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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

Form 19b-4

Proposed Rules

by

Public Company Accounting Oversight Board

In Accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") proposed rules to clarify the amendments to the professional standards adopted by the PCAOB as its interim standards resulting from the adoption of PCAOB Auditing Standard No. 2. The proposed rules are attached as Exhibit A to this rule filing.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Board

(a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its Open Meeting on September 15, 2004. No other action by the Board is necessary for the filing of these proposed rules.

(b) Questions regarding this rule filing may be directed to Michael Sullivan, Assistant General Counsel (202-207-9110; sullivanm@pcaobus.org).

3. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

As explained more fully in Exhibit 3, when the Board adopted PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (PCAOB Release No. 2004-001, dated March 9, 2004) (the "internal control standard"), the Board recognized that the internal control standard superseded the professional standards adopted by the Board

as its interim standards^{1/} in some respects, and that express amendments to those standards could be helpful to make the interim standards consistent with the principles and requirements in the internal control standard. The Board also planned to make several amendments to the interim standards that would be applicable to situations in which Section 404 of the Sarbanes-Oxley Act of 2002 is not applicable and only the financial statements of a company are required to be audited. Accordingly, the Board issued for public comment the proposed conforming amendments, which identified conforming changes to the interim standards resulting from the adoption of PCAOB Auditing Standard No. 2.

The purpose of the conforming amendments is to specifically identify changes to the interim standards that result from the adoption of PCAOB Auditing Standard No. 2. The Board believes that identification of such changes is helpful in enabling auditors to comply with the Board's standards, as well as in eliminating potential confusion and inconsistencies in interpretation with respect to the affected portions of the interim standards. Accordingly, the scope of the conforming amendments is relatively narrow and comprises amendments to the interim standards resulting only from the adoption of PCAOB Auditing Standard No. 2.

^{1/} Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the Securities and Exchange Commission on April 25, 2003 (See SEC Release No. 33-8222). On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules."

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules identify changes to the interim standards that result from the adoption of PCAOB Auditing Standard No. 2.

5. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rules for public comment on March 9, 2004. See Exhibit 2(a)(1). The Board received ten written comment letters. See Exhibits 2(a)(2) and 2(a)(3).

The Board has carefully considered the written comments. In response to the written comments received, the Board has clarified and modified certain aspects of the proposed rules. The Board's response to the comments it received and the changes made to the rules in response to these comments are summarized in Exhibit 3 to this filing.

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Exchange Act.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

The proposed rules are not based on the rules of another board or of the Commission.

9. Exhibits

- Exhibit A – Text of the Proposed Rules
- Exhibit 1 – Form of Notice of Proposed Rules for Publication in the Federal Register
- Exhibit 2(a)(1) – PCAOB Release No. 2004-002 (March 9, 2004)
- Exhibit 2(a)(2) – Alphabetical List of Comments
- Exhibit 2(a)(3) – Written comments on the rules proposed in PCAOB Release No. 2004-002
- Exhibit 3 – PCAOB Release No. 2004-008 (September 15, 2004)

10. Signature

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

BY: _____
William J. McDonough, Chairman

Date: September 16, 2004

Exhibit A – Text of Proposed Rules**Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, "An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements"****Auditing Standards**AU sec. 310, "Appointment of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 310, "Appointment of the Independent Auditor," as amended by SAS No. 45, "Omnibus Statement on Auditing Standards-1983," SAS No. 83, "Establishing an Understanding With the Client," and SAS No. 89, "Audit Adjustments" (AU sec. 310, "Appointment of the Independent Auditor"), is amended as follows:

- a. The first sentence of paragraph .06 is amended to read as follows:

An understanding with the client generally includes the following matters.

- b. The first bullet point of paragraph .06 is amended to read as follows:

The objective of the audit is:

- Integrated audit of financial statements and internal control over financial reporting: The expression of an opinion on both management's assessment of internal control over financial reporting and on the financial statements.
- Audit of financial statements: The expression of an opinion on the financial statements.

- c. The third bullet point of paragraph .06 is amended to read as follows:

Management is responsible for establishing and maintaining effective internal control over financial reporting. In an integrated audit of financial statements and internal control over financial reporting, an auditor is required to 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 if management has not:

- Accepted responsibility for the effectiveness of the company's internal control over financial reporting.

- Evaluated the effectiveness of the company's internal control over financial reporting using suitable control criteria,
- Supported its evaluation with sufficient evidence, including documentation, and
- Presented a written 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.

d. The seventh bullet point of paragraph .06 is amended to read as follows:

The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

- Integrated audit of financial statements and internal control over financial reporting: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.
- Audit of financial statements: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

e. The eighth bullet point of paragraph .06 is amended to read as follows:

An audit includes:

- Integrated audit of financial statements and internal control over financial reporting: Planning and performing 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. The auditor is also responsible for obtaining an understanding of internal control sufficient to plan the financial statement audit and to determine the nature, timing, and extent of audit procedures to be performed. The auditor is also responsible for communicating in writing:
 - To the audit committee - all significant deficiencies and material weaknesses identified during the audit.
 - To management - all internal control deficiencies identified during the audit and not previously communicated in writing by the auditor or by others, including internal auditors or others inside or outside the company.

To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.
- Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating in writing:
 - To the audit committee - all significant deficiencies and material weaknesses identified during the audit.
 - To the board of directors – if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that specific significant deficiency or material weakness.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision," as amended by SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 77, "Amendments to Statements on Auditing Standards No. 22, 'Planning and Supervision,' No. 59, 'The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,' No. 62, 'Special Reports'" (AU sec. 311, "Planning and Supervision"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Auditing Standard No. 2 regarding planning considerations in addition to the planning considerations set forth in this section.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," as amended by SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," SAS No. 96, "Audit Documentation," and SAS No. 98, "Omnibus Statement on Auditing Standards--2002" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), is amended as follows:

- a. The following note is added after paragraph 3.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 of PCAOB Auditing Standard No. 2 regarding materiality considerations.

- b. The following note is added after paragraph 5.

Note: An integrated audit of financial statements and internal control over financial reporting is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness.

- c. The following note is added after paragraph 7.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

- d. The following note is added after paragraph 12.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 regarding materiality and planning considerations, respectively.

- e. The following note is added after paragraph 18.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for considerations when a company has multiple locations or business units.

- f. The following note is added after paragraph 30.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 147-149 of PCAOB Auditing Standard No. 2 regarding tests of controls.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards--1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 98-103 of PCAOB Auditing Standard No. 2 regarding timing of tests of controls.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations, in addition to the fraud consideration set forth in this section.

- b. In paragraph 80, the phrase "the auditor should consider whether these risks represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee" is replaced by "the auditor should consider whether these risks represent significant deficiencies that must be communicated to senior management and the audit committee" and the reference to section 325, "Communication of Internal Control Related Matters Noted in an Audit," paragraph .04 is replaced by the reference to section 325, "Communications About Control Deficiencies in An Audit of Financial Statements," paragraph 4.

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment of Statement on Auditing Standards No. 55," and SAS No. 94, "The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), is amended as follows:

a. In paragraph 2, the term "assertions" is replaced by the term "relevant assertions."

b. The following sentence is added at the end of paragraph 2:

Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

c. The following note is added after paragraph 2:

Note: Refer to paragraphs 68-70 of PCAOB Auditing Standard No. 2 for discussion of identifying relevant financial statement assertions.

d. The following note is added after paragraph 9:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for discussion of considerations when a company has multiple locations or business units.

e. The following note is added after paragraph 42:

Note: For 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 in a financial statement audit.

f. The following note is added after paragraph 65:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion.

g. The following note is added after paragraph 83:

Note: In an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, in part, that "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." Accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for additional information regarding documentation requirements.

- h. The following note is added after paragraph 97:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 104-105 of PCAOB Auditing Standard No. 2 for discussion on the extent of tests of controls.

- i. The last sentence of paragraph 107 is replaced with the following sentence:

Consequently, regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 108-126 of PCAOB Auditing Standard No. 2 for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

- b. The second sentence of paragraph 16 is replaced with the following sentence:

The auditor assesses control risk for each of the relevant financial statement assertions related to all significant accounts and disclosures in the financial statements and performs tests of controls to support assessments below the maximum.

- c. The following note is added after paragraph 20:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 112-116 of

PCAOB Auditing Standard No. 2 regarding evaluating the nature of controls subjected to the work of others.

- d. The following note is added after paragraph 22:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 122 of PCAOB Auditing Standard No. 2 regarding assessing the interrelationship of the nature of the controls and the competence and objectivity of those who performed the work.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standard No. 55," SAS No. 88, "Service Organizations and Reporting on Consistency," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 324, "Service Organizations"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," in PCAOB Auditing Standard No. 2 regarding the use of service organizations.

- b. In paragraph 20, the term "reportable conditions" is replaced by the term "significant deficiencies" and the reference to section 325, "Communication of Internal Control Related Matters Noted in an Audit," is replaced by the reference to section 325, "Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"

SAS No. 60, "Communication of Internal Control Related Matters Noted in an Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55," and SAS No. 87, "Restricting the Use of an Auditor's Report" (AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"), is superseded.

- In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60, as amended, is superseded by paragraphs 207-214 of PCAOB Auditing Standard No. 2.
- In an audit of financial statements only, SAS No. 60, as amended, is superseded by the following paragraphs.

Communications about Control Deficiencies in An Audit of Financial Statements

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

- A 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.

2. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 3) has the same meaning as the term "remote" as used 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.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

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

- 3. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 1, 2 and 3, and the directions in paragraphs 130 through 137 of PCAOB Auditing Standard No. 2. As explained in paragraph 23 of PCAOB Auditing Standard No. 2, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency, or combination of deficiencies, is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

- 4. The auditor must communicate in writing to management and 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 the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined in paragraphs 2 and 3.

Note: 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.^{1/} The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors or an audit committee at these companies indicative, by themselves, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3^{2/} are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).^{3/} Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).^{4/} Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X^{5/} (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

5. If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's

^{1/} See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

^{2/} See 17 C.F.R. 240.10A-3.

^{3/} See 17 C.F.R. 240.10A-3(c)(2).

^{4/} See 17 C.F.R. 240.10A-3(c)(2).

^{5/} See 17 C.F.R. 240.2-01(c)(7).

oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

6. These written communications should include:
 - a. The definitions of significant deficiencies and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.
 - b. A statement that the objective of the audit was to report on the financial statements and not to provide assurance on internal control.
 - c. A statement that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such written communications, specific reference to such regulatory authorities may be made.

 7. The auditor might identify matters in addition to those required to be communicated by this standard. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.

 8. The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.

 9. 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 to issue an interim communication should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.
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In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency," as defined in paragraph 9 of PCAOB Auditing Standard No. 2.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter," as amended by SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 80, "Amendment to Statement on Auditing Standards No. 31, 'Evidential Matter'" (AU sec. 326, "Evidential Matter"), is amended by adding the following sentences at the end of paragraph 19:

Additionally, the auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures," as amended by SAS No. 96, "Audit Documentation" (AU sec. 329, "Analytical Procedures"), is amended as follows:

- a. The following sentence is added to the end of paragraph 9:

For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

- b. The following sentences are added to the end of paragraph 10:

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 alone are not well suited to detecting fraud.

- c. The following sentence is added to the beginning of paragraph 16:

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.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended by adding the following note after paragraph 11:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if a company's investment in derivatives and securities represents a significant account, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations," as amended by SAS No. 89, "Audit Adjustments," and SAS No. 99 "Consideration of Fraud in a Financial Statement Audit" (AU sec. 333, "Management Representations"), is amended by adding the following note after paragraph 5:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for additional required written representations to be obtained from management.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended by adding the following note after paragraph 10:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.

AU sec. 380, "Communication with Audit Committees"

SAS No. 61, "Communication with Audit Committees" (AU sec. 380, "Communication with Audit Committees"), is amended by replacing the title of Section 325 in the first bullet in footnote 1 in paragraph 1 with "Communications About Control Deficiencies in An Audit of Financial Statements" and adding the following after the last bullet in footnote 1 in paragraph 1:

- PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990," SAS No. 79, "Amendment to Statement on Auditing Standards No. 58, 'Reports on Audited Financial Statements,'" SAS No. 85, "Management Representations," SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 508, "Reports on Audited Financial Statements"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 162-199 of PCAOB Auditing Standard No. 2 for direction on reporting on internal control over financial reporting. In addition, see Appendix A, "Illustrative Reports on Internal Control Over Financial Reporting," of PCAOB Auditing Standard No. 2 which includes an illustrative combined audit report and examples of separate reports.

- b. The following subparagraph is added to paragraph 8:

k. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control 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 opinions].

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 530, "Dating of the Independent Auditor's Report," as amended by SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 530, "Dating of the Independent Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraphs 171-172 of PCAOB Auditing Standard No. 2, which provide direction with respect to the report date in an audit of internal control over financial reporting.

AU sec. 532, "Restricting the Use of an Auditor's Report"

SAS No. 87, "Restricting the Use of an Auditor's Report," (AU sec. 532, "Restricting the Use of an Auditor's Report"), is amended by replacing "Section 325, Communication of Internal Control Related Matters Noted in an Audit" in the first bullet of paragraph .07 with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 543, "Part of Audit Performed by Other Independent Auditors," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 182-185 of PCAOB Auditing Standard No. 2, which provide direction with respect to opinions based, in part, on the report of another auditor in an audit of internal control over financial reporting.

AU sec. 9550, "Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550"

AU sec. 9550, "Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550," is amended by replacing the term "reportable conditions" with the term "significant deficiencies" in footnote 8 to paragraph 15 and also replaces in that footnote the reference to Section 325.17 with the reference Section 325.8.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 560, "Subsequent Events," as amended by SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 560, "Subsequent Events"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 186-189 of PCAOB Auditing Standard No. 2, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," as amended by SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 197 of PCAOB Auditing Standard No. 2, which provides direction with respect to the subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.

AU sec. 634, "Letters for Underwriters and Certain Other Requesting Parties"

SAS No. 72, "Letters for Underwriters and Certain Other Requesting Parties," as amended by SAS No. 76, "Amendments to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties," and SAS No. 86, "Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties" (AU sec. 634, "Letters for Underwriters and Certain Other Requesting Parties") is amended by replacing the reference to "Section 325, Communication of Internal Control Related Matters Noted in an Audit" with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended by adding the following note after paragraph 2:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, which provide direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in filings under federal securities statutes.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows:

- a. The following note is added after paragraph 3:

Note: When an auditor is engaged to perform an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 202-206 of PCAOB Auditing Standard No. 2, which provide direction regarding the auditor's evaluation responsibilities as they relate to management's quarterly certifications on internal control over financial reporting.

- b. In paragraph 9, the term "reportable conditions" is replaced by the term "significant deficiencies."
- c. In paragraph 33, the term "reportable conditions" is replaced by the term "significant deficiencies." Also, the third sentence is replaced by the following:

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

- d. The reference in footnote 22 to paragraph 33 to "Section 325, Communication of Internal Control Related Matters in an Audit" is replaced with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

Attestation Standards

AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"

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" (AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"), and its related interpretation (AT sec. 9501, "Reporting on an Entity's Internal Control Over Financial Reporting: Attest Engagements Interpretations of Section 501"), are superseded by the conforming amendments and, accordingly, are no longer interim standards of the Board.

Independence Standards

ET sec. 101.05

Rule 101, "Independence" (ET sec. 101.05) is amended by adding the following note after the second paragraph of interpretation 101-3, "Performance of Other Services:"

Note: Paragraph 33 of PCAOB Auditing Standard No. 2 contains an additional requirement related to audit committee pre-approval of internal control-related services.

EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION
(Release No. 34- ; File No. PCAOB-2004-07)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, "An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit of Financial Statements"

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on September 16, 2004, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") the proposed rules described in Items I, II, and III below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On September 15, 2004, the Board adopted *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, "An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit of Financial Statements"* ("the proposed rules"). The proposed rules text is set out as follows:

Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, "An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements"

Auditing Standards

AU sec. 310, "Appointment of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 310, "Appointment of the Independent Auditor," as amended by SAS No. 45, "Omnibus Statement on Auditing Standards-1983," SAS No. 83, "Establishing an Understanding With the Client," and SAS No. 89, "Audit Adjustments" (AU sec. 310, "Appointment of the Independent Auditor"), is amended as follows:

- a. The first sentence of paragraph .06 is amended to read as follows:

An understanding with the client generally includes the following matters.

- b. The first bullet point of paragraph .06 is amended to read as follows:

The objective of the audit is:

- Integrated audit of financial statements and internal control over financial reporting: The expression of an opinion on both management's assessment of internal control over financial reporting and on the financial statements.
- Audit of financial statements: The expression of an opinion on the financial statements.

- c. The third bullet point of paragraph .06 is amended to read as follows:

Management is responsible for establishing and maintaining effective internal control over financial reporting. In an integrated audit of financial statements and internal control over financial reporting, an auditor is required to 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 if management has not:

- Accepted responsibility for the effectiveness of the company's internal control over financial reporting.
- Evaluated the effectiveness of the company's internal control over financial reporting using suitable control criteria,

- Supported its evaluation with sufficient evidence, including documentation, and
 - Presented a written 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.
- d. The seventh bullet point of paragraph .06 is amended to read as follows:

The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

- Integrated audit of financial statements and internal control over financial reporting: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.
- Audit of financial statements: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- e. The eighth bullet point of paragraph .06 is amended to read as follows:

An audit includes:

- Integrated audit of financial statements and internal control over financial reporting: Planning and performing 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. The auditor is also responsible for obtaining an understanding of internal control sufficient to plan the financial statement audit and to determine the nature, timing, and extent of audit procedures to be performed. The auditor is also responsible for communicating in writing:
 - To the audit committee - all significant deficiencies and material weaknesses identified during the audit.
 - To management - all internal control deficiencies identified during the audit and not previously communicated in writing by the auditor or by others, including internal auditors or others inside or outside the company.

To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.
- Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating in writing:
 - To the audit committee - all significant deficiencies and material weaknesses identified during the audit.
 - To the board of directors – if the auditor becomes aware that the oversight of the company's external

financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that specific significant deficiency or material weakness.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision," as amended by SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 77, "Amendments to Statements on Auditing Standards No. 22, 'Planning and Supervision,' No. 59, 'The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,' No. 62, 'Special Reports'" (AU sec. 311, "Planning and Supervision"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Auditing Standard No. 2 regarding planning considerations in addition to the planning considerations set forth in this section.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," as amended by SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," SAS No. 96, "Audit Documentation," and SAS No. 98, "Omnibus Statement on Auditing Standards--2002" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), is amended as follows:

- a. The following note is added after paragraph 3.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 of PCAOB Auditing Standard No. 2 regarding materiality considerations.

- b. The following note is added after paragraph 5.

Note: An integrated audit of financial statements and internal control over financial reporting is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness.

- c. The following note is added after paragraph 7.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-

26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

- d. The following note is added after paragraph 12.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 regarding materiality and planning considerations, respectively.

- e. The following note is added after paragraph 18.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for considerations when a company has multiple locations or business units.

- f. The following note is added after paragraph 30.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 147-149 of PCAOB Auditing Standard No. 2 regarding tests of controls.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards--1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 98-103 of PCAOB Auditing Standard No. 2 regarding timing of tests of controls.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud

considerations, in addition to the fraud consideration set forth in this section.

- b. In paragraph 80, the phrase "the auditor should consider whether these risks represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit committee" is replaced by "the auditor should consider whether these risks represent significant deficiencies that must be communicated to senior management and the audit committee" and the reference to section 325, "Communication of Internal Control Related Matters Noted in an Audit," paragraph .04 is replaced by the reference to section 325, "Communications About Control Deficiencies in An Audit of Financial Statements," paragraph 4.

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment of Statement on Auditing Standards No. 55," and SAS No. 94, "The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), is amended as follows:

- a. In paragraph 2, the term "assertions" is replaced by the term "relevant assertions."
- b. The following sentence is added at the end of paragraph 2:

Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

- c. The following note is added after paragraph 2:

Note: Refer to paragraphs 68-70 of PCAOB Auditing Standard No. 2 for discussion of identifying relevant financial statement assertions.

- d. The following note is added after paragraph 9:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for

discussion of considerations when a company has multiple locations or business units.

- e. The following note is added after paragraph 42:

Note: For 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 in a financial statement audit.

- f. The following note is added after paragraph 65:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion.

- g. The following note is added after paragraph 83:

Note: In an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, in part, that "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." Accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for additional information regarding documentation requirements.

- h. The following note is added after paragraph 97:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 104-105 of PCAOB Auditing Standard No. 2 for discussion on the extent of tests of controls.

- i. The last sentence of paragraph 107 is replaced with the following sentence:

Consequently, regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 108-126 of PCAOB Auditing Standard No. 2 for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

- b. The second sentence of paragraph 16 is replaced with the following sentence:

The auditor assesses control risk for each of the relevant financial statement assertions related to all significant accounts and disclosures in the financial statements and performs tests of controls to support assessments below the maximum.

- c. The following note is added after paragraph 20:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 112-116 of PCAOB Auditing Standard No. 2 regarding evaluating the nature of controls subjected to the work of others.

- d. The following note is added after paragraph 22:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 122 of PCAOB Auditing Standard No. 2 regarding assessing the interrelationship of the nature of the controls and the competence and objectivity of those who performed the work.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standard No. 55," SAS No. 88, "Service Organizations and Reporting on Consistency," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 324, "Service Organizations"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," in PCAOB Auditing Standard No. 2 regarding the use of service organizations.

- b. In paragraph 20, the term "reportable conditions" is replaced by the term "significant deficiencies" and the reference to section 325, "Communication of Internal Control Related Matters Noted in an Audit," is replaced by the reference to section 325, "Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"

SAS No. 60, "Communication of Internal Control Related Matters Noted in an Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55," and SAS No. 87, "Restricting the Use of an Auditor's Report" (AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"), is superseded.

- In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60, as amended, is superseded by paragraphs 207-214 of PCAOB Auditing Standard No. 2.
- In an audit of financial statements only, SAS No. 60, as amended, is superseded by the following paragraphs.

Communications about Control Deficiencies in An Audit of Financial Statements

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

- A 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.

2. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 3) has the same meaning as the term "remote" as used 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.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

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

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

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 1, 2 and 3, and the directions in paragraphs 130 through 137 of PCAOB Auditing Standard No. 2. As explained in paragraph 23 of PCAOB Auditing Standard No. 2, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency, or combination of deficiencies, is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

4. The auditor must communicate in writing to management and 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 the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined in paragraphs 2 and 3.

Note: 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.^{1/} The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors or an audit committee at these companies indicative, by themselves, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3^{2/} are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).^{3/} Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).^{4/} Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X^{5/} (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

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

^{1/} See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

^{2/} See 17 C.F.R. 240.10A-3.

^{3/} See 17 C.F.R. 240.10A-3(c)(2).

^{4/} See 17 C.F.R. 240.10A-3(c)(2).

^{5/} See 17 C.F.R. 240.2-01(c)(7).

Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

6. These written communications should include:
 - a. The definitions of significant deficiencies and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.
 - b. A statement that the objective of the audit was to report on the financial statements and not to provide assurance on internal control.
 - c. A statement that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such written communications, specific reference to such regulatory authorities may be made.
7. The auditor might identify matters in addition to those required to be communicated by this standard. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.
8. The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.
9. 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 to issue an interim communication should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency," as defined in paragraph 9 of PCAOB Auditing Standard No. 2.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter," as amended by SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 80, "Amendment to Statement on Auditing Standards No. 31, 'Evidential Matter'" (AU sec. 326, "Evidential Matter"), is amended by adding the following sentences at the end of paragraph 19:

Additionally, the auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures," as amended by SAS No. 96, "Audit Documentation" (AU sec. 329, "Analytical Procedures"), is amended as follows:

- a. The following sentence is added to the end of paragraph 9:

For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

- b. The following sentences are added to the end of paragraph 10:

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 alone are not well suited to detecting fraud.

- c. The following sentence is added to the beginning of paragraph 16:

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.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended by adding the following note after paragraph 11:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if a company's investment in derivatives and securities represents a significant account, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations," as amended by SAS No. 89, "Audit Adjustments," and SAS No. 99 "Consideration of Fraud in a Financial Statement Audit" (AU sec. 333, "Management Representations"), is amended by adding the following note after paragraph 5:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for additional required written representations to be obtained from management.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended by adding the following note after paragraph 10:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of

the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.

AU sec. 380, "Communication with Audit Committees"

SAS No. 61, "Communication with Audit Committees" (AU sec. 380, "Communication with Audit Committees"), is amended by replacing the title of Section 325 in the first bullet in footnote 1 in paragraph 1 with "Communications About Control Deficiencies in An Audit of Financial Statements" and adding the following after the last bullet in footnote 1 in paragraph 1:

- PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990," SAS No. 79, "Amendment to Statement on Auditing Standards No. 58, 'Reports on Audited Financial Statements,'" SAS No. 85, "Management Representations," SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 508, "Reports on Audited Financial Statements"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 162-199 of PCAOB Auditing Standard No. 2 for direction on reporting on internal control over financial reporting. In addition, see Appendix A, "Illustrative Reports on Internal Control Over Financial Reporting," of PCAOB Auditing Standard No. 2 which includes an illustrative combined audit report and examples of separate reports.

- b. The following subparagraph is added to paragraph 8:

- k. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph

should be added to the auditor's report on the company's financial statements:

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on *[identify control 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 opinions]*.

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 530, "Dating of the Independent Auditor's Report," as amended by SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 530, "Dating of the Independent Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraphs 171-172 of PCAOB Auditing Standard No. 2, which provide direction with respect to the report date in an audit of internal control over financial reporting.

AU sec. 532, "Restricting the Use of an Auditor's Report"

SAS No. 87, "Restricting the Use of an Auditor's Report," (AU sec. 532, "Restricting the Use of an Auditor's Report"), is amended by replacing "Section 325, Communication of Internal Control Related Matters Noted in an Audit" in the first bullet of paragraph .07 with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 543, "Part of Audit Performed by Other Independent Auditors," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 182-185 of PCAOB Auditing Standard No. 2, which provide direction with respect to opinions based, in part, on the report of another auditor in an audit of internal control over financial reporting.

AU sec. 9550, "Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550"

AU sec. 9550, "Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550," is amended by replacing the term "reportable conditions" with the term "significant deficiencies" in footnote 8 to paragraph 15 and also replaces in that footnote the reference to Section 325.17 with the reference Section 325.8.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 560, "Subsequent Events," as amended by SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 560, "Subsequent Events"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 186-189 of PCAOB Auditing Standard No. 2, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," as amended by SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 197 of PCAOB Auditing Standard No. 2, which provides direction with respect to the subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.

AU sec. 634, "Letters for Underwriters and Certain Other Requesting Parties"

SAS No. 72, "Letters for Underwriters and Certain Other Requesting Parties," as amended by SAS No. 76, "Amendments to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties," and SAS No. 86, "Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties" (AU sec. 634, "Letters for Underwriters and Certain Other Requesting Parties") is amended by replacing the reference to "Section 325, Communication of Internal Control

Related Matters Noted in an Audit" with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended by adding the following note after paragraph 2:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, which provide direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in filings under federal securities statutes.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows:

- a. The following note is added after paragraph 3:

Note: When an auditor is engaged to perform an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 202-206 of PCAOB Auditing Standard No. 2, which provide direction regarding the auditor's evaluation responsibilities as they relate to management's quarterly certifications on internal control over financial reporting.

- b. In paragraph 9, the term "reportable conditions" is replaced by the term "significant deficiencies."
- c. In paragraph 33, the term "reportable conditions" is replaced by the term "significant deficiencies." Also, the third sentence is replaced by the following:

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

- d. The reference in footnote 22 to paragraph 33 to "Section 325, Communication of Internal Control Related Matters in an Audit" is

replaced with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

Attestation Standards

AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"

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" (AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"), and its related interpretation (AT sec. 9501, "Reporting on an Entity's Internal Control Over Financial Reporting: Attest Engagements Interpretations of Section 501"), are superseded by the conforming amendments and, accordingly, are no longer interim standards of the Board.

Independence Standards

ET sec. 101.05

Rule 101, "Independence" (ET sec. 101.05) is amended by adding the following note after the second paragraph of interpretation 101-3, "Performance of Other Services:"

Note: Paragraph 33 of PCAOB Auditing Standard No. 2 contains an additional requirement related to audit committee pre-approval of internal control-related services.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

When the Board adopted PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (PCAOB Release No. 2004-001, dated March 9, 2004) (the "internal control standard"), the Board recognized that the internal control standard superseded the professional standards adopted by the Board as its interim standards^{1/} in some respects, and that express amendments to those standards could be helpful to make the interim standards consistent with the principles and requirements in the internal control standard. The Board also planned to make several amendments to the interim standards that would be applicable to situations in which Section 404 of the Sarbanes-Oxley Act of 2002 is not applicable and only the financial statements of a company are required to be audited. Accordingly, the Board issued for public comment the proposed conforming amendments, which identified conforming changes to the interim standards resulting from the adoption of PCAOB Auditing Standard No. 2.

^{1/} Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the Securities and Exchange Commission on April 25, 2003 (See SEC Release No. 33-8222). On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules."

The purpose of the conforming amendments is to specifically identify changes to the interim standards that result from the adoption of PCAOB Auditing Standard No. 2. The Board believes that identification of such changes is helpful in enabling auditors to comply with the Board's standards, as well as in eliminating potential confusion and inconsistencies in interpretation with respect to the affected portions of the interim standards. Accordingly, the scope of the conforming amendments is relatively narrow and comprises amendments to the interim standards resulting only from the adoption of PCAOB Auditing Standard No. 2.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rules will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules identify changes to the interim standards that result from the adoption of PCAOB Auditing Standard No. 2.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rules for public comment in PCAOB Release No. 2004-002 (March 9, 2004). A copy of PCAOB Release No. 2004-002 and the comment letters received in response to the PCAOB's request for comment are available on the PCAOB's Web site at www.pcaobus.org. The Board received 10 written comments. The Board has modified certain aspects of the proposed rules in response to comments it received, as discussed below:

1. Auditing Standards

The Board's interim auditing standards include the Statements on Auditing Standards promulgated by the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board ("ASB"), as in existence on April 16, 2003.^{2/} The conforming amendments to the Board's interim auditing standards include (a) the addition of references to assist auditors in performing an integrated audit of financial statements and internal control over financial reporting and (b) amendments to incorporate certain requirements in PCAOB Auditing Standard No. 2 that also apply when an auditor is engaged solely to audit a company's financial statements.

a. Addition of References to the Interim Standards

References have been added to assist auditors in performing an integrated audit of financial statements and internal control over financial reporting. Auditors are cautioned that the references might not be all inclusive. If there is any conflict between the interim auditing standards and PCAOB Auditing Standard No. 2, auditors should follow the provisions of PCAOB Auditing Standard No. 2.

In the release relating to the proposed conforming amendments, commenters were asked whether the proposed references would be useful to auditors performing an integrated audit of financial statements and internal control over financial reporting. The release also asked whether any references considered beneficial were omitted from the proposed standard.

^{2/} The Statements on Auditing Standards ("AU") are codified into the AICPA *Professional Standards*, vol. 1, as AU sections 100 through 901.

Most commenters found the proposed references to be helpful to auditors performing both integrated audits and audits of financial statements. Several commenters voiced concerns stemming from the lack of a codification of PCAOB auditing standards. The Board believes that auditors will find the listing of conforming amendments in this rulemaking to be a useful tool for reconciling changes to the interim standards. The Board decided that no change is necessary to the conforming amendments in response to these comments regarding a codification because these comments were outside the scope of this rulemaking.

In addition, several commenters suggested additional references to include in the final conforming amendments. The Board evaluated each of these suggestions individually and included them in the final conforming amendments where deemed appropriate.

b. Amendments to Incorporate Requirements from PCAOB Auditing Standard No. 2

While PCAOB Auditing Standard No. 2 is directed primarily to an auditor performing an integrated audit of financial statements and internal control over financial reporting, some provisions in that standard are relevant to situations in which an auditor is engaged solely to audit a company's financial statements, such as in an audit of financial statements presented in connection with an initial public offering, in which the company is not subject to the requirements of Section 404 of the Act and the SEC's rules implementing that provision.^{3/} Therefore, this rulemaking amends certain interim standards directly because those amendments would apply in all cases.

In the release relating to the proposed conforming amendments, commenters were asked (a) whether the proposed amendments clearly describe the new requirements that apply either when the auditor is engaged to audit only the financial statements or when the auditor is engaged to perform an integrated audit of the financial statements and internal control over financial reporting; and (b) whether there were any additional requirements not already identified that also should apply when the auditor is engaged to audit only the financial statements.

Most commenters found the proposed amendments both clear and helpful. A few commenters suggested editorial changes to the proposed

^{3/} 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].

amendments, while others suggested additional amendments. The Board reviewed all such comments and, where appropriate, incorporated them into the final conforming amendments.

One commenter believed that a number of new requirements that apply when the auditor is engaged to audit only the financial statements have been obscured behind the label of "conforming changes" and that, as a result, auditors will fail to notice such new requirements. This commenter suggested that the Board appropriately highlight each new requirement for such audits to ensure that auditors are aware of and fully understand the ramifications of each new requirement. The changes described in the conforming amendments were first presented for public comment in connection with the Board's proposal of Auditing Standard No. 2 in October 2003. Because a number of commenters, when commenting on that proposal, suggested that a more detailed explanation of these changes could be helpful to practitioners, the Board decided to more clearly identify the changes in separate conforming amendments. These two notice and comment periods have served to highlight these changes, and the Board believes that the conforming amendments adopted today, together with this release describing those amendments, provide auditors adequate explanation to understand the effects of these changes on the financial statement audit.

Significant areas of amendment to the auditing standards are discussed below, including comments received and the Board's response thereto. For ease

of reference, the references herein are to the interim standards as codified in *AICPA Professional Standards*, rather than to the original pronouncements.

(1) AU sec. 310, "Appointment of the Independent Auditor"

This standard has been amended to include requirements related to the auditor's understanding with the client when performing an integrated audit of financial statements and internal control over financial reporting. For consistency, certain related amendments also have been made to the auditor's required understanding with the client when performing an audit of financial statements. One commenter suggested that the amendments to this standard indicating that reasonable assurance is "a high level of assurance" were inappropriate and should be subject to further deliberation and discussion. The Board's clarification that reasonable assurance is "a high level of assurance" was clearly included in PCAOB Auditing Standard No. 2. As indicated in the Board's release proposing the conforming amendments, the scope of this rulemaking did not include reconsidering any principles or requirements of PCAOB Auditing Standard No. 2. Accordingly, the Board viewed this comment regarding reasonable assurance as beyond the scope of the proposed conforming amendments rulemaking. No changes have been made based upon this comment.

(2) AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

This interim standard has been amended by adding a requirement that states, "Regardless of the assessed level of control risk, the auditor should

perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." As it relates to this requirement, Auditing Standard No. 2 states, "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." A similar conforming amendment has been made to AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

(3) AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit."

This standard has been superseded in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207 through 214 of PCAOB Auditing Standard No. 2. By this rulemaking, the Board is also amending this interim standard, as applied to an audit only of financial statements, by substituting the paragraphs included in the appendix accompanying this release (See AU sec. 325, subparagraphs 1-9 in the appendix).

Communication of Significant Deficiencies and Material Weaknesses in a Financial Statement Audit. The release relating to the proposed standard asked for comments on the appropriateness of a proposed amendment that would require an auditor, in an audit of only the financial statements, to report to management and the audit committee only those control deficiencies identified

during the audit that are considered either significant deficiencies or material weaknesses. In an integrated audit of internal control over financial reporting and the financial statements, Auditing Standard No. 2 requires the auditor also to communicate to management, in writing, all deficiencies in internal control over financial reporting identified during the audit and inform the audit committee when such a communication has been made. The proposed amendment would not have required the auditor to communicate to management and the audit committee *all* control deficiencies noted in an audit of the financial statements, but only those that meet the definition of a significant deficiency or material weakness. All commenters agreed with this proposed amendment except one. One commenter suggested that the auditor should be required to communicate *all* control deficiencies noted in an audit of the financial statements. While an auditor may, based on his or her own judgment or upon request of management or an audit committee, communicate all control deficiencies noted in an audit of the financial statements, the Board believes that to require such a communication in all audits of only the financial statements would be unnecessarily burdensome on audit committees. Therefore, the Board has retained the requirement for the auditor to report to management and the audit committee only those control deficiencies identified in the audit of the financial statements that are either significant deficiencies or material weaknesses.

Communication of the Ineffectiveness of the Audit Committee. The proposed amendment stated that, in an audit only of financial statements, an auditor does not have a requirement to evaluate the effectiveness of the audit

committee's oversight of the company's internal control over financial reporting. The proposed amendment would also have required an auditor to communicate, in writing, to the board of directors if a significant deficiency or material weakness exists, however, because the oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

While commenters unanimously agreed with this provision, several commenters asked for clarification of the auditor's responsibility. In response, the Board has amended subparagraph 5 of the conforming amendments to AU sec. 325 to read as follows –

If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, ~~of the external financial reporting process and the internal control over financial reporting,~~ if the auditor becomes aware that a significant deficiency or material weakness exists ~~because~~ the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

This change is intended to clarify that, while an auditor does not have an explicit requirement to perform a separate and distinct evaluation of the effectiveness of the audit committee in a financial statement audit, the auditor does have a communication responsibility when he or she becomes aware of a significant deficiency or material weakness caused by the audit committee's ineffectiveness.

Illustrative Internal Control Reports. Several commenters requested that the Board revise and include in the conforming amendments illustrative reports to management about deficiencies in internal control similar to those previously contained in AU sec. 325 and its related interpretation. The Board noted that presenting such reports in a rulemaking of the Board might lead firms to use boilerplate language in such communications to management and others. In addition, the Board believes that any new illustrative reports it issues as part of the Board's standards must not only reflect conforming changes but also incorporate best practices at the time of issuance. This type of revision of illustrative reports is beyond the scope of the conforming amendments. Additionally, the Board expects that auditors will be able to clearly and appropriately communicate these matters without relying on illustrative reports. For these reasons, illustrative reports have not been included in the conforming amendments.

(4) AU sec. 326, "Evidential Matter"

This standard has been amended to add a requirement stating that, "the auditor's substantive procedures must include reconciling the financial

statements to the accounting records. The auditor's substantive procedures should include examining material adjustments made during the course of preparing the financial statements." PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial reporting. The Board believes that it is logical and appropriate that these procedures also be performed in an audit of the financial statements. No commenters objected to this amendment.

(5) AU sec. 329, "Analytical Procedures"

This standard is amended to add the following directions –:

- For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.
- 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 alone are not well suited to detecting fraud.
- 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.

PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial reporting. The Board also believes that it is logical and appropriate to perform these procedures in an audit of the financial statements. The Board did

not receive any comments on these amendments other than comments that re-challenged their inclusion in PCAOB Auditing Standard No. 2. As indicated in the Board's proposing release, these types of comments were considered to be beyond the scope of the proposed conforming amendments; therefore, no changes have been made based upon these comments.

(6) AU sec. 339, "Audit Documentation"

The proposed conforming amendments would have added a subparagraph to Appendix A of this standard ("SAS No. 96"). Subsequent to the conforming amendments being issued for public comment, the Board adopted, and the Securities and Exchange Commission approved, PCAOB Auditing Standard No. 3, *Audit Documentation*. PCAOB Auditing Standard No. 3 superseded SAS No. 96 in its entirety, including Appendix A. Therefore, this proposed conforming amendment is not included in the final conforming amendments because the Board's interim standards no longer contain Appendix A of AU sec. 339.

(7) AU sec. 380, "Communication with Audit Committees"

Footnote one to this standard includes a list of other standards that also require audit committee communications. Because PCAOB Auditing Standard No. 2 also includes required audit committee communications, this standard is amended by including a reference to PCAOB Auditing Standard No. 2 in footnote one. The Board added this conforming amendment based on a suggestion from a commenter.

2. Attestation Standards

The Board's interim attestation standards include the Statements on Standards for Attestation Engagements promulgated by the ASB, as in existence on April 16, 2003.^{4/} Auditors performing an integrated audit of financial statements and internal control over financial reporting to comply with Section 404 of the Act must follow PCAOB Auditing Standard No. 2 when reporting on an entity's internal control over financial reporting. Therefore, in the context of an audit of a company that is subject to Section 404 of the Act, AT sec. 501 has been superseded by the internal control standard. Because AT 501, even as applied to an engagement other than an engagement under Section 404, is outdated, the proposed conforming amendments recommended that AT sec. 501 be superseded in its entirety and removed from the Board's standards.

The release to the proposed conforming amendments asked commenters whether AT sec. 501 should be amended rather than superseded in its entirety. Furthermore, it asked commenters to provide information on (a) whether there are any circumstances in which an issuer would want or need to file an AT sec. 501 report with the SEC and (b) whether there is a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting for purposes of complying with Section 404 of the Act. Commenters who believed such a need exists were requested to indicate in their responses the type of information that

^{4/} The Statements on Standards for Attestation Engagements ("AT") are codified into the AICPA *Professional Standards*, vol. 1, as AT sections 101 through 701.

should be included in the report, the circumstances in which such a report might be issued, and the intended users of such a report.

Most commenters agreed with the deletion of AT sec. 501 from the Board's interim standards. Those commenters believed that AT sec. 501 is inferior to PCAOB Auditing Standard No. 2. In addition, those commenters were unaware of any circumstances in which an issuer would be required to file an AT sec. 501 report with the SEC, or of any instances in which issuers might need an auditor's report on internal control other than the one embodied in PCAOB Auditing Standard No. 2.

Other commenters, however, expressed concerns about superseding AT sec. 501 in its entirety for a number of reasons. A couple of commenters pointed out that the auditors of some asset-backed securities ("ABS") issuers issue AT sec. 501 reports in order for those ABS issuers to comply with the SEC's annual filing requirements. ABS issuers are not required to comply with Section 404 of the Act, however. No ABS issuer is required to file an auditor's report performed pursuant to AT sec. 501; rather, ABS issuers may comply with the SEC's annual filing requirements by filing an auditor's report performed pursuant to AT sec. 601, *Compliance Attestation*. Further, under a recent SEC proposal (*Proposed Rule: Asset-Backed Securities, Release Nos. 33-8419 and 34-49644, May 3, 2004*), the SEC would require an ABS issuer to include in its annual filing one consistent form of auditor's report. In lieu of audited financial statements and compliance with Section 404 of the Act, the SEC proposal would require that management of certain ABS issuers assess the issuer's compliance with

servicing criteria and that the auditor attest to, and report on, management's assertion as to whether it complied with the servicing standards through the performance of a compliance attestation. According to the proposal, the attestation standard under which the auditor should perform such engagement would be "Compliance Attestation," AT sec. 601 or another standard for compliance auditing established by the PCAOB. Therefore, if the SEC proposal is adopted, the SEC would no longer accept AT sec. 501 reports for this purpose.

Other commenters expressed less specific concerns over superseding AT sec. 501 in its entirety. These commenters expressed a belief that, at some point, both issuers and nonissuers might need (or want) other reports on internal control presently not provided for under PCAOB Auditing Standard No. 2. For example, these commenters suggested that issuers might need an interim report on internal control, especially when a material weakness that existed at year end is subsequently corrected. Another commenter suggested that an issuer might want an audit report on some other aspect of internal control. None of these commenters, however, provided the detailed discussion requested in the release about the type of information that should be included in such a report, the circumstances in which it might be issued, and the intended users of such a report.

The Board continues to believe that AT sec. 501 lacks the necessary specificity provided in PCAOB Auditing Standard No. 2. At a minimum, if AT sec. 501 were to be retained in the Board's standards, the reporting directions in AT sec. 501 would require immediate revision to clearly distinguish for report users

the difference between a report issued under AT sec. 501 and PCAOB Auditing Standard No. 2. Further, it would be necessary to make extensive revisions to AT sec. 501 to conform it to the principles and requirements embodied in PCAOB Auditing Standard No. 2. Because commenters were unable to describe a specific need that is currently unmet by reports issued under PCAOB Auditing Standard No. 2 or other professional standards, there appears to be no compelling reason at this time for the Board either to amend AT sec. 501 or to propose a new standard to replace AT sec. 501. Accordingly, the conforming amendments supersede AT sec. 501 altogether and remove it from the Board's standards effective immediately upon approval by the SEC.

Because AT sec. 501 is no longer a part of the Board's interim standards, it is not appropriate for auditors of issuers following the PCAOB's standards to use AT sec. 501 when reporting on the internal control over financial reporting of an issuer.

3. Independence Standards

The Board's interim independence standards include the AICPA *Code of Professional Conduct* Rule 101, and interpretations and rulings thereunder, promulgated by the AICPA Professional Ethics Executive Committee, as in existence on April 16, 2003.^{5/} As indicated in PCAOB Auditing Standard No. 2, a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer for which the

^{5/} The AICPA's Code of Professional Conduct ("ET") Rule 101, and interpretations and rulings thereunder, are codified into the AICPA *Professional Standards*, vol. 2, as ET sections 101 and 191.

registered public accounting firm also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee. Because this requirement adds to current independence requirements, a reference to this requirement has been added to interpretation 101-3, "Performance of Other Services," to Rule 101, "Independence" (ET sec. 101.05). The Board did not receive any comments objecting to this amendment.

Please note that a table, "Cross-References to Conforming Amendments to PCAOB Interim Standards," which identifies all of the amendments that the conforming amendments describe, can be found in PCAOB Release 2004-008, dated September 15, 2004, which is available on the PCAOB's Web site at www.pcaobus.org.

4. Lack of "Background and Basis for Conclusions"

In auditing standards issued by the Board, a discussion of the comments received and other factors deemed significant by the Board in reaching the conclusions embodied in the final standard is contained in an appendix to the standard titled "Background and Basis for Conclusions." Because this rulemaking is not an auditing standard, it does not include such an appendix. The Board, however, believes this type of discussion is helpful to this rulemaking. Accordingly, in addition to describing the nature and extent of amendments made to the interim standards, the foregoing also contains, when appropriate, a discussion of the significant factors considered by the Board in developing the final conclusions reflected in the conforming amendments.

5. Effective Date

As to the effective date of the amendments, PCAOB Rule 3200T requires auditors to comply with the Board's interim auditing standards "to the extent not superseded or amended by the Board." Similarly, the Board's interim attestation and independence standards rules require registered firms and their associated persons to comply with certain existing attestation and independence standards "to the extent not superseded or amended by the Board."^{6/}

PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, was approved by the Commission on June 17, 2004 as the standard for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002. PCAOB Auditing Standard No. 2 supersedes the Board's interim standards in a number of respects and auditors must comply with all applicable provisions of Auditing Standard No. 2 once it is effective, including those provisions that supersede the Board's interim standards.

As discussed above, the proposed rules describe and expressly state the changes to the interim standards caused by the adoption of PCAOB Auditing Standard No. 2. Accordingly, pending SEC approval and subject to the two exceptions noted below, the Board intends for the conforming amendments to become effective for integrated audits of financial statements and internal control over financial reporting at the same time PCAOB Auditing Standard No. 2 becomes effective. Companies considered accelerated filers under Securities

^{6/} PCAOB Rules 3300T, 3600T.

Exchange Act Rule 12b-2^{7/} 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 November 15, 2004. Other companies have until fiscal years ending on or after July 15, 2005, to comply with the internal control reporting and disclosure requirements and the conforming amendments. Early implementation of the conforming amendments is permitted.

There are two exceptions to this general statement. First, certain parts of the conforming amendments apply to an audit of financial statements of an issuer regardless of whether the issuer is required to comply with the internal control requirements of Section 404 of the Act. In order to provide for an orderly transition for issuers not required to comply with Section 404 of the Act, the Board has determined that these parts of the conforming amendments should be effective for audits of financial statements for periods ending on or after July 15, 2005, pending approval of the conforming amendments by the SEC. This means that auditors of non-accelerated filers are not required to comply with the conforming amendments in conducting audits of financial statements until performing audits of financial statements for fiscal years ending on or after July 15, 2005. The effect of these parts of the conforming amendments is discussed further below.

Second, the Board intends for the part of the conforming amendments that supersedes AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting," to be effective immediately upon approval of the conforming

^{7/} See 17 U.S.C. 240.12b-2.

amendments by the SEC. As discussed in greater detail above, in light of the adoption of PCAOB Auditing Standard No. 2, the Board does not see a compelling reason for the Board to retain AT sec. 501 in its interim standards.

6. Effect of Auditing Standard No. 2 on Audits of Financial Statements Only

The conforming amendments are effective, pending SEC approval, for audits of financial statements only for periods ending on or after July 15, 2005. For the most part, however, the Board believes the amendments represent clarifications of concepts already included in the Board's interim standards, rather than wholly new concepts or requirements. Accordingly, the Board encourages auditors to carefully consider their obligations under the Board's interim standards and not to draw a negative inference from the inclusion of a specific provision in the conforming amendments that equivalent procedures are not currently required to comply with the Board's interim standards.

III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents the Commission will:

- (a) by order approve such proposed rules; or
- (b) institute proceedings to determine whether the proposed rules should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549-0609. Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All submissions should refer to File No. PCAOB-2004-07 and should be submitted within [] days.

By the Commission.

Secretary



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A. Overview of Conforming Amendments to the Standards of the PCAOB

When the Board proposed its auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (PCAOB Release No. 2003-017, dated October 7, 2003) (the "proposed internal control standard"), the Board recognized that some amendments of the professional standards adopted by the Board as its interim standards^{1/} were necessary to make those standards consistent with the principles and requirements in the proposed internal control standard. The Board also intended to make several amendments to the interim standards that would be applicable to situations in which section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") is not applicable and only the financial statements of the company must be audited.

Some commenters on the Board's proposed internal control standard believed that the Board's proposal was not clear about whether the Board intended to amend the interim standards and recommended that the Board specifically identify changes made by the proposed internal control standard to the interim standards. The commenters suggested that identification of such changes is critical in enabling auditors to comply with the Board's standards, as well as in eliminating potential confusion and inconsistencies in interpretation with respect to the affected portions of the interim standards.

^{1/} Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the Securities and Exchange Commission ("SEC" or the "Commission") on April 25, 2003. [See SEC Release No. 33-8222.] On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules." This rule is pending approval from the SEC.



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The Board agrees that its proposed standards should identify how they affect existing standards, to the greatest extent practicable. In future standards-setting proposals, the Board intends to include a specific identification of related proposed amendments to other standards. The Board also agrees that it is important to identify amendments to the interim standards that arise from issuance of PCAOB Auditing Standard No. 2. Accordingly, the Board is issuing, for public comment, this proposed auditing standard that identifies the conforming amendments to the interim standards resulting from the Board's adoption of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

Commenters should recognize that the scope of this proposed auditing standard is relatively narrow and comprises only proposed amendments to the interim standards resulting from the adoption of PCAOB Auditing Standard No. 2. Accordingly, the Board will not consider comments on the principles and requirements in PCAOB Auditing Standard No. 2 itself. Instead, the Board requests comments on the questions identified in this release and seeks other relevant comments on this proposed auditing standard.

B. Nature and Extent of the Conforming Amendments to the Interim Standards of the PCAOB

As a result of the adoption of PCAOB Auditing Standard No. 2, conforming amendments are proposed to the Board's interim standards, in particular the interim auditing, attestation, and independence standards. The nature and extent of those amendments are described below.

1. Auditing Standards

The Board's interim auditing standards include the Statements on Auditing Standards promulgated by the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board ("ASB"), as in existence on April 16, 2003.^{2/} The proposed conforming amendments to the Board's interim auditing standards include –

^{2/} The Statements on Auditing Standards are codified into the AICPA *Professional Standards*, vol. 1, as AU sections 100 through 901.



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a. Addition of References.

References would be added to assist auditors in performing an integrated audit of financial statements and internal control over financial reporting. Auditors are cautioned that the references may not be all inclusive. If there is any conflict between the interim auditing standards and PCAOB Auditing Standard No. 2, auditors should follow the provisions of PCAOB Auditing Standard No. 2.

Question 1 – Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.

Question 2 – Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.

b. Amendments applicable to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements.

While PCAOB Auditing Standard No. 2 is primarily directed to auditors when performing an integrated audit of financial statements and internal control over financial reporting, some requirements in that standard also apply when an auditor is engaged solely to audit a company's financial statements. Such would be the case in limited circumstances, such as in an audit of financial statements in an initial public offering, in which the company is not subject to the requirements of Section 404 of the Act and the SEC's rules implementing that provision.^{3/}

Areas in which changes to the interim auditing standards were intended to apply to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements include the following (for ease of reference, the references below are made to the standards as codified in AICPA *Professional Standards*, rather than to the original pronouncements) –

^{3/} See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, SEC Release No. 33-8238 (June 5, 2003) [68 FR 36636].



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i. AU sec. 310, "Appointment of the Independent Auditor."

This standard would be amended to include the auditor's understanding with the client when performing an integrated audit of financial statements and internal control over financial reporting. For consistency, certain related amendments also would be made to the auditor's understanding with the client when performing an audit of financial statements.

ii. AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit."

This standard would be amended to add a requirement stating, "Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." As it relates to this requirement, the Board's proposed internal control standard stated, "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." A similar conforming amendment would be made to AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

iii. AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit."

This standard would be superseded in an integrated audit of financial statements and internal control over financial reporting by paragraphs 207 through 214 of PCAOB Auditing Standard No. 2. This standard also would be superseded in an audit of financial statements by the paragraphs included in the appendix accompanying this Release.

iv. AU sec. 326, "Evidential Matter."

This standard would be amended to add a requirement stating that, "the auditor's substantive procedures must include reconciling the financial statements to the



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accounting records. The auditor's substantive procedures should include examining material adjustments made during the course of preparing the financial statements." PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial reporting. The Board believes that it is logical and appropriate that these procedures also be performed in an audit of the financial statements.

v. AU sec. 329, "Analytical Procedures."

This standard would be amended to add the following directions:

- For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.
- 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 alone are not well suited to detecting fraud.
- 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.

PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial reporting. The Board believes that it is logical and appropriate that these procedures also be performed in an audit of the financial statements.



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Question 3 – Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?

Question 4 – Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements? For example:

- Should the auditor be required to report all internal control deficiencies (i.e., including internal control deficiencies that are less severe than significant deficiencies and material weaknesses) to management not previously communicated in writing by the auditor or by others? (Under the proposed amendment, the auditor would be required to report to management and the audit committee significant deficiencies and material weaknesses identified during the audit.)*
- Should the auditor evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting? (Under the proposed amendment, the auditor does not have an explicit requirement to make this evaluation but would be required to report in writing to the board of directors a conclusion that the audit committee's oversight is ineffective, even if the auditor did not perform an evaluation to reach that conclusion.)*

Question 5 – Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.



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2. Attestation Standards

The Board's interim attestation standards include the Statements on Standards for Attestation Engagements promulgated by the ASB, as in existence on April 16, 2003.^{4/} Auditors performing an integrated audit of financial statements and internal control over financial reporting to comply with Section 404 of the Act are to follow PCAOB Auditing Standard No. 2 when reporting on an entity's internal control over financial reporting. Accordingly, auditors would not be permitted to use AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting," for this purpose. This standard would supersede AT sec. 501 in its entirety and, therefore, remove it from the Board's interim attestation standards.

While an auditor is not precluded from reporting on the effectiveness of internal control over financial reporting using AT sec. 501 for purposes other than satisfying Section 404 of the Act, auditors should recognize that AT sec. 501 (as it would continue to exist in the professional standards of other bodies) would no longer be considered an interim attestation standard of the Board. Accordingly, it would not be permissible for AT sec. 501 reports to state that the examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States).

Question 6 – Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.

Question 7 – Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?

Question 8 – Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?

^{4/} The Statements on Standards for Attestation Engagements are codified into the AICPA *Professional Standards*, vol. 1, as AT sections 101 through 701.



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3. Independence Standards

The Board's interim independence standards include the AICPA Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, promulgated by the AICPA Professional Ethics Executive Committee, as in existence on April 16, 2003.^{5/} As indicated in PCAOB Auditing Standard No. 2, a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer for which the registered public accounting firm also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee. Accordingly, since this requirement is an addition to current independence requirements, it would be added to interpretation 101-3, "Performance of Other Services," to Rule 101, "Independence" (ET sec. 101.05).

Table 1, "Cross-References to Conforming Amendments to PCAOB Interim Standards," identifies all of the proposed amendments, which the appendix to this release describes in more detail. For ease of reference, Table 1 organizes the interim standards according to the codified sections of the AICPA *Professional Standards* (vols. 1 and 2).

^{5/} The AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, are codified into the AICPA *Professional Standards*, vol. 2, as ET sections 101 and 191.



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**TABLE 1 – CROSS-REFERENCES TO CONFORMING AMENDMENTS TO
 PCAOB INTERIM STANDARDS**

AU Section	Title	Paragraph ^{6/} Changes
310	Appointment of the Independent Auditor	.06
311	Planning and Supervision	.01
312	Audit Risk and Materiality in Conducting an Audit	.03,.05,.12,.18,.30
313	Substantive Tests Prior to the Balance Sheet Date	.01
316	Consideration of Fraud in a Financial Statement Audit	.01
319	Consideration of Internal Control in a Financial Statement Audit	.02,.09,.65,.83,.97, .107
322	The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	.01,.16,.20,.22
324	Service Organizations	.01
325	Communication of Internal Control Related Matters Noted in an Audit	In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60 is superseded by paragraphs 207 - 214 of PCAOB Auditing Standard No. 2. In an audit of financial statements only, SAS No. 60 is superseded as described in the appendix.
326	Evidential Matter	.19
329	Analytical Procedures	.09,.10,.16
332	Auditing Derivative Instruments, Hedging Activities, and Investments in Securities	.11
333	Management Representations	.05

^{6/} The word "paragraph" refers to the paragraph number in the corresponding interim standard.



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339	Audit Documentation	Appendix A
342	Auditing Accounting Estimates	.10
508	Reports on Audited Financial Statements	.01,.08
530	Dating of the Independent Auditor's Report	.01
543	Part of Audit Performed by Other Independent Auditors	.01
560	Subsequent Events	.01
561	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	.01
711	Filings Under Federal Securities Statutes	.02
722	Interim Financial Information	.03

AT Section	Title	Paragraph ^{7/} Changes
501	Reporting on an Entity's Internal Control Over Financial Reporting	Superseded

ET Section	Title	Paragraph ^{7/} Changes
101	Independence	.05

C. Proposed Effective Date

The Board is proposing November 15, 2004 as the effective date for its standard, *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. Although early implementation of the standard would be permitted, the standard would be effective for audits of financial statements and integrated audits of financial statements and internal control over financial reporting for periods ending on or after November 15, 2004.

Companies considered accelerated filers under Securities Exchange Act Rule 12b-2^{8/} are required to comply with the internal control reporting and disclosure

^{7/} The word "paragraph" refers to the paragraph number in the corresponding interim standard.

^{8/} See 17 C.F.R. 240.12b-2.



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requirements of Section 404 of the Act for fiscal years ending on or after November 15, 2004. Other companies have until fiscal years ending on or after July 15, 2005 to comply with these internal control reporting and disclosure requirements. While non-accelerated filers are not required to comply with the internal control reporting and disclosure requirements until July 15, 2005, the provisions included in this standard relating to audits of financial statements would be effective November 15, 2004.

D. Opportunity for Public Comment

The Board will seek comment on the proposed auditing 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 also may 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. 014 in the subject or reference line and should be received by the Board no later than 5:00 p.m. EST on April 23, 2004.

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



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* * *

On the 9th day of March, in the year 2004, 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

March 9, 2004

APPENDIX – Proposed Auditing Standard – *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit of Financial Statements*

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Appendix – Proposed Auditing Standard

March 9, 2004

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard—

**CONFORMING AMENDMENTS TO PCAOB INTERIM
STANDARDS RESULTING FROM THE ADOPTION OF
PCAOB AUDITING STANDARD NO. 2, AN AUDIT OF
INTERNAL CONTROL OVER FINANCIAL REPORTING
PERFORMED IN CONJUNCTION WITH AN AUDIT OF
FINANCIAL STATEMENTS**





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Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements

1. The following conforming amendments to the interim standards of the PCAOB result from the adoption of PCAOB Auditing Standard No. 2, *An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*.

Auditing Standards

2. Statement on Auditing Standards (SAS) No. 1, "Codification of Auditing Standards and Procedures," AU sec. 310, "Appointment of the Independent Auditor," as amended by SAS No. 45, "Omnibus Statement on Auditing Standards-1983," SAS No. 83, "Establishing an Understanding With the Client," and SAS No. 89, "Audit Adjustments" (AU sec. 310, "Appointment of the Independent Auditor"), is amended as follows:

- a. The first sentence of paragraph .06 is amended to read as follows:
An understanding with the client generally includes the following matters.
- b. The first bullet point of paragraph .06 is amended to read as follows:
The objective of the audit is:
 - Integrated audit of financial statements and internal control over financial reporting: The expression of an opinion on both management's assessment of internal control over financial reporting and on the financial statements.
 - Audit of financial statements: The expression of an opinion on the financial statements.
- c. The third bullet point of paragraph .06 is amended to read as follows:

Management is responsible for establishing and maintaining effective internal control over financial reporting. In an integrated audit of financial statements and internal control over financial reporting, an auditor is



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required to 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 if management has not fulfilled the following responsibilities:

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

- d. The seventh bullet point of paragraph .06 is amended to read as follows:

The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

- Integrated audit of financial statements and internal control over financial reporting: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in



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combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- Audit of financial statements: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- e. The eighth bullet point of paragraph .06 is amended to read as follows:

An audit includes:

- Integrated audit of financial statements and internal control over financial reporting: Planning and performing 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. The auditor is also responsible for obtaining an understanding of internal control sufficient to plan the financial statement audit and to determine the nature, timing, and extent of audit procedures to be performed. The auditor is also responsible for communicating in writing:
 - To the audit committee – all significant deficiencies and material weaknesses identified during the audit.



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- To management – all internal control deficiencies not previously communicated in writing by the auditor or by others, including internal auditors or others inside or outside the company.
- To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.
- Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating in writing:
 - To the audit committee – all significant deficiencies and material weaknesses identified during the audit.
 - To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

3. SAS No. 22, "Planning and Supervision," as amended by SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 77, "Amendments to Statements on Auditing Standards No. 22, 'Planning and Supervision,' No. 59, 'The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,' and No. 62, 'Special Reports'" (AU sec. 311, "Planning and Supervision"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Standard No. 2 regarding planning considerations.



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4. SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," as amended by SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," SAS No. 96, "Audit Documentation," and SAS No. 98, "Omnibus Statement on Auditing Standards--2002" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), is amended as follows:

- a. The following note is added after paragraph 3.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 of PCAOB Auditing Standard No. 2 regarding materiality considerations.

- b. The following note is added after paragraph 5.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

- c. The following note is added after paragraph 12.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 regarding materiality and planning considerations, respectively.

- d. The following note is added after paragraph 18.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for discussion of tests to be performed when a company has multiple locations or business units.



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- e. The following note is added after paragraph 30.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 147-149 of PCAOB Auditing Standard No. 2 regarding tests of controls.

5. SAS No. 45, "Omnibus Statement on Auditing Standards--1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 98-103 of PCAOB Auditing Standard No. 2 regarding timing of tests of controls.

6. SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

7. SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment of Statement on Auditing Standards No. 55," and SAS No. 94, "The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), is amended as follows:

a. In paragraph 2, the term "assertions" is replaced by the term "relevant assertions."

- b. The following sentence is added at the end of paragraph 2:

Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.



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- c. The following note is added after paragraph 2:

Note: Refer to paragraphs 68-70 of PCAOB Auditing Standard No. 2 for discussion of identifying relevant financial statement assertions.

- d. The following note is added after paragraph 9:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for discussion of tests to be performed when a company has multiple locations or business units.

- e. The following note is added after paragraph 65:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion.

- f. The following note is added after paragraph 83:

Note: In an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, in part, that "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." Accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for additional information regarding documentation requirements.

- g. The following note is added after paragraph 97:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 104-105 of PCAOB Auditing Standard No. 2 for discussion on the extent of tests of controls.



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h. The last sentence of paragraph 107 is replaced with the following sentence:

Consequently, regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

8. SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows:

a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 108-126 of PCAOB Auditing Standard No. 2 for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

b. The second sentence of paragraph 16 is replaced with the following sentence:

The auditor assesses control risk for each of the relevant financial statement assertions related to all significant accounts and disclosures in the financial statements and performs tests of controls to support assessments below the maximum.

c. The following note is added after paragraph 20:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 112-116 of PCAOB Auditing Standard No. 2 regarding evaluating the nature of controls subjected to the work of others.



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- d. The following note is added after paragraph 22:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 122 of PCAOB Auditing Standard No. 2 regarding assessing the interrelationship of the nature of the controls and the competence and objectivity of those who performed the work.

9. SAS No. 70, "Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standard No. 55," SAS No. 88, "Service Organizations and Reporting on Consistency," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 324, "Service Organizations"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," in PCAOB Auditing Standard No. 2 regarding the use of service organizations.

10. SAS No. 60, "Communication of Internal Control Related Matters Noted in an Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55," and SAS No. 87, "Restricting the Use of an Auditor's Report" (AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"), is superseded.

- In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60, as amended, is superseded by paragraphs 207-214 of PCAOB Auditing Standard No. 2.
- In an audit of financial statements only, SAS No. 60, as amended, is superseded by the following paragraphs.



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Communications about Control Deficiencies in An Audit of Financial Statements

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

- A 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.

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

Note: The term "remote likelihood" as used in the definitions of significant deficiency and material weakness (paragraph 3) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies" ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:



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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.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

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

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

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in



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paragraphs 1, 2 and 3, and the directions in paragraphs 130 through 137 of PCAOB Auditing Standard No. 2. As explained in paragraph 23 of PCAOB Auditing Standard No. 2, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency, or combination of deficiencies, is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

4. The auditor must communicate in writing to management and 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 the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined in paragraphs 2 and 3.

Note: 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.^{1/} The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors or an audit committee at these companies indicative, by themselves, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3^{2/} are not

^{1/} See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

^{2/} See 17 C.F.R. 240.10A-3.



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applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).^{3/} Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).^{4/} Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X^{5/} (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

5. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting, if a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

^{3/} See 17 C.F.R. 240.10A-3(c)(2).

^{4/} See 17 C.F.R. 240.10A-3(c)(2).

^{5/} See 17 C.F.R. 210.2-01(c)(7).



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6. These written communications should include:
 - a. The definitions of control deficiencies, significant deficiencies, and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.
 - b. A statement that the objective of the audit was to report on the financial statements and not to provide assurance on internal control.
 - c. A statement that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization.
7. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made.
8. The auditor might identify matters in addition to those required to be communicated by this standard. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.
9. The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.
10. 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 to issue an interim communication should be determined based on the relative



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significance of the matters noted and the urgency of corrective follow-up action required.

11. In an audit of financial statements only, auditors may continue to apply auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," except that the term "reportable condition" means "significant deficiency," as defined in paragraph 9 of PCAOB Auditing Standard No. 2.

12. SAS No. 31, "Evidential Matter," as amended by SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 80, "Amendment to Statement on Auditing Standards No. 31, 'Evidential Matter'" (AU sec. 326, "Evidential Matter"), is amended by adding the following sentences at the end of paragraph 19:

Additionally, the auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements.

13. SAS No. 56, "Analytical Procedures," as amended by SAS No. 96, "Audit Documentation" (AU sec. 329, "Analytical Procedures"), is amended as follows:

a. The following sentence is added to the end of paragraph 9:

For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

b. The following sentences are added to the end of paragraph 10:

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



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statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

- c. The following sentence is added to the beginning of paragraph 16:

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.

14. SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended by adding the following note after paragraph 11:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if a company's investment in derivatives and securities represents a significant account, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and the service organization whose services are part of the entity's information system.

15. SAS No. 85, "Management Representations," as amended by SAS No. 89, "Audit Adjustments," and SAS No. 99 "Consideration of Fraud in a Financial Statement Audit" (AU sec. 333, "Management Representations"), is amended by adding the following note after paragraph 5:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing



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Standard No. 2 for required written representations to be obtained from management.

16. Appendix A of SAS No. 96, "Audit Documentation" (AU sec. 339, "Audit Documentation"), is amended by adding the following subparagraph:

q. PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, to document the auditor's assessment of internal control over financial reporting when performing an integrated audit of financial statements and internal control over financial reporting. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for documentation requirements.

17. SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended by adding the following note after paragraph 10:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would have understood the process management used to develop the estimate and tested controls over all relevant assertions related to the estimate.

18. SAS No. 58, "Reports on Audited Financial Statements," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990," SAS No. 79, "Amendment to Statement on Auditing Standards No. 58, 'Reports on Audited Financial Statements,'" SAS No. 85, "Management Representations," SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 508, "Reports on Audited Financial Statements"), is amended as follows:

a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a



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combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 162-199 of PCAOB Auditing Standard No. 2 for direction on reporting on internal control over financial reporting. In addition, see Appendix A, "Illustrative Reports on Internal Control Over Financial Reporting," of PCAOB Auditing Standard No. 2 which includes an illustrative combined audit report and examples of separate reports.

b. The following subparagraph is added to paragraph 8:

k. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of W Company's internal control over financial reporting as of December 31, 20X3, based on *[identify control 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 opinions]*.

19. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 530, "Dating of the Independent Auditor's Report," as amended by SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 530, "Dating of the Independent Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same. Refer to paragraphs 171-172 of PCAOB Auditing Standard No. 2, which provide direction with respect to the report date in an audit of internal control over financial reporting.



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20. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 543, "Part of Audit Performed by Other Independent Auditors," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 182-185 of PCAOB Auditing Standard No. 2, which provide direction with respect to opinions based, in part, on the report of another auditor in an audit of internal control over financial reporting.

21. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 560, "Subsequent Events," as amended by SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 560, "Subsequent Events"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 186-189 of PCAOB Auditing Standard No. 2, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

22. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," as amended by SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 197 of PCAOB Auditing Standard No. 2, which provides direction with respect to the subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.



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23. SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended by adding the following note after paragraph 2:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, which provide direction with respect to filings under federal securities statutes in an audit of internal control over financial reporting.

24. SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended by adding the following note after paragraph 3:

Note: When an auditor is engaged to perform an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 202-206 of PCAOB Auditing Standard No. 2, which provide direction regarding the auditor's evaluation responsibilities as they relate to management's quarterly certifications on internal control over financial reporting.

Attestation Standards

25. 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" (AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"), is superseded by this standard and, accordingly, is no longer an interim standard of the Board.

Independence Standards

26. The following paragraph is added after the second paragraph of interpretation 101-3, "Performance of Other Services," to Rule 101, "Independence" (ET sec. 101.05):

Additionally, a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer (defined in section 2(a)(7) of the Sarbanes-Oxley Act of 2002) for which the registered public accounting firm also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee.



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Effective Date

27. This standard is effective for audits of financial statements and integrated audits of financial statements and internal control over financial reporting for periods ending on or after November 15, 2004. Early compliance with this standard is permitted.



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Exhibit 2(a)(2)
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Exhibit 2(a)(2)

Tab Number	Comment Source
1	The Center for Public Company Audit Firms of the American Institute of Certified Public Accountants, Authors: Robert J. Kueppers, Chair, Center for Public Company Audit Firms, and John A. Fogarty, Chair, Auditing Standards Board, April 23, 2004
2	BDO Seidman LLP, April 26, 2004
3	Crowe Chizek and Company LLC, April 23, 2004
4	Deloitte & Touche LLP, April 23, 2004
5	Ernst & Young LLP, April 23, 2004
6	Grant Thornton LLP, April 23, 2004
7	KPMG LLP, April 23, 2004
8	New York State Society of Certified Public Accountants, Author: Jeffrey R. Hoops, President, April 27, 2004
9	PricewaterhouseCoopers LLP, April 23, 2004
10	Texas Society of Certified Public Accountants, Author: C. Jeff Gregg, CPA, Chair, Professional Standards Committee, April 21, 2004



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April 23, 2004

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

**RE: PCAOB Rulemaking Docket Matter No. 014: Proposed Auditing Standard
Conforming Amendments to PCAOB Interim Standards**

Members and Staff of the Public Company Accounting Oversight Board:

The Center for Public Company Audit Firms (“Center”) of the American Institute of Certified Public Accountants (“AICPA”) respectfully submits the following written comments on the Public Company Accounting Oversight Board’s (“PCAOB” or “Board”) proposed conforming amendments to the Board’s interim standards. The Center was established by the AICPA to, among other things, provide a focal point of commitment to the quality of public company audits and provide the PCAOB, when appropriate, with comments on its proposals on behalf of Center member firms. The AICPA is the largest professional association of Certified Public Accountants in the United States, with more than 330,000 members in public practice, business, industry, government, and education.

Paragraph 9 of the proposed standard amends SAS No. 70, *Service Organizations* (AU sec. 324), by inserting a note after paragraph 1 of SAS No. 70 referring the reader to paragraphs B18 – B29 of appendix B of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. The note in paragraph B21(c) indicates that a service auditor’s report used in an integrated audit of financial statements and internal control over financial reporting should be one that provides evidence about the operating effectiveness of controls (a type 2 service auditor’s report), or an agreed-upon procedures report that provides evidence about the operating effectiveness of controls. Further, the note in paragraph B21(c) indicates that a service auditor’s report covering only controls placed in operation (a type 1 service auditor’s report) would not be adequate for this engagement. It would be helpful to the reader if that information were communicated in the note inserted after paragraph 1 of SAS No. 70 since SAS No. 70 covers both types of reports.

We also have noted several editorial recommendations in Appendix A to this letter.

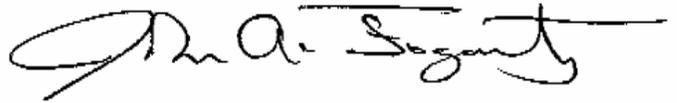
Office of the Secretary
April 23, 2004

We appreciate the opportunity to comment on the proposed amendments to the Board's interim standards. We are firmly committed to working with the PCAOB in accomplishing the timely and effective implementation of the Act, and would welcome the opportunity to meet with you to clarify any of our recommendations.

Sincerely,



Robert J. Kueppers
Chair
Center for Public Company Audit Firms



John A. Fogarty
Chair
Auditing Standards Board

cc: Mr. William J. McDonough, Chairman, PCAOB
Ms. Kayla J. Gillan, Member, PCAOB
Mr. Daniel L. Goelzer, Member, PCAOB
Mr. Willis D. Gradison, Member, PCAOB
Mr. Charles D. Niemeier, Member, PCAOB

Appendix A

PCAOB Rulemaking Docket Matter No. 014: Proposed Auditing Standard Conforming Amendments to PCAOB Interim Standards PCAOB Release 2004-002

Editorial Recommendations

New language is shown in bold; deleted language is shown by strikethrough.

1. Paragraph 2b of the proposed standard amends AU Section 310, “Appointment of the Independent Auditor.” The bulleted items in the amended paragraph do not follow from the lead in. Also, since an integrated audit of financial statements and internal control over financial reporting covers management’s assessment of internal control over financial reporting as well as the effectiveness of internal control over financial reporting, we recommend the following revision:

The objective of ~~the audit~~ is **an**:

- Integrated audit of financial statements and internal control over financial reporting ~~is:—~~the expression of an opinion on ~~both~~ management’s assessment of internal control over financial reporting, **on the effectiveness of internal control over financial reporting**, and **on** the financial statements.
- Audit of financial statements ~~is:—~~the expression of an opinion on the financial statements.

2. Paragraph 2c of the proposed standard amends the third bullet of AU Section 310.06. As amended, the bulleted items do not follow from the lead in; accordingly, we recommend the following revision:

.....In an integrated audit of financial statements and internal control over financial reporting, an auditor is required to 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 if management has not ~~fulfilled the following responsibilities~~:

- **Accepted** responsibility for the effectiveness of the company's internal control over financial reporting.
- **Evaluated** the effectiveness of the company's internal control over financial reporting using suitable control criteria,
- **Supported** its evaluation with sufficient evidence, including documentation, and
- **Presented** a written 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.

Appendix A

3. Paragraph 2e of the proposed standard amends the eighth bullet point of AU Section 310.06. To clarify the guidance to the board of directors we recommend the following revision:

Integrated audit of financial statements and internal control over financial reporting:The auditor is also responsible for communicating in writing:

- To the audit committee — all significant deficiencies and material weaknesses identified during the audit.
- To management – all internal control deficiencies not previously communicated in writing by the auditor or by others, including internal auditors or others inside or outside the company.
- To the board of directors – any ~~specific~~ significant deficiency or material weakness identified because the auditor concludes that the audit committee's **would be ineffective in providing** oversight of the company's external financial reporting and internal control over financial reporting ~~is ineffective~~.

Audit of financial statements However the auditor is responsible for communicating in writing:

- To management – all internal control deficiencies not previously communicated in writing by the auditor or by others, including internal auditors or others inside or outside the company.
- To the board of directors – any ~~specific~~ significant deficiency or material weakness identified because the auditor concludes that the audit committee's **would be ineffective in providing** oversight of the company's external financial reporting and internal control over financial reporting ~~is ineffective~~.



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April 26, 2004

Office of the Secretary
Public Company Accounting Oversight Board
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**RE: PCAOB Rulemaking Docket Matter No. 014
PROPOSED AUDITING STANDARD – CONFORMING AMENDMENTS TO PCAOB
INTERIM STANDARDS RESULTING FROM THE ADOPTION OF PCAOB AUDITING
STANDARD NO. 2, AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL
REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL
STATEMENTS**

Dear Mr. Secretary:

BDO Seidman, LLP respectfully submits the following comments on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed auditing standard ("the proposed standard") governing the conforming amendments to PCAOB interim standards in response to the Adoption of PCAOB Auditing Standard number 2.

We recognize the importance of establishing and enforcing standards that will restore confidence in our financial reporting environment and are anxious to participate further in the initiatives of the PCAOB and other regulatory bodies to advance the quality of our professional standards. We appreciate the dedicated effort necessary to develop quality standards.

We apologize to the Board for submitting this comment letter after the published deadline.

Questions Posed in the Exposure Draft

Question 1 – Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.

We believe the references are essential and useful. An integrated professional literature is necessary to guide auditors in the fulfillment of their responsibilities.

Question 2 – Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.

We believe the essential references are made, except as noted below.

Regarding AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit." The Board states:

This standard would be amended to add a requirement stating, "Regardless of the



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assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." As it relates to this requirement, the Board's proposed internal control standard stated, "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." A similar conforming amendment would be made to AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

The Board proposes that this requirement to perform substantive procedures by assertion be placed in AU sec 319 and AU sec. 322. Since the PCAOB proposes this as a general requirement for all substantive procedures, and not just for those performed in conjunction with tests of controls, we believe that this requirement should be additionally cited in AU sec. 326 Evidential Matter. It is in this section of the professional literature where assertions and broad auditing principles are discussed. The impact of this provision in the Standard on practice extends beyond the subject matter of internal control. We do not believe that practitioners would anticipate guidance governing substantive testing to be limited to the literature addressing internal control. We support repeating this important requirement in several areas of the literature due to its pervasive implications.

Question 3 – Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?

We believe they are clear, except as noted in the answer to Question two above. If the focus of the audit is not on AU sec 319 (Internal Controls), the general requirement to perform substantive procedures for "*all relevant assertions for all significant accounts and disclosures*" might be overlooked if such a requirement is noted only in AU sec. 319.

Question 4 – Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements?

We do not support any expansion at this time to the already significant requirements of



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PCAOB Standard No. 2 on issuers. However, we believe the Board should continue to monitor the environment and consider additional requirements if they are clearly in the public interest and are cost-justified.

Question 5 – Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.

We have not identified any specific issues on this point.

Question 6 – Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.

Yes, but not for the same reasons an issuer would perform procedures required by PCAOB Standard No. 2. We believe that initial filers or even pre-IPO companies as well as companies about to be merged with other entities might wish to receive a report on internal controls, and might be required to include that information in certain findings. Thus, such reports might appear, not as a requirement envisioned in PCAOB Standard No. 2, but as a voluntary disclosure. Further, we believe that if the PCAOB removed Section AT sec. 501 from its literature, such reports would have to reference AICPA Standards. If the Board wishes to prohibit such references, it should create an equivalent purpose Standard to Section AT sec. 501 as part of its literature. However, we do not understand the basis for the Board's conclusions that the AICPA Standards could not be referenced if they relate to a service performed on a voluntary basis.

Question 7 – Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?

We believe that if the PCAOB believes that an AICPA AT sec. 501 report cannot be referenced, even for voluntary disclosures, AT sec. 501 should be amended in the PCAOB literature. The AICPA, before the effective date of the standards setting function of the PCAOB, proposed a significant number of performance changes to the current AT 501 in anticipation of its amendment to meet the requirements of the Sarbanes-Oxley Act



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of 2002. Many of the provisions in PCAOB Standard No. 2 are rooted in those proposed changes. When proposing revisions to AT sec. 501, the Board should consider further the current requirements of PCAOB Standard No. 2 as well as the need to provide for more flexibility to meet a variety of company needs.

Question 8 – Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?

There is a need for companies to be able to report on internal control for special purposes. For example, the gaming commission in one state requires the filing of a report of the effectiveness of internal controls in gaming establishments (the specific report requirements are defined by State Law). However, this work has been, and can continue to be done under the AICPA's AT sec. 501. Even though the consolidated entity is an issuer, the segment the report covers is not a separate issuer, but must report on the controls comprising the segment as defined by State Law. Since such a report would presumably not appear in a filing with the Commission, we believe there is no need for the PCAOB to make provision for such a report in its standards.

We also believe the Standards of the Board should provide for an interim auditor report indicating that weaknesses identified in a prior audit report of internal controls have been corrected. If only an integrated audit report is permitted under PCAOB Standards, then an audit report on the financial statements would be required to accompany any updated report. We urge the Board to consider a provision for such an engagement and report, apart from an audit of internal controls.

We appreciate your consideration of our comments and suggestions, and would be pleased to communicate or meet with the PCAOB and its staff to clarify any of our comments.

Please direct comments to Wayne Kolins National Director of Assurance at 212-885-8595 Wkolins@bdo.com or Lynford Graham, National Director of Audit Policy at 212-885-8551 Lgraham@bdo.com.

Sincerely,

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April 23, 2004

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RE: PCAOB Rulemaking Docket Matter No. 014

We are pleased to comment on the PCAOB's proposed Auditing Standard on Conforming Amendments resulting from the adoption of PCAOB Auditing Standard No. 2. We respect the limited scope of the PCAOB's proposal and that comments on the principles and requirements of PCAOB Auditing Standard No. 2 are not being considered.

1. The PCAOB proposes approximately 40 changes to the PCAOB's existing professional standards. With these proposed changes to the professional standards, and with the changes the PCAOB has already made, we suggest that it is now time for the PCAOB to prepare a formal codification of the PCAOB's professional standards requirements and to keep this codification continuously updated. With such a codification, auditors, audit committees, and other interested parties can determine the exact wording of the current requirements pertaining to audits of financial statements, audits of internal control, independence, and so on. Without such a codification, auditors and other users may not be able to efficiently and accurately determine the current requirements, which increases the risk of inadequate, incomplete, outdated, or delayed adoption of, and compliance with, the PCAOB's requirements.

Without the availability of such a codification, each user would have to prepare its own codification of the PCAOB's professional standards. This appears to be inefficient as well as to run the risk of missed changes and inadequate updating.

To increase the ability of registered firms to adapt their policies and procedures to the PCAOB's requirements and the ability of other users to understand the current audit requirements, the codification should be made available electronically in formats that are directly usable in word processing programs.

2. In paragraph 2d of the proposal, the PCAOB indicates it intends "reasonable assurance" to mean "a high level of assurance". If the PCAOB does intend to equate "reasonable assurance" with "high assurance", then the PCAOB should clarify expectations and replace all references in its standards to the former term with the latter term. However, we suggest this issue requires further deliberation and discussion before "reasonable assurance" is stated to always mean "high assurance", or to mean "high assurance" in some cases but not in others.

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April 23, 2004
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For example, we note four references in the new combined auditor's report to "reasonable assurance": the auditor plans and performs the audit "to obtain reasonable assurance about whether the financial statements...", a company's internal control system is "a process designed to provide reasonable assurance...", the internal control policies and procedures "provide reasonable assurance that transactions are recorded..." and the internal control policies and procedures "provide reasonable assurance regarding prevention...". It is not clear whether all these references are intended to be, or should be, interpreted by preparers, auditors, and users to mean "high assurance."

3. We suggest that the PCAOB clarify whether and how its standards, including the proposed conforming changes, apply to the audits of employee benefit plans where the plan is registered with and files Form 11-K with the Securities and Exchange Commission. The PCAOB's rules on registration of auditing firms (PCAOB Release 2003-07) indicate that such registered employee benefit plans are "issuers". Paragraph 2 of PCAOB Auditing Standard No. 2 indicates three classes of entities (registered investment companies, issuers of asset-backed securities, and nonpublic companies) that are not subject to the internal control reporting requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002, but does not refer to registered employee benefit plans in the list of exempt entities. Page 4 of the PCAOB's release on the current proposal indicates the "limited circumstances" in which a report under Section 404 is not required, but does not refer to registered employee benefit plans. Due to the number of registered employee benefit plans, clarity would be useful in the PCAOB auditing standards as to what auditing standards are to apply to audits of registered employee benefit plans.

We would be pleased to discuss these comments if you desire. Please contact Jim Brown at 574 232-3992 if you have any questions.

Yours very truly,

Crowe Chizek and Company LLC



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April 23, 2004

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Re: PCAOB Rulemaking Docket Matter No. 014
Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards
Resulting From the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal
Control Over Financial Reporting Performed in Conjunction with an Audit of Financial
Statements

Deloitte & Touche LLP is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the “PCAOB” or the “Board”) on its Proposed Auditing Standard, *Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2* (“PCAOB Auditing Standard No. 2”), *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (the “Proposed Standard”), PCAOB Rulemaking Docket Matter No. 014 (March 9, 2004). We have carefully reviewed the Proposed Standard, and we have several comments organized into three categories as follows: I) Responses to Questions Posed by the Board, II) Other Substantive Comments and III) Editorial Comments.

I) Responses to Questions Posed by the Board

1. Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.

Yes. The references are useful and will assist auditors in following the correct guidance. However, we believe that some of the references can be better placed as indicated below.

- Paragraph 4b adds a reference in AU sec. 312.05 to paragraphs 24-26 of PCAOB Auditing Standard No. 2, which describes fraud considerations in an audit of internal control over financial reporting. We believe that a more appropriate place for such a reference is in AU sec. 316, which describes fraud considerations in a

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financial statement audit; however, paragraph 6 of the Proposed Standard already includes this reference. Because AU sec. 312 addresses audit risk and materiality in conducting an audit, we recommend that the Board add a comment to AU sec. 312.05 to the effect that in planning an integrated audit, the integrated audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness (as stated in PCAOB Auditing Standard No. 2, paragraph 27 and paragraph 2d of the Proposed Standard). Deleting the current proposed reference in AU sec. 312.05 and adding the suggested statement would provide a parallel construction in paragraph 4b regarding audit risk and materiality.

- Paragraph 4e adds a note to AU sec. 312.30 referring to paragraphs 147-149 of PCAOB Auditing Standard No. 2, which describe the objective of tests of controls in an audit of internal control over financial reporting. However, the subject matter of AU sec. 312.30 is control risk; accordingly, the reference to paragraphs 147-149 does not appear to be on point.
- Paragraph 7c adds a reference in AU sec. 319 to PCAOB Auditing Standard No. 2, paragraphs 68-70, which discuss relevant assertions. We believe that a more appropriate place for such a reference is in AU sec. 326, which is the section of the interim standards that currently discusses assertions.
- Paragraph 7g adds a reference in AU sec. 319.97 to PCAOB Auditing Standard No. 2, paragraphs 104-105, which discuss “extent of tests of controls.” We believe that this reference would be better placed in the section of AU sec. 319 that discusses “performing tests of controls” (AU sec. 319.75-79).

2. *Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.*

Yes. We noted that the last sentence of AU sec 319.42 states “ordinarily, audit planning does not require an understanding of the control activities related to each account, balance, transaction class, and disclosure component in the financial statements or to every assertion relevant to them.” We believe this sentence needs to be updated for an integrated audit to conform to or reference PCAOB Auditing Standard No. 2.

3. *Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?*

No. We believe that a number of new requirements have been obscured behind the label of “conforming changes” and, that as a result, auditors who are engaged to audit only the financial statements will fail to notice such new requirements and, therefore, fail to

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appropriately modify the financial statement audit process. Accordingly, we recommend that the PCAOB appropriately highlight each new requirement for such audits to ensure that practitioners are aware of and fully understand the ramifications of each new requirement. Please refer to our comments in Section II relating to paragraphs 7b and 7h and paragraph 13a-c.

As we have previously expressed to the Board, it is extremely important to clearly communicate changes to interim standards resulting from proposed standards. We fully agree that it is necessary to make specific changes to the Board's interim standards in order to conform such standards to PCAOB Auditing Standard No. 2. However, until such time as a full codification of both current text and proposed amended text can be produced, the ability of auditors to follow the correct guidance will be greatly hampered, increasing the likelihood of auditors failing to effectively implement new requirements adopted by the Board. Accordingly, we strongly urge the PCAOB to come to a resolution over the codification issue with the American Institute of Certified Public Accountants (the "AICPA") as quickly as possible.

4. *Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements?*

No. We do not believe there are any other additional requirements that are applicable in an integrated audit that should also be applied when the auditor is engaged to audit only the financial statements. With respect to the two examples provided by the PCAOB:

- We believe that the auditor should be able to apply judgment in determining whether to communicate internal control deficiencies that are less severe than significant deficiencies in a financial statement only audit.
- Although the Proposed Standard states that the auditor in a financial statement only audit does not have an explicit requirement to evaluate the effectiveness of the audit committee, we understood that to mean that the Board intends for the auditor to perform some basic level of procedures to consider whether the audit committee appeared to be effective for purposes of gaining an understanding of internal control in order to plan the audit but not necessarily sufficient to form an opinion on the effectiveness of the audit committee. If the Board did not intend for the auditor to perform procedures as described above, further clarification of such statement is necessary.

5. *Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are*

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required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.

Yes. As discussed in Section II below relating to the proposed amendments to AU sec. 325 (paragraph 10 of the Proposed Standard), we do not believe that the report examples contained in AU sec. 325 should be deleted. Rather we recommend that they be conformed for the definitions in PCAOB Auditing Standard No. 2. Additionally, we do not believe it is sufficient to say in paragraph 11 of the Proposed Standard that in an audit of financial statements only, that the auditor may continue to apply Auditing Interpretation No. 1 to AU sec. 325 without the PCAOB also conforming all relevant terminology, including the definition of a material weakness, contained in the illustration of a report in paragraph .04 of such interpretation.

6. Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.

Yes. We are aware that some asset-backed securitization issuers have been filing AT sec. 501 reports to comply with their filing requirements with the Commission. In lieu of obtaining an audit of the financial statements of the trust, asset-backed securitization issuers may obtain an attest report on their processing activities. A variety of different attest reports from compliance with minimum servicing requirements under the Mortgage Bankers Association's Uniform Standard Audit Program or other compliance criteria to an examination of the effectiveness of internal control over financial reporting of the trust have been used to satisfy these requirements.

Although some issuers who do file audited financial statements with the Commission might want to obtain an AT sec. 501 report for filing with the Commission for other reasons, we do not believe that such approach would be appropriate under the premise that an audit of financial statements and of internal control over financial reporting is an integrated audit. We expect that auditors will receive questions from issuers regarding the following types of scenarios:

- If the issuer has a material weakness at year end, can the auditor perform an audit of internal control as of a subsequent interim date under either PCAOB Auditing Standard No. 2 or AT sec. 501 to issue a report to be filed in a Form 10-Q or Form 8-K without performing a subsequent audit of financial statements?
- Can an issuer file an AT sec. 501 report of a nonpublic entity that the issuer is proposing to acquire or has acquired (e.g., when such report is included in the annual report of the nonpublic entity)?

We recommend that the Board consider addressing such scenarios in any interpretive guidance that the PCAOB develops.

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7. *Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?*

The answer to this question depends on whether the PCAOB wants to change practice for asset-backed securitization issuers. If those issuers that used an AT sec. 501 report in the past are prohibited from doing so once the PCAOB supersedes AT sec. 501, such issuers could follow the approach that other issuers use of reporting on compliance (based on AT sec. 601) or on the effectiveness of the operational aspect of processing (based on AT sec. 101, with the AICPA AT sec. 501 standards providing useful information).

8. *Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?*

It is unclear whether the PCAOB is questioning (a) whether a stand-alone audit of internal control would be necessary in any circumstances for an issuer or (b) whether there is a need for an issuer to provide the internal control report issued under the integrated audit approach without the accompanying report on the financial statements. Accordingly, we have provided responses to both.

As discussed above in our responses to questions 7 and 8, the current need for a report on the effectiveness of internal control for a situation other than an integrated audit relates to asset-backed securitization issuers. However, we believe it would be confusing to users if such engagements and related reports were to follow PCAOB Auditing Standard No. 2 when an integrated audit is not performed.

We believe that subsidiaries of issuers who have needs, other than for purposes of the needs of the parent company issuer, to provide a report on the effectiveness of internal control over financial reporting would be able to obtain such a report under either PCAOB Auditing Standard No. 2 (if it relates to the entity's year-end in an integrated audit), or under the existing AICPA standards (if required by a particular regulator or for a date other than the subsidiary's year-end).

We believe that an issuer should be able to provide their assertion regarding the effectiveness of internal control over financial reporting together with the auditor's report thereon without the related financial statements and auditor's report for purposes other than complying with Section 404. In such situation, we do not believe that any additional language should be included in the auditor's report; however, we would recommend removing any reference to the audited financial statements and related auditor's report when such documents are not included.

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II) Other Substantive Comments

Paragraphs 7b and 7h

The Proposed Standard would add the following to AU sec 319.02 “the auditor should perform substantive procedures for *all relevant assertions* related to all significant accounts and disclosures in the financial statements.” Additionally, the Proposed Standard would amend the last sentence of AU sec 319.107 to state that the “auditor should perform substantive procedures for *all relevant assertions* related to all significant accounts and disclosures in the financial statements.” However, current guidance contained in AU sec. 319.81 and AU sec. 322.16, and elsewhere throughout the interim standards, requires that substantive procedures be performed at “*the account balance or class of transaction level.*”

The proposed amended language represents a significant change in current auditing standards and significantly impacts the audit process and the fundamental performance of substantive audit procedures. Accordingly, as discussed in our response to Question 3 above, the Board needs to better publicize the importance of this change and the Board’s plans to conform the remainder of the interim standards to adopt this change in order to ensure that practitioners are aware of and fully understand the ramifications of the new requirements.

Paragraph 10

The Proposed Standard would supersede AU sec. 325 in two different manners—first, AU sec. 325 would be superceded in its entirety for an integrated audit by paragraphs 207-214 of PCAOB Auditing Standard No. 2 and second, AU sec. 325 would be superceded for a financial statement audit by the new text in the Proposed Standard (subparagraphs 1-10 of paragraph 10). We believe that a clearer approach to communicating new requirements would be to amend AU sec. 325 to specifically state that it does not apply to an integrated audit, provide a cross-reference to the appropriate paragraphs in PCAOB Auditing Standard No. 2 for guidance related to communicating internal control related matters in an integrated audit, and then revise AU sec. 325 as the PCOAB determines appropriate for the financial statement audit only situation.

Additionally, we believe that there is still a need for the PCAOB to provide more meaningful guidance, including an illustrative form of report for purposes of communicating control deficiencies (including significant deficiencies and material weaknesses) in the standards for both an integrated audit and a financial statement audit. The Proposed Standard, as currently framed, would supercede the existing illustrative language for a financial statement audit and the PCAOB standards would be left without any illustrative form of report for either an integrated audit or a financial statement only audit. Accordingly, we recommended in our response to Question 5 above that the PCAOB retain a report example in AU sec. 325 with conforming language to PCAOB Auditing Standard No. 2. Additionally, we recommend that the PCAOB, through amendment to its Auditing Standard No. 2 or otherwise, provide an illustrative report for the communication resulting from an integrated audit described in paragraphs .207-.214 of such standard.

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Subparagraph 4—We are concerned that the written communication for a financial statement only audit would *always* be required to be made *prior* to the issuance of the auditor’s report. Where significant deficiencies are noted at the very end of the audit, it would seem appropriate to issue the written communication *concurrent* with the auditor’s report on the financial statements to make it clear that it covers matters through completion of the audit, and to make reference to the issued auditor’s report in the communication. This would be particularly true for situations in which a written communication under AU sec. 325 was issued following interim audit work and the auditor had additional matters to report at year end.

Subparagraph 6—Proposed paragraph 6 of amended AU sec. 325 lists the required elements of a written communication about control deficiencies in an audit of financial statements, including a statement about intended use of the written communication in paragraph 6c. Such statement, however, is inconsistent with AU sec. 532, which would also require that a statement be included in the written communication that the report is not intended to be and should not be used by anyone other than the specified parties. We recommend that the statement in paragraph 6c be modified to be consistent with AU sec. 532. However, if the Board fully intends to modify current practice, this should be clearly identified and publicized as a significant change and the Board should describe its plans to conform the interim standards.

Paragraph 13a

Paragraph 13a proposes amending AU sec. 329.09 to include a statement that “For significant risks of material misstatement, it is unlikely that audit evidence obtained from *substantive* analytical procedures alone will be sufficient” [emphasis added]. It is not clear from this language how the auditor is required to respond or what would be considered sufficient evidence. We believe clearer wording would be as follows: “Often the auditor will need to obtain evidence from test of details or from a combination of tests of details and substantive analytical procedures for significant risks of material misstatement.”

Paragraph 13c

Paragraph 13c states “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”; however, it is unclear what is meant by the phrase “before using the results obtained from substantive analytical procedures.” Perhaps the following would more clearly articulate the PCAOB’s intent: “If the auditor plans on performing substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information to be used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.” However, if this suggested language is adopted, the PCAOB would then need to determine how to apply such guidance in situations in which prior-year information is used by the auditor to develop expectations and one or more of such prior years were audited by a predecessor auditor. Would it be acceptable for the successor auditor to merely tie out the prior-year information to

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the audited prior-year financial statements or would the successor auditor be required to perform other procedures? The Proposed Standard should clearly set forth the intended requirements.

Paragraphs 18 and 19

Paragraphs 18 and 19 provide guidance on the dating of reports and state that the reports on the audits of the financial statements and internal control over financial reporting should be dated the same. In the course of developing interpretive guidance, we recommend that the PCAOB address various dating scenarios that auditors traditionally have been faced with, including dual-dating of reports for subsequent events and restatements for corrections of an error.

III) Editorial Comments:

In addition to the comments below, we would caution the Board against repeating portions of new standards within other standards, as doing so will make it more difficult and challenging for the Board to ensure on a go-forward basis that all relevant guidance has been appropriately updated when and if the Board subsequently modifies its standards. In the text of the Proposed Standard, portions of PCAOB Auditing Standard No. 2 have been repeated in several places including in paragraphs 2, 14, and 17. We believe a cleaner approach is to include cross-references only rather than repeating actual text.

Paragraph 2a-e

We believe the suggested amendments to AU sec. 310.06 are extremely confusing and will be difficult for auditors to follow because, as proposed, each bullet point bounces back and forth between an integrated audit and a financial statement audit. We believe that a much clearer approach to providing the guidance would be to have two categories of bulleted items within AU sec. 310.06—one complete set related to a financial statement audit and another complete set related to an integrated audit. Alternatively, a grid might be created that clearly sets out the elements that need to be understood by the client, including the responsibilities of management and the auditors, with one column for a financial statement audit only and another column for an integrated audit.

Additionally, as PCAOB Auditing Standard No. 2 requires an opinion both on management's assertion and on the effectiveness of internal control, the conforming amendments should be consistent. Accordingly, paragraphs 2b (first bullet) and 2d (first bullet) should be revised to refer to the opinion on the effectiveness of internal control over financial reporting.

Paragraph 2e requires communications to be made to management and, depending on whether they constitute significant deficiencies, to the board of directors. A cross-reference should be added to direct the auditor to the specific guidance.

Paragraph 14

We recommend that the last sentence of the proposed note to paragraph 11 of SAS 92 be revised to recognize the fundamental risk of misstatement with respect to derivative

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transactions arising from one of the essential characteristics of a derivative, as defined in paragraph 6 b. of Financial Accounting Standards Board Statement No. 133, namely that “it represents no initial net investment or an initial net investment that is smaller than would be required for other types of contracts....” Accordingly, we propose revising the proposed note to read as follows [with inserted text shown in bold italics and deleted text shown in strike-through]:

“Therefore, in an integrated audit ... if a company’s investment in ~~derivatives and securities~~ represents a significant account ***or if its derivative activities represent a significant class of transactions***, the auditor’s understanding of controls should include controls over ~~derivatives and securities~~ ***such*** transactions...”

Paragraph 15

As PCAOB No. 2 includes only the written representations that should be obtained in connection with the audit of internal control, we believe that the note in paragraph 15 should read “refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for ***additional*** required written representations...” [inserted text is shown in bold italics].

Paragraph 17

We believe that the phrase “should necessarily inform the auditor’s decisions” included in the note to be added to AU sec. 342.10 should read “should necessarily influence [or impact] the auditor’s decisions,” to more clearly articulate the action required as clearly work cannot “inform” someone’s decisions.

We appreciate the opportunity to comment, and would be pleased to discuss these issues with you further. If you have any questions or would like to discuss these issues further, please contact Robert J. Kueppers at (203) 761-3579 or John A. Fogarty at (203) 761-3227.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: William J. McDonough, Chairman of the PCAOB
Kayla J. Gillan, Member
Daniel L. Goelzer, Member
Willis D. Gradison, Jr., Member
Charles D. Niemeier, Member

! @ #

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April 23, 2004

Mr. J. Gordon Seymour
Acting Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006-2803

PCAOB Rulemaking Docket Matter No. 014
Proposed Auditing Standard—Conforming Amendments to PCAOB Interim Standards Resulting From the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements

Dear Mr. Seymour:

We are pleased to comment on the PCAOB's proposed auditing standard related to conforming amendments to PCAOB interim standards. Overall, we support the proposed auditing standard because we believe it clarifies the changes that are being made to interim standards resulting from the adoption of PCAOB Auditing Standard No. 2, and knowledge of such changes is very important to practitioners in performing audits for which Section 404 is not applicable and only the financial statements of an entity must be audited.

We have organized our comment letter to respond to the questions on which the Board seeks public comment and then to provide one additional comment regarding the effective date.

1. Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting?

Yes. We believe the references in specific paragraphs of interim standards will be useful to auditors in determining those provisions of interim standards that are changed or affected by PCAOB No. 2.

2. Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial?

No. We believe the references identified are sufficient and address the key areas of change.

Mr. J. Gordon Seymour

3. Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements?

Yes. We believe the amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements, although we also have comments on some of those requirements as discussed in Question 4 below.

4. Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements? For example:

- Should the auditor be required to report all internal control deficiencies (i.e., including internal control deficiencies that are less severe than significant deficiencies and material weaknesses) to management not previously communicated in writing by the auditor or by others? (Under the proposed amendment, the auditor would be required to report to management and the audit committee significant deficiencies and material weaknesses identified during the audit.)
- Should the auditor be required to evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting? (Under the proposed amendment, the auditor does not have an explicit requirement to make this evaluation but would be required to report in writing to the board of directors a conclusion that the audit committee's oversight is ineffective, even if the auditor did not perform an evaluation to reach that conclusion.)

When the auditor is engaged to audit only the financial statements, and not to perform an integrated audit, we believe it is appropriate for auditing standards to require the auditor to report only significant deficiencies and material weaknesses in writing, and to permit the audit committee or management to decide whether it wishes to have the auditor report other deficiencies in writing.

When the auditor is engaged to audit only the financial statements, and not to perform an integrated audit, we agree with the proposed amendment that the auditor should not be explicitly required to evaluate the effectiveness of the audit committee's oversight, but should be required to communicate in writing if the auditor reaches a conclusion that there is a significant deficiency or material weakness in the audit committee oversight. We further suggest that the wording in paragraph 5 of the proposed auditing standard to supersede SAS 60 be amended as follows (inserted words are underlined):

Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting, if the auditor becomes aware that a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

Mr. J. Gordon Seymour

5. Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate?

No, except for the following editorial suggestion. We believe the last line to the amendment to SAS 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities," should be modified to indicate that there may be no, one, or multiple service organizations that may be part of the entity's information system as follows:

...and should encompass controls placed in operation by the entity and ~~the~~ any service organizations whose services are part of the entity's information system.

6. Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission?

No. We are not aware of any circumstances in which an issuer would want or need to file an AT sec. 501 report as part of an integrated audit or quarterly review. However, we do believe there may be situations in which an issuer will want to engage an auditor to issue a report on aspects of internal control over financial reporting other than as part of an integrated audit (or quarterly review).

7. Should AT sec. 501 be amended rather than superseded?

No. We do not see any need for AT sec. 501 to remain part of the PCAOB interim standards.

8. Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting?

As indicated above, we believe issuers may choose to have reports issued on internal control topics, but we do not believe such reports would be prepared as part of an integrated audit or quarterly review.

Additional Comment on Effective Date

The proposed effective date for these conforming amendments is "...for audits of financial statements and integrated audits of financial statements and internal control over financial reporting for periods ending on or after November 15, 2004. Early compliance with this standard is permitted." Audits for such periods have already commenced. We believe auditing standards should not be effective retroactively. Although the nature of this proposed auditing standard is such that we believe auditors would be able to apply it for audits of periods ending on or after November 15, 2004, we encourage the PCAOB in its standard-setting activities to adopt a practice in which the effective date for changes to auditing standards is prospective rather than retroactive.

Mr. J. Gordon Seymour

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Very truly yours,

Ernst + Young LLP

Grant Thornton LLP
The US Member Firm of
Grant Thornton International

175 West Jackson
Chicago, IL 60604
312 602-8000



April 23, 2004

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Via e-mail: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 014, *Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*

Dear Board Members and Staff,

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("Board" or "PCAOB") *Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. As the Board has adopted PCAOB Auditing Standard No. 2, we support the Board's proposal to amend the PCAOB's interim standards for changes resulting from such adoption. As stated in our previous comment letters, we believe this is critical in order for auditors to be able to fully comply with the PCAOB's auditing and related professional practice standards. It also helps to eliminate potential confusion and inconsistencies in interpretation with respect to the affected portions of the interim standards.

Our concerns with respect to the proposal are expressed below and in Appendix A, which contains our responses to the questions put forward by the Board.

Communications about Control Deficiencies

We concur with the Board's revisions with respect to AU sec. 325, *Communication of Internal Control Related Matters Noted in an Audit*. We recommend, however, that the Board consider providing examples of communications to management and the audit committee regarding internal control deficiencies and communications to the board of directors regarding the audit committee's ineffectiveness. To assist the Board, we have provided potential illustrative communications in Appendices B and C, respectively.

April 23, 2004

We would be pleased to discuss our comments with you. If you have any questions, please contact Mr. John L. Archambault, Managing Partner of Professional Standards, at (312) 602-8701.

Very truly yours,

A handwritten signature in blue ink that reads "Grant Thornton LLP". The signature is written in a cursive, flowing style.

Grant Thornton LLP

Appendix A – Responses to Questions

- 1. Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.**

The revisions proposed by the Board to include references in the PCAOB's interim standards to PCAOB Auditing Standard No. 2 are useful. They appropriately direct auditors to the applicable paragraphs within PCAOB Auditing Standard No. 2 when performing an integrated audit of financial statements and internal control over financial reporting. We suggest, however, that the Board consider minimizing such references, where possible. For example, the proposed references to be included in paragraphs 3, 5, and 12 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, can be combined into one note. We believe that a note added after each relevant paragraph is not necessary, especially where a particular matter may have been purposely or inadvertently omitted.

With respect to the note to be included after paragraph 1 in AU sec. 313, *Substantive Tests Prior to the Balance-Sheet Date*, we believe the reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2, which discusses the timing of tests of controls, may be confusing, as AU sec. 313 deals with the performance of substantive procedures. A note added after paragraph 5 of AU sec. 313 might be more appropriate. Such note could reference paragraphs 150-156 of PCAOB Auditing Standard No. 2, which discuss tests of controls in an audit of financial statements and the effect of such tests on substantive procedures. If deemed necessary, it could then reference paragraphs 98-103 of PCAOB Auditing Standard No. 2.

- 2. Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.**

Paragraph 192 of PCAOB Auditing Standard No. 2 addresses the auditor's procedures when management includes additional information regarding internal control outside of its report on internal control over financial reporting but within its annual report on the entity's financial statements. We believe a reference to this paragraph within AU Sec. 550, *Other Information in Documents Containing Audited Financial Statements*, would be appropriate.

- 3. Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?**

Except as noted herein and in our letter, we believe the proposed amendments clearly describe the new requirements.

- 4. Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements?**

Paragraph 18 of AU sec. 324, *Service Organizations*, requires the auditor to make inquiries concerning the service auditor's professional reputation when considering whether the service auditor's report is satisfactory for his or her purposes. Paragraph B24 of PCAOB Auditing Standard No. 2 requires the auditor to make inquiries regarding the service auditor's competence and independence, in addition to their reputation, when determining whether the service auditor's report provides sufficient evidence to support management's assessment and the auditor's opinion. As we cannot determine why such inquiries would differ for a financial statement audit versus an integrated audit of financial statements and internal control over financial reporting, we suggest amending AU sec. 324 to require the auditor to also inquire as

to the service auditor's competence and independence when only performing a financial statement audit.

For Example:

- **Should the auditor be required to report all internal control deficiencies (i.e., including internal control deficiencies that are less severe than significant deficiencies and material weaknesses) to management not previously communicated in writing by the auditor or by others? (Under the proposed amendment, the auditor would be required to report to management and the audit committee significant deficiencies and material weaknesses identified during the audit.)**

For a financial statement audit, we believe that the auditor should communicate all identified significant deficiencies and material weakness in writing. We do not believe it is appropriate to require the auditor to communicate in writing internal control deficiencies that are below the level of a significant deficiency. Any oral or written communications of such matters should be made at the discretion of the auditor. For example, the auditor may choose to communicate deficiencies that management may not be aware of. As with the reporting of misstatements that come to the auditor's attention during an audit of financial statement, there is no need to require the reporting of every minor internal control deficiency that comes to the auditor's attention. However, the auditor may report all deficiencies noted if requested to do so by management or the audit committee.

- **Should the auditor evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting? (Under the proposed amendment, the auditor does not have an explicit requirement to make this evaluation but would be required to report in writing to the board of directors a conclusion that the audit committee's oversight is ineffective, even if the auditor did not perform an evaluation to reach that conclusion.)**

For a financial statement audit, we do not believe that the auditor should be required to separately evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and internal control over financial reporting. However, because the audit committee "...plays an important role within the control environment and monitoring components of internal control over financial reporting," we believe the auditor should be required to obtain an understanding of the audit committee's oversight. To the extent (a) such controls would be relevant, individually or in combination with others, in preventing or detecting material misstatements in financial statement assertions and (b) the auditor places reliance on such controls, additional procedures to evaluate the effectiveness of the audit committee would be performed.

5. **Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.**

The proposed amendment (paragraph 2. e.) for AU sec 310, *Appointment of the Independent Auditor*, states that in an integrated audit, we plan and perform the audit to obtain reasonable assurance about whether the entity maintained, in all material respects, effective internal control. It also states that the auditor is responsible for obtaining an understanding of internal control sufficient to plan the financial statement audit. We believe such statements in an

engagement letter could be potentially confusing, as they indirectly imply that a separate and distinct understanding of internal control is obtained for both audits. It may be appropriate to add the concepts discussed in paragraph 146 of PCAOB Auditing Standard No. 2, which address how such understanding is interrelated.

In addition, we suggest that the Board thoroughly review the interim standards to determine whether any other references to “assertions” should be replaced by the term “relevant assertions.”

6. Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.

We cannot identify any circumstance where the Securities and Exchange Commission (“Commission”) would require or even permit an issuer to file an AT sec. 501 report. Accordingly, we do not believe issuers would want or need to file such a report with the Commission. Refer to our response to Question No. 8.

7. Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?

We believe that PCAOB Auditing Standard No. 2 set the bar for performing an audit (or examination) of the effectiveness of an entity’s internal control over financial reporting. Accordingly, if the Board were to amend AT sec. 501, it should be closely aligned with PCAOB Auditing Standard No. 2. Otherwise, there will be different standards for the two engagements, which would not be in the public interest.

On the other hand, AT sec. 501 could be amended to provide a lower level of assurance, such as that provided by a review of interim financial information. However, the need for such a report ought to be evaluated. Refer to our response to Question No. 8.

8. Is there a need for an auditor’s report on internal control in addition to the auditor’s report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?

We believe the goal of professional standards to be inclusive, rather than proscriptive. Accordingly, although we may not be aware of the circumstances in which such audit reports would be requested, we do believe that once the world understands these engagements, there might come requests from different places. Refer to our response to Questions No. 6 and 7.

Appendix B - Illustrative Communication of Internal Control Related Matters to Management and the Audit Committee

Audit Committee and Management
ABC Corporation

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 20XX, we considered ABC Corporation's internal control over financial reporting in order to determine our audit procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. Accordingly, our consideration of internal control would not necessarily disclose all deficiencies in internal control over financial reporting that might be significant deficiencies [*or material weaknesses*]. However, as discussed below, we noted certain deficiencies involving internal control that we consider to be significant deficiencies [*and material weaknesses*] under the standards of the Public Company Accounting Oversight Board (United States).

Or

In planning and performing our audit of the effectiveness of ABC Corporation's internal control over financial reporting as of December 31, 20XX, based on [*identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)"*], we considered internal control to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Accordingly, we were not required to perform procedures sufficient to identify all deficiencies involving internal control. However, as discussed below, we noted control deficiencies that we consider to be of a lesser magnitude than significant deficiencies and control deficiencies that we consider to be significant deficiencies [*and material weaknesses*] under the standards of the Public Company Oversight Board (United States).

Continue with the following:

A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects a company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

[A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. We believe that the following significant deficiencies constitute material weaknesses under the standards of the Public Company Accounting Oversight Board (United States). (Include paragraphs to describe the material weaknesses noted and their effect on the achievement of the objectives of the control criteria.)]

We [*further*] consider the following control deficiencies to be significant deficiencies in internal control over financial reporting. (*Include paragraphs to describe the significant deficiencies noted.*)

[In addition,] We consider the following matters to be of a lesser magnitude than significant deficiencies. (*Include paragraphs to describe the internal control deficiencies noted.*)

[We recommend that ABC Corporation consider the following actions: (Include a description of the actions the company may consider.)]

April 23, 2004

This report is intended solely for the information and use of the audit committee [*board of directors, board of trustees*], management, and others within the organization [*and specified regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

Signature

City and State or Country

Date

Appendix C - Illustrative Letter to Board of Directors on Audit Committee Ineffectiveness

Board of Directors
ABC Corporation

In planning and performing our audit of the effectiveness of ABC Corporation's internal control over financial reporting as of December 31, 20XX, based on [*identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)"*], we considered internal control to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included, among other things, an assessment of the effectiveness of the audit committee's oversight of ABC Corporation's external financial reporting and internal control over financial reporting. Such assessment was performed as part of our understanding of the control environment and monitoring components of internal control and not for the purpose of performing a separate and distinct evaluation of the audit committee.

Or

In planning and performing our audit of the financial statements of ABC Corporation for the year ended December 31, 20XX, we considered ABC Corporation's internal control over financial reporting in order to determine our audit procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on internal control. Accordingly, we were not required to perform an assessment of the effectiveness of the audit committee's oversight of ABC Corporation's external financial reporting and internal control over financial reporting. However, as discussed below, we noted a control deficiency relating to the audit committee's oversight that we consider to be a significant deficiency [*or material weakness*] under the standards of the Public Company Oversight Board (United States).

Continue with the following:

An 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 helps to set a positive tone at the top. Within the monitoring component, an effective audit committee challenges a company's activities in the financial arena. The aspects of an audit committee's effectiveness that are important may vary considerably with the circumstances. Accordingly, a company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee.

We noted a control deficiency relating to the audit committee's oversight of ABC Corporation's external financial reporting and internal control over financial reporting that we consider to be a significant deficiency [*or material weakness*] under the standards of the Public Company Oversight Board (United States). A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects a company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's annual or interim financial statements that is more than inconsequential will not be prevented or detected. [*A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.*]

April 23, 2004

We believe that the following [*control deficiency is a significant deficiency in internal control over financial reporting or significant deficiency constitutes a material weakness*] under the standards of the Public Company Accounting Oversight Board (United States). (*Include paragraphs to describe the significant deficiency or material weakness noted, including the effect on the achievement of the objectives of the control criteria.*)

[*We recommend that ABC Corporation and the Board of Directors consider the following actions: (Include a description of the actions the company may consider.)*]

This report is intended solely for the information and use of the [*board of directors, board of trustees*], audit committee, management, and others within the organization [*and specified regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

Signature

City and State or Country

Date



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April 23, 2004

Office of the Secretary
Public Company Accounting Oversight Board
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PCAOB Rulemaking Docket Matter No. 014
Proposed Auditing Standard, Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements

Dear Mr. Secretary:

We appreciate this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Proposed Auditing Standard, *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements* (Proposed Standard). We recognize and acknowledge the efforts of the PCAOB staff to identify timely the conforming amendments to the Board's interim standards resulting from the Board's adoption of PCAOB Auditing Standard No. 2.

We agree with the Board that its proposed standards should identify how they affect existing standards and commend the Board for its commitment to include, in future standard-setting proposals, specific identification of related proposed amendments to other standards. Identification of such changes is essential to enabling auditors to comply with the Board's standards.

This letter is organized by first providing general observations and comments on the Proposed Standard followed by responses to the specific questions posed in PCAOB Release No. 2004-02. Less significant and editorial comments and suggestions are included in Appendix A to this letter.





Office of the Secretary
Public Company Accounting Oversight Board
April 23, 2004
Page 2

General Observations and Comments

Amendment to AU Section 310, “Appointment of the Independent Auditor”

Paragraph 2e of the Proposed Standard sets forth a proposed amendment to the eighth bullet point of AU Section 310.06. This proposed amendment sets forth a requirement for the auditor to communicate to the board of directors any significant deficiency or material weakness identified due to the audit committee’s ineffective oversight of the company’s external financial reporting and internal control over financial reporting. Pursuant to the provisions of PCAOB Auditing Standard No. 2, we recognize that the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating the control environment and monitoring components of internal control in an integrated audit. Because of the differing objectives in an integrated audit and an audit of financial statements, we recommend that the Board clarify that this communication requirement is required in those instances when an audit of internal control is not performed. Accordingly, we suggest that the amendment to the eighth bullet point of paragraph 310.06, under the sub-bullet “Audit of financial statements,” be modified as follows:

To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee’s oversight of the company’s external financial reporting and internal control over financial reporting is ineffective, even if the auditor did not perform an evaluation or otherwise perform procedures to reach that conclusion.

Amendment to AU Section 325, “Communication of Internal Control Related Matters Noted in an Audit”

Paragraph 10 of the Proposed Standard sets forth a proposed replacement of AU Section 325. Paragraph 5 of the proposed replacement of AU Section 325 indicates that there is not an *explicit* requirement for the auditor to evaluate the effectiveness of the audit committee. This language implies that there may be an *implicit* requirement. For clarification, we recommend that the word *explicit* be removed.

In addition, paragraph 5 of the proposed replacement of AU Section 325 sets forth an auditor communication requirement when a significant deficiency or material weakness relating to ineffective oversight by the audit committee *exists*. Consistent with the notion that the auditor is not responsible for performing a separate and distinct evaluation of the audit committee, we suggest that the Board clarify that this communication requirement applies when such a significant deficiency or material weakness *is identified*, and recommend that the proposed replacement be revised accordingly.



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Our recommendations for modifying paragraph 5 of the proposed replacement of AU Section 325 are as follows:

Although there is not ~~an explicit~~ a requirement to ~~evaluate~~ perform a separate and distinct evaluation of the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting, if the auditor identifies a significant deficiency or material weakness ~~exists~~ because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

Paragraph 6 of the proposed replacement of AU Section 325 indicates that the auditor's written communications to management and the audit committee should include, among other things, the definitions of control deficiencies, significant deficiencies and material weaknesses. Because paragraph 4 of the proposed replacement requires the auditor to communicate in writing only significant deficiencies and material weaknesses, we recommend that the required communication of definitions in paragraph 6 omit the definition of control deficiencies.

Paragraph 7 of the proposed replacement of AU Section 325 states, "When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made." We recommend that "such reports" be changed to "such written communications" for consistency with the remainder of the proposed replacement. In addition, we recommend that paragraph 7 be included in paragraph 6c to give this particular communication proper context.

To promote consistency of auditors' communications, we recommend that the replacement for AU Section 325 include an illustrative written communication, similar to that in existing AU Section 325.

Paragraph 11 of the Proposed Standard indicates that, "auditors may continue to apply auditing interpretation 1 to AU Section 325, 'Reporting on the Existence of Material Weaknesses,' except that the term 'reportable condition' means [and presumably should be changed to] 'significant deficiency'" Since the Proposed Standard would supersede AU Section 325 in its entirety and replace it with a rewritten version, we recommend that the interpretation, revised as necessary to reflect terminology adopted by the Board, be incorporated into the replacement for AU Section 325.



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Responses to Individual Questions

Our responses to the questions outlined in PCAOB Release No. 2004-02 follow:

Questions regarding the addition of references

- 1. Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.**

Yes. We believe the references are useful, and in fact are essential, to auditors when performing an integrated audit of financial statements and internal control over financial reporting.

- 2. Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.**

Footnote 1 to AU Section 380, "Communication with Audit Committees," lists standards that have audit committee communication requirements in addition to the requirements in AU Section 380. We suggest that PCAOB Auditing Standard No. 2 be added to this footnote.

Questions regarding amendments applicable to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements

- 3. Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?**

Except for our observations and recommendations elsewhere in this letter, we believe the proposed amendments clearly describe the new requirements that apply when an auditor is engaged to audit only the financial statements.

- 4. Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements? For example:**

- Should the auditor be required to report all internal control deficiencies (i.e., including internal control deficiencies that are less severe than significant deficiencies and material weaknesses) to management not**



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Page 5

previously communicated in writing by the auditor or by others? (Under the proposed amendment, the auditor would be required to report to management and the audit committee significant deficiencies and material weaknesses identified during the audit.)

- **Should the auditor evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting? (Under the proposed amendment, the auditor does not have an explicit requirement to make this evaluation but would be required to report in writing to the board of directors a conclusion that the audit committee's oversight is ineffective, even if the auditor did not perform an evaluation to reach that conclusion.)**

We are not aware of additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements. Our view includes the examples provided regarding reporting of all internal control deficiencies and evaluating the effectiveness of the audit committee's oversight; thus, we do not believe that these concepts should be extended to situations in which the auditor is engaged to audit only a company's financial statements.

5. **Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.**

We do not believe there are circumstances in which the proposed amendments are not appropriate in an audit of financial statements.

Questions regarding attestation standards

6. **Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.**

We believe that this question should be specifically addressed to the Commission. Conceivably, there could be instances where the Commission may require an issuer to file an auditors' report on internal control as of a date other than the



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issuer's fiscal year-end. This alternative is not provided for in PCAOB Auditing Standard No. 2. We are not aware of any circumstances in which an issuer would want to file an AT Section 501 report with the Commission.

7. Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?

We believe that AT Section 501 should be superseded. Because of the differences in auditor performance requirements between PCAOB Auditing Standard No. 2 and AT Section 501, preserving AT Section 501 would likely create confusion among users of auditors' reports on internal control over financial reporting. Accordingly, we believe there should be only one such standard for audits of issuers' internal control over financial reporting.

8. Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?

We agree with the Board's conclusions, as expressed in Appendix E of PCAOB Auditing Standard No. 2, that the objectives of, and work involved in performing, an audit of internal control over financial reporting and an audit of financial statements are so closely related that an auditor should not audit a company's internal control over financial reporting without also auditing the company's financial statements. Accordingly, we do not believe an auditor should express an opinion on the effectiveness of an issuer's internal control over financial reporting without also auditing the issuer's financial statements.

* * * * *

Questions regarding information included in this letter should be directed to Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Craig W. Crawford, (212) 909-5536, ccrawford@kpmg.com.

Very truly yours,

KPMG LLP

The following editorial and other comments and suggestions are presented for your consideration:

1. Amendment to AU Section 311, “Planning and Supervision”

Paragraph 3 of the Proposed Standard sets forth a proposed note that would follow AU Section 311.01. The note directs a reader to refer to PCAOB Auditing Standard No. 2 when performing an integrated audit. To clarify that the planning considerations in PCAOB Auditing Standard No. 2 are incremental to, rather than in place of, the planning considerations set forth in AU Section 311, we recommend that the proposed note be modified as set forth below. Also, the word “Auditing” should be included in the reference to PCAOB Auditing Standard No. 2 for consistency.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Auditing Standard No. 2 regarding planning considerations, in addition to the planning considerations set forth in this section.

2. Amendment to AU Section 312, “Audit Risk and Materiality in Conducting an Audit”

Paragraph 4b of the Proposed Standard sets forth a proposed note that would follow AU Section 312.05, and would direct a reader to refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations. AU Section 312.05 discusses the concept of materiality, whereas AU Section 312.07 includes a more substantive explanation of the term *fraud*. We recommend that the note proposed in paragraph 4b of the Proposed Standard be placed following AU Section 312.07.

Paragraph 4d of the Proposed Standard sets forth a proposed note that would follow AU Section 312.18, and would direct a reader to Appendix B of PCAOB Auditing Standard No. 2, “for discussion of tests to be performed when a company has multiple locations or business units.” We believe the precise purpose of the reference is unclear; one could inappropriately infer from the reference that an auditor in an integrated audit should look to Appendix B for guidance on substantive testing as well as internal control testing. We recommend that the reference be clarified by replacing the language quoted above with “for discussion of tests of controls to be performed when a company has multiple locations or business units” or with “for considerations when a company has multiple locations or business units.”

3. Amendment to AU Section 316, “Consideration of Fraud in a Financial Statement Audit”

Paragraph 6 of the Proposed Standard sets forth a proposed note that would follow AU Section 316.01, and would direct a reader to refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations. To clarify that the fraud considerations in PCAOB Auditing Standard No. 2 are incremental to, rather than in

place of, the fraud considerations set forth in AU Section 316, we recommend that the note be modified as follows:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Auditing Standard No. 2 regarding fraud considerations, in addition to the fraud considerations set forth in this section.

4. Amendment to AU Section 319, “Consideration of Internal Control in a Financial Statement Audit”

Paragraph 7d of the Proposed Standard sets forth a proposed note that would follow AU Section 319.09, and would direct a reader to Appendix B of PCAOB Auditing Standard No. 2 “for discussion of tests to be performed when a company has multiple locations or business units.” Please refer to our comment 2 above regarding the same language proposed to be added after AU Section 312.18.

AU Section 319.83 requires that the auditor document the basis for his or her conclusion when assessing the level of control risk at less than the maximum. Paragraph 7f of the Proposed Standard sets forth a proposed note that would follow AU Section 319.83, and would incorporate the requirement in PCAOB Auditing Standard No. 2 that the auditor document the basis for his or her conclusion when assessing the level of control risk as other than low. To add clarity by avoiding an apparent contradiction between existing AU Section 319.83 and the proposed amendment to the same paragraph, we recommend that the proposed note be modified as follows:

Note: ~~In an integrated audit of financial statements and internal control over financial reporting,~~ PCAOB Auditing Standard No. 2, paragraph 160, states, in part, ~~that~~ “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.” Accordingly, in an integrated audit of financial statements and internal control over financial reporting, if control risk is assessed at the maximum level, the auditors should document the basis for that conclusion regardless of whether control risk is assessed at or below the maximum. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for additional information regarding documentation requirements in an integrated audit of financial statements and internal control over financial reporting.

5. Amendment to AU Section 324, “Service Organizations”

Paragraph 9 of the Proposed Standard sets forth a proposed note that would follow AU Section 324.01, and would direct a reader to refer to paragraphs B18-B29 of Appendix B, “Additional Performance Requirements and Directions; Extent-of-

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Testing Examples,” in PCAOB Auditing Standard No. 2 regarding the use of service organizations. To clarify that the considerations regarding the use of service organizations in PCAOB Auditing Standard No. 2 are incremental to, rather than in place of, such considerations set forth in AU Section 324, we recommend that the note be modified as follows:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, “Additional Performance Requirements and Directions; Extent-of-Testing Examples,” of PCAOB Auditing Standard No. 2 regarding the use of service organizations, in addition to the considerations set forth in this section.

6. Amendment to AU Section 332, “Auditing Derivative Instruments, Hedging Activities, and Investments in Securities”

Paragraph 14 of the Proposed Standard sets forth a proposed note that would follow AU Section 332.11, and would state that in an integrated audit, if a company’s investment in derivatives and securities represents a significant account, the auditor’s understanding of controls should include controls over derivatives. The purpose of this note is unclear, as the guidance provided is self-evident, and similar guidance is not proposed to be added to auditing standards on auditing inventories, for example. We recommend that the proposed note be omitted for purposes of clarity.

7. Amendment to AU Section 333, “Management Representations”

Paragraph 15 of the Proposed Standard sets forth a proposed note that would follow AU Section 333.05, and would direct a reader to refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for required representations to be obtained from management. To clarify that the management representations in PCAOB Auditing Standard No. 2 are incremental to, rather than in place of, the written representations set forth in AU Section 333, we recommend that the note be modified as follows:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for additional required written representations to be obtained from management.

8. Amendment to AU Section 508, “Reports on Audited Financial Statements”

Paragraph 18b of the Proposed Standard would add, to AU Section 508.08, a subparagraph k, which would include an illustrative paragraph to be used in the audit report on the financial statements when an auditor performs an integrated audit and issues separate reports on the financial statements and on internal control over financial reporting. For consistency with the remainder of AU Section 508.08, we

recommend that subparagraph k describe the subject element of the report and that the illustrative report paragraph be moved to the body of each of the two illustrative reports at the end of paragraph 8. We also recommend that the new subparagraph be placed before existing subparagraph i (and the remaining subparagraphs be relettered) in order to maintain the basic elements of the report in the order in which they generally will appear in an auditors' report.

In addition, for consistency with the existing examples, the reference to "W Company" in the proposed illustrative paragraph should be changed to "X Company" or "the Company."

9. Amendment to AU Section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

We recommend the following editorial revision to the note proposed to be added to AU Section 561.01:

Note: When an auditor has performed ~~performing~~ an integrated audit of financial statements and internal control over financial reporting and subsequent to the date of the auditor's report(s) becomes aware of facts of the nature described in paragraph .01 above, refer to paragraph 197 of PCAOB Auditing Standard No. 2, which provides direction with respect to subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.

10. Amendment to AU Section 711, "Filings Under Federal Securities Statutes"

We recommend the following editorial revision to the note proposed to be added to AU Section 711.02:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, which provide direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in ~~with respect to~~ filings under federal securities statutes ~~in an audit of internal control over financial reporting.~~

11. Superseding AT Section 501, "Reporting on an Entity's Internal Control over Financial Reporting"

Paragraph 25 of the Proposed Standard indicates that AT Section 501 is intended to be superseded. We presume that Interpretation 1 to AT Section 501, "Pre-Award Surveys," also is intended to be superseded. We recommend that this point be clarified in the final standard.

* * * * *

new york state society of

NYSSCPA

certified public accountants

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April 20, 2004

Office of the Secretary
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1666 K Street, N.W.
Washington, DC 20006-2803

By e-mail: comments@pcaobus.org

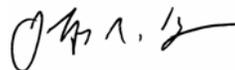
Re: Proposed Auditing Standard on Audit Documentation and Proposed Amendment to
Interim Auditing Standards

PCAOB Release No. 2004-0002
PCAOB Rulemaking Docket Matter No. 014

The New York State Society of Certified Public Accountants, the oldest state accounting association, representing approximately 30,000 CPAs, welcomes the opportunity to comment on the Proposed Auditing Standard referenced above.

The NYSSCPA Auditing Standards and Procedures Committee deliberated the Proposed Auditing Standard and prepared the attached comments. If you would like additional discussion with the committee, please contact Margaret Wood, chair of the Auditing Standards and Procedures Committee, at (212) 542-9528, or Robert Colson, NYSSCPA staff, at (212) 719-8350.

Sincerely,



Jeffrey R. Hoops
President

Attachment

new york state society of

NYSSCPA

certified public accountants

530 fifth avenue, new york, ny 10036-5101

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**COMMENTS ON PCAOB PROPOSED AUDITING STANDARD ON
Audit Documentation and Proposed Amendment to Interim Auditing
Standards**

PCAOB Release No. 2004-0002

PCAOB Rulemaking Docket Matter No. 014

April 20, 2004

Principal Drafters

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NYSSCPA Staff

Robert H. Colson

New York State Society of Certified Public Accountants
Comments to the PCAOB
Release No. 2004-0002
Docket Matter No. 14

General Comments

We concur that the standard should include written communication to management and the audit committee of all significant deficiencies and material weaknesses.

Specific Comments

Question 1 - Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting?

The references are useful. A codification or reissuance of the affected standards with the revisions would further assist auditors.

Question 2 – Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.

It would be helpful to coordinate with the AICPA to update the appropriate AICPA audit guides and SOP's. In some cases, they represent the principal source of guidance for audits of companies in certain industries.

Question 3 – Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the board more clearly describe the new requirements?

PCAOB Auditing Standard No. 2, as referenced by the amendment, effectively describes the requirements under the standard.

Question 4 – Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over their financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements?

All internal control deficiencies noted during the audit should be communicated in writing to management, the audit committee, and, if appropriate, the board of directors. They should be classified and grouped by severity (i.e., material weakness, significant deficiency, and other).

The standard also requires the auditor to report on the effectiveness of the audit committee's oversight over financial reporting. Without testing the effectiveness of the audit committee's oversight over financial reporting, the auditor has no basis for coming to a conclusion. In addition, because the audit committee engages the auditor the report should also go to the board of directors.

In addition, a SAS 61 letter addressed to the Board of Director's normally would include any disagreements with the Audit Committee as well as management. PCAOB should consider adding this requirement.

Question 5 – Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate and should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is inappropriate? Recognizing that requirements in the proposed amendments are required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.

No. The changes are appropriate. Consideration should be given to adding a footnote indicating the limited situations when an audit of financial statements only is appropriate.

Question 6 - Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so explain.

No, if a problem noted in the AT sec. 501 control review is other than inconsequential to the financial statements, then the auditor should follow the procedures in PCAOB Auditing Standard No. 2. If the problem noted is inconsequential to the financial statements, the problem should be communicated in writing to the audit committee and, if appropriate, to the board of directors.

Question 7 – Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec.501.

AT sec. 501 will still be applicable for internal control reports to government agencies or regulatory internal control reports by SEC registrants.

Question 8 – Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?

Yes, governmental and regulatory internal control reports other than yellow book and contractual internal control reports may still require the use of AT 501 internal control reports to report on compliance with internal controls specifically relating to

grants, programs, or statutory regulations when accompanied by a financial statement, an element of a financial statement, or schedule of expenditures.



PricewaterhouseCoopers LLP
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April 23, 2004

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 014, Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements (PCAOB Release No. 2004-002, March 9, 2004)

Dear Mr. Secretary:

PricewaterhouseCoopers LLP appreciates the opportunity to comment on the proposed auditing standard, *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements* (“the proposed standard”), that has been proposed by the Public Company Accounting Oversight Board (the “Board”).

We believe the addition of references to PCAOB Auditing Standard No. 2 (“the standard”) in the interim standards will be very useful to auditors when performing an integrated audit of financial statements and internal control over financial reporting.

We support the proposed amendments to the Board’s interim auditing standards subject to our specific comments in Appendix A. We believe that a few of the proposed amendments, as noted in Appendix A, create additional inconsistencies in the interim standards that should be resolved.

We also support the Board’s proposal to remove AT 501, *Reporting on an Entity’s Internal Control Over Financial Reporting*, from the Board’s interim attestation standards. We are not aware of any circumstances in which issuers would need to file an AT 501 report with the Securities and Exchange Commission.

We support the Board’s plan to include a specific identification of related proposed amendments to other standards in future standards-setting proposals. We encourage the Board to publish such proposed amendments for comment in a format that highlights changes to the existing text (for example, by using boldface italics for new language and strikethrough for deleted language) so that interested parties can obtain a better understanding of the effect of the proposed amendments.



We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions the staff may have. Please do not hesitate to contact Ray Bromark (973-236-7781) or Jim Lee (973-236-4478) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP



Appendix A

SPECIFIC COMMENTS

Paragraph 2: Proposed Amendments to AU 310, *Appointment of the Independent Auditor*

Paragraph 167 of PCAOB Auditing Standard No. 2 (“the standard”) explicitly requires the auditor to express two opinions in the audit of internal control over financial reporting: an opinion on management’s assessment of internal control over financial reporting and an opinion on the effectiveness of internal control over financial reporting. Accordingly, we recommend that paragraph 2.b. of the proposed standard be revised as follows to reflect this requirement:

2. Statement on Auditing Standards (SAS) No. 1, "Codification of Auditing Standards and Procedures," AU sec. 310, "Appointment of the Independent Auditor," as amended by SAS No. 45, "Omnibus Statement on Auditing Standards-1983," SAS No. 83, "Establishing an Understanding With the Client," and SAS No. 89, "Audit Adjustments" (AU sec. 310, "Appointment of the Independent Auditor"), is amended as follows:

b. The first bullet point of paragraph .06 is amended to read as follows:
The objective of the audit is:

- Integrated audit of financial statements and internal control over financial reporting:
The expression of an opinion on ~~both management’s assessment of internal control over financial reporting and on~~ the financial statements ***and opinions on management’s assessment of internal control over financial reporting and on the effectiveness of internal control over financial reporting.***

We also recommend that paragraph 2.d. of the proposed standard be revised as follows to bring the language into conformity with the last sentence of paragraph 18 of the standard, with the scope paragraphs in the illustrative reports in Appendix A of the standard, and with the changes that are proposed to be made to the eighth bullet point of AU 310.06 in paragraph 2.e. of the proposed standard.

d. The seventh bullet point of paragraph .06 is amended to read as follows:

The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

- Integrated audit of financial statements and internal control over financial reporting:
Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether ***effective internal control over financial reporting was maintained*** ~~management’s assessment of the effectiveness of the company’s internal control over financial reporting is fairly stated~~ in all material respects.

In addition, we believe that the proposed amendment to the seventh bullet point of paragraph .06 requires conforming amendments to the discussion of reasonable assurance in other interim standards,



for example, in AU 230.10.

Paragraph 10: Proposed Supersession of AU 325, *Communication of Internal Control Related Matters Noted in an Audit*

We agree that this interim standard is superseded by PCAOB Auditing Standard No. 2 when an integrated audit is being performed. We also agree that this interim standard should be superseded by the proposed guidance, *Communications about Control Deficiencies in An Audit of Financial Statements*, when only an audit of financial statements is being performed, subject to the following comments.

We believe that the proposed guidance should explicitly acknowledge that the auditor's objective in an audit of financial statements is to form an opinion on the financial statements and that the auditor is not obligated to search for significant deficiencies or material weaknesses. Reinforcing this view, we believe that paragraph 5 should be revised as follows:

5. *The auditor is not required* ~~Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting, *nor is the auditor obligated to identify whether a significant deficiency or material weakness in audit committee effectiveness exists. However, if the auditor does identify that* a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.~~

We believe the illustrative sections of reports to audit committees in existing AU 325 should be revised and retained. Also, in response to Question 4, we do not believe that the auditor should be required to report control deficiencies other than significant deficiencies and material weaknesses.

Paragraph 18: Proposed Amendments to AU 508, *Reports on Audited Financial Statements*

We agree with the proposed amendments to AU 508. In addition, we believe that AU 508.08(d) should be amended to indicate that "the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board." This proposal is consistent with the Board's proposed amendment, in paragraph 2.d. of the proposed standard, to the seventh bullet point of AU 310.06.

Paragraph 7: Proposed Amendments to AU 319, *Consideration of Internal Control in a Financial Statement Audit*

We believe that the Board should amend other sections of the interim standards, in addition to AU 319.02, to incorporate "relevant assertions." For example, AU 326, *Evidential Matter*, should include a discussion of "relevant assertions."

In paragraph 7.e., we do not understand the relevance of the note proposed to follow AU 319.65 and recommend that it be deleted.



We suggest that the Board amend paragraph 32 of SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AU 312.32) so that it is consistent with the guidance proposed at AU 319.02 and at AU 319.107 that requires the auditor “to perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.”

Paragraph 13: Proposed Amendments to AU 329, *Analytical Procedures*

We agree with the proposed amendment to paragraph 9 of AU 329, *Analytical Procedures*. However, we believe that guidance should be included on what is meant by “significant risks” in the statement “For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.” The guidance in paragraphs 108-114 of ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, may be helpful in developing such guidance.

The guidance proposed to be added to AU 329.10 appears to be applicable to all substantive procedures and therefore its inclusion only in this interim standard is ambiguous.

Finally, the proposed amendment to AU 329.16 is unnecessary because it is redundant with guidance already included in that paragraph.

Paragraph 14: Proposed Amendment to AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

We believe that the note proposed in paragraph 14 to be added to AU 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*, is misplaced because it contains interpretive guidance on implementing an aspect of that interim standard in an integrated audit. Accordingly, the guidance belongs in PCAOB Auditing Standard No. 2 or in an interpretation of that standard.



**Texas Society of
CPA Certified Public Accountants**

April 21, 2004

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB Release No. 2004-002 – Proposed Auditing Standard – Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its membership when such action is in the best interest of its members and serves the cause of certified public accountants in Texas, as well as the public interest. The TSCPA has established the Professional Standards Committee to represent those interests on accounting and auditing issues. This communication is in accordance with that goal.

Two Questions Related to the Addition of References

Question 1: "Are references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not explain."

Comment: The references are useful to the extent they let the auditor know how the proposed standard has changed existing standards. The references would be much more useful if the effects of the proposed standards could actually be physically integrated into the existing AICPA standards.

Since the AICPA standards are applicable to audits of non-public entities, and have been adopted as interim auditing standards by the PCAOB for SEC registrants, such physical integration is not likely to take place in the near future. The process of having to trace the references from the proposed standard to the AICPA literature is time consuming and, therefore, may not be performed as it should.

Question 2: "Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so explain."

Comment: We are not aware of any references that have been omitted from the proposed auditing standard.

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Auditing Standards

AU 310, Appointment of the Independent Auditor

Comment: We believe the amendment related to this standard is appropriate and should be followed by the practitioner engaged to perform both the audit of the financial statements and the audit of internal control.

AU 319, Consideration of Internal Control in a Financial Statement Audit

Comment: On first reading, one might conclude that this is not a substantive change because under existing standards where a very low level of combined inherent risk and control risk results in an acceptable level of detection risk, the auditor is not permitted to omit substantive auditing procedures related to an assertion. However, as detection risk is the product of test-of-details risk and analytical-procedures risk, many auditors have concluded that where there is very low control risk the substantive tests requirement can be met by applying analytical procedures.

Because analytical procedures are considered substantive tests, it could be argued that the proposed amendment to AU 319 has not changed existing standards. However, the proposed amendment to AU 329, Analytical Procedures, addressed later in this comment letter, will add the following language: "For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient." This amendment, coupled with the one discussed herein, could be interpreted to mean that the substantive tests to be performed, "regardless of the assessed level of control risk" would have to be tests of details.

If this is the intent of the PCAOB, the proposed amendment may be necessary. It appears many material misstatements have not been discovered due to the failure of some auditors to apply enough substantive auditing procedures to overcome management override of controls and other types of fraudulent financial reporting.

AU 325, Communication of Internal Control Related Matters Noted in an Audit

Comment: This amendment finds AU 325 superseded for an audit of financial statements and internal control over financial reporting for a public company. As a result, new paragraphs are added for circumstances that involve only an audit of a public company's financial statements. We believe this update of AU 325 requiring communications of material weaknesses to management and the audit committee is appropriate.

AU 326, Evidential Matter

Comment: This amendment requires that an auditor's substantive procedure include reconciling the financial statements to the accounting records and examining material

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adjustments made during the course of preparing financial statements. While we fully agree with the necessity of such procedures, we consider it unfortunate that such an amendment must be spelled out in a professional standard. One would hope that such procedures would be a normal part of an audit, whether specifically required or not.

AU 329, Analytical Procedures

Comment: We believe the amendment to AU 329 provides excellent guidance for auditors when performing analytical procedures.

Additional Questions Related to the Proposed Amendments to Auditing Standards

Question 3: "Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements?"

Comment: We believe the amendments are clear regarding the requirements that apply when the auditor is engaged to audit only the financial statements.

Question 4: "Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that should be applicable when the auditor is engaged to audit only the financial statements?" For example:

- A. Should the auditor be required to report all internal control deficiencies (i.e., including internal control deficiencies that are less severe than significant deficiencies and material weaknesses) to management not previously communicated in writing by the auditor or by others?

Comment: We do not believe the reporting of such deficiencies meets the cost/benefit test and as such should not be a part of the auditor's required communications to management.

- B. Should the auditor evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting?

Comment: It is our understanding that under the proposed amendment, the auditor does not have an explicit requirement to make this evaluation, but would be required to report in writing to the board of directors a conclusion that the audit committee's oversight is ineffective, even if the auditor did not perform an evaluation to reach that conclusion. We believe that a significant lack of appropriate oversight and involvement on the part of an audit committee is detrimental to the effective functioning of an auditor. In such situations, the auditor should report such behavior to the full board. However, guidance regarding the appropriate oversight and involvement on the part of an audit committee is currently lacking in our professional literature. We strongly encourage the

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PCAOB to develop or adopt guidance that will assist the auditor in evaluating the effectiveness of an audit committee's oversight of the external financial reporting process and the internal control over financial reporting. Such guidance would also serve to inform the audit committee of its responsibilities in these areas.

Question 5: "Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate?"

Comment: See our comments under part B of question 4 above.

Attestation Standards

Comment: The three questions posed in this section of the proposed standard dealing with attestation standards ask: (1) are there any circumstances in which issuers would want or need to file an AT 501 report with the commission; (2) should AT 501 be amended rather than superseded; and (3) is there need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting?

With respect to each of the three questions posed in this section, our committee submits an answer of NO to each of them.

Independence Standards

Comment: This proposed addition to the independence standards would provide that a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer for which the registered public accounting firm also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee.

We believe the addition to the independence standards should prohibit such services in all circumstances rather than permit them with pre-approval of the audit committee. To allow such an amendment would imply that the lack of independence in appearance can be overcome by pre-approval! However, we believe communication between the entity engaged to assist management with the assessment and documentation of internal control and the external auditor does not constitute a separate engagement for the auditor. Such communication is a part of the financial statement audit and would be necessary to clarify issues related to the entity's internal control.

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Comments on Appendix

Comment: All the proposed changes and amendments were traced from the proposed standard to the existing professional standards. We believe the language and the placement of the changes are consistent with the existing literature and are logical when read in conjunction with existing standards.

We do believe the following points should be considered:

Page A-7, item 7.b: The sentence that is added at the end of paragraph 2 should also be considered for addition at the end of Paragraph 3. While this may seem redundant, it would stress the importance of this issue.

Page A-11: Communications about Control Deficiencies in An Audit of Financial Statements, that continues to Page A-16 and consists of Paragraphs numbered 1 through either 10 or 11, should be set forth as an appendix to this standard as its current placement is confusing. Also, paragraph 5 on Page A-14 is 77 words long and very difficult to follow. Some editing here would be helpful.

Page A-18, Paragraph 17: The note added here consists of a sentence that is approximately 72 words long. Any sentence that long is hard to follow and interpret. For example, this sentence states, ". . . should necessarily *inform* (emphasis added) the auditor's decisions." We question whether such phraseology lends itself to understanding by most practitioners.

We appreciate the opportunity to comment on the proposed standard.

Sincerely,

A handwritten signature in black ink, appearing to read "C. Jeff Gregg". The signature is written in a cursive, somewhat stylized font.

C. Jeff Gregg, CPA
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants



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A. Overview of Conforming Amendments to the Standards of the PCAOB

When the Board adopted PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* (PCAOB Release No. 2004-001, dated March 9, 2004) (the "internal control standard"), the Board recognized that the internal control standard superseded the professional standards adopted by the Board as its interim standards^{1/} in some respects, and that express amendments to those standards could be helpful to make the interim standards consistent with the principles and requirements in the internal control standard. The Board also planned to make several amendments to the interim standards that would be applicable to situations in which Section 404 of the Sarbanes-Oxley Act of 2002 is not applicable and only the financial statements of a company are required to be audited. Accordingly, the Board issued for public comment the proposed conforming amendments, which identified conforming changes to the interim standards resulting from the adoption of PCAOB Auditing Standard No. 2.

The purpose of the conforming amendments is to specifically identify changes to the interim standards that result from the adoption of PCAOB Auditing Standard No. 2. The Board believes that identification of such changes is helpful in enabling auditors to comply with the Board's standards, as well as in eliminating potential confusion and inconsistencies in interpretation with respect to the affected portions of the interim standards. Accordingly, the scope of the conforming amendments is relatively narrow and comprises amendments to the interim standards resulting only from the adoption of PCAOB Auditing Standard No. 2.

^{1/} Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the Securities and Exchange Commission on April 25, 2003 (See SEC Release No. 33-8222). On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules."



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B. Highlights of Conforming Amendments, Including Public Comment Process and Board Responses

This section of the release describes the amendments made to the Board's interim standards, in particular the interim auditing, attestation, and independence standards, as a result of the adoption of PCAOB Auditing Standard No. 2. This section also summarizes and discusses the factors the Board deemed significant in reaching the conclusions embodied in the conforming amendments. Such factors include issues raised by commenters in the 10 comment letters^{2/} received by the Board, which included letters from eight of the largest registered accounting firms and two professional associations.

1. Auditing Standards

The Board's interim auditing standards include the Statements on Auditing Standards promulgated by the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board ("ASB"), as in existence on April 16, 2003.^{3/} The conforming amendments to the Board's interim auditing standards include (a) the addition of references to assist auditors in performing an integrated audit of financial statements and internal control over financial reporting and (b) amendments to incorporate certain requirements in PCAOB Auditing Standard No. 2 that also apply when an auditor is engaged solely to audit a company's financial statements.

a. Addition of References to the Interim Standards

References have been added to assist auditors in performing an integrated audit of financial statements and internal control over financial reporting. Auditors are cautioned that the references might not be all inclusive. If there is any conflict between the interim auditing standards and PCAOB Auditing Standard No. 2, auditors should follow the provisions of PCAOB Auditing Standard No. 2.

^{2/} The comment letters are available on the Board's Web site – www.pcaobus.org – and will be attached to the Form 19b-4 that the Board will file with the Commission.

^{3/} The Statements on Auditing Standards ("AU") are codified into the AICPA *Professional Standards*, vol. 1, as AU sections 100 through 901.



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In the release relating to the proposed conforming amendments, commenters were asked whether the proposed references would be useful to auditors performing an integrated audit of financial statements and internal control over financial reporting. The release also asked whether any references considered beneficial were omitted from the proposed standard.

Most commenters found the proposed references to be helpful to auditors performing both integrated audits and audits of financial statements. Several commenters voiced concerns stemming from the lack of a codification of PCAOB auditing standards. The Board believes that auditors will find the listing of conforming amendments in this rulemaking to be a useful tool for reconciling changes to the interim standards. The Board decided that no change is necessary to the conforming amendments in response to these comments regarding a codification because these comments were outside the scope of this rulemaking.

In addition, several commenters suggested additional references to include in the final conforming amendments. The Board evaluated each of these suggestions individually and included them in the final conforming amendments where deemed appropriate.

b. Amendments to Incorporate Requirements from PCAOB Auditing Standard No. 2

While PCAOB Auditing Standard No. 2 is directed primarily to an auditor performing an integrated audit of financial statements and internal control over financial reporting, some provisions in that standard are relevant to situations in which an auditor is engaged solely to audit a company's financial statements, such as in an audit of financial statements presented in connection with an initial public offering, in which the company is not subject to the requirements of Section 404 of the Act and the SEC's rules implementing that provision.^{4/} Therefore, this rulemaking amends certain interim standards directly because those amendments would apply in all cases.

In the release relating to the proposed conforming amendments, commenters were asked (a) whether the proposed amendments clearly describe the new

^{4/} 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].



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requirements that apply either when the auditor is engaged to audit only the financial statements or when the auditor is engaged to perform an integrated audit of the financial statements and internal control over financial reporting; and (b) whether there were any additional requirements not already identified that also should apply when the auditor is engaged to audit only the financial statements.

Most commenters found the proposed amendments both clear and helpful. A few commenters suggested editorial changes to the proposed amendments, while others suggested additional amendments. The Board reviewed all such comments and, where appropriate, incorporated them into the final conforming amendments.

One commenter believed that a number of new requirements that apply when the auditor is engaged to audit only the financial statements have been obscured behind the label of "conforming changes" and that, as a result, auditors will fail to notice such new requirements. This commenter suggested that the Board appropriately highlight each new requirement for such audits to ensure that auditors are aware of and fully understand the ramifications of each new requirement. The changes described in the conforming amendments were first presented for public comment in connection with the Board's proposal of Auditing Standard No. 2 in October 2003. Because a number of commenters, when commenting on that proposal, suggested that a more detailed explanation of these changes could be helpful to practitioners, the Board decided to more clearly identify the changes in separate conforming amendments. These two notice and comment periods have served to highlight these changes, and the Board believes that the conforming amendments adopted today, together with this release describing those amendments, provide auditors adequate explanation to understand the effects of these changes on the financial statement audit.

Significant areas of amendment to the auditing standards are discussed below, including comments received and the Board's response thereto. For ease of reference, the references herein are to the interim standards as codified in AICPA *Professional Standards*, rather than to the original pronouncements.

(1) AU sec. 310, "Appointment of the Independent Auditor"

This standard has been amended to include requirements related to the auditor's understanding with the client when performing an integrated audit of financial statements and internal control over financial reporting. For consistency, certain related amendments also have been made to the auditor's required understanding with the



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client when performing an audit of financial statements. One commenter suggested that the amendments to this standard indicating that reasonable assurance is "a high level of assurance" were inappropriate and should be subject to further deliberation and discussion. The Board's clarification that reasonable assurance is "a high level of assurance" was clearly included in PCAOB Auditing Standard No. 2. As indicated in the Board's release proposing the conforming amendments, the scope of this rulemaking did not include reconsidering any principles or requirements of PCAOB Auditing Standard No. 2. Accordingly, the Board viewed this comment regarding reasonable assurance as beyond the scope of the proposed conforming amendments rulemaking. No changes have been made based upon this comment.

(2) AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

This interim standard has been amended by adding a requirement that states, "Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." As it relates to this requirement, Auditing Standard No. 2 states, "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." A similar conforming amendment has been made to AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

(3) AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit."

This standard has been superseded in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207 through 214 of PCAOB Auditing Standard No. 2. By this rulemaking, the Board is also amending this interim standard, as applied to an audit only of financial statements, by substituting the paragraphs included in the appendix accompanying this release (See AU sec. 325, subparagraphs 1-9 in the appendix).

Communication of Significant Deficiencies and Material Weaknesses in a Financial Statement Audit. The release relating to the proposed standard asked for



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comments on the appropriateness of a proposed amendment that would require an auditor, in an audit of only the financial statements, to report to management and the audit committee only those control deficiencies identified during the audit that are considered either significant deficiencies or material weaknesses. In an integrated audit of internal control over financial reporting and the financial statements, Auditing Standard No. 2 requires the auditor also to communicate to management, in writing, all deficiencies in internal control over financial reporting identified during the audit and inform the audit committee when such a communication has been made. The proposed amendment would not have required the auditor to communicate to management and the audit committee *all* control deficiencies noted in an audit of the financial statements, but only those that meet the definition of a significant deficiency or material weakness. All commenters agreed with this proposed amendment except one. One commenter suggested that the auditor should be required to communicate *all* control deficiencies noted in an audit of the financial statements. While an auditor may, based on his or her own judgment or upon request of management or an audit committee, communicate all control deficiencies noted in an audit of the financial statements, the Board believes that to require such a communication in all audits of only the financial statements would be unnecessarily burdensome on audit committees. Therefore, the Board has retained the requirement for the auditor to report to management and the audit committee only those control deficiencies identified in the audit of the financial statements that are either significant deficiencies or material weaknesses.

Communication of the Ineffectiveness of the Audit Committee. The proposed amendment stated that, in an audit only of financial statements, an auditor does not have a requirement to evaluate the effectiveness of the audit committee's oversight of the company's internal control over financial reporting. The proposed amendment would also have required an auditor to communicate, in writing, to the board of directors if a significant deficiency or material weakness exists, however, because the oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

While commenters unanimously agreed with this provision, several commenters asked for clarification of the auditor's responsibility. In response, the Board has amended subparagraph 5 of the conforming amendments to AU sec. 325 to read as follows –



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If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, ~~of the external financial reporting process and the internal control over financial reporting,~~ if the auditor becomes aware that ~~a significant deficiency or material weakness exists because~~ the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

This change is intended to clarify that, while an auditor does not have an explicit requirement to perform a separate and distinct evaluation of the effectiveness of the audit committee in a financial statement audit, the auditor does have a communication responsibility when he or she becomes aware of a significant deficiency or material weakness caused by the audit committee's ineffectiveness.

Illustrative Internal Control Reports. Several commenters requested that the Board revise and include in the conforming amendments illustrative reports to management about deficiencies in internal control similar to those previously contained in AU sec. 325 and its related interpretation. The Board noted that presenting such reports in a rulemaking of the Board might lead firms to use boilerplate language in such communications to management and others. In addition, the Board believes that any new illustrative reports it issues as part of the Board's standards must not only reflect conforming changes but also incorporate best practices at the time of issuance. This type of revision of illustrative reports is beyond the scope of the conforming amendments. Additionally, the Board expects that auditors will be able to clearly and appropriately communicate these matters without relying on illustrative reports. For these reasons, illustrative reports have not been included in the conforming amendments.



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(4) AU sec. 326, "Evidential Matter"

This standard has been amended to add a requirement stating that, "the auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures should include examining material adjustments made during the course of preparing the financial statements." PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial reporting. The Board believes that it is logical and appropriate that these procedures also be performed in an audit of the financial statements. No commenters objected to this amendment.

(5) AU sec. 329, "Analytical Procedures"

This standard is amended to add the following directions –:

- For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.
- 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 alone are not well suited to detecting fraud.
- 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.

PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial



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reporting. The Board also believes that it is logical and appropriate to perform these procedures in an audit of the financial statements. The Board did not receive any comments on these amendments other than comments that re-challenged their inclusion in PCAOB Auditing Standard No. 2. As indicated in the Board's proposing release, these types of comments were considered to be beyond the scope of the proposed conforming amendments; therefore, no changes have been made based upon these comments.

(6) AU sec. 339, "Audit Documentation"

The proposed conforming amendments would have added a subparagraph to Appendix A of this standard ("SAS No. 96"). Subsequent to the conforming amendments being issued for public comment, the Board adopted, and the Securities and Exchange Commission approved, PCAOB Auditing Standard No. 3, *Audit Documentation*. PCAOB Auditing Standard No. 3 superseded SAS No. 96 in its entirety, including Appendix A. Therefore, this proposed conforming amendment is not included in the final conforming amendments because the Board's interim standards no longer contain Appendix A of AU sec. 339.

(7) AU sec. 380, "Communication with Audit Committees"

Footnote one to this standard includes a list of other standards that also require audit committee communications. Because PCAOB Auditing Standard No. 2 also includes required audit committee communications, this standard is amended by including a reference to PCAOB Auditing Standard No. 2 in footnote one. The Board added this conforming amendment based on a suggestion from a commenter.

2. Attestation Standards

The Board's interim attestation standards include the Statements on Standards for Attestation Engagements promulgated by the ASB, as in existence on April 16, 2003.^{5/} Auditors performing an integrated audit of financial statements and internal control over financial reporting to comply with Section 404 of the Act must follow PCAOB Auditing Standard No. 2 when reporting on an entity's internal control over financial reporting. Therefore, in the context of an audit of a company that is subject to

^{5/} The Statements on Standards for Attestation Engagements ("AT") are codified into the AICPA *Professional Standards*, vol. 1, as AT sections 101 through 701.



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Section 404 of the Act, AT sec. 501 has been superseded by the internal control standard. Because AT 501, even as applied to an engagement other than an engagement under Section 404, is outdated, the proposed conforming amendments recommended that AT sec. 501 be superseded in its entirety and removed from the Board's standards.

The release to the proposed conforming amendments asked commenters whether AT sec. 501 should be amended rather than superseded in its entirety. Furthermore, it asked commenters to provide information on (a) whether there are any circumstances in which an issuer would want or need to file an AT sec. 501 report with the SEC and (b) whether there is a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting for purposes of complying with Section 404 of the Act. Commenters who believed such a need exists were requested to indicate in their responses the type of information that should be included in the report, the circumstances in which such a report might be issued, and the intended users of such a report.

Most commenters agreed with the deletion of AT sec. 501 from the Board's interim standards. Those commenters believed that AT sec. 501 is inferior to PCAOB Auditing Standard No. 2. In addition, those commenters were unaware of any circumstances in which an issuer would be required to file an AT sec. 501 report with the SEC, or of any instances in which issuers might need an auditor's report on internal control other than the one embodied in PCAOB Auditing Standard No. 2.

Other commenters, however, expressed concerns about superseding AT sec. 501 in its entirety for a number of reasons. A couple of commenters pointed out that the auditors of some asset-backed securities ("ABS") issuers issue AT sec. 501 reports in order for those ABS issuers to comply with the SEC's annual filing requirements. ABS issuers are not required to comply with Section 404 of the Act, however. No ABS issuer is required to file an auditor's report performed pursuant to AT sec. 501; rather, ABS issuers may comply with the SEC's annual filing requirements by filing an auditor's report performed pursuant to AT sec. 601, *Compliance Attestation*. Further, under a recent SEC proposal (*Proposed Rule: Asset-Backed Securities, Release Nos. 33-8419 and 34-49644*, May 3, 2004), the SEC would require an ABS issuer to include in its annual filing one consistent form of auditor's report. In lieu of audited financial statements and compliance with Section 404 of the Act, the SEC proposal would require that management of certain ABS issuers assess the issuer's compliance with servicing



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criteria and that the auditor attest to, and report on, management's assertion as to whether it complied with the servicing standards through the performance of a compliance attestation. According to the proposal, the attestation standard under which the auditor should perform such engagement would be "Compliance Attestation," AT sec. 601 or another standard for compliance auditing established by the PCAOB. Therefore, if the SEC proposal is adopted, the SEC would no longer accept AT sec. 501 reports for this purpose.

Other commenters expressed less specific concerns over superseding AT sec. 501 in its entirety. These commenters expressed a belief that, at some point, both issuers and nonissuers might need (or want) other reports on internal control presently not provided for under PCAOB Auditing Standard No. 2. For example, these commenters suggested that issuers might need an interim report on internal control, especially when a material weakness that existed at year end is subsequently corrected. Another commenter suggested that an issuer might want an audit report on some other aspect of internal control. None of these commenters, however, provided the detailed discussion requested in the release about the type of information that should be included in such a report, the circumstances in which it might be issued, and the intended users of such a report.

The Board continues to believe that AT sec. 501 lacks the necessary specificity provided in PCAOB Auditing Standard No. 2. At a minimum, if AT sec. 501 were to be retained in the Board's standards, the reporting directions in AT sec. 501 would require immediate revision to clearly distinguish for report users the difference between a report issued under AT sec. 501 and PCAOB Auditing Standard No. 2. Further, it would be necessary to make extensive revisions to AT sec. 501 to conform it to the principles and requirements embodied in PCAOB Auditing Standard No. 2. Because commenters were unable to describe a specific need that is currently unmet by reports issued under PCAOB Auditing Standard No. 2 or other professional standards, there appears to be no compelling reason at this time for the Board either to amend AT sec. 501 or to propose a new standard to replace AT sec. 501. Accordingly, the conforming amendments supersede AT sec. 501 altogether and remove it from the Board's standards effective immediately upon approval by the SEC.

Because AT sec. 501 is no longer a part of the Board's interim standards, it is not appropriate for auditors of issuers following the PCAOB's standards to use AT sec. 501 when reporting on the internal control over financial reporting of an issuer.



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3. Independence Standards

The Board's interim independence standards include the AICPA *Code of Professional Conduct* Rule 101, and interpretations and rulings thereunder, promulgated by the AICPA Professional Ethics Executive Committee, as in existence on April 16, 2003.^{6/} As indicated in PCAOB Auditing Standard No. 2, a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer for which the registered public accounting firm also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee. Because this requirement adds to current independence requirements, a reference to this requirement has been added to interpretation 101-3, "Performance of Other Services," to Rule 101, "Independence" (ET sec. 101.05). The Board did not receive any comments objecting to this amendment.

Table 1, "Cross-References to Conforming Amendments to PCAOB Interim Standards," identifies all of the amendments that the conforming amendments describe in more detail. For ease of reference, Table 1 organizes the interim standards according to the codified sections of the AICPA *Professional Standards* (vols. 1 and 2).

^{6/} The AICPA's Code of Professional Conduct ("ET") Rule 101, and interpretations and rulings thereunder, are codified into the AICPA *Professional Standards*, vol. 2, as ET sections 101 and 191.



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**Table 1 – Cross-References to Conforming Amendments to
PCAOB Interim Standards**

AU Section	Title	Paragraph^{7/} Changes
310	Appointment of the Independent Auditor	.06
311	Planning and Supervision	.01
312	Audit Risk and Materiality in Conducting an Audit	.03, .05, .07, .12, .18, .30
313	Substantive Tests Prior to the Balance Sheet Date	.01
316	Consideration of Fraud in a Financial Statement Audit	.01, .80
319	Consideration of Internal Control in a Financial Statement Audit	.02, .09, .42, .65, .83, .97, .107
322	The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	.01, .16, .20, .22
324	Service Organizations	.01, .20
325	Communication of Internal Control Related Matters Noted in an Audit	In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60 is superseded by paragraphs 207 - 214 of PCAOB Auditing Standard No. 2. In an audit of financial statements only, SAS No. 60 is superseded as described in the appendix.
326	Evidential Matter	.19
329	Analytical Procedures	.09, .10, .16
332	Auditing Derivative Instruments, Hedging Activities, and Investments in Securities	.11

^{7/} The word "paragraph" refers to the paragraph number in the corresponding interim standard.



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AU Section	Title	Paragraph Changes
333	Management Representations	.05
339	Audit Documentation	Appendix A
342	Auditing Accounting Estimates	.10
380	Communication with Audit Committees	.01, footnote 1
508	Reports on Audited Financial Statements	.01, .08
530	Dating of the Independent Auditor's Report	.01
532	Restricting the Use of an Auditor's Report	.07
543	Part of Audit Performed by Other Independent Auditors	.01
9550	Other Information in Documents Containing Audited Financial Statements Auditing Interpretations of Section 550	.15
560	Subsequent Events	.01
561	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	.01
634	Letters for Underwriters and Certain Other Requesting Parties	.29
711	Filings Under Federal Securities Statutes	.02
722	Interim Financial Information	.03, .09, .33

AT Section	Title	Paragraph Changes
501	Reporting on an Entity's Internal Control Over Financial Reporting	Superseded

ET Section	Title	Paragraph Changes
101	Independence	.01, .05

C. Lack of "Background and Basis for Conclusions"

In auditing standards issued by the Board, a discussion of the comments received and other factors deemed significant by the Board in reaching the conclusions embodied in the final standard is contained in an appendix to the standard titled "Background and Basis for Conclusions." Because this rulemaking is not an auditing



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standard, it does not include such an appendix. The Board, however, believes this type of discussion is helpful to this rulemaking. Accordingly, in addition to describing the nature and extent of amendments made to the interim standards, Section B of this release also contains, when appropriate, a discussion of the significant factors considered by the Board in developing the final conclusions reflected in the conforming amendments.

D. Effective Date

PCAOB Rule 3200T requires auditors to comply with the Board's interim auditing standards "to the extent not superseded or amended by the Board." Similarly, the Board's interim attestation and independence standards rules require registered firms and their associated persons to comply with certain existing attestation and independence standards "to the extent not superseded or amended by the Board."^{8/}

PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, was approved by the Commission on June 17, 2004 as the standard for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002. PCAOB Auditing Standard No. 2 supersedes the Board's interim standards in a number of respects and auditors must comply with all applicable provisions of Auditing Standard No. 2 once it is effective, including those provisions that supersede the Board's interim standards.

As discussed above, the conforming amendments adopted today describe and expressly state the changes to the interim standards caused by the adoption of PCAOB Auditing Standard No. 2. Accordingly, pending SEC approval and subject to the two exceptions noted below, the Board intends for the conforming amendments to become effective for integrated audits of financial statements and internal control over financial reporting at the same time PCAOB Auditing Standard No. 2 becomes effective. Companies considered accelerated filers under Securities Exchange Act Rule 12b-2^{9/} 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 November 15, 2004. Other companies have until fiscal years ending on or after July 15, 2005, to comply with the

^{8/} PCAOB Rules 3300T, 3600T.

^{9/} See 17 U.S.C. 240.12b-2.



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internal control reporting and disclosure requirements and the conforming amendments. Early implementation of the conforming amendments is permitted.

There are two exceptions to this general statement. First, certain parts of the conforming amendments apply to an audit of financial statements of an issuer regardless of whether the issuer is required to comply with the internal control requirements of Section 404 of the Act. In order to provide for an orderly transition for issuers not required to comply with Section 404 of the Act, the Board has determined that these parts of the conforming amendments should be effective for audits of financial statements for periods ending on or after July 15, 2005, pending approval of the conforming amendments by the SEC. This means that auditors of non-accelerated filers are not required to comply with the conforming amendments in conducting audits of financial statements until performing audits of financial statements for fiscal years ending on or after July 15, 2005. The effect of these parts of the conforming amendments is discussed further below in Part "E" of this Release.

Second, the Board intends for the part of the conforming amendments that supersedes AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting," to be effective immediately upon approval of the conforming amendments by the SEC. As discussed in greater detail above, in light of the adoption of PCAOB Auditing Standard No. 2, the Board does not see a compelling reason for the Board to retain AT sec. 501 in its interim standards.

E. Effect of Auditing Standard No. 2 on Audits of Financial Statements Only

As discussed above, the conforming amendments are effective, pending SEC approval, for audits of financial statements only for periods ending on or after July 15, 2005. For the most part, however, the Board believes the amendments represent clarifications of concepts already included in the Board's interim standards, rather than wholly new concepts or requirements. Accordingly, the Board encourages auditors to carefully consider their obligations under the Board's interim standards and not to draw a negative inference from the inclusion of a specific provision in the conforming amendments that equivalent procedures are not currently required to comply with the Board's interim standards.



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On the 15th day of September, in the year 2004, 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

September 15, 2004

APPENDIX –

Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit of Financial Statements



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Appendix –Conforming Amendments

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AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

CONFORMING AMENDMENTS TO PCAOB INTERIM STANDARDS RESULTING FROM THE ADOPTION OF PCAOB AUDITING STANDARD NO. 2, "AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS"





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Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, "An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements"

Auditing Standards

AU sec. 310, "Appointment of the Independent Auditor"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 310, "Appointment of the Independent Auditor," as amended by SAS No. 45, "Omnibus Statement on Auditing Standards-1983," SAS No. 83, "Establishing an Understanding With the Client," and SAS No. 89, "Audit Adjustments" (AU sec. 310, "Appointment of the Independent Auditor"), is amended as follows:

- a. The first sentence of paragraph .06 is amended to read as follows:

An understanding with the client generally includes the following matters.

- b. The first bullet point of paragraph .06 is amended to read as follows:

The objective of the audit is:

- Integrated audit of financial statements and internal control over financial reporting: The expression of an opinion on both management's assessment of internal control over financial reporting and on the financial statements.
- Audit of financial statements: The expression of an opinion on the financial statements.

- c. The third bullet point of paragraph .06 is amended to read as follows:

Management is responsible for establishing and maintaining effective internal control over financial reporting. In an integrated audit of financial



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statements and internal control over financial reporting, an auditor is required to 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 if management has not:

- Accepted responsibility for the effectiveness of the company's internal control over financial reporting.
- Evaluated the effectiveness of the company's internal control over financial reporting using suitable control criteria,
- Supported its evaluation with sufficient evidence, including documentation, and
- Presented a written 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.

d. The seventh bullet point of paragraph .06 is amended to read as follows:

The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

- Integrated audit of financial statements and internal control over financial reporting: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in



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combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- Audit of financial statements: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

e. The eighth bullet point of paragraph .06 is amended to read as follows:

An audit includes:

- Integrated audit of financial statements and internal control over financial reporting: Planning and performing 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. The auditor is also responsible for obtaining an understanding of internal control sufficient to plan the financial statement audit and to determine the nature, timing, and extent of audit procedures to be performed. The auditor is also responsible for communicating in writing:
 - To the audit committee - all significant deficiencies and material weaknesses identified during the audit.
 - To management - all internal control deficiencies identified during the audit and not previously communicated in writing



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by the auditor or by others, including internal auditors or others inside or outside the company.

To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

- Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating in writing:
 - To the audit committee - all significant deficiencies and material weaknesses identified during the audit.
 - To the board of directors – if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that specific significant deficiency or material weakness.

AU sec. 311, "Planning and Supervision"

SAS No. 22, "Planning and Supervision," as amended by SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 77, "Amendments to Statements on Auditing Standards No. 22, 'Planning and Supervision,' No. 59, 'The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,' No. 62, 'Special Reports'" (AU sec. 311, "Planning and Supervision"), is amended by adding the following note after paragraph 1:



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Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Auditing Standard No. 2 regarding planning considerations in addition to the planning considerations set forth in this section.

AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"

SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," as amended by SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," SAS No. 96, "Audit Documentation," and SAS No. 98, "Omnibus Statement on Auditing Standards--2002" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), is amended as follows:

- a. The following note is added after paragraph 3.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 of PCAOB Auditing Standard No. 2 regarding materiality considerations.

- b. The following note is added after paragraph 5.

Note: An integrated audit of financial statements and internal control over financial reporting is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness.

- c. The following note is added after paragraph 7.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

- d. The following note is added after paragraph 12.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 regarding materiality and planning considerations, respectively.



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- e. The following note is added after paragraph 18.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for considerations when a company has multiple locations or business units.

- f. The following note is added after paragraph 30.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 147-149 of PCAOB Auditing Standard No. 2 regarding tests of controls.

AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"

SAS No. 45, "Omnibus Statement on Auditing Standards--1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 98-103 of PCAOB Auditing Standard No. 2 regarding timing of tests of controls.

AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"

SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations, in addition to the fraud consideration set forth in this section.

- b. In paragraph 80, the phrase "the auditor should consider whether these risks represent reportable conditions relating to the entity's internal control that should be communicated to senior management and the audit



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committee" is replaced by "the auditor should consider whether these risks represent significant deficiencies that must be communicated to senior management and the audit committee" and the reference to section 325, "Communication of Internal Control Related Matters Noted in an Audit," paragraph .04 is replaced by the reference to section 325, "Communications About Control Deficiencies in An Audit of Financial Statements," paragraph 4.

AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"

SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment of Statement on Auditing Standards No. 55," and SAS No. 94, "The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), is amended as follows:

- a. In paragraph 2, the term "assertions" is replaced by the term "relevant assertions."
- b. The following sentence is added at the end of paragraph 2:

Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

- c. The following note is added after paragraph 2:

Note: Refer to paragraphs 68-70 of PCAOB Auditing Standard No. 2 for discussion of identifying relevant financial statement assertions.

- d. The following note is added after paragraph 9:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for discussion of considerations when a company has multiple locations or business units.



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- e. The following note is added after paragraph 42:

Note: For 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 in a financial statement audit.

- f. The following note is added after paragraph 65:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion.

- g. The following note is added after paragraph 83:

Note: In an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, in part, that "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." Accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for additional information regarding documentation requirements.

- h. The following note is added after paragraph 97:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 104-105 of PCAOB Auditing Standard No. 2 for discussion on the extent of tests of controls.

- i. The last sentence of paragraph 107 is replaced with the following sentence:

Consequently, regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.



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AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"

SAS No. 65, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements" (AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 108-126 of PCAOB Auditing Standard No. 2 for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

- b. The second sentence of paragraph 16 is replaced with the following sentence:

The auditor assesses control risk for each of the relevant financial statement assertions related to all significant accounts and disclosures in the financial statements and performs tests of controls to support assessments below the maximum.

- c. The following note is added after paragraph 20:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 112-116 of PCAOB Auditing Standard No. 2 regarding evaluating the nature of controls subjected to the work of others.

- d. The following note is added after paragraph 22:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 122 of PCAOB Auditing Standard No. 2 regarding assessing the interrelationship of the nature of the controls and the competence and objectivity of those who performed the work.



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AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standard No. 55," SAS No. 88, "Service Organizations and Reporting on Consistency," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 324, "Service Organizations"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," in PCAOB Auditing Standard No. 2 regarding the use of service organizations.

- b. In paragraph 20, the term "reportable conditions" is replaced by the term "significant deficiencies" and the reference to section 325, "Communication of Internal Control Related Matters Noted in an Audit," is replaced by the reference to section 325, "Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"

SAS No. 60, "Communication of Internal Control Related Matters Noted in an Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55," and SAS No. 87, "Restricting the Use of an Auditor's Report" (AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"), is superseded.

- In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60, as amended, is superseded by paragraphs 207-214 of PCAOB Auditing Standard No. 2.
- In an audit of financial statements only, SAS No. 60, as amended, is superseded by the following paragraphs.



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Communications about Control Deficiencies in An Audit of Financial Statements

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

- A 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.

2. A *significant deficiency* is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 3) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:



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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.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

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

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

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 1, 2 and 3, and the directions in paragraphs 130



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through 137 of PCAOB Auditing Standard No. 2. As explained in paragraph 23 of PCAOB Auditing Standard No. 2, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency, or combination of deficiencies, is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

4. The auditor must communicate in writing to management and 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 the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined in paragraphs 2 and 3.

Note: 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.^{1/} The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors or an audit committee at these companies indicative, by themselves, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3^{2/} are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer

^{1/} See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

^{2/} See 17 C.F.R. 240.10A-3.



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that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).^{3/} Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).^{4/} Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X^{5/} (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

5. If oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, that circumstance should be regarded as at least a significant deficiency and as a strong indicator that a material weakness in internal control over financial reporting exists. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight in an audit of only the financial statements, if the auditor becomes aware that the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

^{3/} See 17 C.F.R. 240.10A-3(c)(2).

^{4/} See 17 C.F.R. 240.10A-3(c)(2).

^{5/} See 17 C.F.R. 240.2-01(c)(7).



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6. These written communications should include:
 - a. The definitions of significant deficiencies and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.
 - b. A statement that the objective of the audit was to report on the financial statements and not to provide assurance on internal control.
 - c. A statement that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such written communications, specific reference to such regulatory authorities may be made.
 7. The auditor might identify matters in addition to those required to be communicated by this standard. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.
 8. The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.
 9. 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 to issue an interim communication should be determined based on the relative significance of the matters noted and the urgency of corrective follow-up action required.
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In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency," as defined in paragraph 9 of PCAOB Auditing Standard No. 2.

AU sec. 326, "Evidential Matter"

SAS No. 31, "Evidential Matter," as amended by SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 80, "Amendment to Statement on Auditing Standards No. 31, 'Evidential Matter'" (AU sec. 326, "Evidential Matter"), is amended by adding the following sentences at the end of paragraph 19:

Additionally, the auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements.

AU sec. 329, "Analytical Procedures"

SAS No. 56, "Analytical Procedures," as amended by SAS No. 96, "Audit Documentation" (AU sec. 329, "Analytical Procedures"), is amended as follows:

- a. The following sentence is added to the end of paragraph 9:

For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

- b. The following sentences are added to the end of paragraph 10:

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



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erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

- c. The following sentence is added to the beginning of paragraph 16:

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.

AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"

SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended by adding the following note after paragraph 11:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if a company's investment in derivatives and securities represents a significant account, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations," as amended by SAS No. 89, "Audit Adjustments," and SAS No. 99 "Consideration of Fraud in a Financial Statement Audit" (AU sec. 333, "Management Representations"), is amended by adding the following note after paragraph 5:



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Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing Standard No. 2 for additional required written representations to be obtained from management.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended by adding the following note after paragraph 10:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would be required to obtain an understanding of the process management used to develop the estimate and to test controls over all relevant assertions related to the estimate.

AU sec. 380, "Communication with Audit Committees"

SAS No. 61, "Communication with Audit Committees" (AU sec. 380, "Communication with Audit Committees"), is amended by replacing the title of Section 325 in the first bullet in footnote 1 in paragraph 1 with "Communications About Control Deficiencies in An Audit of Financial Statements" and adding the following after the last bullet in footnote 1 in paragraph 1:

- PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.

AU sec. 508, "Reports on Audited Financial Statements"

SAS No. 58, "Reports on Audited Financial Statements," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990," SAS No. 79, "Amendment to Statement on Auditing Standards No. 58, 'Reports on Audited Financial Statements,'" SAS No. 85, "Management Representations," SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," and SAS No. 98, "Omnibus Statement on Auditing



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Standards – 2002" (AU sec. 508, "Reports on Audited Financial Statements"), is amended as follows:

- a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 162-199 of PCAOB Auditing Standard No. 2 for direction on reporting on internal control over financial reporting. In addition, see Appendix A, "Illustrative Reports on Internal Control Over Financial Reporting," of PCAOB Auditing Standard No. 2 which includes an illustrative combined audit report and examples of separate reports.

- b. The following subparagraph is added to paragraph 8:

k. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on *[identify control 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 opinions]*.

AU sec. 530, "Dating of the Independent Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 530, "Dating of the Independent Auditor's Report," as amended by SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU



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sec. 530, "Dating of the Independent Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same date. Refer to paragraphs 171-172 of PCAOB Auditing Standard No. 2, which provide direction with respect to the report date in an audit of internal control over financial reporting.

AU sec. 532, "Restricting the Use of an Auditor's Report"

SAS No. 87, "Restricting the Use of an Auditor's Report," (AU sec. 532, "Restricting the Use of an Auditor's Report"), is amended by replacing "Section 325, Communication of Internal Control Related Matters Noted in an Audit" in the first bullet of paragraph .07 with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 543, "Part of Audit Performed by Other Independent Auditors"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 543, "Part of Audit Performed by Other Independent Auditors," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 182-185 of PCAOB Auditing Standard No. 2, which provide direction with respect to opinions based, in part, on the report of another auditor in an audit of internal control over financial reporting.

AU sec. 9550, "Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550"

AU sec. 9550, "Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550," is amended by replacing the term "reportable conditions" with the term "significant deficiencies" in footnote 8 to paragraph



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15 and also replaces in that footnote the reference to Section 325.17 with the reference Section 325.8.

AU sec. 560, "Subsequent Events"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 560, "Subsequent Events," as amended by SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 560, "Subsequent Events"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 186-189 of PCAOB Auditing Standard No. 2, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"

SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," as amended by SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 197 of PCAOB Auditing Standard No. 2, which provides direction with respect to the subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.

AU sec. 634, "Letters for Underwriters and Certain Other Requesting Parties"

SAS No. 72, "Letters for Underwriters and Certain Other Requesting Parties," as amended by SAS No. 76, "Amendments to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties," and SAS No. 86, "Amendment to Statement on Auditing Standards No. 72, Letters for Underwriters and Certain Other Requesting Parties" (AU sec. 634, "Letters for Underwriters and Certain Other Requesting Parties") is amended by replacing the reference to "Section 325,



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Communication of Internal Control Related Matters Noted in an Audit" with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

AU sec. 711, "Filings Under Federal Securities Statutes"

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended by adding the following note after paragraph 2:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, which provide direction when an auditor's report on internal control over financial reporting is included or incorporated by reference in filings under federal securities statutes.

AU sec. 722, "Interim Financial Information"

SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended as follows:

- a. The following note is added after paragraph 3:

Note: When an auditor is engaged to perform an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 202-206 of PCAOB Auditing Standard No. 2, which provide direction regarding the auditor's evaluation responsibilities as they relate to management's quarterly certifications on internal control over financial reporting.

- b. In paragraph 9, the term "reportable conditions" is replaced by the term "significant deficiencies."
- c. In paragraph 33, the term "reportable conditions" is replaced by the term "significant deficiencies." Also, the third sentence is replaced by the following:

A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data



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reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

- d. The reference in footnote 22 to paragraph 33 to "Section 325, Communication of Internal Control Related Matters in an Audit" is replaced with "Section 325, Communications About Control Deficiencies in An Audit of Financial Statements."

Attestation Standards

AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"

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" (AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"), and its related interpretation (AT sec. 9501, "Reporting on an Entity's Internal Control Over Financial Reporting: Attest Engagements Interpretations of Section 501"), are superseded by the conforming amendments and, accordingly, are no longer interim standards of the Board.

Independence Standards

ET sec. 101.05

Rule 101, "Independence" (ET sec. 101.05) is amended by adding the following note after the second paragraph of interpretation 101-3, "Performance of Other Services:"

Note: Paragraph 33 of PCAOB Auditing Standard No. 2 contains an additional requirement related to audit committee pre-approval of internal control-related services.