

Section 404(a) of the Sarbanes-Oxley Act of 2002 (the Act), and the Securities and Exchange Commission's ("SEC") related implementing rules,^{1/} 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 about whether the company's internal control is effective. Companies considered accelerated filers (seasoned U.S. companies with public float exceeding \$75 million) are required to comply with the internal control reporting and disclosure requirements of Section 404(a) of the Act for fiscal years ending on or after June 15, 2004. Other companies (including smaller companies, foreign private issuers and companies with only registered debt securities) have until fiscal years ending on or after April 15, 2005, to comply with these internal control reporting and disclosure requirements.

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.

An attestation, in a general sense, is an expert's communication of a conclusion about the reliability of someone else's assertion. For example, a financial statement audit is a form of attestation. In a financial statement audit, the auditor attests to the fairness of a company's financial statements, which are assertions by management regarding the financial performance and financial condition of the company. To accomplish this task, the auditor evaluates the process management uses to prepare the company's financial statements and gathers evidence to support or refute the assertions. Similarly, the auditor's attestation on management's assessment of the effectiveness of the company's internal control over financial reporting involves evaluating management's assessment process and gathering evidence regarding the design and operating effectiveness of the company's internal control, determining whether that evidence supports or refutes management's assessment, and opining as to whether management's assessment is fair.

When the Board adopted its interim attestation standards in Rule 3300T on a transitional basis, the Board adopted a pre-existing standard governing an auditor's

^{1/} See 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].

attestation on internal control. 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 reporting on internal control. The participants at the roundtable included representatives from public companies, accounting firms, investor groups and regulatory organizations. As a result of 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 was insufficient for purposes of effectively implementing the requirements of Section 404 of the Act, and for the Board to appropriately discharge the Board's standard-setting obligations under Section 103(a) of the Act. In response, the Board developed this proposed auditing standard.

An Integrated Audit of the Financial Statements and Internal Control Over Financial Reporting

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 and an audit of the financial statements are closely interrelated, the proposed auditing standard introduces an integrated audit of internal control and financial statements. The proposed auditing standard is an integrated standard, addressing both the work that is required to audit internal control over financial reporting and the relationship of that audit to the audit of the financial statements. Nevertheless, the integrated audit results in two opinions: one on internal control over financial reporting and one on the financial statements, which may be expressed in a combined report or in separate reports. Throughout the proposed standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting is referred to as the "audit of internal control over financial reporting."

To conduct and report on the results of an audit of internal control over financial reporting pursuant to the proposed standard, the auditor also would be required to audit the company's financial statements. That is because of the potential significance of the information that might be obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control.

In evaluating the proposed standard, the Board seeks comments on 31 questions. The Board requests respondents to answer the questions and provide

explanations as to why they agree or disagree with the positions the Board has taken in the proposed standard. The first three of these questions are presented below.

Questions regarding an integrated audit of the financial statements and internal control over financial reporting:

1. Is it appropriate to refer to the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting as the audit of internal control over financial reporting?
2. Should the auditor be prohibited from performing an audit of internal control over financial reporting without also performing an audit of the financial statements?
3. Rather than requiring the auditor to also complete an audit of the financial statements, would an appropriate alternative be to require the auditor to perform work with regard to the financial statements *comparable to* that required to complete the financial statement audit?

Internal Control Over Financial Reporting

Internal control is a process designed to provide reasonable assurance regarding the achievement of a company's objectives in the areas of financial reporting reliability, operating efficiency and effectiveness, and compliance with applicable laws and regulations. The SEC's rules implementing Section 404(a) of the Act, and the Board's proposed auditing standard, focus on those objectives exclusively related to the reliability of a company's external financial reporting. This subset of internal control is commonly referred to as *internal control over financial reporting*.

Internal control over financial reporting consists of company policies and procedures that are designed and operated to provide reasonable assurance – that is, a high but not absolute level of assurance – about the reliability of a company's financial reporting and its process for preparing and fairly presenting financial statements in accordance with generally accepted accounting principles. It includes policies and procedures that pertain to the maintenance of accounting records, the authorization of receipts and disbursements, and the safeguarding of assets.

Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control

framework established by a body of experts that followed due-process procedures to develop the framework. In the United States, the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission has published *Internal Control – Integrated Framework*. Known as the "COSO Report," it provides a suitable framework for purposes of management's assessment. Because of the frequency with which management of public companies is expected to use COSO as the framework for the assessment, the directions in the proposed standard are based on the COSO framework. Other suitable frameworks have been published in other countries and likely will be published in the future. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass all of COSO's general themes. The auditor should therefore be able to apply the concepts and guidance in the proposed standard in a reasonable manner if management uses a framework other than COSO.

Regardless of how well any system of internal control over financial reporting is designed and operating, it cannot provide absolute assurance of achieving financial reporting objectives because of inherent limitations. These inherent limitations exist because internal control over financial reporting is a process that involves human diligence and compliance and, consequently, can be intentionally circumvented.

The Costs and Benefits of Internal Control

Effective internal control over financial reporting is essential for a company to effectively manage its affairs and to fulfill its obligation to its investors. A company's management and its owners – public investors – and others must be able to rely on the financial information reported by companies to make decisions.

Reliable financial reporting adds value and also can offset risks in a cost-beneficial manner. Evaluating a company's internal control over financial reporting is sometimes costly, but there also are many far-reaching benefits. Some of the benefits of a company developing, maintaining, and improving its system of internal control include identifying cost-ineffective procedures, reducing costs of processing accounting information, increasing productivity of the company's financial function, and simplifying financial control systems. It also may result in fewer financial statement restatements and less litigation. The primary benefit, however, is to provide the company, its management, its board and audit committee, and its owners and other stakeholders with a reasonable basis to rely on the company's financial reporting. The integrity of financial reporting represents the foundation upon which this country's public markets are built.

As companies develop processes to assist management in its internal control assessment under Section 404 and in its quarterly certification under Section 302, the annual assessment process should result in a continuous strengthening of internal controls while simultaneously reducing the future time and costs of compliance with these requirements. The Board anticipates that most companies will experience the highest cost of complying with Section 404 during the first year of implementation.

The Board is sensitive to the possible effects of the proposed standard on small and medium-sized companies. Internal control is not "one-size-fits-all," and the nature and extent of controls that are necessary depend, to a great extent, on the size and complexity of the company. Large, complex, multi-national companies, for example, are likely to need extensive and sophisticated internal control systems. In smaller companies, or in companies with less complex operations, the ethical behavior and core values of a senior management group that is directly involved in daily interactions with both internal and external parties might reduce the need for elaborate internal control systems. For a smaller, less complex company, the Board expects that the auditor will exercise reasonable professional judgment in determining the extent of the audit of internal control and perform only those tests that are necessary to ascertain the effectiveness of the company's internal control.

Question regarding the costs and benefits of internal control:

4. Does the Board's proposed standard give appropriate 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 issuers?

The Audit of Internal Control Over Financial Reporting

An audit of internal control over financial reporting is an extensive process involving several steps. It is integrated with the audit of the financial statements. Under the proposed auditing standard, these steps would include: planning the audit; evaluating the process management used to perform its assessment of internal control effectiveness; obtaining an understanding of the internal control; evaluating the effectiveness of both the design and operation of the internal control; and forming an opinion about whether internal control over financial reporting is effective.

The auditor's objective is to express an opinion about whether management's assessment, or conclusion, on the effectiveness of internal control over financial

reporting is stated fairly, in all material respects. To support his or her opinion, the auditor must obtain evidence about whether internal control over financial reporting is effective. The auditor obtains this evidence in several ways, including evaluating and testing management's assessment process; evaluating and testing work on internal control performed by others, such as internal auditors; and testing the effectiveness of the controls himself or herself.

Question regarding the audit of internal control over financial reporting:

5. Should the Board, generally or in this proposed standard, specify the level of competence and training of the audit personnel that is necessary to perform specified auditing procedures effectively? For example, it would be inappropriate for a new, inexperienced auditor to have primary responsibility for conducting interviews of a company's senior management about possible fraud.

Evaluating Management's Assessment

A natural starting place for the audit of a company's internal control over financial reporting is an evaluation of management's assessment. This evaluation provides the auditor with confidence that management has a basis for expressing its opinion on the effectiveness of internal control, provides information that will help the auditor understand the company's internal control, helps the auditor plan the work necessary to complete the audit, and provides some of the evidence the auditor will use to support his or her opinion.

The objective of an audit of internal control over financial reporting is to form an opinion "as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects."^{2/} Further, Section 103(a)(2)(A)(iii) of the Act requires the auditor's report to present an evaluation of whether the internal control structure provides reasonable assurance that transactions are recorded as necessary, among other requirements. Importantly, the auditor's conclusion will pertain directly to whether the auditor can agree with management that internal control is effective, not just to the adequacy of management's process for determining whether internal control is effective. 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

^{2/} See SEC Regulation S-X 2-02(f), 17 C.F.R. 210.2-02(f).

correct. The auditor needs to evaluate management's assessment process to be satisfied that management has an appropriate basis for its conclusion. The auditor, however, also needs to test the effectiveness of internal control to be satisfied that management's conclusion is correct and, therefore, fairly stated. Indeed, as the Board heard at the internal control roundtable, investors expect the independent auditor to test whether the company's internal control over financial reporting is effective, and the proposed auditing standard would require the auditor to do so.

Nevertheless, the work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work the independent auditor will need to perform. The proposed auditing standard would allow the auditor to use, to a reasonable degree, the work performed by others, including management. Thus, the more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

As a part of evaluating management's assessment, the auditor must evaluate the adequacy of management's documentation of the design of the internal controls and their assessment of internal control effectiveness. The proposed standard would provide the auditor with criteria to use in evaluating the adequacy of management's documentation. Inadequate documentation would be considered an internal control deficiency, the severity of which the auditor would evaluate just as he or she would be required to evaluate the severity of other internal control deficiencies.

Questions regarding evaluation of management's assessment:

6. Is the scope of the audit appropriate in that it requires the auditor to both evaluate management's assessment and obtain, directly, evidence about whether internal control over financial reporting is effective?
7. Is it appropriate that the Board has provided criteria that auditors should use to evaluate the adequacy of management's documentation?
8. Is it appropriate to state that inadequate documentation is an internal control deficiency, the severity of which the auditor should evaluate? Or should inadequate documentation automatically rise to the level of significant deficiency or material weakness in internal control?

Planning the Audit

Planning the audit of internal control over financial reporting allows the auditor to develop an overall strategy for the audit. Many factors enter into audit planning, and the proposed auditing standard includes among them the auditor's knowledge of the company, matters affecting the company's industry, matters relating to the company's business, and the extent of recent changes in the company's operations or internal control over financial reporting. Armed with a good understanding of these types of factors, the auditor is in a position to effectively design the nature, timing, and scope of the audit.

Obtaining an Understanding of Internal Control Over Financial Reporting

The auditor should understand how internal control over financial reporting is designed and operates to evaluate and test its effectiveness. The auditor obtains a substantial amount of this understanding when evaluating management's assessment process.

The auditor also should be satisfied, however, that the controls *actually* have been implemented and are operating as they were designed to operate. Thus, while inquiry of company personnel and a review of management's assessment provide the auditor with an understanding of how the system of internal control is designed and operates, other procedures are necessary for the auditor to confirm his or her understanding.

The proposed auditing standard would have the auditor confirm his or her understanding by performing procedures that include making inquiries of and observing the personnel who actually perform the controls; reviewing documents that are used in, and that result from, the application of the controls; and comparing supporting documents (for example, sales invoices, contracts, and bills of lading) to the accounting records. The most effective means of accomplishing this objective is for the auditor to perform "walkthroughs" of the company's significant processes. For this reason, and because of the importance of several other objectives that walkthroughs accomplish, the proposed auditing standard would require the auditor to perform walkthroughs in each audit of internal control over financial reporting.

In a walkthrough, the auditor traces all types of company transactions and events – both those that are routine and recurring and those that are unusual – from origination, through the company's accounting and information systems and financial

report preparation processes, to their being reported in the company's financial statements. Walkthroughs provide the auditor with audit evidence that supports or refutes his or her understanding of the process flow of transactions, the design of controls, and whether controls are in operation. Walkthroughs also help the auditor to determine whether his or her understanding is complete and provide information necessary for the auditor to evaluate the effectiveness of the design of the internal control over financial reporting.

Because of the judgment that a walkthrough requires and the significance of the objectives that walkthroughs allow the auditor to achieve, the proposed auditing standard would require the auditor to perform the walkthroughs himself or herself. In other words, the proposed auditing standard would not allow the auditor to use the work performed by management or others to satisfy the requirement to perform walkthroughs.

As a part of obtaining an understanding of internal control, the auditor also determines which controls should be tested, either by the auditor, management or others. The proposed standard would require that the auditor obtain evidence about the operating effectiveness of internal control over financial reporting for all relevant assertions for all significant accounts or disclosures. This requirement relies heavily on two concepts: significant account and relevant assertion.

The auditing standards implicitly recognize that some accounts are more significant than others. The proposed standard provides additional direction on how to determine significant accounts for purposes of the audit of internal control over financial reporting. In short, the auditor begins by performing a quantitative evaluation of accounts at the financial-statement caption or note-disclosure level. Then the auditor expands the evaluation to include qualitative factors, such as differing risks, company organization structure, and other factors, which would likely result in additional accounts being identified as significant.

Financial statement amounts and disclosures embody what are known as financial statement assertions. Does the asset exist, or did the transaction occur? Has the company included all loans outstanding in its loans payable account? Have marketable investments been properly valued? Does the company have the rights to the accounts receivable, and are the loans payable the proper obligation of the company? Are the amounts in the financial statements appropriately presented, and is

there adequate disclosure about them? This process will allow the auditor to identify the relevant financial statement assertions for which the company should have controls.

Identifying "relevant" assertions is a familiar process for experienced auditors. Because of the importance relevant assertions play in the required extent of testing, the proposed standard provides additional direction.

Questions regarding obtaining an understanding of internal control over financial reporting:

9. Are the objectives to be achieved by performing walkthroughs sufficient to require the performance of walkthroughs?
10. Is it appropriate to require that the walkthrough be performed by the auditor himself or herself, rather than allowing the auditor to use walkthrough procedures performed by management, internal auditors, or others?

Testing and Evaluating the Effectiveness of the Design of Controls

To be effective, internal controls must be designed properly and all the controls necessary to provide reasonable assurance about the fairness of a company's financial statements should be in place and performed by appropriately qualified people who have the authority to implement them. At some point during the internal control audit, the auditor will need to make a determination as to whether the controls would be effective if they were operated as designed, and whether all the necessary controls are in place. This is known as *design effectiveness*.

The procedures the auditor performs to test and evaluate design effectiveness include inquiries of company personnel, observation of internal controls, walkthroughs, and a specific evaluation of whether the controls are likely to prevent or detect financial statement misstatements if they operate as designed. The proposed auditing standard would adopt these methods of testing and evaluating design effectiveness. The last step is especially important because it calls for the auditor to apply professional judgment and knowledge of and experience with internal control over financial reporting to his or her understanding of the company's controls.

Testing Operating Effectiveness

The proposed standard would require the auditor to obtain evidence about the design and operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements.

For this reason, in addition to being satisfied as to the effectiveness of the design of the internal controls, the auditor performs tests of controls to obtain evidence about the operating effectiveness of the controls. These tests include a mix of inquiries of appropriate company personnel, inspection of relevant documentation, such as sales orders and invoices, observation of the controls in operation, and reperformance of the application of the control.

The proposed standard directs required tests of controls to "relevant assertions" rather than to "significant controls." To comply with the requirements of the proposed standard, the auditor would apply tests to those controls that are important to fairly presenting each relevant assertion in the financial statements. It is neither necessary to test all controls nor is it necessary to test redundant controls (unless redundancy is itself a control objective, as in the case of certain computer controls). However, the emphasis is better placed on addressing relevant assertions (because those are the points where misstatements could occur) rather than significant controls. This emphasis encourages the auditor to identify and test controls that address the primary areas where misstatements could occur yet limits the auditor's work to only the necessary controls.

Expressing the extent of testing in this manner also resolves the issue of the extent of testing from year to year (the so-called "rotating tests of controls" issue). The proposed standard states 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, each year's audit must stand on its own. Therefore, the auditor must obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year.

The Act requires management's assessment and the auditor's opinion to address whether internal control was effective as of the end of the company's most recent fiscal year, in other words, as of a point-in-time. Performing all of the testing on December 31 is neither practical nor appropriate, however. To form a basis to express an opinion about whether internal control was effective as of a point in time requires the auditor to obtain evidence that the internal control operated effectively over an appropriate period

of time. The proposed auditing standard recognizes this and allows the auditor to obtain evidence about operating effectiveness at different times throughout the year, provided that the auditor updates those tests or obtains other evidence that the controls still operated effectively at the end of the company's fiscal year.

Also at the Board's roundtable, public company representatives and auditors indicated that providing examples of extent of testing decisions would be helpful. In response, paragraph B41 of Appendix B of the proposed standard includes several examples.

Question regarding testing operating effectiveness:

11. Is it appropriate to require the auditor to obtain evidence of the effectiveness of controls for all relevant assertions for all significant accounts and disclosures every year or may the auditor use some of the audit evidence obtained in previous years to support his or her current opinion on management's assessment?

Using the Work of Management and Others

The auditor also should consider other relevant and available information about internal control when evaluating internal control effectiveness. In this regard, the proposed standard would require the auditor to understand the results of procedures performed by management and others, for example, internal auditors and third parties working under the direction of management, on internal control over financial reporting. At a minimum, the auditor should consider the results of those tests in designing the audit approach and ultimately in forming an opinion on the effectiveness of internal control over financial reporting. To this end, the proposed standard would require the auditor to review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address internal controls over financial reporting and evaluate any internal control deficiencies identified in those reports.

Additionally, the auditor may use the results of testing by others to alter the nature, timing, and extent of his or her tests of controls. At the Board's roundtable, public company representatives indicated their concern that at some point, the Board's standard could require an excessive amount of retesting by the auditor in order to use the work of others, especially internal auditors. Public company representatives were particularly sensitive to this issue because of its direct bearing on their total cost to comply with Section 404. On the other hand, the federal bank regulator representative

indicated that experience with the Federal Deposit Insurance Corporation Improvement Act of 1991, which requires internal control reporting similar to Section 404 of the Act, revealed instances where the auditor used the work of internal auditors to an inappropriately high degree, where the auditor himself or herself did not perform sufficient work to provide a reasonable basis for his or her opinion.

The proposed standard describes an evaluation process, focusing on the competence and objectivity of the persons who performed the work, that the auditor should use in determining the extent to which he or she may use the work of others. The proposed standard also describes two principles that limit the auditor's use of the work of others. First, the proposed standard defines three categories of controls and the extent to which the auditor may use the work of others for each of these categories: (1) 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, (2) 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 (3) 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. Second, the proposed standard requires that, on an overall basis, the auditor's own work must provide the principal evidence for the audit opinion.

These two principles interact to provide the auditor with flexibility in using the work of others and also prevent inappropriate over-reliance on the work of others. Although the proposed standard requires that the auditor reperform some of the tests performed by others in order to use their work, it does not set any specific requirement on the extent of the reperformance. For example, the standard does not require that the auditor reperform tests of controls over all significant accounts for which the auditor uses the work of others. Rather, the proposed standard relies on the auditor's judgment and the interaction of the two principles discussed above to determine the appropriate extent of reperformance.

Questions regarding using the work of management and others:

12. To what extent should the auditor be permitted or required to use the work of management and others?

13. Are the three categories of controls and the extent to which the auditor may rely on the work of others appropriately defined?
14. Does the proposed standard give appropriate recognition to the work of internal auditors? If not, does the proposed standard place too much emphasis and preference on the work of internal auditors or not enough?
15. Is the flexibility in determining the extent of reperformance of the work of others appropriate, or should the auditor be specifically required to reperform a certain level of work (for example, reperform tests of all significant accounts or reperform every test performed by others that the auditor intends to use)?
16. Is the requirement for the auditor to obtain the principle evidence, on an overall basis, through his or her own work the appropriate benchmark for the amount of work that is required to be performed by the auditor?

Evaluating the Results

Both management and the auditor may identify deficiencies in internal control over financial reporting. An *internal control deficiency* exists when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

The proposed auditing standard would require the auditor to evaluate the severity of all identified internal control deficiencies because such deficiencies can have an effect on the auditor's overall conclusion about whether internal control is effective. The auditor also has a responsibility to make sure that certain parties, such as the audit committee, are aware of internal control deficiencies that rise to a certain level of severity.

Under the proposed auditing standard, an internal control deficiency (or a combination of internal control deficiencies) should be classified as a *significant deficiency* if, by itself or in combination with other internal control deficiencies, it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected. A significant deficiency should be classified as a *material weakness* if, by itself or in combination with other internal control deficiencies, it results in more than a

remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected.

At the Board's roundtable, issuers, investors and auditors all suggested that while the existing definitions of internal control deficiencies are familiar and not fundamentally flawed, additional guidance that provides additional specificity would be very helpful. However, the participants acknowledged that articulating such guidance is very difficult, particularly because the process of evaluating deficiencies and whether they constitute significant deficiencies or material weaknesses will necessarily always involve judgment. The Roundtable participants suggested that the Board provide additional guidance in the form of examples.

The proposed auditing standard's definitions of significant deficiency and material weakness focus on likelihood and magnitude as the framework for evaluating deficiencies. The Board anticipates that this framework will bring increased consistency to these evaluations yet preserve an appropriate degree of judgment. Additionally, the proposed standard includes examples in Appendix D of how these definitions would be applied in several different scenarios.

The proposed auditing standard requires the auditor to communicate in writing to the company's audit committee all significant deficiencies and material weaknesses of which the auditor is aware. The auditor also is required to communicate to the company's management, in writing, all internal control deficiencies of which he or she is aware and to notify the audit committee that such communication has been made.

The proposed standard identifies 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, including –

- *Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.* Effective oversight by the company's board of directors, including its audit committee, is essential to the company's achievement of its objectives and is an integral part of a company's monitoring of internal control. In addition to requiring the audit committee to oversee the company's external financial reporting and internal control over financial reporting, the Act makes the audit committee directly responsible for the appointment, compensation, and oversight of the work of the auditor. Thus, an

ineffective audit committee can have detrimental effects on the company and its internal control over financial reporting, as well as on the independent audit. The proposed auditing standard requires the auditor to evaluate factors related to the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting, including whether audit committee members act independently from management.

- *Material misstatement in the financial statements not initially identified by the company's internal controls.* The audit of internal control over financial reporting and the audit of the company's financial statements are an integrated activity and are required by the Act to be a single engagement. The results of the work performed in a financial statement audit provide evidence to support the auditor's conclusions on the effectiveness of internal control, and vice-versa. Therefore, if the auditor discovers a material misstatement in the financial statements as a part of the audit of the financial statements, the auditor should consider whether internal control over financial reporting is effective. That the company's internal controls did not first detect the misstatement is a strong indicator that the company's internal control over financial reporting is not effective.
- *Significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after some reasonable period of time.* Significant deficiencies in internal control that are not also determined to be material weaknesses, as defined in the proposed auditing standard, are not so severe as to require the auditor to conclude that internal control is ineffective. However, these deficiencies are, nonetheless, significant, and the auditor should expect the company to correct them. If management fails to correct significant deficiencies within a reasonable period of time, that situation reflects poorly on tone-at-the-top as well as the control environment. Additionally, the significance of the deficiency can change over time (for example, increases in sales volume or added complexity in sales transaction structures would increase the severity of a significant deficiency affecting sales).

Questions regarding evaluating results:

17. Will the definitions in the proposed standard of significant deficiency and material weakness provide for increased consistency in the evaluation of deficiencies? How can the definitions be improved?
18. Do the examples in Appendix D of how to apply these definitions in various scenarios provide helpful guidance? Are there other specific examples that commenters could suggest that would provide further interpretive help?
19. Is it necessary for the auditor to evaluate the severity of all identified internal control deficiencies?
20. Is it appropriate to require the auditor to communicate all internal control deficiencies (not just material weaknesses and significant deficiencies) to management in writing?
21. Are the matters that the Board has classified as strong indicators that a material weakness in internal control exists appropriately classified as such?
22. Is it appropriate to require the auditors to evaluate the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting?
23. Will auditors be able to effectively carry out their responsibility to evaluate the effectiveness of the audit committee's oversight?
24. If the auditor concludes that ineffective audit committee oversight is a material weakness, rather than require the auditor to issue an adverse opinion with regard to the effectiveness of the internal control over financial reporting, should the standard require the auditor to withdraw from the audit engagement?

Forming an Opinion and Reporting

If the auditor has identified no material weaknesses in internal control after having performed all of the procedures that the auditor considers necessary in the

circumstances, then the proposed standard would permit the auditor to express an unqualified opinion that management's assessment of the effectiveness of internal control over financial reporting is fairly stated in all material respects. In the event that the auditor could not perform all of the procedures that the auditor considers necessary in the circumstances, then the proposed standard would permit the auditor to either qualify or disclaim an opinion. If an overall opinion cannot be expressed, the proposed auditing standard would require the auditor to explain why.^{3/}

No Disclosure of Significant Deficiencies

The auditor's report must follow the same disclosure model as management's assessment. The SEC's final rules implementing Section 404 only require management's assessment to disclose material weaknesses, not significant deficiencies. Therefore, because management's assessment will disclose only material weaknesses, the auditor's report should disclose only material weaknesses.^{4/}

Material Weaknesses Result in Adverse Opinion

The existing attestation standard provides that when the auditor has identified a material weakness in internal control, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion ("except for the effect of the material weakness,

^{3/} See also SEC Regulation S-X 2-02(f), 17 C.F. R. § 212.2-02(f) ("The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and clearly state the opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects, or must include an opinion to the effect that an overall opinion cannot be expressed. If an overall opinion cannot be expressed, explain why.").

^{4/} It should be noted, however, that the final rules indicated that an aggregation of significant deficiencies may constitute a material weakness in a company's internal control over financial reporting, in which case disclosure would be required. See Final Rule: Management's Reports in 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].

internal control was effective") or may express an adverse opinion ("internal control over financial reporting was not effective").

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 is not effective (i.e., a qualified or "except for" conclusion is not acceptable).

Similar to the reporting of significant deficiencies, the reporting model for the auditor must 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 must also be adverse; the proposed standard does not permit a qualified audit opinion in the event of a material weakness.

Questions regarding forming an opinion and reporting:

25. Is it appropriate that the existence of a material weakness would require the auditor to express an adverse conclusion about the effectiveness of the company's internal control over financial reporting, consistent with the required reporting model for management?
26. Are there circumstances where a qualified "except for" conclusion would be appropriate?
27. Do you agree with the position that when the auditor issues a non-standard opinion, such as an adverse opinion, that the auditor's opinion should speak directly to the effectiveness of the internal control over financial reporting rather than to whether management's assessment is fairly stated?

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

Strong internal controls provide better opportunities to detect and deter fraud. For example, many frauds resulting in financial statement restatement relied upon the ability of management to exploit weaknesses in internal control. To the extent that the internal control reporting required by Section 404 can help restore investor confidence by improving the effectiveness of internal controls (and reducing the incidence of fraud),

the auditing standard on performing the audit of internal control over financial reporting should emphasize controls that prevent or detect errors as well as fraud. For this reason, the proposed standard specifically addresses and emphasizes the importance of controls over possible fraud and requires the auditor to test controls specifically intended to prevent or detect fraud that is reasonably likely to result in material misstatement of the financial statements.

Auditor Independence

The Act, and the SEC rules implementing Section 404 of the Act, require the auditor to be independent to perform an audit of internal control over financial reporting. Under the SEC's Rule 2-01 on auditor independence, an auditor impairs his or her independence if the auditor audits his or her own work, including any work on designing or implementing an audit client's internal control system. The proposed standard explicitly prohibits the auditor from accepting an engagement to provide an internal control-related non-audit service to an audit client that has not been specifically pre-approved by the audit committee. In other words, the audit committee would not be able to pre-approve internal control-related non-audit services as a category. Rather, each specific engagement would be required to be specifically pre-approved.

While the Board has not proposed to provide specific guidance on permissible internal control-related non-audit services in the proposed standard on the audit of internal control, the Board intends to conduct an in-depth evaluation of independence requirements in the future. The Board may, as a result of its evaluation, amend the independence information included in the proposed auditing standard.

Questions regarding auditor independence:

28. Should the Board provide specific guidance on independence and internal control-related non-audit services in the context of this proposed standard?
29. Are there any specific internal control-related non-audit services the auditor should be prohibited from providing to an audit client?

Auditor's Responsibilities With Regard to Management's Certifications

The proposed standard also outlines the auditor's work related to management's quarterly and annual certifications required by Section 302 of the Act.

A company's principal executive and financial officers are responsible for internal control over financial reporting. Section 302 of the Act emphasizes this responsibility by requiring these parties to certify, quarterly and annually, their responsibility, among others, for establishing and maintaining internal control over financial reporting and for disclosing changes in the company's internal control over financial reporting that occurred during the most recent quarter (or the fourth quarter, for the annual certification) that have materially affected, or are likely to affect materially, the company's internal control over financial reporting.

The Board believes that the auditor's responsibility for management's disclosure of a material weakness corrected by the end of one of the first three quarters should be similar to the auditor's responsibility regarding material misstatements of interim financial statements. Under AU sec. 722, *Interim Financial Information*,^{5/} the auditor performs limited procedures on the interim financial information which are substantially less than an audit; however, if the auditor became aware that the financial statements are materially misstated, the auditor would be required to communicate the matter to management. If management fails to respond appropriately, the auditor would be required to communicate the matter to the audit committee. If the audit committee did not respond appropriately, the auditor would be required to evaluate whether or not to resign from the engagement. The auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934. If the auditor became aware that a material weakness in internal control had been identified and corrected yet management had not appropriately disclosed the correction in its report as indicated in the quarterly certification, that situation would be closely analogous to the auditor's knowledge of a material financial statement misstatement. Therefore, the responsibilities should run a similar path.

The auditor has a different level of responsibility as it relates to changes in internal control made in the fourth quarter. While the auditor is not required to issue a

^{5/} The Board adopted the generally accepted auditing standards, as described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in this Release to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

report on his or her quarterly review procedures, the auditor is required to report on management's annual assessment based on his or her audit of internal control. If, as a result of the auditor's audit procedures, the auditor becomes aware that management's annual report fails to appropriately disclose a material weakness that was corrected during the fourth quarter, the auditor has the responsibility to modify his or her audit report on internal control. Assume, for example, that management identified and corrected a material weakness during the fourth quarter and that the material weakness was corrected in time for both management and the auditor to have a sufficient period of time to test the operating effectiveness of the correction. Management makes the conclusion in its report on its assessment of internal control over financial reporting that internal control over financial reporting is effective; the auditor's opinion is unqualified, stating that management's assessment is stated fairly. However, if the company's annual report fails to also disclose the material weakness that was identified and corrected in the fourth quarter, and the auditor concludes that the disclosure is material information, the auditor would have to include an explanatory paragraph in his or her report describing the material weakness that was identified and corrected in the fourth quarter and note it was omitted from the company's annual report.

Questions regarding auditor's responsibilities with regard to management's certifications:

30. Are the auditor's differing levels of responsibility as they relate to management's quarterly certifications versus the annual (fourth quarter) certification, appropriate?
31. Is the scope of the auditor's responsibility for quarterly disclosures about the internal control over financial reporting appropriate?

Effective Date of the Proposed Standard

Companies considered accelerated filers (seasoned U.S. companies with public float exceeding \$75 million) are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act for fiscal years ending on or after June 15, 2004. Accordingly, auditors engaged to audit the financial statements of such companies for fiscal years ending on or after June 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. Other companies (including smaller companies, foreign private issuers and companies with only registered debt securities) have until fiscal years ending on or after April 15, 2005, to comply with these internal control reporting and disclosure

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requirements and the requirement for audit reporting on internal control is similarly delayed. The proposed standard would be effective at the same time as these requirements. Early implementation of the proposed standard would be permitted.

Opportunity for Public Comment

The Board will seek comment on the proposed standard for a 45-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments may also be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 008 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on November 21, 2003.

The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt a final standard, with or without amendments. Any final standard adopted will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are deemed to be rules under the Act.

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* * *

On the 7th day of October, in the year 2003, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

October 7, 2003

APPENDIX –

Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements

Appendix – Proposed Auditing Standard

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

***AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL
REPORTING PERFORMED IN CONJUNCTION WITH AN
AUDIT OF FINANCIAL STATEMENTS***

STATEMENT OF AUTHORITY

The Public Company Accounting Oversight Board (the "Board") is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002 (the "Act") to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

The Board has adopted Rule 3100 to require all registered public accounting firms to adhere to the Board's auditing and related professional practice standards (including interim professional standards) in the audits of public companies. Any registered public accounting firm that fails to adhere to the Board's standards is subject to disciplinary proceedings in accordance with Section 105 of the Act and the Board's rules.

Reference in the Board's standards to "the auditor" means a registered public accounting firm or an associated person of such a firm as defined in the Act and the Board's rules, unless specifically stated otherwise.

Reference in the Board's standards to the AICPA Professional Standards refers to those professional standards as they existed on April 16, 2003, the date the Board adopted them as interim standards.

The Board has proposed Rule 3101 regarding the use of certain terms in the Board's standards.* The Board's standards use the words "must," "shall," or "is required" to indicate unconditional obligations. The auditor's performance of these obligations is necessary to the accomplishment of the audit. The standards use the word "should" to indicate obligations that are presumptively mandatory. The auditor must comply with the requirements of this nature specified in the Board's standards unless the auditor can demonstrate, by verifiable objective and documented evidence, that alternative actions he or she followed in the circumstances were sufficient to achieve the objectives of the standard and serve adequately to protect the interests of investors and further the preparation of informative, fair, and independent audit reports. The Board uses the words "may," "might," "could," or other terms and phrases to describe actions and procedures that the auditor has a professional obligation to consider. Matters described in this fashion require the auditor's attention and understanding; how and whether they are implemented in the audit will depend on the exercise of professional judgment in the circumstances. Additionally, appendices to the Board's standards are an integral part of the standard and carry the same authoritative weight as the body of the standard.

This Statement of Authority is an integral part of the Board's auditing and related professional practice standards.

* See PCAOB Release No. 2003-019, *Proposed Rule Regarding Certain Terms Used in Auditing and Related Professional Practice Standards*.

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Appendix A – Illustrative Reports on Internal Control Over Financial Reporting

Appendix B – Additional Performance Requirements and Guidance; Extent of Testing Examples

Appendix C – Safeguarding of Assets

Appendix D – Examples of Material Weaknesses and Significant Deficiencies

Appendix E – Special Internal Control Over Financial Reporting Considerations for Small and Mid-Sized Companies

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1. This standard establishes requirements that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting.¹
2. A company subject to the reporting requirements of the Securities Exchange Act of 1934 is required to include in its annual report a report of management on the company's internal control over financial reporting. Registered investment companies, issuers of asset-backed securities, and nonpublic companies are not subject to the reporting requirements mandated by Section 404 of the Sarbanes-Oxley Act (the Act) of 2002 (PL 107-204). The report of management is required to contain management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether the company's internal control over financial reporting is effective. The auditor that audits the company's financial statements included in the annual report is required to attest to and report on management's assessment. The company is required to file the auditor's attestation report as part of the annual report.
3. This standard is the standard on attestation engagements referred to in Section 404(b) of the Act.² Throughout this standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting required by

¹ This standard supersedes Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting" of *Statement on Standards for Attestation Engagements No. 10, Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, Vol. 1, AT sec. 501), as it relates to performing an audit (referred to in AT sec. 501 as an "examination") of the design and operating effectiveness of internal control over financial reporting. This standard also supersedes *Statement on Auditing Standards No. 60, Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, Vol. 1, AU sec. 325). This standard requires that, for public companies, the auditor cannot audit internal control over financial reporting without also auditing the financial statements. However, the auditor may audit the financial statements without also auditing internal control over financial reporting. When an auditor is engaged to audit only the financial statements of a public company, this standard does not apply. However, in that situation, the auditor should follow this standard as it relates to the definition of a deficiency in internal control over financial reporting, a significant deficiency, and a material weakness, as well as the required communications of these matters described herein.

² This standard is also the standard referred to in Section 103(a)(2)(A)(iii).

Section 404(b) of the Act is referred to as the *audit of internal control over financial reporting*.³

Auditor's Objective in an Audit of Internal Control Over Financial Reporting

4. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit 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 assessment.

5. To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting is designed and operated effectively. The auditor obtains this evidence from a number of sources, including using the work performed by management in making its assessment, internal auditors and others under the direction of management, and performing auditing procedures himself or herself.

Definitions Related to Internal Control Over Financial Reporting

6. For purposes of management's assessment and the audit of internal control over financial reporting in this standard, *internal control over financial reporting* is defined as follows:⁴

A process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar

³ The two terms "audit of internal control over financial reporting" and "attestation of management's assessment of the effectiveness of internal control over financial reporting" refer to the same professional service. The first refers to the process, and the second refers to the result of that process.

⁴ This definition is the same one used by the SEC in its rules requiring management to report on internal control over financial reporting, except the word "registrant" has been changed to "company" to conform to the wording in this standard. (See 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].)

functions, and effected by the company's board of directors, management, and other personnel, 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 and 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.

7. An *internal control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in *design* exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that even if the control operates as designed, the control objective is not always met.
- A deficiency in *operation* exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

8. A *significant deficiency* is an internal control deficiency that adversely affects the company's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. A significant deficiency could be a single deficiency, or a combination of deficiencies, that results in more than a remote likelihood⁵ that a misstatement of the annual or interim financial statements that is more than inconsequential in amount will not be prevented or detected.

⁵ The term "remote likelihood" as used in the definition of *significant deficiency* and *material weakness* has the same meaning as the term "remote" as used

9. A *material weakness* is a significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

10. Internal controls over financial reporting may be *preventive controls* or *detective controls*.

- Preventive controls have the objective of preventing a misstatement from occurring in the first place.
- Detective controls have the objective of detecting a misstatement that has already occurred.

11. Even well-designed internal controls might not prevent a misstatement from occurring. However, this possibility is countered by detective controls. Therefore, effective internal control over financial reporting often includes a combination of preventive and detective controls to achieve a specific control objective. The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal controls over financial reporting.

Framework Used by Management to Conduct Its Assessment

12. Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures,

in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* (FAS No. 5). Paragraph 3 of FAS No. 5 states:

When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range, as follows:

- a. *Probable*. The future event or events are likely to occur.
- b. *Reasonably possible*. The chance of the future event or events occurring is more than remote but less than likely.
- c. *Remote*. The chance of the future events or events occurring is slight.

including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

- Is free from bias;
- Permits reasonably consistent qualitative and quantitative measurements of a company's internal control over financial reporting;
- Is sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls over financial reporting are not omitted; and
- Is relevant to an evaluation of internal control over financial reporting.

Committee of Sponsoring Organizations Framework

13. In the United States, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission has published *Internal Control – Integrated Framework*. Known as the COSO report, it provides a suitable and available framework for purposes of management's assessment. For that reason, the performance and reporting directions in this standard are based on the COSO framework. Other suitable frameworks have been published in other countries and may be developed in the future. Such other suitable frameworks may be used in an audit of internal control over financial reporting. Although different frameworks may not contain exactly the same elements as COSO, they should have elements that encompass, in general, all the themes in COSO. The auditor should therefore be able to apply the concepts and guidance in this standard in a reasonable manner.

14. The COSO perspective on internal control over financial reporting does not ordinarily encompass elements related to the effectiveness and efficiency of operations or compliance with laws and regulations. However, operations and compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements are encompassed in internal control over financial reporting. Additionally, not all controls relevant to financial reporting are accounting controls. The auditor should identify all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and which also have a material effect on the reliability of financial reporting. More information about the COSO framework is included in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*.⁶

⁶ The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's (ASB) Statement on Auditing

Appendix E discusses special internal control over financial reporting considerations for small and medium-sized companies.

Inherent Limitations in Internal Control Over Financial Reporting

15. Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Internal control over financial reporting also can be circumvented by collusion or improper management override. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. However, these inherent limitations are known features of the financial reporting process. Therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

Reasonable Assurance

16. Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion.⁷ Reasonable assurance includes the understanding that there is a relatively low risk that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

17. Just as there are inherent limitations on the assurance that can be provided by effective internal control over financial reporting, as discussed in paragraph 15, there are limitations on the amount of assurance the auditor can obtain as a result of performing his or her audit of internal control over financial reporting. Limitations arise

Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in this standard to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

⁷ See 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] for further discussion of reasonable assurance.

because an audit is conducted on a test basis and requires the exercise of professional judgment. Nevertheless, the audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective.

18. Users of the reports from management and the auditor are entitled to receive the same level of assurance from both management and the auditor. This means that users should expect reasonable assurance that internal control over financial reporting is effective. There is no difference in the level of work or assurance given by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting. In either case, the auditor must obtain sufficient evidence in order to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion. The auditor provides the same level of assurance, though not the same assurance, as management. However, the auditor's assurance does not relieve management of its responsibility for assuring users of its financial reports about the effectiveness of internal control over financial reporting.

Management's Responsibilities in an Audit of Internal Control Over Financial Reporting

19. For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:⁸

- a. Accept responsibility for the effectiveness of the company's internal control over financial reporting,
- b. Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria,
- c. Support its evaluation with sufficient evidence, including documentation, and

⁸ Management is required to fulfill these responsibilities. See 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].

- d. Present a written assessment about the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

20. If the auditor concludes that management has not fulfilled the responsibilities enumerated in the preceding paragraph, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. Paragraphs 41 through 47 provide information for the auditor on understanding management's process for evaluating and reporting on internal control over financial reporting.

Materiality Considerations in an Audit of Internal Control Over Financial Reporting

21. The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statements level and at the individual account-balance level. The auditor uses materiality at the financial-statements level in deciding whether a significant deficiency, or combination of significant deficiencies, in controls is a material weakness. Materiality at the individual account-balance level is relevant to deciding whether a deficiency represents a significant deficiency; accordingly, it is lower than materiality at the financial-statements level.

22. The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.⁹

- The quantitative considerations are essentially the same as in an audit of financial statements, and relate to whether misstatements that would not be prevented or detected by internal control over financial reporting, individually or collectively, have a quantitatively material effect on the financial statements.
- The qualitative considerations apply to evaluating materiality with respect to the financial statements and to additional factors that relate to the perceived needs of reasonable persons who will rely on the information.

23. The auditor should be aware that persons who rely on the information concerning internal control over financial reporting include investors, creditors, the board of directors and audit committee, and regulators in specialized industries, such as banking

⁹ AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, provides additional explanation of materiality.

or insurance. Information on internal control over financial reporting is intended to provide an early warning to those inside and outside the company who are in a position to insist on improvements in internal control over financial reporting, such as the audit committee and regulators in specialized industries. The auditor should also be aware that external users are also interested in information on internal control over financial reporting because it enhances the quality of financial reporting and increases their confidence in financial information, particularly financial information issued between annual reports, such as quarterly information.

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

24. The auditor should evaluate all controls specifically intended to address the risks of fraud that are reasonably likely to have a material effect on the company's financial statements, which may be a part of any of the five components of internal control over financial reporting, as discussed in paragraph 50. However, the auditor should place a special emphasis on the evaluation of such controls in the control environment. Controls related to the prevention, identification, and detection of fraud in the control environment often have a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

- Controls restraining the inappropriate use of company assets,
- Company's risk assessment processes,
- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board,
- Adequacy of the internal audit activity and whether it reports functionally to the audit committee, and
- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters.

25. Part of management's responsibility when designing a company's internal control over financial reporting is to design and implement programs and controls to prevent, deter, and detect fraud. Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee), should set the proper tone; create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter, and detect fraud. When management

and those responsible for the oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.

26. In an audit of internal control over financial reporting, the auditor's evaluation of controls is interrelated with the auditor's evaluation of controls in a financial statement audit, as required by AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Often, controls identified and evaluated by the auditor during the audit of internal control over financial reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If an auditor identifies deficiencies in controls related to the prevention, identification, and detection of fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing and extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in AU sec. 316.

Performing an Audit of Internal Control Over Financial Reporting

27. In an audit of internal control over financial reporting, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls related to all relevant financial statement assertions for all significant accounts and disclosures in the financial statements. 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 auditor cannot audit internal control over financial reporting without also auditing the financial statements.¹⁰

28. The auditor must adhere to the general and applicable fieldwork and reporting standards in performing an audit of a company's internal control over financial reporting. This involves the following:

- a. Planning the engagement,
- b. Evaluating management's assessment process,
- c. Obtaining an understanding of internal control over financial reporting,

¹⁰ However, the auditor may audit the financial statements without also auditing internal control over financial reporting, as might be necessary, for example, in the case of certain initial public offerings by a company. See the discussion beginning at paragraph 131 for more information about the importance of auditing both internal control over financial reporting as well as the financial statements when the auditor is engaged to audit internal control over financial reporting.

- d. Testing and evaluating design effectiveness of internal control over financial reporting,
- e. Testing and evaluating operating effectiveness of internal control over financial reporting, and
- f. Forming an opinion on the effectiveness of internal control over financial reporting.

29. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing internal control over financial reporting involves a process of gathering, updating, and analyzing information. Accordingly, the auditor may perform some of the procedures and evaluations described in this section on "Performing an Audit of Internal Control Over Financial Reporting" concurrently.

General and Applicable Fieldwork and Reporting Standards

30. The general standards (see AU sec. 150, *Generally Accepted Auditing Standards*) are applicable to an audit of internal control over financial reporting. These standards require technical training and proficiency as an auditor, independence in fact and appearance, and the exercise of due professional care, including professional skepticism.

31. *Technical Training and Proficiency.* To perform an audit of internal control over financial reporting, the auditor should have competence in the subject matter of internal control over financial reporting.

32. *Independence.* The applicable basic principles of independence are that, to remain independent, the auditor must not function in the role of management and must not audit his or her own work. If the auditor were to design or implement controls, that situation would place the auditor in a management role and result in auditing the auditor's own work. This does not necessarily preclude the auditor from making substantive recommendations as to how management may improve the design or operation of the company's internal controls.

33. For any internal control services the auditor provides, management must be actively involved and cannot delegate responsibility for these matters to the auditor. Management's involvement must be substantive and extensive. Management's acceptance of responsibility for documentation and testing performed by the auditor is not enough to satisfy the independence requirements. Additionally, the auditor must not accept an engagement to provide internal control-related services to an issuer audit client that has not been specifically pre-approved by the audit committee.

34. Maintaining independence, in fact and appearance, requires more than ordinary attention in an audit of internal control over financial reporting due to its complexity. Unless the auditor and the audit committee are diligent in evaluating the nature and extent of services provided, the services might violate basic principles of independence and cause an impairment of independence in fact or appearance.

35. The independent auditor and the audit committee have significant and distinct responsibilities for evaluating whether the auditor's services impair independence in fact or appearance. The test for independence in fact is whether the activities would impede the ability of anyone on the engagement team or in a position to influence the engagement team from exercising objective judgment in the audits of the financial statements or internal control over financial reporting. The test for independence in appearance is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having interests which could jeopardize the exercise of objective and impartial judgments on all issues brought to the auditor's attention.

36. *Due Professional Care.* The auditor must exercise due professional care in an audit of internal control over financial reporting. One important tenet of due professional care is exercising professional skepticism. In an audit of internal control over financial reporting, exercising professional skepticism involves essentially the same considerations as in an audit of financial statements. It includes a critical assessment of the work that management has performed in evaluating and testing controls. Inquiry of management and employees is the beginning point for obtaining an understanding of internal control over financial reporting, but inquiry alone is not adequate for reaching a conclusion on any aspect of internal control over financial reporting effectiveness.

37. *Fieldwork and Reporting Standards.* This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

38. The concept of materiality, as discussed in paragraphs 21 through 23, underlies the application of the general and fieldwork standards.

Planning the Engagement

39. The audit of internal control over financial reporting should be properly planned and assistants, if any, are to be properly supervised. When planning the audit of internal control over financial reporting, the auditor should evaluate how the following matters will affect the auditor's procedures:

- Knowledge of the company's internal control over financial reporting obtained during other engagements.

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes.
- Matters relating to the company's business, including its organization, operating characteristics, capital structure, and distribution methods.
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.
- Management's process for assessing the effectiveness of the company's internal control over financial reporting based upon control criteria.
- Preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses.
- Internal control deficiencies previously communicated to the audit committee or management.
- Legal or regulatory matters of which the company is aware.
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting.
- Preliminary judgments about the effectiveness of internal control over financial reporting.
- The number of significant business locations or units, including management's documentation and monitoring of controls over such locations or business units. (Appendix B, paragraphs B1 through B16, discusses factors the auditor should evaluate to determine the locations at which to perform auditing procedures.)

40. The auditor could also evaluate additional relevant factors when planning the audit of internal control over financial reporting.

Evaluating Management's Assessment Process

41. The auditor must obtain an understanding of, and evaluate, management's process for assessing the effectiveness of the company's internal control over financial reporting. When obtaining the understanding, the auditor should determine whether management has addressed the following elements:

- Determining which controls should be tested, including controls over relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:
 - Controls over initiating, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.
 - Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.
 - Antifraud programs and controls.
 - Controls, including information technology general controls, on which other controls are dependent.
 - Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.
 - 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).
- Evaluating the likelihood that failure of the control could result in a misstatement and the degree to which other controls, if effective, achieve the same control objectives.
- Determining the locations or business units to include in the evaluation for a company with multiple locations or business units (see paragraphs B1 through B16).
- Evaluating the design effectiveness of controls.
- Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Examples of such procedures include testing of the controls by internal audit, testing of controls by others under the direction of management, using a service organization's reports (see paragraphs B24 through B39), or testing by means of a self-assessment process. Inquiry alone is not adequate to complete this evaluation. To evaluate the effectiveness of the company's internal control over financial reporting, management must

have evaluated controls over all relevant assertions related to all significant accounts and disclosures.

- Determining the deficiencies in internal control over financial reporting that are of such a magnitude and likelihood of occurrence that they constitute significant deficiencies or material weaknesses.
- Communicating findings to the auditor and to others, if applicable.
- Evaluating whether findings are reasonable and support management's assessment.

42. As part of the understanding and evaluation of management's process, the auditor should obtain an understanding of the results of procedures performed by others. Others include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment.

43. *Documentation.* When determining whether management's documentation provides reasonable support for its assessment, the auditor should evaluate whether such documentation includes the following:

- The design of controls over relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting as discussed in paragraph 50,
- Information about how significant transactions are initiated, recorded, processed and reported,
- Enough information about the flow of transactions to identify where material misstatements due to error or fraud could occur,
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties,
- Controls over the period-end financial reporting process,
- Controls over safeguarding of assets (see paragraphs C1 through C3), and
- The results of management's testing and evaluation.

44. Documentation might take many forms of presentation and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. No one form of documentation is required, and the extent of documentation will vary depending on the size, nature, and complexity of the company.

45. Documentation of the design of controls over relevant assertions related to significant accounts and disclosures is evidence that controls related to management's assessment about the effectiveness of internal control over financial reporting, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company. Such documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls.

46. Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting. As discussed in paragraph 125, the auditor should evaluate this documentation deficiency. The auditor might conclude that the deficiency is only a deficiency, or that the deficiency represents a significant deficiency or a material weakness. In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting in the absence of documentation.

47. Inadequate documentation also could cause the auditor to conclude that there is a limitation on the scope of the engagement.

Obtaining an Understanding of Internal Control Over Financial Reporting¹¹

48. The auditor should obtain an understanding of the *design* of specific controls by applying procedures that include:

- Making inquiries of appropriate management, supervisory, and staff personnel,
- Inspecting company documents,
- Observing the application of specific controls, and
- Tracing transactions through the information system relevant to financial reporting.

¹¹ For additional information with regard to special internal control considerations for small and medium-sized companies, see Appendix E.

49. The auditor could also apply additional procedures to obtain an understanding of the design of specific controls.

50. The auditor must obtain an understanding of the design of controls related to each component of internal control over financial reporting, as discussed below.

- *Control Environment.* Because of the pervasive effect of the control environment on the reliability of financial reporting, the auditor's preliminary judgment about its effectiveness often influences the nature, timing, and extent of the tests of operating effectiveness considered necessary. Weaknesses in the control environment should cause the auditor to alter the nature, timing, or extent of tests of operating effectiveness that otherwise would have been performed.
- *Risk Assessment.* When obtaining an understanding of the company's risk assessment process, the auditor should evaluate whether management has identified the risks of material misstatement in the significant accounts and disclosures and related assertions of the financial statements and has implemented controls to prevent or detect material misstatements. For example, the risk assessment process should address how management considers the possibility of unrecorded transactions or identifies and analyzes significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.
- *Control Activities.* The auditor's understanding of control activities relates to the controls that management has implemented to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements. For the purposes of evaluating the effectiveness of internal control over financial reporting, the auditor's understanding of control activities encompasses a broader range of accounts and disclosures than what is normally obtained for the financial statement audit.
- *Information and Communication.* The auditor's understanding of management's information and communication involves understanding the same systems and processes that he or she addresses in an audit of financial statements. In addition, this understanding includes a greater emphasis on comprehending the safeguarding controls and the processes for authorization of transactions and the maintenance of records, as well as the period-end financial reporting process (discussed further beginning at paragraph 71).
- *Monitoring.* The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of all controls, including control activities, which management has identified and designed to prevent or detect material

misstatement in the accounts and disclosures and related assertions of the financial statements.

51. Some controls (such as company-level controls, described in paragraph 53) might have a pervasive effect on achieving many overall objectives of the control criteria. For example, information technology general controls over program development, program changes, computer operations, and access to programs and data help ensure that specific controls over the processing of transactions are operating effectively. In contrast, other controls are designed to achieve specific objectives of the control criteria. For example, management generally establishes specific controls, such as accounting for all shipping documents, to ensure that all valid sales are recorded.

52. The auditor should focus on combinations of controls, in addition to specific controls in isolation, in assessing whether the objectives of the control criteria have been achieved. The absence or inadequacy of a specific control designed to achieve the objectives of a specific criterion might not be a deficiency if other controls specifically address the same criterion. Further, when one or more controls achieve the objectives of a specific criterion, the auditor might not have to evaluate other controls designed to achieve those same objectives.

53. *Identifying Company-Level Controls.* Company-level controls are controls such as the following:

- Control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units,
- Management's risk assessment process,
- Centralized processing and controls, including shared service environments,
- Monitoring results of operations,
- Monitoring of controls, including activities of the internal audit function, the audit committee, and self-assessment programs,
- The period-end financial reporting process, and
- Board-approved policies that address significant business control and risk management practices.

54. Controls that exist at the company-level often have a pervasive impact on controls at the process, transaction, or application level. For that reason, as a practical consideration, it may be appropriate for the auditor to test and evaluate the design effectiveness of company-level controls first, because the results of that work might affect the way the auditor evaluates the other aspects of internal control over financial reporting.

55. Testing company-level controls alone is not sufficient for the purpose of expressing an opinion on the effectiveness of a company's internal control over financial reporting.

56. *Evaluating the Effectiveness of the Audit Committee's Oversight of the Company's External Financial Reporting and Internal Control Over Financial Reporting.*¹² The company's audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting. Within the control environment, the existence of an effective audit committee is essential to setting a positive tone at the top. Within the monitoring component, an effective audit committee is crucial to challenging the company's activities in the financial arena.

57. The auditor should evaluate factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, including:

- Independence of the audit committee members from management (see paragraph 58),
- Clarity with which the audit committee's responsibilities are articulated and how well the audit committee and management understand those responsibilities,
- Level of involvement and interaction with the independent auditor, including the committee's role in the appointment, retention, and compensation of the independent auditor,
- Level of involvement and interaction with internal audit, including the committee's line of authority and role in appointing and compensating employees in the internal audit function,
- Committee's compliance with applicable listing standards adopted pursuant to Section 301 of the Act,

¹² If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.

- Whether the committee includes one or more financial experts as described in Section 407 of the Act, and
- Amount of time that the audit committee devotes to control issues, as well as the amount of time that audit committee members are able to devote to committee activity.

58. As part of evaluating the independence of committee members, the auditor should evaluate how audit committee members are nominated and selected and whether they act independently from management.¹³ Generally, the more independence that is built into the process of nominating members of the audit committee to the board, the more the auditor can be assured of committee independence. For example, are qualified candidates identified by outsiders, such as an outside search firm or a nominating committee composed of outside directors, or does management pick "friends?" Are board candidates for the audit committee selected based upon desired skill sets?

59. Ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists.

60. *Identifying Significant Accounts.* The auditor should identify significant accounts and disclosures, first at the financial statement level and then at the account or disclosure component level. Determining specific controls to test begins by identifying significant accounts and disclosures within the financial statements. When identifying significant accounts, the auditor should evaluate both quantitative and qualitative factors.

61. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually or when aggregated with others could have a material effect on the financial statements. Other accounts may be significant on a qualitative basis based on the expectations of a reasonable user. For example, investors might be interested in a particular financial statement account even though it is not quantitatively large because it represents an important performance measure in a specialized industry.

62. Components of an account balance subject to differing risks (inherent and control) or different controls should be considered separately as potential significant accounts.

¹³ The auditor should be aware that elections to the board of directors may be governed by state law, SRO listing standards, and the SEC's Regulation 14A.

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For instance, inventory accounts often consist of raw materials (purchasing process), work in process (manufacturing process), finished goods (distribution process), and an allowance for obsolescence.

63. In some cases, separate components of an account may also need to be considered a significant account because of the company's organizational structure. For example, for a company that has a number of separate business units, each with unique management and accounting processes, the accounts at each separate business unit are considered individually as potential significant accounts.

64. An account may also be considered significant because of the exposure to unrecognized obligations represented by the account. For example, loss reserves related to a captive insurance entity or self-insurance program may have historically been insignificant in amount yet might represent a more than remote likelihood of material misstatement due to the existence of material unrecorded claims.

65. Appendix B, paragraphs B17 through B19, contains additional requirements about determining which accounts and disclosures are significant.

66. *Identifying Relevant Financial Statement Assertions.* For each significant account, the auditor should determine the relevance of each of these financial statement assertions:¹⁴

- Existence or occurrence,
- Completeness,
- Valuation or allocation,
- Rights and obligations, and
- Presentation and disclosure.

67. To identify relevant assertions, the auditor should determine the source of likely potential misstatements in each significant account. In determining whether a particular assertion is relevant to a significant account balance or disclosure, the auditor should evaluate:

- The nature of the assertion,

¹⁴ See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- The volume of transactions or data related to the assertion, and
- The nature and complexity of the systems, including the use of information technology by which the company processes and controls information supporting the assertion.

68. *Relevant assertions* are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance, but is relevant to the related allowance accounts. Additionally, the auditor may focus on the *presentation and disclosure* assertion separately in connection with the period-end financial reporting process.

69. *Identifying Significant Processes.* The auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts. For each significant process, the auditor should:

- Understand the flow of transactions, including how transactions are initiated, recorded, processed, and reported.
- Identify the points within the process where a misstatement – including a misstatement due to fraud – related to each relevant financial statement assertion could arise.
- Identify the controls that management has implemented to address these potential misstatements.
- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets.

70. The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting. Paragraphs 16 through 20 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, discusses the effect of information technology on internal control over financial reporting.

71. *Understanding the Period-end Financial Reporting Process.* The period-end financial reporting process includes the following:

- The procedures used to enter transaction totals into the general ledger;

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- The procedures used to initiate, record, and process journal entries in the general ledger;
- Other procedures used to record recurring and nonrecurring adjustments to the financial statements, such as consolidating adjustments, report combinations, and classifications; and
- Procedures for drafting financial statements and related disclosures.

72. As part of understanding and evaluating the period-end financial reporting process, the auditor should evaluate:

- The inputs, procedures performed, and outputs of the processes the company uses to produce its financial statements,
- The extent of information technology involvement in each period-end financial reporting process element,
- Who participates from management,
- The number of locations involved,
- Types of adjusting entries (for example, standard, nonstandard, eliminating, and consolidating), and
- The nature and extent of the audit committee's involvement in the process.

73. The period-end financial reporting process is always a significant process because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements. The auditor's understanding of the company's period-end financial reporting process and how it interrelates with the company's other significant processes assists the auditor in identifying and testing controls that are the most relevant to financial statement risks.

74. *Identifying Controls to Test.* The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others)¹⁵ for all relevant assertions related to all significant accounts and disclosures in the financial statements. After identifying significant accounts, relevant assertions, and significant processes, the auditor should evaluate the following to identify the controls to be tested:

¹⁵ See paragraphs 103-110 for additional direction on using the work of others.

- Where errors or fraud could occur,
- The nature of the controls implemented by management,
- The significance of each control in achieving the objectives of the control criteria and whether more than one control achieves a particular objective,
- The nature and extent of tests of the operating effectiveness of the controls performed by the company, if any, and
- The risk that the controls might not be operating effectively. Factors that affect whether the control might not be operating effectively include the following:
 - Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness,
 - Whether there have been changes in the design of controls,
 - The degree to which the control relies on the effectiveness of other controls (for example, the control environment or information technology general controls),
 - Whether there have been changes in key personnel who perform the control or monitor its performance,
 - Whether the control relies on performance by an individual or is automated, and
 - The complexity of the control.

75. The auditor should clearly link individual controls with the significant accounts and assertions to which they relate.

76. The auditor should evaluate whether to test preventive controls, detective controls, or a combination of both for individual relevant assertions for individual significant accounts. For instance, when performing tests of preventive and detective controls, the auditor might conclude that a deficient preventive control could be compensated for by an effective detective control and, therefore, not result in a significant deficiency or material weakness. For example, a monthly reconciliation control procedure, which is a detective control, might detect an out-of-balance situation resulting from an unauthorized transaction being initiated due to an ineffective authorization procedure, which is a preventive control. When determining whether the detective control is

effective, the auditor should evaluate whether the detective control is sufficient to achieve the control objective to which the preventive control relates.

77. Because effective internal control over financial reporting often includes a combination of preventive and detective controls, the auditor ordinarily will test a combination of both.

78. The auditor should apply tests of controls to those controls that are important to achieving each control objective. It is neither necessary to test all controls nor is it necessary to test redundant controls (that is, controls that duplicate other controls that achieve the same objective and already have been tested), unless redundancy is itself a control objective, as in the case of certain computer controls.

79. *Performing Walkthroughs.* Walkthroughs are required procedures. The auditor should perform a walkthrough for all of the company's significant processes. In a walkthrough, the auditor should trace all types of transactions and events, both recurring and unusual, from origination through the company's information systems until they are reflected in the company's financial reports. 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 where 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.

80. The auditor's walkthroughs should encompass the entire process of initiating, recording, processing, and reporting individual transactions, and controls for all five internal control components and fraud, not just control activities. During the walkthrough, at each point where important processing procedures or controls occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls and determine whether the processing procedures are performed as originally understood and on a timely basis. (Controls might not be performed regularly but still be timely.) During the

walkthrough, the auditor should be alert for exceptions to the company's prescribed procedures and controls.

81. While performing a walkthrough, the auditor should evaluate the quality of the evidence obtained and perform walkthrough procedures that produce a level of evidence consistent with the objectives listed in paragraph 79. Rather than reviewing copies of documents and making inquiries of a single person at the company, the auditor should follow the process flow using the same documents and information technology that company personnel use and make inquiries of relevant personnel involved in significant aspects of the process or controls. To corroborate information at various points in the walkthrough, the auditor might ask personnel to describe their understanding of the previous and succeeding processing or control activities and to demonstrate what they do. In addition, inquiries should include follow-up questions that could help identify the abuse of controls or indicators of fraud. Examples of follow-up inquiries include asking personnel:

- What they do when they find an error or what they are looking for to determine if there is an error (rather than simply asking them if they perform listed procedures and controls); what kind of errors they have found; what happened as a result of finding the errors, and how the errors were resolved. If the person being interviewed has never found an error, the auditor should evaluate whether that is due to good preventive controls or whether the individual performing the control lacks the necessary skills.
- Whether they have ever been asked to override the process or controls, and if so, to describe the situation, why it occurred, and what happened.

82. During the period under audit, when there have been significant changes in the process flow of transactions, including the supporting computer applications, the auditor should evaluate the nature of the change(s) and the effect on related accounts to determine whether to walkthrough transactions that were processed both before and after the change.

83. For non-routine and estimation processes, the auditor can often gain an understanding of the transaction flow, identify and understand controls, and conduct the walkthrough simultaneously.

Testing and Evaluating Design Effectiveness

84. Internal control over financial reporting is effectively designed when the controls complied with would be expected to prevent or detect material misstatements in the financial statements. The auditor should determine whether the company has controls to meet the objectives of the control criteria by:

- Identifying the company's control objectives in each area,
- Identifying the controls that satisfy each objective, and
- Determining whether the controls, if operating properly, can effectively prevent or detect material misstatements in the financial statements.

85. Procedures the auditor performs to test and evaluate design effectiveness include inquiry, observation, walkthroughs, and a specific evaluation of whether the controls are likely to prevent or detect misstatements if they are operated as prescribed by appropriately qualified persons.

86. The procedures that the auditor performs in evaluating management's assessment process and obtaining an understanding of internal control over financial reporting also provide the auditor with evidence about the design effectiveness of internal control over financial reporting.

87. The procedures the auditor performs to test and evaluate design effectiveness also might provide evidence about operating effectiveness.

Testing and Evaluating Operating Effectiveness

88. An auditor should evaluate the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively.

89. *Nature of Tests of Controls.* Tests of controls over operating effectiveness should include a mix of inquiries of appropriate personnel, inspection of relevant documentation, observation of the company's operations, and reperformance of the application of the control. For example, the auditor might observe the procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor should supplement the observation with inquiries of company personnel and inspection of documentation about the operation of such controls at other times.

90. Inquiry is a procedure that is used extensively throughout the audit and often is complementary to performing other procedures. Inquiry consists of seeking information, both financial and nonfinancial, of knowledgeable persons throughout the company. Inquiries may range from formal written inquiries to informal oral inquiries.

91. Evaluating responses to inquiries is an integral part of the inquiry procedure. Responses to inquiries might provide the auditor with information not previously possessed or with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information the auditor obtains (for example, information regarding the possibility of management override of controls). In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional procedures.

92. Because inquiry alone does not provide sufficient evidence to support the operating effectiveness of a control, the auditor should perform additional tests of controls. For example, if the company implements a control activity whereby its sales manager reviews and investigates a report of invoices with unusually high or low gross margins, inquiry of the sales manager as to whether he or she investigates discrepancies would be inadequate. To obtain sufficient evidence about the operating effectiveness of the control, the auditor should corroborate the sales manager's responses by performing other procedures, such as inspecting reports or other documentation used in or generated by the performance of the control, and evaluate whether appropriate actions were taken regarding discrepancies.

93. The nature of the control also influences the nature of the tests of controls the auditor can perform. For example, the auditor might examine documents regarding controls for which documentary evidence exists. However, documentary evidence regarding some aspects of the control environment, such as management's philosophy and operating style, might not exist. In circumstances in which documentary evidence of controls or the performance of controls does not exist and is not expected to exist, the auditor's tests of controls would consist of inquiries of appropriate personnel and observation of company activities. As another example, a signature on a voucher package to indicate that the signer approved it does not necessarily mean that the person carefully reviewed the package before signing. The package may have been signed based on only a cursory review (or without any review). As a result, the quality of the evidence regarding the effective operation of the control might not be sufficiently persuasive. If that is the case, the auditor should reperform the control (for example, checking prices, extensions, and additions) as part of the test of the control.

94. *Timing of Tests of Controls.* The auditor must perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in management's report, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor performs tests of controls varies with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied. Some controls operate continuously (for example, controls over sales), while others operate

only at certain times (for example, controls over the preparation of monthly or quarterly financial statements and controls over physical inventory counts).

95. The auditor's testing of the operating effectiveness of such controls should occur at the time the controls are operating. Controls "as of" a specific date encompass controls that are relevant to the company's internal control over financial reporting "as of" that specific date, even though such controls might not operate until after that specific date. For example, some controls over the period-end financial reporting process normally operate only after the "as of" date. Therefore, if controls over the December 31, 20X4 period-end financial reporting process operate in January 20X5, the auditor tests the control operating in January 20X5 to have sufficient evidence of operating effectiveness "as of" December 31, 20X4.

96. When the auditor reports on the effectiveness of controls "as of" a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what additional evidence to obtain concerning the operation of the control for the remaining period. In making that determination, the auditor should evaluate:

- The specific controls tested prior to the "as of" date and the results of those tests,
- The degree to which evidence about the operating effectiveness of those controls was obtained,
- The length of the remaining period, and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

97. The auditor could also evaluate additional factors when determining what additional evidence to obtain.

98. For controls over significant nonroutine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the auditor should perform tests of controls closer to or at the "as of" date rather than at an interim date. However, the auditor should balance performing the tests of controls closer to the "as of" date with the need to obtain sufficient evidence of operating effectiveness.

99. Prior to the date specified in management's report, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor might not need to evaluate controls that have been superseded. For example, if the auditor determines that the

new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls,¹⁶ he or she will not need to evaluate the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.

100. As discussed in paragraph 190, however, the auditor must communicate any identified significant deficiencies and material weaknesses in controls to the audit committee in writing. In addition, the auditor should evaluate how the design and operating effectiveness of the superseded controls relates to the auditor's reliance on controls for financial statement audit purposes.

101. *Extent of Tests of Controls.* Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

102. In determining the extent of procedures to perform, the auditor should design the procedures to provide a high level of assurance that the control being tested is operating effectively. In making this determination, the auditor should consider the following factors:

- *Nature of the control.* Manual controls should be subjected to more extensive testing than automated controls. In some circumstances, testing a single operation of an automated control may be sufficient to obtain a high level of assurance that the control operated effectively, provided that information technology general controls also are operating effectively. For manual controls, sufficient evidence about the operating effectiveness of the controls is obtained by evaluating multiple operations of the control and the results of each operation. The auditor also should consider the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the control to operate effectively. As the complexity and level of judgment

¹⁶ Paragraph 166 provides reporting directions in circumstances when the auditor has not been able to obtain evidence that the new controls were appropriately designed or have been operating effectively for a sufficient period of time.

increase or the level of competence of the person performing the control decreases, the extent of the auditor's testing should increase.

- *Frequency of operation.* The more frequently a manual control operates, the more operations of the control the auditor should test. For example, for a manual control that operates in connection with each transaction, the auditor tests multiple operations of the control over a sufficient period of time to obtain a high level of assurance that the control operated effectively. For controls that operate less frequently, such as monthly account reconciliations and controls over the period-end financial reporting process, the auditor may test significantly fewer operations of the control. However, the auditor's evaluation of each operation of controls operating less frequently is likely to be more extensive. For example, when evaluating the operation of a monthly exception report, the auditor should evaluate whether the judgments made with regard to the disposition of the exceptions were appropriate and adequately supported.
- *Importance of the control.* Controls that are relatively more important should be tested more extensively. For example, some controls may address multiple financial statement assertions, and certain period-end detective controls might be considered more important than related preventive controls. The auditor should test more operations of such controls or, if such controls operate infrequently, the auditor should evaluate each operation of the control more extensively.

103. *Use of the Work of Management and Others.* The auditor should evaluate whether to use the work performed by management and others. When evaluating whether to use the results of procedures performed by others, the auditor should evaluate the following factors:

- The materiality or the risk of misstatement of the accounts and disclosures that the controls address.
- The degree of judgment required to evaluate the operating effectiveness of the control.
- The degree the control can be subjected to objective testing vs. a subjective evaluation.
- The pervasiveness of the control.
- The level of judgment or estimation that is required in the account or disclosure.

104. There are a number of areas in which the auditor should not use the results of testing performed by management and others, including:

- 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, as discussed beginning at paragraph 79.

105. The auditor's use of the results of procedures performed by management and others should be limited in the following areas:

- Controls over significant nonroutine and nonsystematic transactions (such as accounts involving *significant* judgments and estimates).
- Controls over significant accounts, processes, or disclosures where the auditor has assessed the risk of failure of the controls to operate effectively as high.

106. The auditor might decide to use the results of tests performed by management and others within the company in other areas, such as controls over routine processing of significant accounts and disclosures, without specific limitation.

107. If the auditor intends to use the results of tests performed by others to alter the nature, timing, and extent of the tests of controls that the auditor performs, he or she should assess the degree of objectivity and competence of the individuals performing the tests of controls. In addition to assessing the objectivity and competence of those performing the tests, the auditor should reperform some of the tests of controls originally performed by others.

108. Internal auditors would normally be expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use the results of their procedures to a greater extent than the results of procedures performed by others. This is particularly

true in the case of internal auditors who follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors. At companies where the importance of the internal audit function results in a high degree of competence and objectivity and their work is extensive, the auditor could use their work to the greatest extent an auditor could use the work of others. On the other hand, if, for example, internal audit reports solely to management, which would reduce internal audit's objectivity, or if limited resources allocated to internal audit result in very limited testing procedures on its part, the auditor would need to perform more testing himself or herself.

109. In addition to following the directions in paragraphs 103-108, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion.

110. Appendix B, paragraphs B20 through B23, provides additional guidance as well as an application example on using the work of others.

111. *Use of Professional Skepticism when Evaluating the Results of Testing.* The auditor must conduct the audit of internal control over financial reporting and the audit of the financial statements with professional skepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence. For example, even though a control is performed by the same employee whom the auditor believes performed the control effectively in prior periods, the control may not be operating effectively during the current period because the employee could have become complacent, distracted, or otherwise not effectively carry out his or her responsibilities. Also, regardless of any past experience with the entity or the auditor's beliefs about management's honesty and integrity, the auditor should recognize the possibility that a material misstatement due to fraud could be present. Furthermore, professional skepticism requires the auditor to consider whether evidence obtained suggests that a material misstatement due to fraud has occurred. In exercising professional skepticism in gathering and evaluating evidence, the auditor must not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

112. When the auditor identifies exceptions to the company's prescribed control procedures, he or she should determine, using professional skepticism, the effect of the exception on the nature and extent of additional testing that may be appropriate or necessary and on the operating effectiveness of the control being tested. A conclusion that an identified exception does not represent an internal control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion.

Forming an Opinion on the Effectiveness of Internal Control Over Financial Reporting

113. When forming an opinion on internal control over financial reporting, the auditor should evaluate all evidence obtained from all sources, including:

- The results of tests of controls,
- The results of substantive procedures performed during the financial statement audit, and
- Any identified internal control deficiencies.

114. As part of this evaluation, the auditor should review all reports issued during the year by internal audit (or similar functions, such as loan review in a financial institution) that address controls related to internal control over financial reporting and evaluate any internal control deficiencies identified in those reports. This review should include reports issued by internal audit as a result of operational audits or specific reviews of key processes if those reports address controls related to internal control over financial reporting.

115. *Circumstances for Issuance of Unqualified Opinion.* The auditor may issue an unqualified opinion only when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor's work. The existence of a material weakness in internal control over financial reporting requires the auditor to express an adverse opinion (see paragraph 162), while a scope limitation requires the auditor to express a qualified opinion or a disclaimer of opinion, depending on the significance of the limitation in scope (see paragraph 165). The following paragraphs provide directions on evaluating internal control deficiencies noted during the audit.

116. *Evaluating Deficiencies in Internal Control Over Financial Reporting.* The auditor must evaluate identified internal control deficiencies and determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses.

117. The auditor should evaluate the significance of a deficiency in internal control over financial reporting initially by determining the following:

- The likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure, and
- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

118. The significance of a deficiency in internal control over financial reporting depends on the *potential* for a misstatement, not on whether a misstatement actually has occurred.

119. Several factors affect the *likelihood* that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The susceptibility of the related assets or liability to loss or fraud; that is, greater susceptibility increases risk.
- The subjectivity, complexity, or extent of judgment required to determine the amount involved; that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk.
- The nature of the accounts, processes, or disclosures; for example, suspense accounts and related party transactions involve greater risk.
- The cause and frequency of known or detected exceptions for the operating effectiveness of a control; for example, a control with an observed non-negligible deviation rate is a deficiency.
- The interaction or relationship of the control with other controls; that is, the interdependence or redundancy of the control.

120. When evaluating the likelihood that a deficiency or combination of deficiencies could result in a misstatement, the auditor should evaluate how the controls interact with other controls. There are controls, such as information technology general controls, on which other controls depend. Some controls function together as a group of controls. Other controls overlap, in the sense that these other controls achieve the same objective.

121. Several factors affect the magnitude of the misstatement that could result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions that are exposed to the deficiency.
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period, or that is expected in future periods.

122. In evaluating the magnitude of the potential misstatement, the auditor should recognize that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount. However, the recorded amount is not a limitation on the amount of potential understatement. The auditor also should recognize that the risk of misstatement might be different for the maximum possible misstatement than for lesser possible amounts.

123. The interaction of qualitative considerations that affect internal control over financial reporting with quantitative considerations ordinarily results in deficiencies in the following areas being at least significant deficiencies in internal control over financial reporting:

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles,
- Antifraud programs and controls,
- Controls over non-routine and nonsystematic transactions, and
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements.

124. When evaluating the significance of a deficiency in internal control over financial reporting, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance,¹⁷ then the auditor should consider the deficiency to be at least a significant deficiency. Having determined in this manner that a deficiency represents a significant deficiency, the auditor must further evaluate the deficiency to determine whether individually, or in combination with other deficiencies, the deficiency is a material weakness.

¹⁷ See SEC Staff Accounting Bulletin Topic 1M2, *Immaterial Misstatements That Are Intentional*, for further discussion about the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs.

125. Inadequate documentation of the design of controls and the absence of sufficient documented evidence to support management's assessment of the operating effectiveness of internal control over financial reporting also are internal control deficiencies. As with other internal control deficiencies, the auditor should evaluate these deficiencies as to their significance.

126. Each of the following circumstances should be regarded as at least a significant deficiency and is a strong indicator that a material weakness in internal control over financial reporting exists:

- Restatement of previously issued financial statements to reflect the correction of a misstatement.
- 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. (This is still a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective. (Paragraphs 56 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)
- For larger, more complex entities, the internal audit function or the risk assessment function is ineffective.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function.
- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.

127. In addition, Appendix D provides examples of significant deficiencies and material weaknesses.

Requirement for Written Representations

128. In an audit of internal control over financial reporting, the auditor should obtain written representations from management:

- a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting,
- b. Stating that management has performed an evaluation of the effectiveness of the company's internal control over financial reporting and specifying the control criteria,
- c. Stating management's conclusion about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date,
- d. Stating that management has disclosed to the auditor all significant deficiencies in the design or operation of internal control over financial reporting that it believes to be material weaknesses in internal control over financial reporting,
- e. Describing any material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting,
- f. Stating whether internal control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 190 have been resolved, and specifically identifying any that have not, and
- g. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

129. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. As discussed further in paragraph 165, when management limits the scope of the audit, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including, if applicable, representations obtained in an audit of the company's financial statements.

130. AU sec. 333, *Management Representations*, explains matters such as who should sign the letter, the period to be covered by the letter, and when to obtain an updating letter.

Relationship of an Audit of Internal Control over Financial Reporting to an Audit of Financial Statements

131. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the procedures for the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits.

132. The understanding of internal control over financial reporting the auditor obtains and the procedures the auditor performs for purposes of expressing an opinion on management's assessment are interrelated with the internal control over financial reporting understanding the auditor obtains and procedures the auditor performs to assess control risk for purposes of expressing an opinion on the financial statements. As a result, it is efficient for the auditor to coordinate obtaining the understanding and performing the procedures.

Tests of Controls in an Audit of Internal Control Over Financial Reporting

133. The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of internal controls to support the auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

134. To express an opinion on internal control over financial reporting effectiveness as of a *point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting effectiveness *taken as a whole*, the auditor must obtain evidence about the effectiveness of controls related to all relevant assertions for all significant accounts and disclosures in the financial statements. This requires the auditor to test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

135. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on management's assessment, the auditor should

incorporate the results of any additional tests of control performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

Tests of Controls in an Audit of Financial Statements

136. To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* covered by the company's financial statements. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions for the entire period covered by the financial statements, and, for a variety of reasons, the auditor may choose not to do so.¹⁸

137. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should consider the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on management's assessment, as discussed in paragraphs 133 through 135. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified internal control deficiencies.

Effect of Tests of Controls on Substantive Procedures

138. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

139. The substantive procedures that the auditor should perform consist of tests of details of transactions and balances and analytical procedures. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

¹⁸ See paragraph 146 for additional documentation requirements when the auditor assesses control risk as other than low.

140. When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures are not well suited to detecting fraud.

141. The auditor's substantive procedures must include reconciling the financial statements to the accounting records and examining material adjustments made during the course of preparing the financial statements. Also, other auditing standards require auditors to perform specific tests of details in the financial statement audit. For instance, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to perform certain tests of details to further address the risk of management override, whether or not a specific risk of fraud has been identified. AU sec. 330.34, *The Confirmation Process*, states that there is a presumption that the auditor will request the confirmation of accounts receivable. Similarly, AU sec. 331.01, *Inventories*, states that observation of inventories is a generally accepted auditing procedure and that the auditor who issues an opinion without this procedure "has the burden of justifying the opinion expressed."

142. If, during the audit of internal control over financial reporting, the auditor identifies an internal control deficiency, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce the risk of material misstatement of the financial statements to an appropriately low level.

Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls

143. In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of all substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, but not be limited to:

- The auditor's risk evaluations in connection with the selection and application of substantive procedures, especially those related to fraud (see paragraph 26),
- Findings with respect to illegal acts and related party transactions,
- Indications of management bias in making accounting estimates and in selecting accounting principles, and

- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

144. However, the absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective.

Documentation Requirements

145. In addition to the documentation requirements in AU sec. 339, *Audit Documentation*, the auditor should document:

- The understanding obtained and the evaluation of the design of each of the five components of the company's internal control over financial reporting,
- The process used to determine significant accounts, classes of transactions, and disclosures, including the determination of the locations or business units at which to perform testing,
- The identification of where misstatements related to relevant financial statement assertions could occur within significant accounts, assertions, and processes,
- The extent to which the auditor relied upon work performed by management or others,
- The evaluation of any deficiencies noted as a result of the auditor's testing, and
- Other findings that could result in a modification to the auditor's report.

146. For a company that has effective internal control over financial reporting, the auditor ordinarily will be able to perform sufficient testing of controls to be able to assess control risk related to relevant assertions for significant accounts and disclosures at a low level. If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion. Examples of when it is appropriate to not assess control risk as low include:

- When a control over a relevant assertion related to a significant account or disclosure was superseded late in the year and only the new control was tested for operating effectiveness.
- When a material weakness existed during the period under audit and was corrected by the end of the period.

147. The auditor also should document the effect of a conclusion that control risk is other than low for any relevant assertions for any significant accounts on his or her opinion on the audit of internal control over financial reporting.

Reporting on Internal Control Over Financial Reporting

Management's Report

148. Management is required to include in its annual report its assessment of the effectiveness of the company's internal control over financial reporting in addition to its audited financial statements as of the end of the most recent fiscal year. Management's report on internal control over financial reporting is required to include the following:¹⁹

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company,
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting,
- An assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement as to whether that internal control over financial reporting is effective, and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

149. Management should provide, both in its report on internal control over financial reporting and in its representation letter to the auditor, a written conclusion about the effectiveness of the company's internal control over financial reporting. The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms, however, management is required to state a direct conclusion about whether the company's internal control over financial reporting is effective. This standard, for example, includes the phrase "management's assessment that W

¹⁹ Management is required to include these matters in their report. See 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].

Company maintained effective internal control over financial reporting as of [date]" to illustrate such a conclusion. Other phrases, such as "management's assessment that W Company's internal control over financial reporting as of [date] is sufficient to meet the stated objectives," also might be used. However, the conclusion should not be so subjective (for example, "very effective internal control") that people having competence in and using the same or similar criteria would not ordinarily be able to arrive at similar conclusions.

150. Management is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses. In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year.

151. Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective.²⁰

Auditor's Evaluation of Management's Report

152. With respect to management's report on its assessment, the auditor should evaluate the following matters:

- a. Whether management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting.
- b. Whether the framework used by management to conduct the evaluation is suitable. (As discussed in paragraph 13, the framework described in COSO constitutes a suitable and available framework.)

²⁰ However, when the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor need to evaluate whether the reason for the change and the circumstances surrounding the change are material information necessary to make the disclosure about the change not misleading in a filing subject to certification under Section 302. See discussion beginning at paragraph 183 for further direction.

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- c. Whether management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year, is free of material misstatement.
- d. Whether management has expressed its assessment in an acceptable form.
 - Management is required to state whether the company's internal control over financial reporting is effective.
 - A negative assurance statement indicating that, "Nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective," is not acceptable.
 - Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.
- e. Whether material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed, including those corrected during the period.²¹

Auditor's Report on Management's Assessment of Internal Control Over Financial Reporting

153. The auditor's report on management's assessment of the effectiveness of internal control over financial reporting must include the following elements:

- a. A title that includes the word *independent*,
- b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria [for example, criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)] ,
- c. An identification of the title of the management report that includes management's assessment (the auditor should use the same description of the

²¹ See paragraph 189 for direction when a material weakness was corrected during the fourth quarter and the auditor believes that modification to the disclosures about changes in internal control over financial reporting are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302.

company's internal control over financial reporting as management uses in its report),

- d. A statement that the assessment is the responsibility of management,
- e. A statement that the auditor's responsibility is to express an opinion on the written assessment based on his or her audit,
- f. A definition of internal control over financial reporting as stated in paragraph 4,
- g. A statement that the audit was conducted in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board (PCAOB),
- h. A statement that the PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects,
- i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the auditor considered necessary in the circumstances,
- j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion,
- k. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that 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,
- l. The auditor's opinion on 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 (see discussion beginning at paragraph 148),²²
- m. The manual or printed signature of the auditor's firm,
- n. The date of the audit report.

²² Nothing precludes the auditor from auditing management's assessment but opining directly on the effectiveness of internal control over financial reporting.

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154. Example A-1 in Appendix A is an illustrative auditor's report – an unqualified opinion – on management's assessment of the effectiveness of the company's internal control over financial reporting.

155. *Separate or Combined Reports.* The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting. Appendix A includes an illustrative combined audit report on internal control over financial reporting and examples of separate reports on internal control over financial reporting.

156. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph to the auditor's report on the financial statements:

We also have audited, in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board, the effectiveness of W Company's internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*] and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*].

157. *Report Date.* As stated previously, the auditor cannot audit internal control over financial reporting without also auditing the financial statements. Therefore, the reports should be dated the same.

158. When the auditor elects to issue a combined report on the audit of the financial statements and the audit of internal control over financial reporting, the audit opinion will address multiple reporting periods for the financial statements presented but only the end of the most recent fiscal year for management's assessment of the effectiveness of internal control over financial reporting. See a combined report in Example A-6 in Appendix A.

159. *Report Modifications.* The auditor should modify the standard report if any of the following conditions exist.

- a. Management's assessment is inadequate or management's report is inappropriate. (See paragraph 161.)
- b. There is a material weakness in the company's internal control over financial reporting. (See paragraphs 162 through 164.)

- c. There is a restriction on the scope of the engagement. (See paragraphs 165 through 167.)
- d. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report. (See paragraphs 168 and 169.)
- e. A significant subsequent event has occurred since the date being reported on. (See paragraphs 170 through 173.)
- f. There is other information contained in management's report on internal control over financial reporting. (See paragraphs 174 through 176.)

160. If, for any of the situations listed in the paragraph above, the auditor plans to issue other than an unqualified opinion, the auditor should report directly on the effectiveness of the company's internal control over financial reporting rather than on management's assessment. Expressing an opinion on management's assessment in these circumstances could result in confusion. For example, if management makes an adverse assessment because a material weakness has been identified and not corrected ("...internal control over financial reporting is not effective...") and the auditor expressed 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. 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.").

161. *Management's Assessment Inadequate or Report Inappropriate.* If the auditor determines that management's process for assessing internal control over financial reporting is inadequate, the auditor should modify his or her opinion for a scope limitation (discussed further beginning at paragraph 165). If the auditor determines that management's report is inappropriate, the auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion.

162. *Material Weaknesses.* Paragraphs 116 through 127 describe significant deficiencies and material weaknesses. If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting.

163. When expressing an adverse opinion because of a material weakness, the auditor's report must include:

- The definition of a material weakness and a significant deficiency, as provided in paragraphs 8 and 9.
- A statement that a material weakness has been identified and included in management's assessment. (If the material weakness has not been included in management's assessment, this sentence should be modified to state that the material weakness has been identified but not included in management's assessment. In this case, the auditor also is required to communicate to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's report, as discussed in paragraph 190.)
- A description of any material weaknesses identified in a company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address requirements described in paragraph 178.

164. In addition, the auditor should modify the opinion paragraph to express an adverse opinion directly on the effectiveness of the company's internal control over financial reporting. Example A-2 in Appendix A illustrates the form of the report that is appropriate in this situation.

165. *Scope Limitations.* The auditor can express an unqualified opinion on internal control over financial reporting only if the auditor has been able to apply all the procedures necessary under the circumstances. If there are restrictions on the scope of the engagement imposed by the circumstances, the auditor should withdraw from the engagement, disclaim an opinion, or express a qualified opinion. The auditor's decision depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the effectiveness of the company's internal control over financial reporting. However, when the restrictions are imposed by management, the auditor should withdraw from the engagement or disclaim an opinion on the effectiveness of internal control over financial reporting.

166. For example, management might have identified a material weakness in its internal control over financial reporting prior to the date specified in its report and implemented controls to correct it. If management believes that the new controls have been operating for a sufficient period of time to determine that they are both effectively designed and operating, management would be able to include in its assessment its

conclusion that internal control over financial reporting is effective as of the date specified. However, if the auditor disagrees with the sufficiency of the time period, he or she would be unable to obtain sufficient evidence that the new controls have been operating effectively for a sufficient period. In that case, the auditor should modify the opinion because of a scope limitation.

167. When the auditor plans either to issue a qualified opinion or to disclaim an opinion because of a scope limitation, the auditor should report directly on the effectiveness of internal control over financial reporting (rather than on management's assessment) to best communicate the effect of such factors on his or her opinion. Example A-3 in Appendix A illustrates the form of report when there is a limitation on the scope of the audit causing the auditor to issue a qualified opinion. Example A-4 illustrates the form of report when restrictions on the scope of the audit cause the auditor to disclaim an opinion.

168. *Opinion Based in Part on the Report of Another Auditor.* When another auditor has audited internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion on internal control over financial reporting. If the auditor decides it is appropriate to serve as the principal auditor, he or she should decide whether to make reference in the report to the audit performed by the other auditor. In these circumstances, the auditor's criteria are similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor and, if so, whether to make reference to the audit performed by the other auditor.

169. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion, the auditor should disclose this when describing the scope of the audit and should refer to the report of the other auditor when expressing the opinion. Whether the other auditor's opinion is expressed on management's assessment or on the effectiveness of internal control over financial reporting does not affect the determination of whether the principal auditor's opinion is expressed on the assessment or on the subject matter itself.

170. *Subsequent Events.* Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. As described in paragraph 128, the auditor should obtain written representations from management relating to such

matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

- Relevant internal audit reports (or similar functions, such as loan review in a financial institution) issued during the subsequent period,
- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses,
- Regulatory agency reports on the company's internal control over financial reporting, and
- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

171. The auditor could inquire about and examine other documents for the subsequent period. Paragraphs .01 through .09 of AU sec. 560, *Subsequent Events*, provides direction on subsequent events for a financial statement audit that may also be helpful to the auditor performing an audit of internal control over financial reporting.

172. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment the auditor should issue an adverse opinion. If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph 175, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

173. The auditor may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assessment but arose subsequent to that date. If a subsequent event of this type has a material effect on the company, the auditor should include in his or her report an explanatory paragraph describing the event and its effects or directing the reader's attention to the event and its effects as disclosed in management's report. Management's consideration of such events to be disclosed in its report should be limited to a change that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

174. *Management's Report Containing Additional Information.* Management's report on internal control over financial reporting may contain information in addition to

management's assessment of the effectiveness of its internal control over financial reporting. Such information might include, for example:

- Disclosures about corrective actions taken by the company after the date of management's assessment,
- The company's plans to implement new controls, and
- A statement that management believes the cost of correcting a material weakness would exceed the benefits to be derived from implementing new controls.

175. If management's assessment includes such additional information, the auditor should disclaim an opinion on the information. For example, the auditor should use the following language as the last paragraph of the report to disclaim an opinion on management's cost-benefit statement:

We do not express an opinion or any other form of assurance on management's statement referring to the costs and related benefits of implementing new controls.

176. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If the auditor concludes that there is a valid basis for concern, he or she should propose that management consult with some other party whose advice might be useful, such as the company's legal counsel. If, after discussing the matter with management and those management has consulted, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. The auditor also should consider consulting the auditor's legal counsel about further actions to be taken, including the auditor's responsibility under Section 10A of the Securities Exchange Act of 1934.

177. *Effect of Auditor's Adverse Opinion on Internal Control Over Financial Reporting on the Opinion on Financial Statements.* In some cases, the auditor's report on internal control over financial reporting might describe a material weakness that resulted in an adverse opinion on the effectiveness of internal control over financial reporting while the audit report on the financial statements remains unqualified. Consequently, during the audit of the financial statements, the auditor did not rely on that control. However, he or she performed additional substantive procedures to determine whether there was a material misstatement in the account related to the control. If, as a result of these procedures, the auditor determines that there was not a material misstatement in the account, he or she would be able to express an unqualified opinion on the financial statements.

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178. When the auditor's opinion on the financial statements is unaffected by the adverse opinion on the effectiveness of internal control over financial reporting, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

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] on those financial statements. *[Revise this wording appropriately for use in a combined report.]*

179. Such disclosure is important to ensure that users of the auditor's report on the financial statements understand why the auditor issued an unqualified opinion on those statements.

180. *Subsequent Discovery of Information Existing at the Date of the Auditor's Report on Internal Control Over Financial Reporting.* After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. That standard requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor should determine (1) whether the facts would have changed the report if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. For instance, if previously issued financial statements and the auditor's report have been recalled and reissued to reflect the correction of an error, the auditor should presume that his or her report on the company's internal control over financial reporting as of same specified date also should be recalled and reissued to reflect the material weakness that existed at that date. Based on these considerations, AU sec. 561.06 provides detailed requirements for the auditor.

181. *Filings Under Federal Securities Statutes.* AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should also apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other

executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements should be extended to matters that could have a material effect on management's assessment of internal control over financial reporting.

182. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of internal control over financial reporting in the securities filing, the auditor's consent should clearly indicate that both the audit report on financial statements and the audit report on management's assessment of the effectiveness of internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Auditor's Responsibilities for Evaluating Management's Certification Disclosures About Internal Control Over Financial Reporting

Required Management Certifications

183. Section 302 of the Act, as amended, requires a company's management, with the participation of the principal executive and financial officers (the certifying officers), to make the following quarterly and annual certifications with respect to the company's internal control over financial reporting:

- A statement that the certifying officers are responsible for establishing and maintaining internal control over financial reporting,
- A statement that the certifying officers have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, 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, and
- A statement that the report discloses any changes in the company's internal control over financial reporting that occurred during the most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

184. When the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor need to evaluate

whether the reason for the change and the circumstances surrounding that change are material information necessary to make the disclosure about the change not misleading.²³

Auditor Evaluation Responsibilities

185. The auditor's responsibility as it relates to management's quarterly certifications on internal control over financial reporting is different from the auditor's responsibility as it relates to management's annual assessment of internal control over financial reporting. The auditor should perform limited procedures quarterly to provide a basis for determining whether he or she has become aware of any material modifications that, in the auditor's judgment, should be made to the disclosures about changes in internal control over financial reporting in order for the certifications to be accurate and to comply with the requirements of Section 302.

186. To fulfill this responsibility, the auditor should perform, on a quarterly basis, the following procedures:

- Inquire of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information, and
- Determine, through a combination of observation and inquiry, whether significant changes in internal control over financial reporting may introduce significant deficiencies or material weaknesses in the design of internal control over financial reporting.

187. When matters come to auditor's attention that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting are necessary for the certifications to be accurate and to comply with the requirements

²³ The SEC's 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], states: "Although the final rules do not explicitly require the company to disclose the reasons for any change that occurred during a fiscal quarter, or to otherwise elaborate about the change, a company will have to determine, on a facts and circumstances basis, whether the reasons for the change, or other information about the circumstances surrounding the change, constitute material information necessary to make the disclosure about the change not misleading."

of Section 302, the auditor should communicate the matter(s) to the appropriate level of management as soon as practicable.

188. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform the audit committee. If, in the auditor's judgment, the audit committee does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should evaluate whether to resign from the engagement. The auditor should evaluate whether to consult with his or her attorney when making these evaluations. In these circumstances, the auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934. The auditor's responsibilities for evaluating the disclosures about changes in internal control over financial reporting do not diminish in any way management's responsibility for ensuring that their certifications comply with the requirements of Section 302.

189. If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302, the auditor should follow the same communication responsibilities as described in paragraphs 187 and 188. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in the preceding two paragraphs, 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 the auditor believes management's certification should be modified.

Required Communications in An Audit of Internal Control Over Financial Reporting

190. The auditor must communicate in writing to the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on internal control over financial reporting. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined beginning in paragraph 8.

191. In addition, the auditor should communicate to management, in writing, all deficiencies in internal control over financial reporting (that is, those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a

communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that have been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization. Rather, the auditor may incorporate those deficiencies by referring to the title and date of such reports. Furthermore, the auditor is not required to perform procedures sufficient to identify all internal control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which he or she is aware.

192. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. If the matter involves fraud, it must be brought to the attention of the appropriate level of management. If the fraud involves senior management, the auditor must communicate the matter directly to the audit committee as described in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. If the matter involves possible illegal acts, the auditor must assure himself or herself that the audit committee is adequately informed, unless the matter is clearly inconsequential, in accordance with AU sec. 317, *Illegal Acts by Clients*. The auditor also must determine his or her responsibilities under Section 10A of the Securities Exchange Act of 1934.

193. When timely communication is important, the auditor should communicate the preceding matters during the course of the audit rather than at the end of the engagement. The decision about whether an interim communication should be issued should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.

Effective Date

194. Companies considered *accelerated filers* under Exchange Act Rule 12b-2 are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act *for fiscal years ending on or after June 15, 2004*. (Other companies have until fiscal years ending on or after April 15, 2005, to comply with these internal control reporting and disclosure requirements.) Accordingly, independent auditors engaged to audit the financial statements of accelerated filers for fiscal years ending on or after June 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. This standard is required to be complied with for such engagements.

195. Early compliance with this standard is permitted.

APPENDIX A

Illustrative Reports on Internal Control Over Financial Reporting

A.1 Paragraphs 152 through 179 of this standard provide direction on the auditor's report on management's assessment of internal control over financial reporting. The following examples illustrate how to apply that guidance in several different situations.

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Example A-1

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

Independent Auditor's Report

[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 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 its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit.

[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.

¹ If the auditor issues separate reports on the audit of internal control and the audit of the financial statements, both reports should include a statement that the audit was conducted in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board.

[Scope paragraph]

We conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our 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, 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.

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

[Signature]

[Date]

Example A-2

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

Independent Auditor's Report

[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 its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit.

[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.

[Scope paragraph]

We conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our 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, 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.

[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 significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood of a material misstatement of the annual or interim financial statements. A significant deficiency is an internal control deficiency that adversely affects the company's ability to initiate, record, process, and report external financial data reliably in accordance with generally accepted accounting principles. The following material weakness has been identified and included in management's assessment.¹ *[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 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. *[Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.]*"

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[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, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, 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)."]*.

[Signature]

[Date]

Example A-3

ILLUSTRATIVE REPORT EXPRESSING A QUALIFIED OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Independent Auditor's Report

[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 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 its assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment based on our audit.

[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.

[Scope paragraph]

Except as described below, we conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our 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, 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 significant deficiency that, by itself, or in combination with other significant deficiencies, results in more than a remote likelihood of a material misstatement of the annual or interim financial statements. A *significant deficiency* is an internal control deficiency that adversely affects the company's ability to initiate, record, process, and report external financial data reliably in accordance with generally accepted accounting principles. 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.

[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

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. *[Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.]*"

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changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[*Opinion paragraph*]

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

[*Signature*]

[*Date*]

Example A-4

ILLUSTRATIVE REPORT DISCLAIMING AN OPINION ON THE EFFECTIVENESS OF INTERNAL CONTROL OVER FINANCIAL REPORTING BECAUSE OF A LIMITATION ON THE SCOPE OF THE AUDIT

Independent Auditor's Report

[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 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.

[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.

[Omit scope paragraph]

[Explanatory paragraph that describes scope limitation]

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[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 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 on the effectiveness of the company's internal control over financial reporting.

[Signature]

[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

Independent Auditor's Report

[Introductory paragraph]

We have audited management's assessment that W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, 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. Our responsibility is to express an opinion on management's assessment 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, 20XX. 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.

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

[Scope paragraph]

We conducted our audit in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. Those standards require that we plan and perform our 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, 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.

[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, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, 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)."]*.

[Signature]

[Date]

Example A-6

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

Independent Auditor's Report

[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 *[identify title of management's report]*, that W Company maintained effective internal control over financial reporting as of December 31, 20X3, 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 these financial statements and for the assessment about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements and on management's assessment based on our audits.

[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.

[Scope paragraph]

We conducted our audits in accordance with auditing and related professional practice standards established by the Public Company Accounting Oversight Board. 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. An audit of financial statements includes 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. An audit of internal control includes obtaining an understanding of internal control over financial reporting, 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.

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

[Signature]

[Date]

APPENDIX B

Additional Performance Requirements and Guidance; 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 the documentation of controls and test controls over the specific risks.

B2. The auditor should determine which other locations or business units, 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 and 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, 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 84 through 110. 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 for 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. Such a 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 monitor the operations and to oversee the control environment and risk assessment process at these 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 to what degree 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.

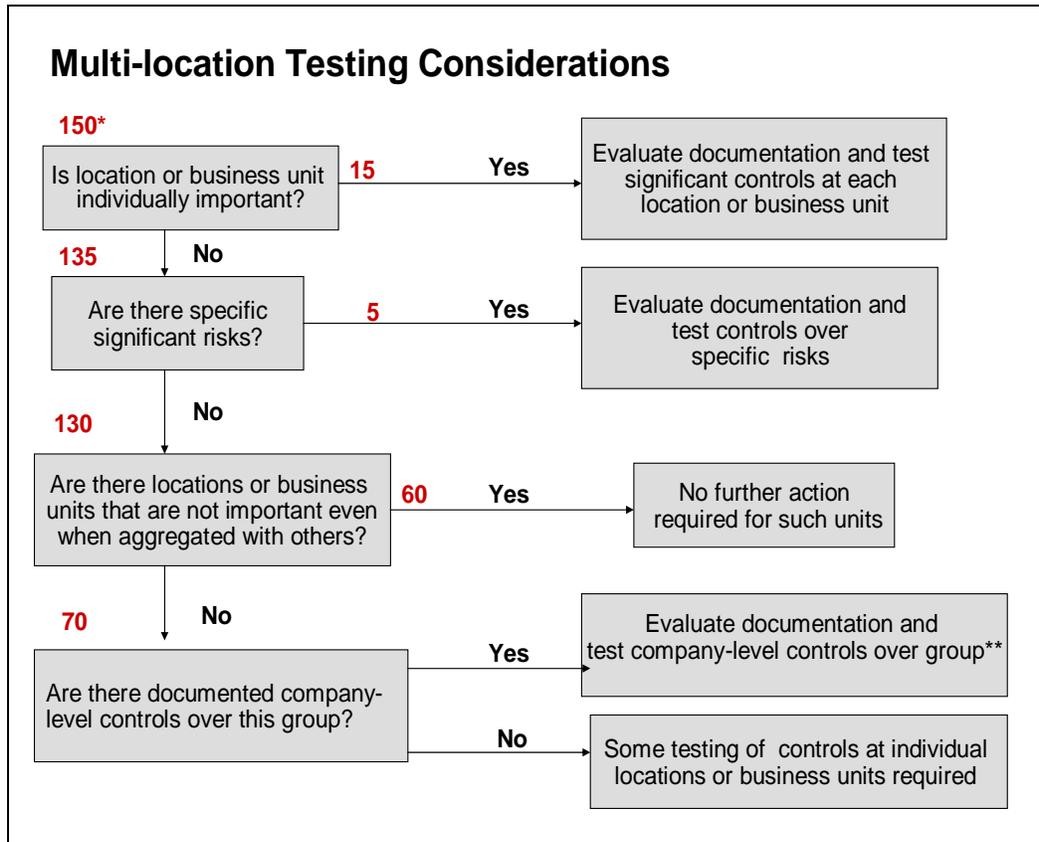
Locations and Business Units That Do Not Require Testing

B12. No testing is required with respect to 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. 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 have the ability 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. However, the auditor should evaluate the reasonableness of management's conclusion that they do not have the ability to obtain the necessary information as well as 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 187 and 188. 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 the auditor believes management's disclosure should be modified.

Identifying Significant Accounts

B17. When deciding whether an account is significant, it is important for the auditor to evaluate both quantitative and qualitative factors, including the:

- Size and composition of the account,

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.

- Susceptibility of loss due to errors or fraud,
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account,
- Nature of the account (for example, suspense accounts generally warrant greater attention),
- Accounting and reporting complexities associated with the account,
- Exposure to losses represented by the account (for example, loss reserves related to a consolidated captive insurance company),
- Likelihood (or possibility) of significant contingent liabilities arising from the activities represented by the account,
- Existence of related party transactions in the account, and
- Changes from the prior period in account characteristics (for example, new complexities or subjectivity or new types of transactions).

B18. For example, in a financial statement audit, the auditor might not consider the fixed asset accounts significant when there is a low volume of transactions and inherent risk is assessed as low, even though the balances are material to the financial statements. Accordingly, he or she might decide to perform only substantive tests on such balances. In an audit of internal control over financial reporting, however, such accounts are significant accounts because of their materiality to the financial statements.

B19. As another example, the auditor of the financial statements of a financial institution might not consider trust accounts significant to the institution's financial statements because such accounts are not included in the institution's balance sheet and the associated fee income generated by trust activities is not material. However, in determining whether trust accounts are a significant account for purposes of the audit of internal control over financial reporting, the auditor should assess whether the activities of the trust department are significant to the institution's financial reporting, which also would include considering the contingent liabilities that could arise if a trust department failed to fulfill its fiduciary responsibilities (for example, if investments were made that were not in accordance with stated investment policies). When assessing the significance of possible contingent liabilities, consideration of the amount of assets under the trust department's control may be useful. For this reason, an auditor who has not previously considered trust accounts significant accounts for purposes of the

financial statement audit might determine that they are significant for purposes of the audit of internal control over financial reporting.

Using the Work of Others

Other Standards to Consider

B20. The auditor might find the directions in AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, useful in assessing the competence and objectivity of internal auditors and others who have performed procedures as a basis for management's assessment.

Application Example

B21. The example included in the following paragraphs demonstrates how to apply the directions discussed in this section.

B22. In evaluating controls over the recording of revenue, the auditor needs to look at a variety of factors including, among other things, information technology general controls and controls over (1) determining the appropriate methods of revenue recognition under generally accepted accounting principles as it relates to the company's operations, (2) evaluating nonroutine sales transactions and contracts to determine the appropriate accounting and (3) the routine processing of daily sales through the company's accounting system.

- Because of the pervasive impact of the controls in (1) and the material impact those controls ordinarily have on the financial statements, the auditor should not use the results of testing by management and others within the company, as discussed in paragraph 104.
- The auditor should limit use of the results of testing performed by others within the company for the controls identified in (2), since the nonroutine nature of these transactions and contracts involve controls over decisions requiring considerable judgment.
- On the other hand, the auditor could increase the use of the results of testing by management and others relating to the controls in (3), which relate to the routine processing of daily sales transactions and accounts receivable. In that case, the auditor should follow the directions in paragraphs 106 through 109.

B23. In the situations described in (1) through (3) above, when evaluating whether sufficient evidence has been obtained, the auditor should understand that evidence obtained through his or her direct personal knowledge, observation, reperformance, and

inspection is more persuasive than information obtained indirectly from others, such as from management, internal auditors, or other personnel. Furthermore, judgments about the sufficiency of evidence obtained and other factors affecting the auditor's opinion, such as the materiality of identified control deficiencies, should be those of the auditor.

Use of Service Auditor's Report

B24. When the company uses a service organization, the auditor, when planning the audit, should obtain an understanding of the portion of the company's internal control over financial reporting (that is, the initiating, recording, processing, and reporting of its transactions) performed at the service organization and the interaction of controls at the service organization with controls at the company.

B25. The use of a service organization does not reduce management's responsibility to maintain effective internal control over financial reporting. Rather, management should evaluate controls at the service organization, as well as related controls at the company, when making its assessment about internal control over financial reporting.

B26. The auditor should determine whether management has evaluated the activities of the service organization when making its assessment about internal control over financial reporting. For instance, a service organization is considered part of the company's internal control over financial reporting when it provides services that affect –

- How the company initiates its transactions,
- How the company's transactions are processed and reported in its accounting records, supporting information, and specific financial statement accounts,
- How the company's transactions are processed from the initiation of the transaction to its inclusion in the financial statements, or
- How the financial reporting process is used to prepare the client's financial statements.

B27. In addition, the auditor should evaluate the activities of the service organization in determining the nature, timing, and extent of evidence required to support his or her opinion on internal control over financial reporting. Paragraph .07 of AU sec. 324, *Service Organizations*, describes the procedures that management and the auditor should perform with respect to the activities performed by the service organization, which include:

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- Obtaining an understanding of the controls at the service organization that are relevant to the company's internal control over financial reporting, and
- Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively.

B28. A service organization might do several things to assist the auditor. For example, the service organization might:

- Engage its own auditor (service auditor) to review and report on the systems it uses to process the company's transactions.
- Engage a service auditor to test the effectiveness of the controls applied to the company's transactions to enable the auditor to evaluate controls at the service organization in an audit of internal control over financial reporting.

Auditor's Use of Service Auditor's Report

B29. Whenever the company uses a service organization to provide services that are part of the company's information system, the auditor should inquire whether management has received a service auditor's report. If so, the auditor should read the report for information that might be useful in planning the audit.

B30. A service auditor's *report on controls placed in operation*, as described in Paragraph .24a of AU sec. 324, expresses an opinion on a description of the controls at the service organization as of a specified date. The opinion indicates whether the controls described (a) were presented fairly in all material respects and (b) were suitably designed to provide reasonable assurance that the control objectives specified in the description would be achieved if complied with satisfactorily.

B31. A report on controls placed in operation might be helpful when planning the audit; however, it provides assurance only with respect to the control objectives specified in the description. Accordingly, there is no assurance that the specified objectives include all those that would be relevant to the company's internal control over financial reporting. Furthermore, if such a report contains a caveat 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 center were processed by checking a control total. Finally, this type of report does not provide any evidence of the operating effectiveness of controls.

B32. If the auditor uses a service auditor's report when planning the audit, he or she should make inquiries concerning the service auditor's reputation, competence, and independence. In making those inquiries, the auditor should evaluate the relevance of the information in AU sec. 543, *Part of Audit Performed by Other Independent Auditors of Financial Statements*. The auditor also should read the report to determine whether it provides information the auditor needs, for example, by addressing the service organization's controls relevant to the assertions the auditor is testing. If the service auditor's report is not sufficient to meet the auditor's objectives, the auditor should gather the desired information from other sources, such as those discussed in the next section.

Unavailable Service Auditor's Report

B33. If a service auditor's report on controls placed in operation is unavailable, the auditor might obtain information about the service organization's controls needed to plan the audit from a variety of sources, such as –

- User manuals.
- System overviews.
- Technical manuals.
- The contract between the client and the service organization.
- Reports by internal auditors or regulatory authorities on the information system and other controls placed in operation by the service organization.
- Inquiries or observations of personnel at the company or at the service organization.

B34. In addition, the auditor's prior experience with the specific service organization might be helpful in planning the audit.

Report on Operating Effectiveness

B35. If the auditor believes that he or she also must obtain evidence about the operating effectiveness of service center controls, one way an auditor can obtain such evidence is by obtaining a service auditor's *report on controls placed in operation and tests of operating effectiveness*, as described in Paragraph .24b of AU sec. 324. This report provides a description of the tests of controls and results of those tests performed by the service auditor, as well as the service auditor's opinion on whether the controls that were tested were operating effectively during the specified period. If a service

auditor's report on controls placed in operation and tests of operating effectiveness is available, management and the auditor should evaluate whether the report provides sufficient evidence to support their assessment and opinion, respectively. The evaluation should include the following factors:

- The time period covered by the service auditor's tests of controls in relationship to the date of management's assessment of internal control over financial reporting,
- The controls tested by the service auditor and how they relate to the company's controls,
- The results of the tests of controls performed by the service auditor, and
- The service auditor's opinion on the operating effectiveness of the controls.

B36. Such evaluations are similar to those the auditor would make when determining whether the service auditor's 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. However, the auditor is responsible for evaluating the evidence provided by the service auditor's report and for determining its effect on the audit of internal control over financial reporting.

Inquiries About Changes in Controls

B37. When a significant period of time has elapsed between the time period covered by the service auditor's tests of controls and the date of management's assessment, the auditor should inquire of management about whether there have been changes in the service organization's controls subsequent to the period covered by the service auditor's report. Such changes might include:

- Changes communicated to management from the service organization,
- Changes in personnel, with whom management interacts, at the service organization,
- 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.

B38. If management has informed the auditor of the types of changes noted in the preceding paragraph, the auditor should determine whether management has performed procedures to evaluate the effect of the changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether management was aware of changes in the service organization's controls that the auditor discovered while performing other procedures during the audit of internal control over financial reporting. In light of such evaluations, the auditor should determine whether there is a need for obtaining additional evidence about the operating effectiveness of controls at the service organization. If additional evidence is necessary, the auditor should:

- Reperform tests performed by management or others within the company,
- Contact the service organization, through the client, to obtain specific information,
- Request that a service auditor be engaged to perform procedures that will supply the necessary information, or
- Visit the service organization and perform procedures that will supply the necessary evidence.

B39. Because the auditor is responsible for obtaining sufficient evidence to support the opinion on internal control over financial reporting, he or she should not refer to the service auditor's report when expressing such an opinion.

Examples of Extent of Testing Decisions

B40. 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 110 provide the auditor with directions about the nature, timing, and extent of testing of the operating effectiveness of internal control over financial reporting.

B41. 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 detective 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 used 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 found 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 walkthrough 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 detect 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 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 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 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 tests over the accounts receivable confirmation procedures, which were performed in July.

To test the reconciliation process, the auditor:

- **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?

- 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.
- Reperformed the Control. Finally, the auditor inspected the reconciliations and reperformed 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 Prevent 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 tested an additional number of items. If another control exception had been noted, the auditor would have decided (a) that this control was not effective and (b) to increase the extent of substantive tests to be performed in connection with the financial statement audit of the cash and accounts payable accounts.]

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).

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 Detect 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 is reviewed and followed up by employees on a weekly basis.

In this case, the computer match is a programmed application control, and the review and follow-up of the unmatched items report is a detect 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:

- 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.
- The auditor established 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.
- 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.
- 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).
- 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 walkthrough 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:
 - 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.
 - 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.
 - 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.
 - 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.

- 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.
- 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.
- 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.

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:

- 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.

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- 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.
- Reperformance of the Control. The auditor selected five weekly Unmatched Items Reports, selected several items from each, and reperfomed 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* in a financial reporting context includes protection only against losses arising from intentional and unintentional misstatements in processing transactions and handling the related assets. Examples of unintentional misstatements include:

- Understatement of sales through failure to prepare invoices or through incorrect pricing or computation;
- Overpayments to vendors or employees arising from inaccuracies in quantities of materials or services, prices or rates, or computations;
- Physical loss or misappropriation of assets such as cash, securities, or inventory; and
- Improper allocation of certain costs, which would result in failure to recover these costs from customers.

C2. Examples of intentional misstatements include falsification of records for the purpose of causing improper computation of commissions, profit-sharing bonuses, royalties, and similar payments based on the recording of other transactions. Consequently, safeguarding controls over the use of a lockbox system for collecting cash and over access controls, such as passwords, that limit access to data and programs that process cash disbursements might both be relevant to an audit of internal control over financial reporting.

C3. The definition of *safeguarding of assets* used in this standard does not encompass the concept that one of management's primary functions is to protect the company's existing assets and acquire new ones. Thus, when evaluating whether the company's internal control over financial reporting is effective, the auditor is not required to understand and test controls over management's decision-making process for all sales and acquisitions. For example, management's decision to sell a product at a price that proves to be unprofitable might be regarded as a failure to protect existing assets. However, because that decision is outside the financial reporting process, it is not considered to be a deficiency in internal control over financial reporting. Likewise, decisions to incur expenditures for equipment that prove to be unnecessary or inefficient, for materials that prove to be unsatisfactory in production, for merchandise

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that proves to be unsaleable, for research that proves to be unproductive, for advertising that proves to be ineffective, and for similar management decisions are not deficiencies in a company's internal control over financial reporting because they are outside the scope of internal control over financial reporting.

APPENDIX D

Examples of Material Weaknesses and Significant Deficiencies

D1. Paragraph 7 of this standard defines an *internal control deficiency*. Paragraphs 8 and 9 go on to define a *significant deficiency* and a *material weakness*.

D2. Materiality in an audit of internal control over financial reporting is discussed in paragraphs 21-23, and paragraphs 116-126 provide additional direction on evaluating deficiencies in internal control over financial reporting.

D3. 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 where 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 in sales contract terms. Although management reviews gross margins on a monthly basis, the significant differences in gross margin on individual transaction 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

Special Internal Control Over Financial Reporting Considerations for Small and Medium-Sized Companies

E1. Although the five components of internal control over financial reporting apply to every company, regardless of its size, the manner in which each component applies depends on a number of factors, including the:

- Nature and size of the business,
- Diversity and complexity of operations,
- Methods for processing financial information, and
- Applicable legal and regulatory requirements.

E2. The following paragraphs discuss how the five components of internal control over financial reporting might be applied in a typical small or medium-sized company (referred to as a *small company* throughout this section).

E3. *Control Environment.* The integrity of senior management often plays a critical role in establishing a strong control environment in a small company. Because written policies and procedures at such companies often are less complete or less formal than at large companies, the behavior and interaction of senior managers is critical to an effective control environment. For instance, a small company might not monitor developments in corporate governance best practices or maintain codes of conduct that reflect current best practice except for senior financial officers. However, ethical behavior and core values can still exist and be supported by the senior management through their daily interaction with employees.

E4. In a small company, the actions of senior management play an important role in the control environment. Sometimes, senior management interacts directly with external parties such as critical suppliers, vendors, customers, independent auditors, and regulators. For that reason, their integrity and ethical values are critical.

E5. Another component of the control environment is the organizational structure. A company's size, complexity, and operations determine the proper organizational structure for that company. Generally, larger organizations that have several operating divisions with prescribed responsibilities and reporting protocols are structured more formally than small companies that focus on accomplishing business objectives with only a few employees. The challenge in a small company is to ensure that the organizational structure does not hinder the company's ability to produce reliable financial reports and to safeguard assets.

E6. If a company has not formed an audit committee, Section 301 of the Act states that the entire board of directors will be designated as the audit committee.

E7. *Risk Assessment.* Small companies generally have a less formal risk assessment process than larger ones. Fewer layers of management in a small company often results in more timely and direct communication of risks with senior management. Furthermore, senior managers who are directly involved in business operations often have a more in-depth understanding of the company's processes and, thus, are in a much better position to identify problems with them than are senior managers in a larger organization. For instance, managers involved in the company's day-to-day operations are more likely to be aware of risks posed by the following—

- Variances between actual and expected results.
- Problems with operational or financial data.
- Issues and concerns about operational issues, such as production processes, inventory shortages.
- Complaints and other communications received from customers or vendors.
- Communications received from regulators and other third parties.

E8. Also, once risks are identified, a small company might be able to more quickly develop and implement action plans.

E9. *Control Activities.* As with the risk assessment process, although the concept of control activities in a small company is the same as in a larger one, the formality with which the activities operate might be different. Furthermore, because of the active involvement of senior managers, certain control activities might not be necessary. For example, the CFO's careful review of daily sales and key ratios might be just as effective in a small company as lower level control activities that might be found in a larger business. In fact, the CFO's day-to-day involvement in the company goes a long way in identifying and preventing material errors in the financial statements.

E10. Because of the limited number of employees in a small company, segregation of duties is not always possible. However, even small companies with few employees might be able to achieve adequate segregation of duties by assigning responsibilities wisely. If that is not possible, the president or other senior manager usually can provide the necessary control through his or her direct oversight. For example, procedures performed directly by the CFO (such as signing all checks and reviewing all bank statements and reconciliations) might mitigate the lack of segregation of duties in the cash area.

E11. *Information and Communication.* Although it might be less formal, the process of communication in a small company can be both effective and efficient. Effective communication often is easier to achieve in small companies since they usually have fewer layers of management. In fact, communication often takes place through daily discussions with senior management. Such communication usually is not only more frequent but more effective. Nevertheless, even with frequent and effective communications, smaller public companies need effective accounting systems and most will benefit greatly from modest investments in information technology. Indeed, completely manual accounting systems have almost completely disappeared.

E12. *Monitoring.* Similar to many of the other components previously discussed, the monitoring component in a small company is likely to be informal. Generally, a small company does not have an internal audit department or other group that evaluates internal controls throughout the company. Rather, senior managers often perform monitoring procedures as part of their normal, routine tasks. Sometimes, while performing such procedures, they identify a deficiency in internal control over financial reporting. When other employees identify a deficiency, the few layers of management usually simplify determining to whom communication of the deficiency should be made.