasonably possible, more likely than not, probable) and magnitude (such as material, significant, insignificant).

E80. Some commenters suggested that the auditing standard retain the existing definitions of material weakness and significant deficiency, consistent with the SEC's final rules implementing Section 404. In their final rules, the SEC tied management's assessment to the existing definitions of material weakness and significant deficiency (through the existing definition of a reportable condition) in AU sec. 325. These commenters suggested that, if the auditing standard used a different definition, a dangerous disconnect would result, whereby management would be using one set of definitions under the SEC's rules and auditors would be using another set under the Board's auditing standards. They further suggested that, absent rulemaking by the SEC to change its definitions, the Board should simply defer to the existing definitions.

E81. A number of other commenters questioned the reference to "a misstatement of the annual or interim financial statements" in the definitions, with the emphasis on why "interim" financial statements were included in the definition, since Section 404 required only an annual assessment of internal control over financial reporting effectiveness, made as of year-end. They questioned whether this definition implied that the auditor was required to identify deficiencies that could result in a misstatement in interim financial statements; they did not believe that the auditor should be required to plan his or her audit of internal control over financial reporting at a materiality level of the interim financial statements.

E82. The Board ultimately concluded that focusing the definitions of material weakness and significant deficiency on likelihood of misstatement and magnitude of misstatement provides the best framework for evaluating deficiencies. Defaulting to the existing definitions would not best serve the public interest nor facilitate meaningful and effective implementation of the auditing standard.

E83. The Board observed that the SEC's final rules requiring management to report on internal control over financial reporting define material weakness, for the purposes of the final rules, as having "the same meaning as the definition under GAAS and attestation standards." Those rules state:

> The term "significant deficiency" has the same meaning as the term "reportable condition" as used in AU §325 and AT§501. The terms "material weakness" and "significant deficiency" both represent deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements, with a "material weakness" constituting a greater deficiency than a "significant deficiency." Because of this relationship, it is our judgment that an aggregation of significant deficiencies

could constitute a material weakness in a company's internal control over financial reporting.[4/]

E84. The Board considered the SEC's choice to cross-reference to generally accepted auditing standards (GAAS) and the attestation standards as the means of defining these terms, rather than defining them outright within the final rules, noteworthy as it relates to the question of whether any disconnect could result between auditors' and managements' evaluations if the Board changed the definitions in its standards. Because the standard changes the definition of these terms within the interim standards, the Board believes the definitions are, therefore, changed for both auditors' and managements' purposes.

E85. The Board noted that commenters who were concerned that the definitions in the proposed standard set too low of a threshold for significant deficiencies and material weaknesses believed that the proposed standard required that each control deficiency be evaluated in isolation. The intent of the proposed standard was that control deficiencies should first be evaluated individually; the determination as to whether they are significant deficiencies or material weaknesses should be made considering the effects of compensating controls. The effect of compensating controls should be taken into account when assessing the likelihood of a misstatement occurring and not being prevented or detected. The proposed standard illustrated this type of evaluation, including the effect of compensating controls when assessing likelihood, in the examples in Appendix D. Based on the comments received, however, the Board determined that additional clarification within the standard was necessary to emphasize the importance of considering compensating controls when evaluating the likelihood of a misstatement occurring. As a result, the note to paragraph 10 was added.

E86. The Board concluded that considering the effect of compensating controls on the likelihood of a misstatement occurring and not being prevented or detected sufficiently addressed the concerns that the definitions set too low a threshold. For example, several issuer commenters cited concerns that the proposed definitions precluded a rational cost-benefit analysis of whether to correct a deficiency. These issuers believed they would be compelled to correct deficiencies (because the deficiencies would be considered to be at least significant deficiencies) in situations in which management had made a previous conscious decision that the costs of correcting the deficiency outweighed the benefits. The Board observed that, in cases in which management has determined not to correct a known deficiency based on a cost-benefit analysis, effective compensating controls usually lie at the heart of management's decision. The standard's use of "likelihood" in the definition of a significant deficiency or material weakness accommodates such a consideration of compensating controls. If a

[4/] See footnote 73 to *Final Rule: 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) [68 FR 36636].

deficiency is effectively mitigated by compensating controls, then the likelihood of a misstatement occurring and not being prevented or detected may very well be remote.

E87. The Board disagreed with comments that "more than inconsequential" was too low a threshold; however, the Board decided the term "inconsequential" needed additional clarity. The Board considered the term "inconsequential" in relation to the SEC's guidance on audit requirements and materiality. Section 10A(b)(1)(B)[5/] describes the auditor's communication requirements when the auditor detects or otherwise becomes aware of information indicating that an illegal act has or may have occurred, "unless the illegal act is clearly inconsequential." Staff Accounting Bulletin (SAB) No. 99, *Materiality*, provides the most recent and definitive guidance on the concept of materiality as it relates to the financial reporting of a public company. SAB No. 99 uses the term "inconsequential" in several places to draw a distinction between amounts that are not material. SAB No. 99 provides the following guidance to assess the significance of a misstatement:

> Though the staff does not believe that registrants need to make finely calibrated determinations of significance with respect to immaterial items, plainly it is "reasonable" to treat misstatements whose effects are clearly inconsequential differently than more significant ones.

E88. The discussion in the previous paragraphs provided the Board's context for using "material" and "more than inconsequential" for the magnitude thresholds in the standard's definitions. "More than inconsequential" indicates an amount that is less than material yet has significance.

E89. The Board also considered the existing guidance in the Board's interim standards for evaluating materiality and accumulating audit differences in a financial statement audit. Paragraph .41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit,* states:

> In aggregating likely misstatements that the entity has not corrected, pursuant to paragraphs .34 and .35, the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

E90. The Board considered the discussion in AU sec. 312 that spoke specifically to evaluating differences individually *and in the aggregate*, as well as to considering the possibility of additional undetected misstatements, important distinguishing factors that should be carried through to the evaluation of whether a control deficiency represents a

[5/] See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C., 78j-1.

significant deficiency because the magnitude of the potential misstatement is more than inconsequential.

E91. The Board combined its understanding of the salient concepts in AU sec. 312 and the SEC guidance on materiality to develop the following definition of inconsequential:

> A misstatement is *inconsequential* if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is *more than inconsequential.*

E92. Finally, the inclusion of *annual or interim financial statements* in the definitions rather than just "annual financial statements" was intentional and, in the Board's opinion, closely aligned with the spirit of what Section 404 seeks to accomplish. However, the Board decided that this choice needed clarification within the auditing standard. The Board did not intend the inclusion of the interim financial statements in the definition to require the auditor to perform *an audit of internal control over financial reporting* at each interim date. Rather, the Board believed that the SEC's definition of internal control over financial reporting included all financial reporting that a public company makes publicly available. In other words, internal control over financial reporting includes controls over the preparation of annual and quarterly financial statements. Thus, an evaluation of internal control over financial reporting as of year-end encompasses controls over the annual financial reporting and quarterly financial reporting as such controls exist at that point in time.

E93. Paragraphs 76 and 77 of the standard clarify this interpretation, as part of the discussion of the period-end financial reporting process. The period-end financial reporting process includes procedures to prepare both annual and quarterly financial statements.

Strong Indicators of Material Weaknesses and DeFacto Significant Deficiencies

E94. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists. The Board developed this list to promote increased rigor and consistency in auditors' evaluations of weaknesses. For the implementation of Section 404 of the Act to achieve its objectives, the public must have confidence that all material weaknesses that exist as of the company's year-end will be publicly reported. Historically, relatively few material weaknesses have been reported by the auditor to management and the audit committee. That condition is partly due to the nature of a financial statement audit. In an audit of only the financial statements, the auditor does not have a detection responsibility for material weaknesses in internal control; such a detection responsibility is being newly introduced for all public companies through Sections 103 and 404 of the Act. However, the Board was concerned about instances in which auditors had identified a condition that should have been, but was not, communicated as a material weakness. The intention of including the list of strong indicators of material weaknesses in the proposed standard was to bring further clarity to conditions that were likely to be material weaknesses in internal control and to create more consistency in auditors' evaluations.

E95. Most commenters were generally supportive of a list of significant deficiencies and strong indicators of the existence of material weaknesses. They believed such a list provided instructive guidance to both management and the auditor. Some commenters, however, disagreed with the proposed approach of providing such a list. They believed that the determination of the significance of a deficiency should be left entirely to auditor judgment. A few commenters requested clarification of the term "strong indicator" and specific guidance on how and when a "strong indicator" could be overcome. A number of commenters expressed various concerns with individual circumstances included in the list.

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. Some commenters expressed concern about the kinds of restatements that would trigger this provision. A few mentioned the specific instance in which the restatement reflected the SEC's subsequent view of an accounting matter when the auditor, upon reevaluation, continued to believe that management had reasonable support for its original position. They believed this specific circumstance would not necessarily indicate a significant deficiency in internal control over financial reporting. Others commented that a restatement of previously issued financial statements would indicate a significant deficiency and strong indicator of a material weakness *in the prior period* but not necessarily in the current period.

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement)*. Several commenters, issuers and auditors alike, expressed concern about including this circumstance on the list. They explained that, frequently, management is completing the preparation of the financial statements at the same time that the auditor is completing his or her auditing procedures. In the face of this "strong indicator" provision, a lively debate of "who found it first" would ensue whenever the auditor identifies a misstatement that management subsequently corrects. Another argument is that the company's controls would have detected a misstatement identified by the auditor if the controls had an opportunity to operate (that is, the auditor performed his or her testing before the company's controls had an opportunity to operate). Several issuers indicated that they would prevent this latter situation by delaying the auditor's work until the issuers had clearly completed their entire period-end financial reporting process – a delay they viewed as detrimental.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Several commenters asked for specific factors the auditor was expected to use to assess the effectiveness of these functions.

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function.* Several commenters, particularly issuers in highly regulated industries, objected to the inclusion of this circumstance because they believed this to be outside the scope of internal control over financial reporting. (They agreed that this would be an internal control-related matter, but one that falls into operating effectiveness and compliance with laws and regulations, not financial reporting.) Many of these commenters suggested that this circumstance be deleted from the list altogether. Fewer commenters suggested that this problem could be addressed by simply clarifying that this circumstance is limited to situations in which the ineffective regulatory function relates solely to those aspects for which related violations of laws and regulations could have a direct and material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management*. Several commenters expressed concern that the inclusion of this circumstance created a detection responsibility for the auditor such that the auditor would have to plan and perform procedures to detect fraud *of any magnitude* on the part of senior management. Others expressed concern that identification of fraud on the part of senior management by the company's system of internal control over financial reporting might indicate that controls were operating effectively rather than indicating a significant deficiency or material weakness. Still others requested clarification on how to determine who constituted "senior management."

E96. A couple of commenters also suggested that an ineffective control environment should be added to the list.

E97. The Board concluded that the list of significant deficiencies and strong indicators of material weakness should be retained. Such a list will promote consistency in auditors' and managements' evaluations of deficiencies consistent with the definitions of significant deficiency and material weakness. The Board also decided to retain the existing structure of the list. Although the standard leaves auditor judgment to determine whether those deficiencies are material weaknesses, the existence of one of the listed deficiencies is by definition a significant deficiency. Furthermore, the "strong indicator" construct allows the auditor to factor extenuating or unique circumstances into the evaluation and possibly to conclude that the situation does not represent a material weakness, rather, only a significant deficiency.

E98. The Board decided that further clarification was not necessary within the standard itself addressing specifically how and when a "strong indicator" can be overcome. The term "strong indicator" was selected as opposed to the stronger "presumption" or other such term precisely because the Board did not intend to provide detailed instruction on how to overcome such a presumption. It is, nevertheless, the Board's view that auditors should be biased toward considering the listed circumstances as material weaknesses.

E99. The Board decided to clarify several circumstances included in the list:

- *Restatement of previously issued financial statements to reflect the correction of a misstatement*. The Board observed that the circumstance in which a restatement reflected the SEC's subsequent view of an accounting matter, when the auditor concluded that management had reasonable support for its original position, might present a good example of only a significant deficiency and not a material weakness. However, the Board concluded that requiring this situation to, nonetheless, be considered by definition a significant deficiency is appropriate, especially considering that the primary result of the circumstance being considered a significant deficiency is the communication of the matter to the audit committee. Although the audit committee might already be well aware of the circumstances of any restatement, a restatement to reflect the SEC's view on an accounting matter at least has implications for the quality of the company's accounting principles, which is already a required communication to the audit committee.

  With regard to a restatement being a strong indicator of a material weakness in the prior period but not necessarily the current period, the Board disagreed with these comments. By virtue of the restatement occurring during the current period, the Board views it as appropriate to consider that circumstance a strong indicator that a material weakness existed during the current period. Depending on the circumstances of the restatement, however, the material weakness may also have been corrected during the current period. The construct of the standard does not preclude management and the auditor from determining that the circumstance was corrected prior to year-end and, therefore, that a material weakness did not exist at year-end. The emphasis here is that the circumstance is a strong indicator that a material weakness exists; management and the auditor will separately need to determine whether it has been corrected. The Board decided that no further clarification was needed in this regard.

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the* *misstatement)*. Regarding the "who-found-it-first" dilemma, the Board recognizes that this circumstance will present certain implementation challenges. However, the Board decided that none of those challenges were so significant as to require eliminating this circumstance from the list.

When the Board developed the list of strong indicators, the Board observed that it is not uncommon for the financial statement auditor to identify material misstatements in the course of the audit that are corrected by management prior to the issuance of the company's financial statements. In some cases, management has relied on the auditor to identify misstatements in certain financial statement items and to propose corrections in amount, classification, or disclosure. With the introduction of the requirement for management and the auditor to report on the effectiveness of internal control over financial reporting, it becomes obvious that this situation is unacceptable, unless management is willing to accept other than an unqualified report on the internal control effectiveness. (This situation also raises the question as to the extent management may rely on the annual audit to produce accurate and fair financial statements without impairing the auditor's independence.) This situation is included on the list of strong indicators because the Board believes it will encourage management and auditors to evaluate this situation with intellectual honesty and to recognize, first, that the company's internal control should provide reasonable assurance that the company's financial statements are presented fairly in accordance with generally accepted accounting principles.

Timing might be a concern for some issuers. However, to the extent that management takes additional steps to ensure that the financial information is correct prior to providing it to their auditors, this may, at times, result in an improved control environment. When companies and auditors work almost simultaneously on completing the preparation of the annual financial statements and the audit, respectively, the role of the auditor can blur with the responsibility of management. In the year-end rush to complete the annual report, some companies might have come to rely on their auditors as a "control" to further ensure no misstatements are accidentally reflected in the financial statements. The principal burden seems to be for management's work schedule and administration of their financial reporting deadlines to allow the auditor sufficient time to complete his or her procedures.

Further, if the auditor initially identified a material misstatement in the financial statements but, given the circumstances, determined that management ultimately would have found the misstatement, the auditor could determine that the circumstance was a significant deficiency but not a material weakness. The Board decided to retain the provision that this circumstance is at least a significant deficiency because reporting such a circumstance to the audit committee would always be appropriate.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective*. Relatively few commenters requested clarification on how to evaluate these functions. The Board expects that most auditors will not have trouble making this evaluation. Similar to the audit committee evaluation, this evaluation is not a separate evaluation of the internal audit or risk assessment functions but, rather, is a way of requiring the auditor to speak up if either of these functions is obviously ineffective at an entity that needs them to have an effective monitoring or risk assessment component. Unlike the audit committee discussion, most commenters seemed to have understood that this was the context for the internal audit and risk assessment function evaluation. Nonetheless, the Board decided to add a clarifying note to this circumstance emphasizing the context.

- *For complex entities in highly regulated industries, an ineffective regulatory compliance function*. The Board decided that this circumstance, as described in the proposed standard, would encompass aspects that are outside internal control over financial reporting (which would, of course, be inappropriate for purposes of this standard given its definition of internal control over financial reporting). The Board concluded that this circumstance should be retained, though clarified, to only apply to those aspects of an ineffective regulatory compliance function that could have a material effect on the financial statements.

- *Identification of fraud of any magnitude on the part of senior management.* The Board did not intend to create any additional detection responsibility for the auditor; rather, it intended that this circumstance apply to fraud on the part of senior management that came to the auditor's attention, regardless of amount. The Board decided to clarify the standard to make this clear. The Board noted that identification of fraud by the company's system of internal control over financial reporting might indicate that controls were operating effectively, except when that fraud involves senior management. Because of the critical role of tone-at-the-top in the overall effectiveness of the control environment and due to the significant negative evidence that fraud of any magnitude on the part of senior management reflects on the control environment, the Board decided that it is appropriate to include this circumstance in the list, regardless of whether the company's controls detected the fraud. The Board also decided to clarify who is included in "senior management" for this purpose.

E100. The Board agreed that an ineffective control environment was a significant deficiency and a strong indicator that a material weakness exists and decided to add it to the list.

Independence

E101. The proposed standard explicitly prohibited the auditor from accepting an engagement to provide an internal control-related service to an audit client that has not been specifically pre-approved by the audit committee. In other words, the audit committee would not be able to pre-approve internal control-related services as a category. The Board did not propose any specific guidance on permissible internal control-related services in the proposed standard but, rather, indicated its intent to conduct an in-depth evaluation of independence requirements in the future and highlighted its ability to amend the independence information included in the standard pending the outcome of that analysis.

E102. Comments were evenly split among investors, auditors, and issuers who believed the existing guidance was sufficient versus those who believed the Board should provide additional guidance. Commenters who believed existing guidance was sufficient indicated that the SEC's latest guidance on independence needed to be given more time to take effect given its recency and because existing guidance was clear enough. Commenters who believed more guidance was necessary suggested various additions, from more specificity about permitted and prohibited services to a sweeping ban on any internal control-related work for an audit client. Other issuers commented about auditors participating in the Section 404 implementation process at their audit clients in a manner that could be perceived as affecting their independence.

E103. Some commenters suggested that the SEC should change the pre-approval requirements on internal control-related services to specific pre-approval. Another commenter suggested that specific pre-approval of all internal control-related services would pose an unreasonable burden on the audit committee and suggested reverting to pre-approval by category.

E104. The Board clearly has the authority to set independence standards as it may deem necessary or appropriate in the public interest or for the protection of investors. Given ongoing concerns about the appropriateness of auditors providing these types of services to audit clients, the fact-specific nature of each engagement, and the critical importance of ongoing audit committee oversight of these types of services, the Board continues to believe that specific pre-approval of internal control-related services is a logical step that should not pose a burden on the audit committee beyond that which effective oversight of financial reporting already entails. Therefore, the standard retains this provision unchanged.

Requirement for Adverse Opinion When a Material Weakness Exists

E105. The existing attestation standard (AT sec. 501) provides that, when the auditor has identified a material weakness in internal control over financial reporting, 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 ("except for the effect of the material weakness, internal control over financial reporting was effective") or express an adverse opinion ("internal control over financial reporting was not effective").

E106. The SEC's final rules implementing Section 404 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 other words, in such a case, management must conclude that internal control over financial reporting is not effective (that is, a qualified or "except-for" conclusion is not acceptable).

E107. The Board initially decided that the reporting model for the auditor should follow the required reporting model for management. Therefore, because management is required to express an "adverse" conclusion in the event a material weakness exists, the auditor's opinion also must be adverse. The proposed standard did not permit a qualified audit opinion in the event of a material weakness.

E108. Comments received on requiring an adverse opinion when a material weakness exists were split. A large number affirmed that this seemed to be the only logical approach, based on a philosophical belief that if a material weakness exists, then internal control over financial reporting is ineffective. These commenters suggested that permitting a qualified opinion would be akin to creating another category of control deficiency—material weaknesses that were really material (resulting in an adverse opinion) and material weaknesses that weren't so material (resulting in a qualified opinion).

E109. A number of commenters agreed that the auditor's report must follow the same model as management' reporting, but they believe strongly that the SEC's guidance for management accommodated either a qualified or adverse opinion when a material weakness existed.

E110. These commenters cited Section II.B.3.c of the SEC Final Rule and related footnote no. 72:

> The final rules therefore preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting. This is consistent with interim attestation standards. See AT sec. 501.

E111. They believe this reference to the interim attestation standard in the SEC Final Rule is referring to paragraph .37 of AT sec. 501, which states, in part,

> Therefore, the presence of a material weakness will preclude the practitioner from concluding that the entity has effective internal control. However, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the practitioner may qualify his or her opinion (that is, express an opinion that

internal control is effective "except for" the material weakness noted) or may express an adverse opinion.

E112. Their reading of the SEC Final Rule and the interim attestation standard led them to conclude that it would be appropriate for the auditor to express either an adverse opinion or a qualified "except-for" opinion about the effectiveness of the company's internal control over financial reporting depending on the circumstances.

E113. Some commenters responded that they thought a qualified opinion would be appropriate in certain cases, such as an acquisition close to year-end (too close to be able to assess controls at the acquiree).

E114. After additional consultation with the SEC staff about this issue, the Board decided to retain the proposed reporting model in the standard. The primary reason for that decision was the Board's continued understanding that the SEC staff would expect only an adverse conclusion from management (not a qualified conclusion) in the event a material weakness existed as of the date of management's report.

E115. The commenters who suggested that a qualified opinion should be permitted in certain circumstances, such as an acquisition close to year-end, were essentially describing scope limitations. The standard permits a qualified opinion, a disclaimer of opinion, or withdrawal from the engagement if there are restrictions on the scope of the engagement. As it relates specifically to acquisitions near year-end, this is another case in which the auditor's model needs to follow the model that the SEC sets for management. The standard added a new paragraph to Appendix B permitting the auditor to limit the scope of his or her work (without referring to a scope limitation in the auditor's report) in the same manner that the SEC permits management to limit its assessment. In other words, if the SEC permits management to exclude an entity acquired late in the year from a company's assessment of internal control over financial reporting, then the auditor could do the same.

Rotating Tests of Controls

E116. The proposed standard directed the auditor to perform tests of controls on "relevant assertions" rather than on "significant controls." To comply with those requirements, the auditor would be required to apply tests to those controls that are important to presenting each relevant assertion in the financial statements. The proposed standard emphasized controls that affect relevant assertions because those are the points at which misstatements could occur. However, it is neither necessary to test all controls nor to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). Thus, the proposed standard encouraged the auditor to identify and test controls that addressed the primary areas in which misstatements could occur, yet limited the auditor's work to only the necessary controls.

E117. Expressing the extent of testing in this manner also simplified other issues involving extent of testing decisions from year to year (the so-called "rotating tests of controls" issue). The proposed standard stated that the auditor should vary testing from year to year, both to introduce unpredictability into the testing and to respond to changes at the company. However, the proposed standard maintained that each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures every year.

E118. Auditors and investors expressed support for these provisions as described in the proposed standard. In fact, some commenters compared the notion of rotating tests of control in an audit of internal control over financial reporting to an auditor testing accounts receivable only once every few years in a financial statement audit. Permitting so-called rotation of testing would compromise the auditor's ability to obtain reasonable assurance that his or her opinion was correct.

E119. Others, especially issuers concerned with limiting costs, strongly advocated some form of rotating tests of controls. Some commenters suggested that the auditor should have broad latitude to perform some cursory procedures to determine whether any changes had occurred in controls and, if not, to curtail any further testing in that area. Some suggested that testing as described in the proposed standard should be required in the first year of the audit (the "baseline" year) and that in subsequent years the auditor should be able to reduce the required testing. Others suggested progressively less aggressive strategies for reducing the amount of work the auditor should be required to perform. In fact, several commenters (primarily internal auditors) described "baselining" controls as an important strategy to retain. They argued, for example, that IT application controls, once tested, could be relied upon (without additional testing) in subsequent years as long as general controls over program changes and access controls were effective and continued to be tested.

E120. The Board concluded that each year's audit must stand on its own. Cumulative audit knowledge is not to be ignored; some natural efficiencies will emerge as the auditor repeats the audit process. For example, the auditor will frequently spend less time to obtain the requisite understanding of the company's internal control over financial reporting in subsequent years compared with the time necessary in the first year's audit of internal control over financial reporting. Also, to the extent that the auditor has previous knowledge of control weaknesses, his or her audit strategy should, of course, reflect that knowledge. For example, a pattern of mistakes in prior periods is usually a good indicator of the areas in which misstatements are likely to occur. However, the absence of fraud in prior periods is not a reasonable indicator of the likelihood of misstatement due to fraud.

E121. However, the auditor needs to test controls every year, regardless of whether controls have obviously changed. Even if nothing else changed about the company – no changes in the business model, employees, organization, etc. – controls that were effective last year may not be effective this year due to error, complacency, distraction, and other human conditions that result in the inherent limitations in internal control over financial reporting.

E122. What several commenters referred to as "baselining" (especially as it relates to IT controls) is more commonly referred to by auditors as "benchmarking." This type of testing strategy for application controls is not precluded by the standard. However, the Board believes that providing a description of this approach is beyond the scope of this standard. For these reasons, the standard does not address it.

Mandatory Integration with the Audit of the Financial Statements

E123. Section 404(b) of the Act provides that the auditor's attestation of management's assessment of internal control shall not be the subject of a separate engagement. Because the objectives of and work involved in performing both an attestation of management's assessment of internal control over financial reporting and an audit of the financial statements are closely interrelated, the proposed auditing standard introduced an integrated audit of internal control over financial reporting and audit of financial statements.

E124. However, the proposed standard went even further. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the proposed standard stated that the auditor could not audit internal control over financial reporting without also auditing the financial statements. (However, the proposed standard retained the auditor's ability to audit *only* the financial statements, which might be necessary in the case of certain initial public offerings.)

E125. Although the Board solicited specific comment on whether the auditor should be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements, few commenters focused on the significance of the potentially negative evidence that would be obtained during the audit of the financial statements or the implications of this prohibition. Most commenters focused on the wording of Section 404(b), which indicates that the auditor's attestation of management's assessment of internal control over financial reporting shall not be the subject of a separate engagement. Based on this information, most commenters saw the prohibition in the proposed standard as superfluous and benign.

E126. Several commenters recognized the importance of the potentially negative evidence that might be obtained as part of the audit of the financial statements and expressed strong support for requiring that an audit of financial statements be performed to audit internal control over financial reporting.

E127. Others recognized the implications of this prohibition and expressed concern: What if a company wanted or needed an opinion on the effectiveness of internal control over financial reporting as of an interim date? For the most part, these commenters (primarily issuers) objected to the implication that an auditor would have to audit a company's financial statements as of an interim date to enable him or her to audit and report on its internal control over financial reporting as of that same interim date. Other issuers expressed objections related to their desires to engage one auditor to provide an opinion on the effectiveness of internal control over financial reporting and another to audit the financial statements. Others requested clarification about which guidance would apply when other forms of internal control work were requested by companies.

E128. The Board concluded that an auditor should perform an audit of internal control over financial reporting only when he or she has also audited company's financial statements. The auditor *must* audit the financial statements to have a high level of assurance that his or her conclusion on the effectiveness of internal control over financial reporting is correct. Inherent in the reasonable assurance provided by the auditor's opinion on internal control over financial reporting is a responsibility for the auditor to plan and perform his or her work to obtain reasonable assurance that material weaknesses, if they exist, are detected. As previously discussed, this standard states that the identification by the auditor of a *material misstatement* in the financial statements that was not initially identified by the company's internal control over financial reporting, is a strong indicator of a material weakness. Without performing a financial statement audit, the auditor would not have reasonable assurance that he or she had detected all material misstatements. The Board believes that allowing the auditor to audit internal control over financial reporting without also auditing the financial statements would not provide the auditor with a high level of assurance and would mislead investors in terms of the level of assurance obtained.

E129. In response to other concerns, the Board noted that an auditor can report on the effectiveness of internal control over financial reporting using existing AT sec. 501 for purposes other than satisfying the requirements of Section 404. This standard supersedes AT sec. 501 only as it relates to complying with Section 404 of the Act.

E130. Although reporting under the remaining provisions of AT sec. 501 is currently permissible, the Board believes reports issued for public companies under the remaining provisions of AT sec. 501 will be infrequent. In any event, additional rulemaking might be necessary to prevent confusion that might arise from reporting on internal control engagements under two different standards. For example, explanatory language could be added to reports issued under AT sec. 501 to clarify that an audit of financial statements was not performed in conjunction with the attestation on internal control over financial reporting and that such a report is not the report resulting from an audit of internal control over financial reporting performed in conjunction with an audit of the financial statements under this standard. This report modification would alert report readers, particularly if such a report were to appear in an SEC filing or otherwise be made publicly available, that the assurance obtained by the auditor in that engagement is different from the assurance that would have been obtained by the auditor for Section 404 purposes. Another example of the type of change that might be necessary in separate rulemaking to AT sec. 501 would be to supplement the performance directions to be comparable to those in this standard. Auditors should remain alert for additional rulemaking by the Board that affects AT sec. 501.