PCAOB
Public Company Accounting Oversight Board

1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

PROPOSED AUDITING STANDARD – AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS AND RELATED OTHER PROPOSALS	PCAOB Release No. 2006-007 December 19, 2006 PCAOB Rulemaking Docket Matter No. 021

Summary: The Public Company Accounting Oversight Board (the "Board" or "PCAOB") is proposing an auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that would supersede its Auditing Standard No. 2. The PCAOB is also proposing a related auditing standard, *Considering and Using the Work of Others in an Audit*, an independence rule relating to the auditor's provision of internal control-related non-audit services, and certain amendments to its interim standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the 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. 021 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on February 26, 2007.

Board Contacts: Laura Phillips, Deputy Chief Auditor (202/207-9111; phillipsl@pcaobus.org), Sharon Virag, Associate Chief Auditor (202/207-9164; virags@pcaobus.org).

RELEASE

I. Introduction

In June 2003, the Securities and Exchange Commission ("SEC") implemented Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") by adopting rules requiring issuers to include in their annual reports an assessment of the company's internal control over financial reporting as well as an auditor's report on that assessment.[1/] Soon after, as required by Sections 404(b) and 103 of the Act, the Board adopted Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2"), to apply to the newly required audits. The SEC approved AS No. 2 on June 17, 2004.

Two annual financial reporting cycles have been completed since public company auditors began applying AS No. 2 to audits of accelerated filers.[2/] During this time, the PCAOB has closely monitored implementation of the standard and the progress auditors have made in complying with its requirements. The PCAOB's monitoring has included gathering information during inspections of registered public accounting firms; participating, along with the SEC, in two roundtable discussions with representatives of issuers, auditors, investor groups, and others; meeting with its Standing Advisory Group; receiving feedback from participants in the Board's Forums on Auditing in the Small Business Environment; and reviewing academic, government, and other reports and studies.

From all of these sources of information, two basic propositions have emerged. First, the audit of internal control over financial reporting has produced significant benefits. Issuers and auditors have described a focus on corporate governance that had not existed in the past and improvements in the quality and efficiency of important corporate processes and controls.[3/] Corporate board members have noted an

---

[1/] See Item 308 of Regulation S-K, 17 C.F.R. § 229.308.

[2/] Companies considered accelerated filers by the SEC (generally, U.S. companies with public float of $75 million or more) have been required to comply with Section 404 of the Act since fiscal years ended on or after November 15, 2004.

[3/] See, e.g., comments of Phillip D. Ameen, General Electric Company, and Samuel A. DiPiazza, PricewaterhouseCoopers International, at *Roundtable Discussion on Second-Year Experiences with Internal Control Reporting and Auditing Provisions* (May 10, 2006) ("May 10 Roundtable), transcript available at

improvement in audit committee oversight, while investors have found public company financial reporting to be of higher quality and enhanced transparency.[4/] At the same time, research shows that effective internal control is positively correlated with accurate financial reporting.[5/]

Second, these benefits have come with significant cost. Over the last two years, the Board has heard a consistent message that compliance with the internal control provisions of the Act has required greater effort and resulted in higher costs than expected. The Board agrees that auditors should perform internal control audits as efficiently as possible for companies that are required by the SEC's rules to obtain an audit report on internal control.[6/] With this in mind, the Board has evaluated every significant aspect of the audit of internal control to determine whether the existing standard encourages auditors to perform procedures that are not necessary in order to achieve the intended benefits. As a result of that evaluation, the Board is proposing a new auditing standard on internal control over financial reporting that would supersede AS No. 2. The Board also is proposing a new auditing standard on using the work of

---

http://www.pcaobus.org/Standards/Standards_and_Related_Rules/AS2/2006/05-10/Unedited_Transcript.pdf.

[4/] See, e.g., comments of Barbara Hackman Franklin, board member, various companies and Michael J. McConnell, Managing Director, Shamrock Capital Advisors, May 10 Roundtable.

[5/] See Doyle, Jeffrey T., Ge, Weili and McVay, Sarah E., "Accruals Quality and Internal Control over Financial Reporting," American Accounting Association 2006 Financial Accounting and Reporting Section Meeting Paper (December 4, 2006), available at SSRN: http://ssrn.com/abstract=789985.

[6/] See PCAOB, *"Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle"* (May 1, 2006); *"Report on the Initial Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements"* (Nov. 30, 2005); *"Policy Statement Regarding Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements"* (May 16, 2005) (May 16, 2005 Policy Statement).

others, a new independence rule on non-audit services related to internal control, and certain related amendments to the Board's interim auditing standards.

As described below, the proposals are designed primarily to –

- **Focus the audit on the matters most important to internal control** by, among other things, directing the auditor's testing to the most important controls; emphasizing the importance of risk assessment; revising the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness; and clarifying the role of materiality, including interim materiality, in the audit;

- **Eliminate unnecessary procedures** by, among other things, removing the requirement to evaluate management's process; permitting consideration of knowledge obtained during previous audits; refocusing the multi-location testing requirements on risk rather than coverage; removing barriers to using the work of others; and recalibrating the walkthrough requirement;

- **Scale the audit for smaller companies** by, among other things, directing the auditor to tailor the audit to reflect the attributes of smaller, less complex companies; and

- **Simplify the requirements** by, among other things, reducing detail and specificity; better reflecting the sequential flow of an audit of internal control; and improving readability.

The Board requests comment on all aspects of the proposals. In addition to the specific questions below, the Board is particularly interested in whether the proposed changes will preserve the intended benefits of the audit of internal control. The Board is also particularly interested in whether the proposed changes will reduce audit hours and, if so, by how much.

II. Significant Changes to the Standard

The Board is proposing a new standard on auditing internal control rather than revisions to the existing standard. The following section describes the significant changes the Board proposes to make in order to effect its four primary objectives and specifically seeks comment on these significant changes.

RELEASE

A. Focusing the Audit on the Matters Most Important to Internal Control

Many commentators have expressed concern that the internal control audit is overly focused on the more detailed, process-level aspects of internal control.[7/] Additionally, some commentators have expressed concern that internal control audits are failing to identify the material weaknesses that are most important—those that are early indicators of problems, rather than those that already have resulted in a material misstatement.[8/] The Board's proposals are designed to bolster the audit's ability to detect the most important problems by requiring auditors to use a top-down approach, stressing the importance of risk assessment, and clarifying certain definitions and terms.

1. Directing the Auditor's Attention Towards the Most Important Controls

The proposed standard on auditing internal control incorporates the top-down approach to the audit emphasized in the Board's May 16, 2005 guidance on applying AS No. 2.[9/] When using a top-down approach, the auditor identifies the controls to test by starting at the top—the financial statements and company-level controls—and linking the financial statement elements and company-level controls to significant accounts, relevant assertions, and, finally, to the significant processes where other important controls reside. Following the top-down approach helps the auditor focus the testing on the right controls—those controls that are important to the auditor's conclusion—while avoiding those that are outside the scope of the audit of internal control.

[7/] See, e.g., letter from David C. Chavern, Vice President Capital Markets Programs, Chamber of Commerce of the United States of America to Office of the Secretary, PCAOB (May 3, 2006) ("Greater focus needs to be given to the review and testing of significant entity-level controls, as opposed to individual transaction-based controls.").

[8/] See, e.g., Gregory J. Jonas, Managing Director of Accounting Specialists Group, Moody's Investor Service, remarks at Roundtable (May 10, 2006) ("I really think we need to turn up the volume on controls that prevent and detect fraudulent financial reporting. I think our disclosures about material weaknesses have become, maybe inadvertently, backward looking rather than forward looking.").

[9/] See May 16, 2005 Policy Statement.

RELEASE

In a top-down approach, if company-level controls are strong and link directly to the process-level controls, or if they are sufficiently precise to prevent or detect material misstatements to relevant assertions, the auditor will likely be able to reduce the testing of controls at the process level.[10/] The proposed standard therefore emphasizes the importance of obtaining an understanding of the audit client's company-level controls at the beginning of the audit process. Because of the positive effect a top-down approach can have on the efficiency of the audit, the proposed standard would require auditors to take this approach to the audit, including testing important company-level controls.

The Board also wants to encourage an appropriate focus on controls important to the prevention and detection of fraud. Accordingly, the proposed standard specifically would require the auditor to evaluate the control environment and controls over the period-end financial statement close process and test, among other things, controls to address the risk of management override.

Questions

1. Does the proposed standard clearly describe how to use a top-down approach to auditing internal control?

2. Does the proposed standard place appropriate emphasis on the importance of identifying and testing controls designed to prevent or detect fraud?

3. Will the top-down approach better focus the auditor's attention on the most important controls?

4. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's work, including adequate description of when the testing of other controls can be reduced or eliminated?

[10/] The proposed standard omits the statement in paragraph 54 of AS No. 2 that "[t]esting company level controls alone is not sufficient for the purposes of expressing an opinion on the effectiveness of a company's internal control over financial reporting." This statement has been interpreted to prohibit reliance on company level controls related to individual relevant assertions. The proposed standard would allow the auditor to determine that company-level controls are sufficient to address the risk of misstatement to a particular relevant assertion.

RELEASE

2. Emphasizing the Importance of Risk Assessment

The Board's May 16, 2005 guidance emphasized the importance of risk assessment in the audit of internal control and that element of the guidance also has been incorporated and enhanced in the proposals. The auditor's assessment of risk should have a pervasive effect on an audit of internal control. From the auditor's initial evaluation of the risk of material weakness at the company overall, to the analysis of risk at the individual account, assertion, or control level, the auditor should continuously adjust his or her procedures to reflect information that the auditor has learned, including experiences from both the audit of internal control and the audit of the financial statements. Focusing the auditor's attention on the areas of greatest risk is likely to produce a more effective audit and substantially decrease the opportunity for a material weakness to go undetected. Appropriate use of risk assessment also enhances audit efficiency because the auditor does not spend time testing controls that, even if deficient, would not present a reasonable possibility of material misstatements in the financial statements.

The proposed standard on auditing internal control, therefore, requires risk assessment at each of the decision points in a top-down approach. The auditor's identification of significant accounts and relevant assertions requires an understanding of the related risks and how those risks should affect the auditor's decision making. Additionally, the proposed standard would require a risk-based approach to multi-location testing and includes an expanded discussion of the relationship of risk to the evidence necessary for the auditor to conclude that a given control is effective.

Importantly, the proposed standard makes clear that the evidence necessary to persuade the auditor that a control is effective depends on the risk associated with the control. The proposed standard describes risk factors that the auditor should assess in making this determination. Further, under the proposed standard, different combinations of the nature, timing, and extent of the auditor's testing can provide sufficient evidence in relation to the risk associated with a given control.

To appropriately emphasize the role of risk assessment in the auditor's work, the proposed standard also includes a change to the direction on integrating the audits. AS No. 2 states that "the absence of misstatements detected by substantive procedures [performed in the financial statement audit] does not provide evidence that controls

related to the assertion being tested are effective."[11/] In contrast, the proposed standard directs the auditor to consider the results of substantive audit procedures performed in the financial statement audit when determining the overall risk related to a control. This additional risk factor should be used by the auditor, along with others described in the proposed standard, in determining the evidence necessary for that control. At the same time, however, the proposed standard states that to obtain evidence about whether a control is effective, the control must be directly tested. In other words, effectiveness cannot be inferred solely from the absence of financial statement misstatements detected by the auditor.

Questions

5. Does the proposed standard appropriately incorporate risk assessment, including in the description of the relationship between the level of risk and the necessary evidence?

6. Would the performance of a walkthrough be sufficient to test the design and operating effectiveness of some lower risk controls?

3. Revising the Definitions of Significant Deficiency and Material Weakness

The evaluation of deficiencies is, inherently, one of the most difficult aspects of an audit of internal control. Given the individual characteristics of each company and each deficiency, any method for evaluating deficiencies will demand a high degree of professional judgment. Commentators have suggested that the definitions of both significant deficiency and material weakness in AS No. 2 are confusing and are contributing to the difficulty of assessing the severity of the deficiencies.[12/]

[11/] See AS No. 2, paragraph 158.

[12/] See, e.g., Written Statement of Robert C. Pozen, Chairman, MFS Investment Management, May 10 Roundtable ("the use of phrases like "remote likelihood" or "more than remote" could easily lead to auditor concerns about internal control based on hypothetical situations that have not occurred and are not very likely to occur"); and Written Statement of Joseph A. Grundfest, Professor, Stanford Law School, May 10 Roundtable ("The inescapable implication of these definitions is that, in order to determine whether a company's controls suffer from significant deficiencies, auditors must search for controls at the margin between those that (a) raise a more than

RELEASE

The Board believes that the existing framework in AS No. 2, which describes significant deficiencies and material weaknesses by reference to the likelihood and magnitude of a potential misstatement, is fundamentally sound. At the same time, however, the Board agrees that specific improvements to these definitions would simplify and clarify the standard. As a result, the proposed standard on auditing internal control includes three changes to these definitions –

a. Replacement of the term "more than remote likelihood" with the term "reasonable possibility"

In defining the terms "significant deficiency" and "material weakness" in AS No. 2, the Board used terms defined in Financial Accounting Standards Board's Statement No. 5, *Accounting for Contingencies* ("FASB Statement No. 5") to describe the threshold for likelihood of occurrence. The Board chose to use these terms because it believed that auditors and financial statement preparers were already familiar with how to apply them, and the Board expected that their use would promote consistency in the evaluation of deficiencies. FASB Statement No. 5 describes the likelihood of a future event occurring as "probable" "reasonably possible" or "remote" The definitions in AS No. 2 refer to a "more than remote" likelihood of a misstatement occurring. In accordance with FASB Statement No. 5, the likelihood of an event is "more than remote" when it is either "reasonably possible" or "probable."

The Board's monitoring of the implementation of AS No. 2 has shown, however, that some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, may have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. To encourage correct application of the definitions, the proposed standard replaces the reference to "more than remote likelihood" with "reasonable possibility" within the definitions of both material weakness and significant deficiency. To the extent that the term "more than remote" has resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, this change should significantly improve the evaluation of deficiencies such that material weaknesses, when they are identified, are indeed the deficiencies that are most important.

---

remote likelihood of an immaterial but more than inconsequential misstatement of the company's financial statements, and (b) those that raise a less than remote likelihood of an inconsequential misstatement.").

RELEASE

b. Re-articulation of the definition of material weakness to exclude significant deficiency

AS No. 2 defines a material weakness as "a significant deficiency, or combination of significant deficiencies, that result in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected."[13/] Reference within this definition to significant deficiency has raised concern that auditors may be performing their audits at a level of detail necessary to ensure that their procedures identify all significant deficiencies, rather than only all material weaknesses. The objective of an audit of internal control is to obtain reasonable assurance as to whether material weaknesses exist. The audit of internal control does not require auditors to search for deficiencies that, individually or in combination, are less severe than material weaknesses. To better explain the objective of the audit and minimize confusion, the Board's proposed standard uses the term "a control deficiency, or combination of control deficiencies," in place of the reference to significant deficiencies in the definition of material weakness.

c. Replacement of the term "more than inconsequential" with the term "significant"

AS No. 2 defines a significant deficiency as a control deficiency, or combination of control deficiencies, that has a more than remote likelihood of resulting in a misstatement that is more than inconsequential. Several commentators expressed concern that the term "more than inconsequential" has caused companies and auditors to spend excess time identifying, discussing and fixing deficiencies that are not sufficiently important to the company's overall system of internal control. The Board is, therefore, proposing to re-articulate the definition of significant deficiency to better establish the threshold of what the Board believes is important enough to be identified as a significant deficiency. The proposed standard, therefore, replaces the term "more than inconsequential" with the term "significant" and defines "significant" as "less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

[13/] See AS No. 2, paragraph 10.

Questions

7. Is the proposed definition of "significant" sufficiently descriptive to be applied in practice? Does it appropriately describe the kinds of potential misstatements that should lead the auditor to conclude that a control deficiency is a significant deficiency?

8. Are auditors appropriately identifying material weaknesses in the absence of an actual material misstatement, whether identified by management or the auditor? How could the proposed standard on auditing internal control further encourage auditors to appropriately identify material weaknesses when an actual material misstatement has not occurred?

9. Will the proposed changes to the definitions reduce the amount of effort devoted to identifying and analyzing deficiencies that do not present a reasonable possibility of material misstatement to the financial statements?

4. Revising the Strong Indicators of a Material Weakness

In addition to clarifying the definitions, the proposed standard on auditing internal control is intended to better describe their application in particular contexts. AS No. 2 describes circumstances that should be regarded as at least significant deficiencies and as strong indicators of a material weakness in internal control.[14/] Examples of such circumstances include the restatement of previously issued financial statements and an ineffective control environment. The identification of one of these strong indicators should bias the auditor toward a conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Instead, the auditor may determine that these circumstances do not rise to the level of a material weakness and that only a significant deficiency exists. In practice, however, auditors sometimes have determined that, in fact, no deficiency existed at all.

To ensure that the requirement does not force the auditor to conclude that a deficiency exists when one does not, and to reaffirm the degree of judgment required to make these evaluations, the Board is proposing to modify this provision by removing the requirement to consider the described circumstances as at least significant deficiencies.

[14/] See AS No. 2, paragraph 140.

RELEASE

Under the proposed standard on auditing internal control, these circumstances would continue to be strong indicators of material weaknesses but would, at the same time, accommodate an auditor's appropriate conclusion that no deficiency exists.

The proposed standard also would clarify how the auditor should evaluate whether uncorrected significant deficiencies reflect a material weakness in the company's internal controls. Under AS No. 2, significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after a reasonable period of time are a strong indicator of a material weakness. The proposed standard revises this provision to emphasize its relationship to the auditor's evaluation of the company's control environment. Specifically, significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after a reasonable period of time could indicate that the company's control environment may be ineffective. The auditor would need to evaluate whether the company's control environment is, in fact, ineffective. If so, the ineffective control environment—not the uncorrected significant deficiencies—would be a strong indicator of a material weakness.

This proposed modification would clarify that uncorrected significant deficiencies are an indicator of a material weakness because, in some circumstances, they suggest that the company is not sufficiently committed to or capable of correcting problems in its internal control. Sometimes, however, the auditor may find that the company evaluated the significant deficiencies and reasonably determined under the circumstances not to correct them. When that is the case, the proposed standard would allow the auditor to conclude that the control environment is effective and that no material weakness exists. This proposed modification would highlight the importance of the auditor's evaluation of the control environment by focusing the auditor on the reasons why the company left significant deficiencies uncorrected.

Question

10. Should the standard allow an auditor to conclude that no deficiency exists when one of the strong indicators is present? Will this change improve practice by allowing the use of greater judgment? Will this change lead to inconsistency in the evaluation of deficiencies?

RELEASE

5. Clarifying the Role of Materiality in the Audit

As in the financial statement audit, the concept of materiality is key to the audit of internal control. Although AS No. 2 relies on the existing concept of materiality contained in the federal securities laws,[15/] commentators have expressed concern about several aspects of AS No. 2 relating to materiality, including the concern that auditors have interpreted the standard as directing them to search for all potential defects in internal control, regardless of the effect on financial reporting.[16/] While such an interpretation is contrary to the Board's intentions regarding the scope of the audit of internal control as well as the provisions of AS No. 2 itself, the proposed standard on auditing internal control addresses these concerns by further clarifying that the auditor should plan and perform the audit of internal control using the same materiality measures used to plan and perform the audit of the annual financial statements.

For example, the proposed standard makes clear that the auditor should use the same consideration of account-level materiality in determining the nature, timing, and extent of his or her procedures in the audit of internal control as used in the financial statement audit. Similarly, inherent risk also is the same for both audits and, therefore, the proposed standard clarifies that significant accounts identified in the audit of internal control should be the same as the significant accounts identified in the financial statement audit.

6. Clarifying the Role of Interim Materiality in the Audit

The definitions of material weakness and significant deficiency in AS No. 2 and the proposed standard on auditing internal control refer to both the interim and annual financial statements when describing the likelihood and magnitude of potential misstatements. Some commentators have expressed concern that this reference to interim materiality has caused some auditors to scope their audit procedures at too fine

---

[15/] See AS No. 2, paragraphs 22 and 23.

[16/] See, e.g., Letter from Ross Guyer, AAP, Chairman, Government Relations Committee, Association for Financial Professionals, to Nancy M. Morris, Secretary, SEC (May 1, 2006) ("we have yet to see significant improvement 'in the field' in the determination of what is material and what is not material when auditors perform their audit and SOX testing and reporting.").

a level. The reference to interim financial statements only relates to the evaluation of deficiencies, not to the scope of the auditor's testing. The auditor should plan the audit of internal control using the same materiality considerations he or she would use to plan the audit of the company's annual financial statements. To emphasize this point, the Board added additional description of the role of scoping and evaluation to the proposed standard.

Questions

11. Are further clarifications to the scope of the audit of internal control needed to avoid unnecessary testing?

12. Should the reference to interim financial statements be removed from the definitions of significant deficiency and material weakness? If so, what would be the effect on the scope of the audit?

B. Eliminating Unnecessary Procedures

The proposals eliminate procedures that the Board believes, based on its monitoring, are unnecessary to an effective audit of internal control. Specifically, the proposals would eliminate the requirement to evaluate the process management used to evaluate its internal control, allow the auditor to reduce procedures or the evidence he or she needs to obtain in certain areas of lower risk, refocus the multi-location testing requirements, remove barriers to using the work of others, and recalibrate the walkthrough requirement.

1. Removing the Requirement to Evaluate Management's Process

SEC rules implementing Section 404 of the Act require the management of each issuer to evaluate, as of the end of each fiscal year, the effectiveness of the issuer's internal controls. These rules require management to base this evaluation on a suitable, recognized control framework.[17/] To complete an audit of internal control under AS No. 2, the auditor is required to evaluate management's annual evaluation process.[18/] If the

---

[17/] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c).

[18/] See AS No. 2, paragraphs 40-46.

auditor determines that management's evaluation process did not provide a sufficient basis for management's conclusion, the auditor is required to disclaim an opinion on the company's internal controls.[19/]

Many commentators have expressed concern over these requirements. Some believe that, under AS No. 2, the auditor performs work unnecessary to achieve the intended benefits by both directly testing controls and evaluating management's evaluation process. Some have expressed concern that auditors were performing detailed testing, such as re-testing items tested by management, solely to conclude on management's evaluation process. Others believe that, as a result of these provisions of AS No. 2, auditors are inappropriately dictating how management should perform its evaluation, which in some cases may result in unnecessary cost and effort by management.[20/] In response to these concerns, some commentators have suggested that the auditor only should evaluate the quality of management's process, without any independent testing of controls, while others have recommended that the auditor's involvement in management's process be removed or substantially reduced.[21/]

In considering this issue, the Board has reevaluated what is necessary to complete an effective audit of internal control. The Board continues to believe that the overall scope of the audit described by AS No. 2 is correct, i.e., to attest to and report

---

[19/] See AS No. 2, paragraphs 21, 175 and 178.

[20/] In addition, these provisions may have led some to misunderstand the first of the two auditor's opinions required by AS No. 2—the opinion on management's assessment. Although AS No. 2 requires the auditor to evaluate management's process, the auditor's opinion on management's assessment is not an opinion on management's internal controls evaluation process. Rather, it is the auditor's opinion on whether management's statements about the effectiveness of the company's internal controls are fairly stated. See Thomas Ray, PCAOB Chief Auditor, Remarks at the 25th Annual SEC and Financial Reporting Institute, Pasadena, Cal. (June 8, 2006).

[21/] See, e.g., Letter from Thomas A. Fanning, Executive Vice President and Chief Financial Officer, Southern Company, to Bill Gradison, Acting Chairman, PCAOB, (April 27, 2006) ("Eliminate the requirement for the independent auditor to opine on both management's assessment and operating effectiveness of controls. Instead require the independent auditor to opine only on the effectiveness of the registrant's controls.").

on management's assessment, the auditor must test controls directly to determine whether they are effective.[22/] For that reason, the Board also believes that the auditor can perform an effective audit of internal control without conducting an evaluation of the adequacy of management's evaluation process.

As a result, the proposed standard on auditing internal control eliminates the requirements in paragraphs 40 through 46 of AS No. 2 to evaluate management's annual evaluation process. Under the proposed standard, an auditor still would need to obtain an understanding of management's process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which he or she will use the work of others. The extent of work necessary for these purposes, however, should be limited.

Although the removal of the evaluation requirement should eliminate unnecessary work, the quality of management's process is inherently linked to the amount of work the auditor will need to do. For example, the extent of the auditor's ability to use the work of others will depend on the quality of the company's annual evaluation process and its on-going monitoring activities, as well as on the competence and objectivity of those performing the work. For this reason, it will continue to be necessary for the auditor and management to coordinate their respective efforts.

Additionally, some commentators have suggested that the separate opinion on management's assessment has contributed to the complexity of the standard and confusion regarding the scope of the auditor's work.[23/] To emphasize the proper scope

---

[22/] In addition, Section 103 of the Act requires the Board's standard on auditing internal control to include "testing of the internal control structure and procedures of the issuer." Under Section 103, the Board's standard also must require the auditor to present in the audit report, among other things, "an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles."

[23/] See, e.g., Letter from Michael E. Keane, Vice President and Chief Financial Officer, Computer Sciences Corporation, to Nancy M. Morris, Secretary, SEC (April 28, 2006) ("We recommend the auditor be required to form only two opinions, one on the financial statements and the other on the effectiveness of internal control over financial reporting. The auditors' opinion on management's assertion is redundant and

of the audit and simplify the reporting, the proposed standard would require that the auditor express only one opinion on internal control—a statement of the auditor's opinion on the effectiveness of the company's internal control over financial reporting.[24/] The proposal eliminates the separate opinion on management's assessment because it is redundant of the opinion on internal control itself and because the latter opinion more clearly conveys the same information—specifically, whether the company's internal control is effective.

The proposed standard would further simplify the reporting by providing that the auditor's report expressing an adverse opinion on internal control would refer to the description of the material weakness in management's report rather than including a separate, detailed description of the same material weakness. If management's description does not fairly present the material weakness, the auditor's report would include an explanatory paragraph with the information necessary to fairly describe it.

Questions

13. Will removing the requirement for an evaluation of management's process eliminate unnecessary audit work?

---

does not provide further assurance for the investor. The opinion on the effectiveness of internal control over financial reporting provides the most conclusive assurance and is similar to the manner in which the auditor expresses his attestation on fair presentation of the registrant's financial statements.").

[24/] SEC rules implementing Section 404 require the auditor to express an opinion on "whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects." Rule 2-02 of Regulation S-X, 17 C.F.R.§ 210.2-02; see also Rule 1-02 of Regulation S-X, 17 C.F.R. § 210.1-02 (defining the required auditor's report as one in which the auditor "expresses an opinion concerning management's assessment of the effectiveness of the registrant's internal control over financial reporting."). On December 13, 2006, the SEC voted to propose revisions to these rules which, among other things, would require the auditor to express an opinion on internal control itself. These revisions, if they are adopted, would allow the Board to make the changes it is proposing to the form of the auditor's report. The Board and the SEC have planned their respective comment periods to overlap and will ensure that their final rules are consistent.

RELEASE

14. Can the auditor perform an effective audit of internal control without performing an evaluation of the quality of management's process?

15. Will an opinion only on the effectiveness of internal control, and not on management's assessment, more clearly communicate the scope and results of the auditor's work?

2. Permitting Consideration of Knowledge Obtained During Previous Audits

Many commentators have suggested that, after the first-year's audit of internal control, the auditor should be allowed to reduce the nature, timing, and extent of testing based on his or her cumulative knowledge related to individual controls. The degree to which commentators believed that testing should be decreased has varied, with some suggesting that certain lower risk controls be tested less in subsequent years and others suggesting that the auditor should be allowed to rotate[25/] his or her tests of controls.[26/]

[25/] Rotation is commonly understood as an approach to testing that allows the auditor to rely on the procedures that were performed in prior years for large sections of internal control, refreshing the testing every few years to ensure that nothing has changed and that controls continue to be effective. Under a rotation approach, the auditor might test one-half to one-third of all controls each year, selecting those areas that have not been tested in the past several years.

[26/] See, e.g., Letter from James W. DeLoach, Jr., Managing Director, Protiviti Inc. to Nancy M. Morris, Secretary, SEC (April 28, 2006) ("Reconsider the 'each year stands on its own' premise of Auditing Standard No. 2"), Letter from Bruce Renihan, Executive Vice-President & Controller, CIBC to Nancy M. Morris, Secretary, SEC (April 26, 2006) ("CIBC believes that some relief in assessing operating effectiveness should be provided by introducing rotational testing in the areas of low and medium risk, as identified through risk assessment"); Letter from Arnold C. Hanish, Executive Director, Finance, and Chief Accounting Officer, Eli Lilly and Company, to Nancy M. Morris, Secretary, SEC (September 14, 2006) ("Processes that have not changed could be eligible for periodic rotational testing. Rotational testing could also be permitted for material, but low risk areas even where changes have occurred assuming appropriate change control procedures have been followed.").

RELEASE

The Board recognizes that the knowledge gained from the prior years' audits has significant value in subsequent years. Although the Board is not proposing to permit rotation, as that term is commonly understood, the proposed standard on auditing internal control would provide the auditor with the flexibility to decide to reduce testing in some areas based on that knowledge and its affect on the auditor's assessment of risk. As one step to facilitating this change, the proposed standard deliberately omits the statement that "each year's audit must stand on its own," which is included in AS No. 2.[27/] The proposed standard also includes direction to the auditor describing how to appropriately consider prior years' knowledge to reduce the evidence necessary for a given control in subsequent audits.

The approach outlined in the proposed standard directs the auditor to assess, in addition to the risk factors considered in the initial year, three factors when determining the risk related to a given control in subsequent years' audits: the nature, timing, and extent of procedures performed in prior years' audits; the results of that testing; and any changes in the control or its related process since the last audit. Based on the auditor's overall risk assessment (including the considerations for subsequent years), the auditor should then determine the evidence to be obtained based on the risk associated with the control.

For example, after considering the risk factors described in the proposed standard and determining that a control presents low risk overall (because, for example, there is low inherent risk and a low degree of complexity, there were no changes to the controls or processes since the previous audit, and the previous years' testing revealed no deficiencies), the auditor may determine that sufficient evidence of operating effectiveness could be obtained by performing a walkthrough. For controls that present higher risk, a walkthrough likely would not provide sufficient evidence; however, under the proposed standard the auditor could adjust the nature, timing, and extent of testing in subsequent years commensurate with the risk indicated. Under the approach described by the proposed standard, some controls would be so important to the overall effectiveness of internal control over financial reporting or otherwise present such a high degree of risk that, even in subsequent years, the necessary evidence would not be reduced.

[27/] See AS No. 2, paragraph E120.

RELEASE

Question

16. Does the proposed standard appropriately incorporate the value of cumulative knowledge?

17. What are the circumstances in which it would be appropriate for the auditor to rely upon the walkthrough procedures as sufficient evidence of operating effectiveness?

3. Refocusing the Multi-location Testing Requirements on Risk Rather than Coverage

Companies with multiple locations or business units ("multi-locations") present the auditor with additional decision points when planning and performing the audit. AS No. 2 describes an approach to multi-location scoping that identifies three categories of locations: locations that are individually significant or involve specific risk; locations that are significant only when aggregated with others; and locations that are insignificant individually and in the aggregate. AS No. 2 describes how the auditor should determine the appropriate level of testing for each of these categories. Additionally, AS No. 2 directs the auditor to evaluate whether his or her testing strategy results in the auditor performing tests of controls over a "large portion" of the company. If the auditor's testing strategy for the three categories does not result in coverage of a large portion, the auditor should select additional locations to test until attaining such coverage.

Many commentators have suggested that the approach outlined in AS No. 2 results in excessive and unnecessary work. Generally, these commentators are concerned that this approach may lead the auditor to be overly focused on meeting a certain coverage ratio without adequate consideration of risk at the various locations.[28/]

Based on its monitoring over the past two years, the Board agrees that the approach described in AS No. 2 may not allow the flexibility necessary to efficiently address the specific risks of a particular company. In the proposed standard on auditing internal control, therefore, the Board has omitted the provision requiring testing of

---

[28/] See, e.g., Letter from Loretta V. Cangialosi, Vice President and Controller, Pfizer Inc., to Nancy M. Morris, Secretary, SEC (May 1, 2006) ("Our auditors' interpretation of the requirement to obtain sufficient evidence in a multi-location environment includes obtaining at least 50% coverage of each significant account.").

controls over a large portion of the company and, instead, directs the auditor to use a risk based approach to determining the proper strategy for auditing multiple locations. The flexibility provided by this approach should allow auditors to exercise the necessary judgment in the particular circumstances and result in more efficient multi-location audits.

Question

18. Will the proposed standard's approach for determining the scope of testing in a multi-location engagement result in more efficient multi-location audits?

4. Removing Barriers to Using the Work of Others

The auditor's ability to use the work of others has a direct effect on the procedures that the auditor must perform himself or herself. When the auditor duplicates high-quality, relevant work that already has been performed by competent and objective individuals, he or she risks increasing effort without enhancing quality. AS No. 2 incorporates a flexible approach to using the work of others, and the Board has seen improvement in auditors' willingness, where appropriate, to leverage that work. Nevertheless, commentators have suggested that the Board examine this area of the standard to determine whether there are barriers that prevent auditors from making the best use of this resource, and the Board has done so.[29/]

As a result of that evaluation, the Board believes that certain provisions in AS No. 2 that may have impeded the auditor's ability to use the work of others in the audit of internal control—most notably, the "principal evidence" provision—can be eliminated. In order to effect these changes, and others, the Board is proposing a new auditing standard, *Considering and Using the Work of Others in an Audit.* This standard would provide direction to the auditor for using the work of others in both the audit of internal control over financial reporting and the audit of the financial statements. Accordingly, it

---

[29/] See, e.g., Letter from David K. Owens, Executive Vice President, Edison Electric Institute, to Nancy M. Morris, Secretary, SEC (September 15, 2006) ("provide explicit guidance that allows and encourages external auditors to rely on the work performed by others, including company management and staff and not just internal auditors, provided the auditors are comfortable that the work has been done competently and objectively.").

would supersede the Board's interim standard AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"), and replace the direction on using the work of others in an audit of internal control that is currently included in AS No. 2. This change would, therefore, affect both integrated audits of internal control and the financial statements and audits of only the financial statements.

A single, unified framework for the auditor's use of the work of others would remove possible barriers to integration of the audit of internal control and the audit of the financial statements. At present, the auditor may use the work of internal auditors, other company personnel, and third parties working under the direction of management or the audit committee for purposes of testing controls in the audit of internal control. The auditor may only use the work of internal auditors, however, for purposes of testing controls in the audit of the financial statements. This has resulted in some of the work performed by others being used by the auditor to test the effectiveness of controls in the audit of internal control, but not as support for the auditor's assessment of control risk in the financial statement audit.[30/] The proposed standard would establish a single framework, based on the nature of the subject matter being tested and the competence and objectivity of the personnel performing the testing, for the auditor's decisions about using the work of others (including, but not limited to, internal auditors) as audit evidence—whether testing controls for purposes of the audit of internal control or testing controls and account balances and disclosures for purposes of the audit of the financial statements.

The Board considers a single, unified framework to be appropriate because the factors used to determine when it is appropriate to use the work of others should be the same for both the audit of the financial statements and the integrated audit. These factors include the nature of the subject matter being tested, and the competence and objectivity of the persons performing the testing. If the auditor appropriately evaluates these factors, he or she should make decisions that are sound in any audit engagement.

[30/] As another example, AS No. 2 is silent regarding the auditor's ability to use others as direct assistance, whereas AU sec. 322 allows the auditor only to use internal audit personnel as direct assistance. The proposed standard allows the auditor to use any sufficiently competent and objective others as direct assistance in both audits. Providing this type of consistent, additional flexibility should facilitate auditors' full integration of their audits of internal control and the financial statements.

RELEASE

The proposed standard on using the work of others first directs the auditor to obtain an understanding of work performed by others to identify the activities relevant to the audit. Relevant activities are defined as those that provide evidence about design and operating effectiveness of internal control over financial reporting or that provide evidence about potential misstatements of the company's financial statements. This definition is similar to the description of relevant activities in AU sec. 322.

The proposed standard would require the auditor to obtain an understanding of relevant activities undertaken by others to determine how that work might alter the nature, timing, and extent of the work the auditor otherwise would have performed. This should encourage auditors to leverage the available work of others to the greatest extent possible in their audits. Equally important, the definition of relevant activities is meant to guard against the auditor expending effort to obtain an understanding of work performed by others that is not relevant to the audit.

The proposed standard also would direct the auditor to determine whether the results of relevant activities undertaken by others identified control deficiencies, fraud, or financial statement misstatements. This requirement would apply regardless of the auditor's decision about whether and how to use the work of others. When others working on behalf of the company have surfaced problems with the company's internal controls or financial statements, the auditor should confront those known problems as part of the audit.

The proposed standard would omit two provisions currently contained in AS No. 2. First, as discussed above, the proposed standard would eliminate the "principal evidence" provision. AS No. 2 requires the auditor's own work to provide the principal evidence for the auditor's opinion. Many commentators have expressed concern that the principal evidence provision in AS No. 2 inappropriately limits the auditors' use of the work of others, particularly in lower-risk areas.[31/] The Board believes that the

---

[31/] See Letter from Lawrence J. Salva, Chair, Committee on Corporate Reporting, Financial Executives International, to Nancy M. Morris, Secretary, SEC (May 1, 2006) ("This has caused the auditor to place limited reliance on management and/or internal audit testing, resulting in significant duplicative testing by the auditor—even in low risk areas"); Letter from James G. Campbell, Vice President and Corporate Controller, Intel Corporation, to Nancy Morris, SEC (September 8, 2006,) ("AS2 requires the auditor to rely on their own work as 'principal evidence' for their attestation conclusion. However the requirement creates a conservative posture that does not

proposed standard would guard against inappropriate use of the work of others while encouraging auditors to exercise professional judgment, assess risk, and tailor their work to the facts and circumstances of a particular audit. Accordingly, the Board's proposed standard on using the work of others does not include the principal evidence provision.[32/] Instead, under the proposed standard, auditors would determine how much of the work of others could be used by evaluating the nature of the subject matter tested by others, and the competence and objectivity of those who performed the work. In addition, the proposed standard would remind the auditor that the responsibility to report on the financial statements or management's assessment of internal controls rests solely with the auditor and that the auditor must obtain sufficient competent evidence to support his or her opinion.

Because the proposed standard places significant emphasis on the auditor's evaluation of the degree of objectivity and competence of the persons performing testing, it includes several factors for the auditor to consider in making this evaluation. Factors related to competence include such things as the education and experience level of the individual performing the testing, as well as the quality of his or her work. Factors related to objectivity include the company's policies to address the objectivity of the individuals performing the testing, the organizational status of the persons responsible for the work of others, and the company's policies designed to assure that compensation arrangements for individuals performing the work do not adversely affect objectivity. None of these factors individually determines the competence and objectivity of the personnel. Instead, each of them contributes to the auditor's overall evaluation of the competence and objectivity of the persons performing testing.

Second, the proposed standard would omit the specific restriction in AS No. 2 on using the work of others for testing controls in the control environment. Application of the general principles in the proposed standard would allow the auditor to use the work of others for testing certain aspects of the control environment when the competence and objectivity of the persons performing the work are sufficiently high. In such circumstances, for example, the auditor could use the work of others for determining that a written code of conduct exists and that employees have received and confirmed

---

maximize reliance on the work of others, resulting in duplicative testing efforts and unnecessary operational burden.").

[32/] AU sec. 322 does not include a principal evidence provision.

their understanding of it. On the other hand, evaluating whether the company's code of conduct is actually being followed requires more judgment. Applying the principles in the proposed standard on using the work of others, the auditor should appropriately determine that he or she would need to perform more of the testing himself or herself, regardless of the objectivity or competence of others, due to the high-risk nature of the control being tested.

Questions

19. Is the proposed standard's single framework for using the work of others appropriate for both an integrated audit and an audit of only financial statements? If different frameworks are necessary, how should the Board minimize the barriers to integration that might result?

20. Does the proposed definition of relevant activities adequately capture the correct scope of activities, including activities that are part of the monitoring component of internal control frameworks?

21. Will requiring the auditor to understand whether relevant activities performed by others identified control deficiencies, fraud, or financial statement misstatements improve audit quality?

22. Is the principal evidence provision that was in AS No. 2 necessary to adequately address the auditor's responsibilities to obtain sufficient evidence?

23. Does the proposed standard provide an appropriate framework for evaluating the competence and objectivity of the persons performing the testing? Will this framework be sufficient to protect against inappropriate use of the work of others? Will it be too restrictive?

24. Has the Board identified the right factors for assessing competence and objectivity? Are there other factors the auditor should consider?

25. What will be the practical effect of including, as a factor of objectivity, a company's policies addressing compensation arrangements for individuals performing the testing?

RELEASE

5. Recalibrating the Walkthrough Requirements

In an audit of internal control, performing a walkthrough is an effective way for the auditor to gain an understanding of the company and its controls, determine what has changed within the company and its internal control from year to year, and evaluate the design of internal control in a disciplined manner. In performing a walkthrough, the auditor follows a transaction from its origination through the company's information systems until it is reflected in the company's financial reports. Walkthroughs require the auditor to "get out of the audit room" and interact with those responsible for internal control from day to day. They also provide the auditor with the opportunity to learn about the everyday activities of the company, which may not be reflected in any document that the auditor reviews.

Under AS No. 2, the auditor must complete walkthroughs of all major classes of transactions. Many commentators have expressed concern over the amount of time and effort required to do so, and have suggested that these walkthroughs should be voluntary or that the number or frequency of required walkthroughs should be reduced.[33/]

Based on the experience of the past two years, the Board believes that walkthroughs are essential to every audit of internal control but that the number of required walkthroughs can be reduced without negatively affecting audit quality. The proposed standard on auditing internal control would, therefore, require a walkthrough only for each significant process rather than for each major class of transactions within each significant process. In the case of an issuer that generates revenue through retail sales, for example, it would be necessary to perform a walkthrough of at least one retail sales transaction. If the issuer generates revenue from both store and internet sales, it

---

[33/] See, e.g., Letter from David Fannin, General Counsel, Office Depot, Inc, Chairman, Coordinating Committee, Corporate Governance Task Force Business Roundtable, to Nancy M. Morris, Secretary, SEC (May 5, 2006) ("Propose that the independent auditor may use its professional judgment to conduct walkthroughs for only a random sampling, rather than all, of the major classes of transactions in any given audit year"); and, Letter from Stacey K. Greer, PCAOB Subcommittee Chairperson, Society of Corporate Secretaries & Governance Professionals, to PCAOB members (February 15, 2006) ("We would like to see modifications to AS-2 that limit the frequency of testing and walkthroughs in some circumstances.").

would not, however, be necessary to walk through both types of retail sales as long as both types of transactions were handled by the same significant process and did not have significantly different risks.

As the auditor walks a transaction through the process, he or she should consider whether different risks are present for varying transaction types and determine how the company's internal control addresses those risks. The proposed standard's emphasis on the role of probing inquiries is meant to clarify that the auditor is not required to follow a separate transaction through each minor variance in the process. These proposed changes should make the walkthroughs more efficient.

The proposed standard also would allow the auditor to utilize the direct assistance of others when performing the required walkthroughs.[34/] AS No. 2 requires the walkthroughs to be performed by the auditor himself or herself. In light of the importance of the walkthrough to the audit, the Board continues to believe that the objectives of the walkthrough only can be achieved when the auditor is significantly and personally involved. The difference, however, between an audit staff member and another sufficiently competent and objective individual providing direct assistance should be minimal and should not affect audit quality, provided either is properly supervised. Permitting direct assistance in walkthroughs should, however, afford opportunities to reduce cost and increase efficiency.

Questions

26. Will requiring a walkthrough only for all significant processes reduce the number and detail of the walkthroughs performed without impairing audit quality?

27. Is it appropriate for the auditor to use others as direct assistance in performing walkthroughs? Should the proposed standard allow the auditor to more broadly use the work of others in performing walkthroughs?

[34/] See Appendix 4 – *Proposed Auditing Standard* – Considering and Using the Work of Others in an Audit, for additional information on direct assistance.

RELEASE

C. Scaling the Audit for Smaller Companies

Complying with Section 404 has posed challenges for smaller public companies. Some commentators have noted that although smaller companies may have fairly simple internal control structures, they may not be able to achieve efficiencies of scale, which can make the costs of their own work to design, maintain, and evaluate their internal control, as well as their audit costs, disproportionately higher than those of larger companies. In considering how to minimize the costs of the audit of internal control while preserving its benefits, the Board recognized that such companies often present different financial reporting risks than larger and more complex ones and that their internal control systems often appropriately address those risks in different ways. The proposed standard therefore recognizes that a company's size and complexity are important and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls.

The Board expects that the broad changes in the proposals that are designed to eliminate unnecessary audit work for all companies will particularly affect smaller company audits. In general, the proposals' reliance on principles rather than detailed instruction would require auditors to consider each company's unique facts and circumstances before determining how to apply the standard. Specific changes, which include focusing the auditor on the most important controls and using risk to determine the necessary evidence (and, accordingly, the auditor's effort) should together make the audit more scalable for any company. Under the proposed standard, the auditor can use strong company level controls and financial statement audit procedures to reduce the level of testing for smaller companies.

The Board also has included a section within the proposed standard that would require the auditor to evaluate the size and complexity of a company in planning and performing the audit. Consistent with the SEC's recently proposed guidance to management on evaluating internal control, the proposed standard includes a provision that identifies smaller companies in light of the SEC's Advisory Committee on Smaller Public Companies' final report and the SEC's definition of "large accelerated filer."[35/]

[35/] The Advisory Committee report described "Smaller Public Companies" as those with under $787.1 million in market capitalization and "Microcap Companies" as those Smaller Public Companies with market capitalization under $128.2 million. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at 5 (April 23, 2006); see also Securities

RELEASE

Under the proposed standard, the auditor should scale the audit so that it is appropriate for the company's size and complexity.

The section on scalability in the proposed standard includes a description of some of the attributes of smaller, less-complex companies that typically make them different from larger and more complex companies. For example, senior management of smaller, less-complex companies may be extensively involved in the day-to-day business activities. Understanding whether these attributes are present in a particular company is important in order for the auditor to determine the type and extent of controls that might be appropriate and how the auditor should correspondingly tailor his or her procedures.

To help auditors make these determinations, the section on scaling the audit in the proposed standard also includes discussion of six areas of the audit that are often affected by the attributes of smaller, less-complex companies. For each of these areas, the proposed standard describes the principles the auditor should apply in order to obtain sufficient competent evidence in a manner that is practical and reasonable. This part of the standard would provide the foundation for planned guidance on auditing internal control in smaller companies to be issued next year. That guidance, which is currently being developed with assistance from a task force of small company auditors and input from smaller companies, will expand on the principles in the standard and provide practical advice about the audit of internal control. The section of the proposed standard on scaling the audit, particularly when coupled with the forthcoming guidance, should help auditors tailor the audit of internal control appropriately for the size and complexity of the company.

Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (defining "large accelerated filer" as a public company with "an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more," among other things)."

Questions

28. Does the proposed standard on auditing internal control appropriately describe how auditors should scale the audit for the size and complexity of the company?

29. Are there other attributes of smaller, less-complex companies that the auditor should consider when planning or performing the audit?

30. Are there other differences related to internal control at smaller, less-complex companies that the Board should include in the discussion of scaling the audit?

31. Does the discussion of complexity within the section on scalability inappropriately limit the application of the scalability provisions in the proposed standard?

32. Are the market capitalization and revenue thresholds described in the proposed standard meaningful measures of the size of a company for purposes of planning and performing an audit of internal control?

D. Simplifying the Requirements

Taken as a whole, the proposals are intended to simplify the requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal control. The drafting is intended to reflect three improvements from AS No. 2. First, the level of detail and specificity has been reduced, which should encourage auditors to apply professional judgment under the facts and circumstances, rather than taking a one-size-fits-all approach. Second, the presentation has been reorganized to better reflect the sequential flow of an audit of internal control. Third, the requirements have been articulated in a more readable manner that should be understandable to audit clients as well as auditors.

In reducing the level of detail and specificity in AS No. 2, the Board evaluated the standard to determine what direction is fundamental to a quality audit. Based on this analysis, the Board removed provisions that were more detailed than necessary and that may have inadvertently encouraged a checklist approach to compliance. The proposals thus place more reliance on general principles than on detailed instruction.

This should allow auditors more flexibility to use professional judgment to determine the specific procedures required in particular circumstances. The Board's approach to interpretation of the proposed standard would be to look to the particular facts and circumstances and consider how to apply the general principles in the standard to those facts and circumstances.

The Board also reorganized the requirements to better reflect the flow of an audit of internal control. This approach should help auditors focus their work on identifying the most important controls to test and make the process more efficient. In addition, to simplify organization, where appropriate, some requirements have been moved to the Board's existing interim standards. Finally, the proposals attempt to articulate the requirements in a manner that is more readable, including for non-auditors, and incorporate the significant concepts from the guidance on AS No. 2 issued by the Board and staff, including those focused on efficiencies.[36/] These changes should give auditors from firms of all sizes a clearer understanding of their responsibilities and make the audit of internal control more scalable to any company, regardless of its size or the associated risk.

III. Proposed Rule 3525 – Audit Committee Pre-approval of Services Related to Internal control

The Board also is proposing a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control-related non-audit services. Under Section 10A(i) of the Exchange Act, as amended by Section 202 of the Sarbanes-Oxley Act, all non-audit services that the auditor proposes to perform for an issuer client "shall be pre-approved by the audit committee of the issuer." The proposed rule would further implement the Act's pre-approval requirement by requiring auditors to take certain steps as part of seeking audit committee pre-approval of internal control-related non-audit services. These steps are intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence.

Specifically, the proposed rule would require a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal

---

[36/] See May 16, 2005 Policy Statement; *Staff Questions and Answers, Auditing Internal Control Over Financial Reporting* (May 16, 2005).

control-related non-audit services that are not otherwise prohibited by the Act or the rules of the SEC or the Board to –

- Describe, in writing, to the audit committee the scope of the proposed service;
- Discuss with the audit committee the potential effects of the proposed service on the firm's independence; and
- Document the substance of the firm's discussion with the audit committee.

These requirements parallel the auditor's responsibility in seeking audit committee pre-approval to perform tax services for an audit client under PCAOB Rule 3524 and would be codified, like that rule, as part of the Board's rules on ethics and independence.

The proposed rule would replace existing provisions of AS No. 2 related to auditor independence. In addition to some general discussion, AS No. 2 includes a requirement for the auditor to obtain specific pre-approval from the audit committee to perform an engagement to provide internal control-related services.[37/] The Board has reevaluated this requirement, based in part on its adoption, subsequent to AS No. 2, of the parallel rule on audit committee pre-approval of tax services. Consistent with the Board's tax service pre-approval rule, the proposed rule does not specify that the pre-approval must be specific. Instead, the proposed rule is neutral as to whether an audit committee pre-approves a non-audit service on an ad hoc basis or on the basis of policies and procedures.[38/] Many issuers have adopted policies that provide for pre-approval in annual audit committee meetings, and the Board understands that such an annual planning process can include as robust a presentation to the audit committee as a case-by-case pre-approval process. Therefore, the Board proposes that its rule on audit committee pre-approval of internal control-related services be flexible enough to

---

[37/] AS No. 2, paragraph 33.

[38/] The SEC's 2003 independence rules implemented the Act's pre-approval requirement by adopting a provision on audit committee administration of the engagement. See 17 C.F.R. § 210.2-01(c)(7).

accommodate either system and to encourage auditors and audit committees to develop systems tailored to the needs and attributes of the issuer.

AS No. 2 also includes discussion of the application of principles of independence to internal control-related services and specifically notes that designing or implementing an issuer's controls would place the auditor in a management role and result in the auditor auditing his or her own work.[39/] The Board proposes to not repeat this independence guidance in the auditing standard or in a separate independence rule. As noted above, however, the proposed audit committee pre-approval rule would require auditors, among other things, to discuss with the audit committee the potential effect of the internal control-related service on their independence. The Board proposes to add a Note to this portion of the pre-approval rule that would explain the general standard of independence,[40/] and that application of this general standard is guided by several principles, including whether the auditor assumes a management role or audits his or her own work.[41/] The Note would further specify, as an example of the application of this general standard, that an auditor would not be independent if management had delegated its responsibility for internal control to the auditor or if the auditor had designed or implemented the audit client's internal control.

Question

33. Is there other information the auditor should provide the audit committee that would be useful in its pre-approval process for internal control-related services?

IV. Amendments to the Board's Interim Standards

The Board also is proposing amendments to several of its existing interim standards. In some cases, these proposed amendments are administrative, such as updating the interim standards' references to the proposed new standards' paragraph

---

39/ AS No. 2, paragraph 32.

40/ Reg. S-X, Rule 2-01(b), 17 C.F.R. 210.2-01(b); see also paragarah .03 of AU sec. 220, *Independence*.

41/ Reg. S-X, Rule 2-01 (Preliminary Note), 17 C.F.R. 210.2-01 (Preliminary Note).

numbers and definitions. In other cases, the amendments have been proposed to move information currently contained in AS No. 2 to the existing standards. For example, AU sec. 722, *Interim Financial Information*, would be amended to include the direction in AS No. 2 on the auditor's responsibility as it relates to management's quarterly certifications on internal control. This change would not only simplify the proposed standard on auditing internal control but also would make it easier for auditors to identify all of the relevant information on the auditor's responsibility related to interim periods in one standard.

In the case of the amendment to AU sec. 530, *Dating of the Independent Auditor's Report*, however, the Board is proposing a substantive change that would affect both integrated audits and audits of only financial statements. The proposals would change the existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion." This proposed change is consistent with a recent change adopted by both the International Auditing and Assurance Standards Board and the AICPA Auditing Standards Board and more accurately states the date at which the auditor's responsibility for events affecting the financial statements should reasonably end.[42/] Furthermore, the change in the report date requirement should not have a significant effect on the auditor's current procedures, as many auditors have already begun interpreting the last day of fieldwork as the date the auditor has obtained sufficient competent evidence to support the audit opinion.

VI. Effective Date

The proposals are meant to improve and refine the implementation of the Act's internal control requirements. The Board intends to set an effective date at the time they

---

[42/] See International Standards on Auditing (ISA) 700 (Revised) *"The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements"* Paragraph 52 and Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures,* "Subsequent Events," paragraph 12, as amended by paragraph 12 of SAS 113 Omnibus Statement on Auditing Standards

are adopted that reflects the Board's commitment to minimizing disruption to on-going audits.

Question

34. How can the Board structure the effective date so as to best minimize disruption to on-going audits, but make the greater flexibility in the proposed standards available as early as possible? What factors should the Board consider in making this decision?

VII. Opportunity for Public Comment

The Board will seek comment for a 70-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. 021 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on February 26, 2007

RELEASE

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

On the 19th day of December, in the year 2006, 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
Secretary

December 19, 2006

APPENDIX 1 – *Proposed Auditing Standard* – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of the Financial Statements

APPENDIX 2 – *Proposed Auditing Standard* – Considering and Using the Work of Others in an Audit

APPENDIX 3 – *Proposed Rule 3525* – Audit Committee Pre-approval of Non-Audit Services Related to Internal Control Over Financial Reporting

APPENDIX 4 – *Proposed Amendments to the Interim Standards*

RELEASE

Appendix 1 – Auditing Standard

December 19, 2006
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

This proposed auditing standard will supersede Auditing Standard No. 2, "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements" if it is adopted by the Board and approved by the Securities and Exchange Commission.

RELEASE

Table of Contents

RELEASE

APPENDICES

RELEASE

Introduction

1. This standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of **management's assessment** [1/] of the effectiveness of **internal control over financial reporting** ("the audit of internal control over financial reporting") that is integrated with an audit of the financial statements.

2. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether **material weakness**es exist as of the date specified in management's assessment. A material weakness in internal control over financial reporting may exist even when financial statements are not materially misstated.

3. To obtain reasonable assurance about whether material weaknesses exist as of a specified date, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all **relevant assertion**s.[2/] The auditor may obtain this evidence by performing tests of controls himself or herself or by using the work of others.[3/]

> Note: The auditor should select for testing only those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to a given relevant assertion that could result in a material misstatement to the company's financial statements.

[1/] Terms defined in Appendix A, *Definitions*, are set in **boldface type** the first time they appear.

[2/] See AU sec. 230, *Due Professional Care in the Performance of Work*, for further discussion of the concept of reasonable assurance.

[3/] See paragraph 13 for additional direction on using the work of others.

RELEASE

4. The general standards[4/] are applicable to an audit of internal control over financial reporting. Those standards require technical training and proficiency as an auditor, independence, and the exercise of due professional care, including professional skepticism. This standard establishes the fieldwork and reporting standards applicable to an audit of internal control over financial reporting.

5. The auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.[5/]

Planning the Audit

6. The audit of internal control over financial reporting should be properly planned and assistants, if any, should be properly supervised. When planning the audit, the auditor should evaluate whether the following matters are important to the company's financial statements and internal control over financial reporting and, if so, how they will affect the auditor's procedures –

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

[4/] See AU sec. 150, *Generally Accepted Auditing Standards.*

[5/] See Securities Exchange Act Rules 13a-15(c) and 15d-15(c), 17 C.F.R. §§ 240.13a-15(c) and 240.15d-15(c). SEC rules require management to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework (also known as *control criteria*) established by a body or group that followed due-process procedures, including the broad distribution of the framework for public comment. For example, the report of the Committee of Sponsoring Organizations of the Treadway Commission (known as the COSO report) provides such a framework, as does the report published by the Institute of Chartered Accountants in England & Wales, *Internal Control: Guidance for Directors on the Combined Code* (known as the Turnbull Report.)

- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;
- Matters relating to the company's business, including its organization, operating characteristics, and capital structure;
- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting;
- The auditor's preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses;
- Control deficiencies previously communicated to the audit committee or management;
- Legal or regulatory matters of which the company is aware;
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting; and
- Preliminary judgments about the effectiveness of internal control over financial reporting.

Integration with Financial Statement Audit

7. The audit of internal control over financial reporting should be integrated with the audit of the financial statements. The objectives of the audits are not identical, however, and the auditor must plan and perform the work to achieve the objectives of both audits. (See Appendix B for additional direction on integration.)

Role of Risk Assessment

8. Risk assessment underlies the entire audit process described by this standard. Therefore, the auditor's risk assessment should have a pervasive effect on an audit of internal control. A direct relationship exists between the degree of risk that a material

weakness could exist in a particular area of the company's internal control over financial reporting and the amount of audit attention the auditor should devote to that area. Accordingly, the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected. The lower the risk that a material weakness could exist in a particular area, the less audit attention the auditor would need to devote to the area. Additionally, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

Scaling the Audit for Smaller Companies

9. The auditor should evaluate the size and complexity of the company when planning and performing the audit of internal control. Because the size and complexity of the company affect the risks of misstatement and the controls necessary to address those risks, the auditor's evaluation of both size and complexity should have a pervasive effect on the audit. The auditor should document how the size and complexity of the company affected the audit. In evaluating the size and complexity of the company, the auditor should take into account the company's individual facts and circumstances.

> Note: The final report of the SEC Advisory Committee on Smaller Public Companies indicates that market capitalization and annual revenue are useful indicators of a company's size. In light of the Advisory Committee's report, as well as the SEC's definition of "large accelerated filer," companies with a market capitalization of approximately $700 million or less, with reported annual revenues of approximately $250 million or less, should be considered smaller companies.[6/]

[6/] The Advisory Committee report described "Smaller Public Companies" as those with under $787.1 million in market capitalization and "Microcap Companies" as those Smaller Public Companies with market capitalization under $128.2 million. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at 5 (April 23, 2006); see also Securities Exchange Act Rule 12b-2, 17 C.F.R. § 240.12b-2 (defining "large accelerated filer" as a public company with "an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more," among other things)."

RELEASE

10. As part of evaluating the size and complexity of the company, the auditor should determine to what extent attributes common to a smaller and less-complex company, which affect the risks of misstatement and the controls necessary to address those risks, are present. These attributes include –

- Few business lines,
- Less complex business processes and financial reporting systems,
- Centralized accounting functions,
- Extensive involvement by senior management in the day-to-day activities of the business, and
- Few levels of management, each with a wide span of control.

11. Because of these attributes, the auditor should recognize that a smaller and less-complex company often achieves many of its **control objective**s through the daily interaction of senior management with company personnel rather than through formal policies and procedures. Routine checks and supervisory activities are often used instead of multiple layers of controls involving numerous personnel performing independent functions.

12. The auditor should evaluate how the audit of internal control is affected by the attributes of a smaller and less-complex company. These attributes should affect many aspects of the audit. The audit of a smaller and less-complex company might vary from the audit of a larger and more-complex company in, among others, the following respects –

- *Obtaining sufficient competent audit evidence with limited company documentation.* The auditor should take into account the nature and extent of available audit evidence and the periods of time in which the evidence is obtainable in planning and performing the audit. The absence of documentation evidencing the operation of a control is not determinative that the control is not operating effectively. In a smaller and less-complex company with less formal documentation, testing controls through inquiry combined with observation or other procedures can, in many cases,

provide sufficient evidence about whether the control is effective, even in the absence of documentation.

- *Assessing company-level controls to sufficiently address risks of misstatement.* A smaller and less-complex company might rely more frequently on monitoring controls performed by senior management to detect misstatements in certain assertions. In these circumstances, the auditor should focus on evaluating those company-level controls. As further discussed in paragraphs 43-44, if a company-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

- *Evaluating the risk of management override and mitigating actions.* Because of the extensive involvement of senior management in performing controls and the period-end financial reporting process, controls to prevent management override are particularly important in a smaller and less-complex company. The auditor should anticipate that the controls to address the risk of management override at a smaller and less-complex company may be different from those at a larger company. For example, a smaller and less-complex company may rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- *Evaluating controls implemented in lieu of segregation of duties.* A smaller and less-complex company might have few employees in the accounting function, limiting opportunities to segregate duties and leading the company to implement alternative controls to achieve its control objectives. In such circumstances, the auditor's selection of controls to test should focus on those alternative controls and whether they achieve the control objectives.

- *Evaluating financial reporting competencies.* When assessing the competence of the personnel responsible for the company's financial reporting and associated controls, the auditor should take into account both the competence necessary to address the types of transactions and activities the company enters into and the combined competence of

company personnel and other parties that assist with functions related to financial reporting.

- *Evaluating information technology ("IT") controls.* A smaller and less-complex company with simple business processes and centralized accounting operations often has relatively simple information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information technology controls should focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the IT general controls that are important to the effective operation of those application controls.

Using the Work of Others

13. The auditor should evaluate the extent to which he or she will use the work of others, including management's internal control evaluation. Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*, establishes direction for obtaining an understanding of the nature, timing, and extent of the work performed by others, and determining its effect on the audit. That standard states that to use the work of others to reduce the nature, timing, and extent of the work the auditor would have otherwise performed, the auditor should evaluate the nature of the subject matter tested by others, evaluate the competence and objectivity of the individuals who perform the work, and test some of the work performed by others to evaluate the quality and effectiveness of their work.

Materiality

14. In planning the audit of internal control over financial reporting, the auditor should use the same materiality considerations he or she would use in planning the audit of the company's annual financial statements.[7/]

[7/] AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, provides additional explanation of materiality.

15. To evaluate whether a **control deficiency** or combination of control deficiencies identified during the audit is a **significant deficiency** or material weakness, the auditor must consider the possibility of misstatement to both annual and interim financial statements.

Using a Top-Down Approach

16. The auditor should use a top-down approach to the audit of internal control over financial reporting to select the controls to test. A top-down approach begins at the financial statement level and company-level controls, and then works down to **significant account**s and disclosures, relevant assertions, and **significant process**es. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the **financial statements and related disclosures**. Finally, the auditor selects for testing controls that sufficiently address the assessed risk of misstatement to each relevant assertion. The top-down approach thereby leads to the auditor testing only those controls necessary to obtain reasonable assurance about whether material weaknesses exist.

Identifying Company-Level Controls

17. The auditor must test those company-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. Because the results of that work should affect the way the auditor evaluates the other aspects of internal control over financial reporting, the auditor should test those controls early in the audit process. The auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels.

18. Company-level controls include –

- Controls related to the control environment;
- Controls over management override;
- The company's risk assessment process;

RELEASE

- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

19. *Control Environment.* Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company.

20. As part of evaluating the control environment, the auditor should assess –

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether management and employees are assigned appropriate authority and responsibility to facilitate effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood;
- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control; and
- Whether the company takes actions to reduce or mitigate the incentives and pressures on management that would provide a reason to misstate the company's financial statements.

RELEASE

21. *Period-end Financial Reporting Process*. Because of its importance to financial reporting and to the auditor's opinions on internal control over financial reporting and the financial statements, the auditor must evaluate the period-end financial reporting process. The period-end financial reporting process includes the following –

- Procedures used to enter transaction totals into the general ledger;
- Procedures used to initiate, authorize, record, and process journal entries in the general ledger;
- Procedures used to record recurring and nonrecurring adjustments to the annual and quarterly financial statements; and
- Procedures for drafting annual and quarterly financial statements and related disclosures.

22. As part of evaluating the period-end financial reporting process, the auditor should assess –

- Inputs, procedures performed, and outputs of the processes the company uses to produce its annual and quarterly financial statements;
- The extent of information technology involvement in the period-end financial reporting process;
- Who participates from management;
- The locations involved in the period-end financial reporting process;
- The types of adjusting and consolidating entries; and
- The nature and extent of the oversight of the process by management, the board of directors, and the audit committee.

RELEASE

23. As part of evaluating the period-end financial reporting process, the auditor should perform a walkthrough of the process. Walkthroughs are further described beginning at paragraph 36.

Identifying Significant Accounts

24. The auditor should identify significant accounts and disclosures. To identify significant accounts, the auditor should start by considering financial statement line items or captions. When identifying significant accounts, the auditor should evaluate both qualitative and quantitative risk factors.

25. The factors that the auditor should evaluate in the identification of significant accounts are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts should be the same for both audits.

26. The risk factors the auditor should evaluate in identifying significant accounts include –

- Size and composition of the account;
- Susceptibility of misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account;
- Nature of the account;
- Accounting and reporting complexities associated with the account;
- Exposure to losses in the account;
- Possibility of significant contingent liabilities arising from the activities reflected in the account;
- Existence of related party transactions in the account; and

- Changes from the prior period in account characteristics.

27. The auditor also should evaluate the components of a potential significant account using risk factors identified in the previous paragraph to determine whether they are subject to substantially differing significant risks. If so, different types of controls might be necessary to adequately address those risks. Accordingly, the auditor should take these substantially differing significant risks into account when selecting controls to test. (See paragraphs 41 through 46.)

> Note: Components of a significant account may be subject to differing risks that are neither significant nor sufficiently different to affect the auditor's selection of controls to test. In performing this evaluation, the auditor need not consider such risks.

28. The auditor should use the understanding of risk obtained as part of identifying significant accounts when identifying relevant assertions, **major classes of transactions** and significant processes, and also when selecting the controls to test.

29. When a company has multiple locations or business units, the auditor should determine significant accounts and their relevant assertions, major classes of transactions, and significant processes based on the consolidated financial statements. Having made those determinations, the auditor should then apply the direction in Appendix B for multiple locations scoping decisions.

Identifying Relevant Assertions

30. For each significant account, the auditor should determine which of these financial statement assertions is a relevant assertion[8/] –

- Existence or occurrence
- Completeness

[8/] See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

- Valuation or allocation
- Rights and obligations
- Presentation and disclosure

31. To identify relevant assertions, the auditor should determine the likely sources of those potential misstatements in each significant account that would cause the financial statements to be materially misstated. The auditor might determine the likely sources of potential misstatements by asking himself or herself "what could go wrong?" within a given significant account. The auditor may base his or her work on assertions that differ from those in this standard if the auditor has selected and tested controls over the pertinent risks in each significant account and over the representations by management that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

Identifying Major Classes of Transactions and Significant Processes

32. The auditor should identify the company's major classes of transactions. Different types of major classes of transactions might have different inherent risks associated with them and, consequently, might require different levels of management supervision and involvement. These differences might affect the types of controls that are necessary to adequately address the risks.

33. The controls over major classes of transactions exist within the company's significant processes. Accordingly, the auditor should identify the significant processes affecting the major classes of transactions.

34. For each significant process identified, the auditor should –

- Understand the flow of major classes of transactions, including how these transactions are initiated, authorized, processed and recorded;
- Identify the points within the process at which a misstatement—including a misstatement due to fraud—could arise that, individually or in combination with other misstatements, would be material;

- Identify the controls that management has implemented to address these potential misstatements; and

- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements.

35. As part of understanding a significant process, the auditor should understand how information technology affects the company's flow of transactions. Paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, discuss the effect of information technology on internal control over financial reporting and the risks the auditor should assess. The auditor should apply this direction when auditing internal control over financial reporting.

36. *Performing Walkthroughs.* The auditor should perform a walkthrough for each significant process. In performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records. The auditor should follow the process flow of actual transactions using the same documents and information technology that company personnel use.

37. The objectives of the walkthrough are to provide the auditor with evidence to –

- Verify that the auditor has identified the points in the process at which significant risk of misstatement to a relevant assertion exists,

- Verify the auditor's understanding of the design of controls, including those related to the prevention or detection of fraud,

- Evaluate the effectiveness of the design of controls, and

- Verify whether controls have been placed in operation.

RELEASE

38. If a significant process affects multiple major classes of transactions, the auditor should determine, during the walkthrough, how the significant process addresses the risks unique to those major classes of transactions.

39. At the points at which important processing procedures occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions are essential to the auditor's ability to gain a sufficient understanding of the process and to be able to identify important points at which a necessary control is missing or not designed effectively. These inquiries should go beyond a narrow focus on the single transaction used as the basis for the walkthrough so that the auditor gains an understanding of the types of significant transactions handled by the process.

> Note: The walkthrough performed by the auditor of the period-end financial reporting process may differ from the walkthroughs of significant processes. Because of the nature of the period-end financial reporting process, the auditor need not follow a transaction from initiation through to its reporting to achieve the objectives of the walkthrough. Instead, the auditor should use a combination of probing inquiries and the same documents and information technology used by company personnel to understand how transaction totals recorded in the general ledger are ultimately reflected in the company's financial statements and related disclosures.

40. Because of the degree of judgment required in performing a walkthrough, the auditor should either perform walkthroughs himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit.*

Selecting Controls to Test

41. The auditor should test those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

42. There might be more than one control that addresses the assessed risk of misstatement to a particular relevant assertion; conversely, one control might address

the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective.

43. When selecting the controls to test that sufficiently address the assessed risk of misstatement to each relevant assertion, the auditor should recognize that company-level controls vary in precision. Some company-level controls are designed to operate at the process, transaction, or application level and might adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. On the other hand, some company-level controls may be designed to operate in a manner that would identify possible breakdowns in lower-level controls but not at a level of precision that would, by itself, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis.

44. The auditor should focus on whether the selected controls, individually or in combination, sufficiently address the assessed risk of misstatement of a given relevant assertion rather than on how the control is labeled (e.g., company-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**). The auditor also should link the controls selected to test with the relevant assertions to which they relate.

45. *Fraud controls.* As part of testing those controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion, the auditor should test the company's programs and controls that address identified risks of material misstatement due to fraud as well as controls intended to address the risk of management override of other controls.[9/]

46. In an audit of internal control over financial reporting, the auditor's evaluation of controls is related to the auditor's evaluation of controls in a financial statement audit. Often, controls tested by the auditor during the audit of internal control over financial

---

[9/] See paragraphs .35 through .42 of AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* regarding identifying risks that may result in material misstatement due to fraud.

reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If the auditor identifies deficiencies in controls designed to prevent and detect fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing, or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in AU sec. 316 .44 and .45.

Testing Controls

Testing Design Effectiveness

47. The auditor should test the design effectiveness of controls by determining whether the company's controls, if operating properly, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements in the financial statements.

48. Procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Additionally, the auditor should perform a specific evaluation of whether the controls are likely to prevent or detect errors or fraud if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively. The auditor ordinarily performs procedures sufficient to evaluate design effectiveness during the performance of the walkthrough.

Testing Operating Effectiveness

49. The auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

50. Procedures the auditor performs to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, walkthroughs, and reperformance of the control.

RELEASE

Relationship of Risk to the Evidence to be Obtained

51. For each control selected for testing, the auditor should assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. The evidence necessary to persuade the auditor that the control is effective depends on the risk associated with the control. As the risk associated with the control being tested decreases, the evidence that the auditor needs to obtain also decreases. On the other hand, as the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.

> Note: Although the auditor must obtain evidence about the effectiveness of controls for each relevant assertion, the auditor is not responsible for obtaining sufficient evidence to support an opinion about the effectiveness of each individual control. Rather, the auditor's objective is to express an opinion on the company's internal control over financial reporting overall. This allows the auditor to vary the evidence obtained regarding the effectiveness of individual controls selected for testing based on the risk associated with the individual control.

52. Factors that affect the risk associated with a control include –

- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The inherent risk associated with the related account(s) and assertion(s);
- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether the account has a history of errors;
- The effectiveness of company-level controls, especially controls that monitor other controls;
- The degree to which the control relies on the effectiveness of other controls (e.g., the control environment or information technology general controls);

- The competence of the personnel who perform the control or monitor its performance and whether there have been changes in key personnel who perform the control or monitor its performance;

- Whether the control relies on performance by an individual or is automated (i.e., an automated control would generally be expected to be lower risk if relevant information technology general controls are effective); and

- The complexity of the control.

  Note: Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively.

53. When the auditor identifies deviations from the company's established controls, he or she should determine the effect of the deviations on his or her assessment of the risk associated with the control being tested and the evidence to be obtained, as well as on the operating effectiveness of the control.

Note: Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving the company's control objectives, any individual control does not necessarily have to operate without any deviation to be considered effective.

54. The evidence provided by the auditor's tests of the effectiveness of controls depends upon the mix of the nature, timing, and extent of the auditor's procedures. Further, for any individual control, different combinations of the nature, timing, and extent of testing may provide sufficient evidence in relation to the risk associated with the control.

55. *Nature of Tests of Controls*. Some types of tests, by their nature, produce greater evidence of the effectiveness of controls than other tests. The following tests that the auditor might perform are presented in order of the evidence that they ordinarily would produce, from least to most: inquiry, observation, inspection of relevant documentation,

and reperformance of a control. Walkthroughs ordinarily consist of some combination of these types of procedures.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control. When combined with another test, such as observation, inspection, or reperformance, however, inquiry might provide sufficient evidence about the effectiveness of a control.

56. The auditor should take into account the nature of the control when selecting the nature of the tests to perform, including whether the operation of the control results in documentary evidence of its operation. Documentary evidence of the operation of some controls, such as management's philosophy and operating style, might not exist. In this case, to obtain sufficient evidence, the auditor should supplement inquiries of appropriate company personnel with observation of company activities.

57. *Timing of Tests of Controls*. Testing controls over a greater period of time provides more evidence of the effectiveness of controls than testing over a shorter period of time. Further, testing performed closer to the date of management's assessment provides more evidence than testing performed earlier in the year.

58. The auditor's testing of the operating effectiveness of controls should occur at the time the controls are operating. Controls "as of" a specific date include controls that are relevant to the company's internal control over financial reporting as of that specific date, even though such controls might not operate until after that specific date. For example, if controls over the period-end financial reporting process operate in the month following the period-end, the auditor should test the controls operating in the month following the period-end to have sufficient evidence of operating effectiveness as of the period-end.

59. For controls over higher risk accounts and transactions, such as significant non-routine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the auditor should perform tests of controls closer to or at the as-of date rather than at an interim date. However, the auditor should balance performing the tests of controls closer to the as-of date with the need to test controls over a sufficient period of time to obtain sufficient evidence of operating effectiveness.

RELEASE

60. Prior to the date specified in management's assessment, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. If the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls, he or she will not need to test the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting. The auditor should, however, evaluate how the design and operating effectiveness of the superseded controls relate to the auditor's reliance on controls for financial statement audit purposes. (See additional direction on integration beginning at paragraph B1.)

61. *Extent of Tests of Controls*. The more extensively a control is tested, the greater the evidence obtained from that test.

62. In determining the extent of procedures to perform, the auditor should assess the following factors –

- *Nature of the control*. The auditor should assess the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the controls to operate effectively. As the nature of the control indicates greater risk, the auditor should test the control more extensively to obtain sufficient evidence.

- *Frequency of operation*. Generally, the more frequently a manual control operates, the more operations of the control the auditor should test to obtain sufficient evidence.

  Note: Testing a single operation of an automated control might result in sufficient evidence that the control operated effectively, provided that relevant information technology general controls also are operating effectively.

Note: When sampling is appropriate and the population to be tested is large, increasing the population size does not proportionately increase the required sample size.

63. *Roll-Forward Procedures.* When the auditor reports on the effectiveness of controls as of a specific date and obtains evidence about the operating effectiveness of controls at an interim date, he or she should determine what, if any, additional evidence concerning the operation of the controls for the remaining period is necessary.

Note: The auditor's assessment of the risk associated with the control, as described in paragraphs 51 through 54 is essential to the auditor's decisions about what, if any, roll-forward procedures are necessary. The auditor should take into account the roll-forward procedures, if any, which will be necessary as part of determining the overall mix of the nature, timing, and extent of procedures that will provide sufficient evidence in relation to the risk associated with the control.

64. The auditor should evaluate the following factors when determining if additional evidence is necessary and, if so, the procedures to perform to update the results of his or her testing from an interim date to the company's year-end –

- The specific control tested prior to the as-of date and the results of those tests. The auditor should assess the risks associated with the control and the nature of the control.

- The sufficiency of the evidence of effectiveness obtained at an interim date.

- The length of the remaining period.

- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

RELEASE

Special Considerations for Subsequent Years' Audits

65. In subsequent years' audits, the auditor should incorporate knowledge obtained during past audits he or she performed of the company's internal control over financial reporting into the decision-making process for determining the nature, timing, and extent of testing necessary. This decision-making process is described in paragraphs 51 through 64.

66. The auditor's assessment of the risk associated with a control in subsequent years' audits should include the factors described in paragraph 52 and the following additional risk factors –

- The nature, timing, and extent of procedures performed in previous audits;
- The results of the previous years' testing of the control; and
- Whether there have been changes in the control, or the significant process in which it operates, since the previous audit.

67. After taking into account the risk factors identified in paragraphs 52 and 66, the lower the risk associated with a control, the less evidence that the auditor needs to obtain in the subsequent years' audits.

68. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B30.

69. In addition, the auditor should vary the nature, timing, and extent of testing of controls from year to year to introduce unpredictability into the testing and respond to changes in circumstances. For this reason, each year the auditor might test controls at a different interim period, increase or reduce the number and types of tests performed, or change the combination of procedures used.

Evaluating Identified Deficiencies

70. In planning and performing the audit, the auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness. The auditor must, however, evaluate the severity of each control deficiency that comes to his or her attention. As part of this evaluation, the auditor should determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses as of the date of management's assessment.

71. The auditor should evaluate the severity of a deficiency in internal control over financial reporting by determining the following –

- Whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure; and

- The magnitude of the potential misstatement resulting from the deficiency or deficiencies.

72. The severity of a deficiency in internal control over financial reporting does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement that is either significant or material.

73. Risk factors affect whether there is a reasonable possibility that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following –

- The nature of the financial statement accounts, disclosures, and assertions involved;

- The susceptibility of the related asset or liability to loss or fraud;

- The subjectivity, complexity, or extent of judgment required to determine the amount involved;

- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;

- The interaction of the deficiencies, including whether a combination of two or more deficiencies affect the same financial statement accounts and assertions; and

- The possible future consequences of the deficiency.

Note: The evaluation of whether a control deficiency presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

74. Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls include, but are not limited to, the following –

- The financial statement amounts or total of transactions exposed to the deficiency; and

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

75. In evaluating the magnitude of the potential misstatement, the auditor should recognize that the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

76. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that is significant or material.

RELEASE

77. When evaluating the severity of a deficiency in internal control over financial reporting, the auditor also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then the auditor should deem the deficiency to be at least a significant deficiency.

78. Deficiencies in the following areas ordinarily result in at least significant deficiencies in internal control over financial reporting –

- Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles,
- Antifraud programs and controls,
- Controls over non-routine and non-systematic transactions, and
- Controls over the period-end financial reporting process.

Strong Indicators of Material Weaknesses

79. The auditor should treat each of the following circumstances as a strong indicator that a material weakness in internal control over financial reporting exists –

- An ineffective control environment. Circumstances that may indicate that the company's control environment is ineffective include, but are not limited to –
  - Identification of fraud of any magnitude on the part of senior management.

Note: The auditor is required to plan and perform procedures to obtain reasonable assurance that a material misstatement caused by fraud is detected by the auditor. However, for the purposes of evaluating and reporting deficiencies in internal control over financial reporting, the auditor should evaluate any fraud on the part of senior management of which he or she is aware. Furthermore, for the purposes of this circumstance, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of the Act as well as any other members of management who play a significant role in the company's financial reporting process.

– Significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time.

- Restatement of previously issued financial statements to reflect the correction of a misstatement.

  Note: The correction of a misstatement includes misstatements due to error or fraud; it does not include retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.

- Identification by the auditor of a material misstatement in financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting.

- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

  Note: The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee. This standard does

not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. However, because of the role of the audit committee within the control environment and monitoring components of internal control over financial reporting, the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating those components.

The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor should focus on factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management, the clarity with which the audit committee's responsibilities are articulated (e.g., in the audit committee's charter), and how well the audit committee and management understand those responsibilities. The auditor also might consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer. The auditor also might evaluate whether the committee raises and pursues appropriate questions with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the committee's responsiveness to issues raised by the auditor.

If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company.[10/] When a company is not required by law or applicable listing standards to have independent directors on its audit committee, the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency. In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as

---

[10/] See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

being consistent with provisions for the use of those terms as defined in relevant SEC rules.

- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.

  Note: The evaluation of the internal audit or risk assessment functions is similar to the evaluation of the audit committee in that the evaluation is made within the context of the monitoring and risk assessment components. The auditor is not required to make a separate and distinct evaluation of the effectiveness and performance of these functions. Instead, the auditor should base the evaluation on evidence obtained as part of evaluating the monitoring and risk assessment components of internal control over financial reporting.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

Wrapping-Up

Forming an Opinion

80. The auditor should form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit, and any identified control deficiencies.

81. After forming an opinion on the effectiveness of the company's internal control over financial reporting, the auditor should evaluate the presentation of the elements

that management is required, under the SEC's rules, to present in its annual report on internal control over financial reporting.[11/]

82. If the auditor determines that any required elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should follow the direction in paragraph C2.

83. The auditor may form an opinion on the effectiveness of internal control over financial reporting only when there have been no restrictions on the scope of the auditor's work. A scope limitation requires the auditor to disclaim an opinion or withdraw from the engagement (See paragraphs C3 through C7).

Obtaining Written Representations

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

a. Acknowledging management's responsibility for establishing and maintaining effective internal control over financial reporting;

b. Stating that management has performed an evaluation and made an assessment of the effectiveness of the company's internal control over financial reporting and specifying the control criteria;

c. Stating that management did not use the auditor's procedures performed during the audits of internal control over financial reporting or the financial statements as part of the basis for management's assessment of the effectiveness of internal control over financial reporting;

d. Stating management's conclusion, as set forth in its assessment, about the effectiveness of the company's internal control over financial reporting based on the control criteria as of a specified date;

[11/] See Item 308(a) of Regulations S-B and S-K, 17 C.F.R. §§ 228.308(a) and 229.308(a).

e. Stating that management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's evaluation, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses in internal control over financial reporting;

f. Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a material misstatement to the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;

g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 87 have been resolved, and specifically identifying any that have not; and

h. Stating whether there were, subsequent to the date being reported on, any changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting, including any corrective actions taken by management with regard to significant deficiencies and material weaknesses.

85. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit. As discussed further in paragraph C3, when the scope of the audit is limited, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including those obtained in an audit of the company's financial statements.

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

RELEASE

Communicating Certain Matters

87. 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 internal control over financial reporting. The auditor's communication should distinguish clearly between those matters considered to be significant deficiencies and those considered to be material weaknesses, as defined in paragraphs A12 and A8, respectively.

88. If the auditor concludes 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 conclusion in writing to the board of directors.

89. The auditor should communicate to management, in writing, all deficiencies in internal control over financial reporting (i.e., those deficiencies in internal control over financial reporting that are of a lesser magnitude than significant deficiencies) identified during the audit and inform the audit committee when such a communication has been made. When making this communication, it is not necessary for the auditor to repeat information about such deficiencies that has been included in previously issued written communications, whether those communications were made by the auditor, internal auditors, or others within the organization. Furthermore, the auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor should communicate deficiencies in internal control over financial reporting of which he or she is aware.

90. These written communications should state 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 governmental authorities require furnishing such reports, the auditor may make specific reference to such regulatory agencies.

91. These written communications also should include the definitions of control deficiency, significant deficiency, and material weakness and should clearly distinguish to which category the deficiency being communicated relates.

RELEASE

92. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all significant deficiencies, the auditor should not issue a report stating that no significant deficiencies were noted during the audit.

93. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. In such circumstances, the auditor must determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[12/]

Reporting on Internal Control

94. The auditor's report on management's assessment of the effectiveness of internal control over financial reporting must include the following elements[13/] –

a. A title that includes the word *independent*;

b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria;

c. An identification of management's assessment (the auditor should use the same description of the company's internal control over financial reporting as management uses in its annual report);

d. A statement that the assessment is the responsibility of management;

[12/] See 15 U.S.C. § 78j-1.

[13/] Appendix C provides direction on modifications to the auditor's report that are required 'in certain circumstances.

e. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

f. A definition of internal control over financial reporting as stated in paragraph A5;

g. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);

h. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;

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

l. The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria;

m. The manual or printed signature of the auditor's firm;

n. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

o. The date of the audit report.

Separate or Combined Reports

95. The auditor may choose to issue a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting.

96. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

[*Introductory paragraph*]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited management's assessment, included in the accompanying [*title of management's report*], that W Company maintained effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements and an

opinion on the company's internal control over financial reporting based on our audits.

[*Scope paragraph*]

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

[*Definition paragraph*]

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

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

[*Inherent limitations paragraph*]

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

[*Opinion paragraph*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, 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)."*].

[*Signature*]

[*City and State or Country*]

[*Date*]

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

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), W Company's internal control over

> financial reporting as of December 31, 20X8, 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 opinion*].

The auditor also should add the following paragraph to the report on internal control over financial reporting –

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

Report Date

98. The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Because the auditor cannot audit internal control over financial reporting without also auditing the financial statements, the reports should be dated the same.

Material Weaknesses

99. Paragraphs 70 through 79 describe the evaluation of deficiencies. If there are deficiencies that, individually or in combination, result in one or more material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement.[14/]

100. When expressing an adverse opinion on internal control over financial reporting because of a material weakness, the auditor's report must include –

- The definition of a material weakness, as provided in paragraph A8.

[14/] See paragraph C3 for direction when the scope of the engagement has been limited.

- A statement that a material weakness has been identified and an identification of the material weakness described in management's assessment.

  Note: If the material weakness has not been included in management's assessment, this sentence should be modified to state that a material weakness has been identified but not included in management's assessment. Additionally, the auditor's report should include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also is required to communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's assessment. If the material weakness has been included in management's assessment but the auditor concludes that the disclosure of the material weakness is not fairly presented in all material respects, the auditor's report should describe this conclusion as well as the information necessary to fairly describe the material weakness.

101. The auditor should determine the effect his or her adverse opinion on internal control has on his or her opinion on the financial statements. Additionally, the auditor should disclose whether his or her opinion on the financial statements was affected by the adverse opinion on internal control over financial reporting.

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

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X8 financial statements, and this report does not affect our report dated [*date of report*] on those financial statements. [*Revise this wording appropriately for use in a combined report*.]

> Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the report language described by this paragraph may be combined with the report language described in paragraph 100. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

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

> This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X8 financial statements.

Subsequent Events

104. Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors. As described in paragraph 84h, the auditor should obtain written representations from management relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following –

- Relevant internal audit (or similar functions, such as loan review in a financial institution) reports issued during the subsequent period;

- Independent auditor reports (if other than the auditor's) of significant deficiencies or material weaknesses;

- Regulatory agency reports on the company's internal control over financial reporting; and

- Information about the effectiveness of the company's internal control over financial reporting obtained through other engagements.

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

106. If the auditor obtains knowledge about subsequent events that materially and adversely affect the effectiveness of the company's internal control over financial reporting as of the date specified in the assessment, the auditor should issue an adverse opinion on internal control over financial reporting (and follow the direction in paragraph C2 if management's assessment states that internal control over financial reporting is effective). If the auditor is unable to determine the effect of the subsequent event on the effectiveness of the company's internal control over financial reporting, the auditor should disclaim an opinion. As described in paragraph C13, the auditor should disclaim an opinion on management's disclosures about corrective actions taken by the company after the date of management's assessment, if any.

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

108. After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

RELEASE

APPENDIX A *– Definitions*

A1. For purposes of this standard, the terms listed below are defined as follows –

A2. 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 would not be 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 competence to perform the control effectively.

A3. A **control objective** provides a specific target against which to evaluate the effectiveness of controls. A control objective for internal control over financial reporting generally relates to a relevant assertion and states a criterion for evaluating whether the company's control procedures in a specific area provide reasonable assurance that a misstatement or omission in that relevant assertion is prevented or detected by controls on a timely basis.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with GAAP. References to financial statements and related disclosures do not extend to the preparation of management's discussion and analysis or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

A5. **Internal control over financial reporting** is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external

RELEASE

purposes in accordance with generally accepted accounting principles ("GAAP") and includes those policies and procedures that –

(1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;

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

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.[1/]

Note: The auditor's procedures as part of either the audit of internal control over financial reporting or the audit of the financial statements are not part of a company's internal control over financial reporting.

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

[1/] See Securities Exchange Act Rules 13a-15(f) and 15d-15(f), 17 C.F.R. §§ 240.13a-15(f) and 240.15d-15(f).

RELEASE

A6. **Major classes of transactions** are those transaction flows that have a meaningful bearing on the totals accumulated in the company's significant accounts and, therefore, have a meaningful bearing on relevant assertions.

> Note: For example, at a company whose sales may be initiated by customers through personal contact in a retail store or electronically through use of the internet, these types of sales would be two major classes of transactions affecting the company's reported sales if they were both important to the company's financial statements.

A7. **Management's assessment** is the assessment described in Item 308(a)(3) of Regulations S-B and S-K that is included in management's annual report on internal control over financial reporting.[2/]

A8. A **material weakness** is a control deficiency, or combination of control deficiencies, such that there is a **reasonable possibility** that a material misstatement of the company's annual or interim financial statements will not be prevented or detected.

> Note: There is a **reasonable possibility** of an event, as used in the definitions of *material weakness* and *significant deficiency* (see paragraph A12), when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5").[3/]

A9. Controls over financial reporting may be **preventive controls** or **detective controls**. Effective internal control over financial reporting often includes a combination of preventive and detective controls.

- Preventive controls have the objective of preventing errors or fraud that could result in a misstatement of the financial statements from occurring.

[2/] See 17 C.F.R. §§ 228.308(a)(3) and 229.308(a)(3).

[3/] See FAS No. 5, Paragraph 3.

- Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements.

A10. A **relevant assertion** is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated. The determination of whether an assertion is a relevant assertion should be made without regard to the effect of controls.

A11. An account or disclosure is a **significant account** if there is a reasonable possibility that the account could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement. The determination of whether an account is a significant account should be made without regard to the effect of controls.

A12. A **significant deficiency** is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a **significant misstatement** of the company's annual or interim financial statements will not be prevented or detected.

> Note: A **significant misstatement** is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

A13. A **significant process** refers to those activities required to initiate, authorize, process, and record major classes of transactions.

RELEASE

***APPENDIX B* – Special Topics**

Integration of Audits

B1. In an integrated audit of internal control over financial reporting and the financial statements, the auditor should design his or her testing of controls to accomplish the objectives of both audits simultaneously –

- To obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and

- To obtain sufficient evidence to support the auditor's control risk assessment for purposes of the audit of financial statements.

B2. Obtaining sufficient evidence to support a control risk assessment of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

B3. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

B4. To express an opinion on internal control over financial reporting as of a *point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting *taken as a whole*, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

RELEASE

B5. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B6. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B7. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B4. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B8. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a significant deficiency or material weakness, he or she should determine the effect on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B9. 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. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

RELEASE

B10. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum –

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud;
- Findings with respect to illegal acts and related party transactions;
- Indications of management bias in making accounting estimates and in selecting accounting principles; and
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B11. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Multiple Locations Scoping Decisions

B12. In determining the locations or business units at which to perform tests of controls, the auditor should assess the risk of material misstatement to the financial statements associated with the location or business unit and correlate the amount of audit attention devoted to the location or business unit with the degree of risk.

Note: The auditor may eliminate from further consideration locations or business units that, individually or when aggregated with others, do not present a

reasonable possibility of material misstatement to the company's consolidated financial statements.

B13. In assessing and responding to risk, the auditor should test controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements. In lower-risk locations or business units, the auditor first might evaluate whether testing company-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B14. In determining the locations or business units at which to perform tests of controls, the auditor should take into account work performed by others on behalf of management. For example, if the internal auditors' plan includes relevant audit work at various locations, the auditor may coordinate work with the internal auditors and reduce the number of locations or business units at which the auditor would otherwise need to perform auditing procedures.

B15. The direction in paragraph 69 regarding special considerations for subsequent years' audits means that the auditor should vary the nature, timing, and extent of testing of controls at locations or business units from year to year.

B16. *Special Situations.* The scope of the audit should include entities that are acquired on or before the date of management's assessment and operations that are accounted for as discontinued operations on the date of management's assessment. The auditor should follow the direction in this multiple-locations discussion in determining whether it is necessary to test controls at these entities or operations.

B17. For equity method investments, the scope of the audit should include controls over the reporting in accordance with generally accepted accounting principles, in the company's financial statements, of the company's portion of the investees' income or loss, the investment balance, adjustments to the income or loss and investment balance, and related disclosures. The audit ordinarily would not extend to controls at the equity method investee.

B18. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not

be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure should be modified.

Use of Service Organizations

B19. AU sec. 324, *Service Organizations*, applies to the audit of financial statements of a company that obtains services from another organization that are part of its information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B20. AU sec. 324.03 describes the situation in which a service organization's services are part of a company's information system. If the service organization's services are part of a company's information system, as described therein, then they are part of the information and communication component of the company's internal control over financial reporting. When the service organization's services are part of the company's internal control over financial reporting, the auditor should include the activities of the service organization when determining the evidence required to support his or her opinion.

B21. AU sec. 324.07 through .16 describe the procedures that the auditor should perform with respect to the activities performed by the service organization. The procedures include –

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

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

B22. Evidence that the controls that are relevant to the auditor's opinion are operating effectively may be obtained by following the procedures described in AU sec. 324.12. These procedures include –

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

b. Performing tests of controls at the service organization.

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

Note: The service auditor's report referred to above means a report with the service auditor's opinion on the service organization's description of the design of its controls, the tests of controls, and results of those tests performed by the service auditor, and the service auditor's opinion on whether the controls tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in AU sec. 324.24b). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in AU sec. 324.24a) does not provide evidence of operating effectiveness. Furthermore, if the evidence regarding operating effectiveness of controls comes from an agreed-upon procedures report rather than a service auditor's report issued pursuant to AU sec. 324, the auditor should

evaluate whether the agreed-upon procedures report provides sufficient evidence in the same manner described in the following paragraph.

B23. If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the auditor may evaluate whether this report provides sufficient evidence to support his or her opinion. In evaluating whether such a service auditor's report provides sufficient evidence, the auditor should assess the following factors –

- The time period covered by the tests of controls and its relation to the as-of date of management's assessment,
- The scope of the examination and applications covered, the controls tested, and the way in which tested controls relate to the company's controls, and
- The results of those tests of controls and the service auditor's opinion on the operating effectiveness of the controls.

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements as described in AU sec. 324.16.

B24. If the service auditor's report on controls placed in operation and tests of operating effectiveness contains a qualification that the stated control objectives might be achieved only if the company applies controls contemplated in the design of the system by the service organization, the auditor should evaluate whether the company is applying the necessary procedures.

B25. In determining whether the service auditor's report provides sufficient evidence to support the auditor's opinion, the auditor should make inquiries concerning the service auditor's reputation, competence, and independence. Appropriate sources of information concerning the professional reputation of the service auditor are discussed in paragraph .10a of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

RELEASE

B26. When a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment, additional procedures should be performed. The auditor should inquire of management to determine whether management has identified any changes in the service organization's controls subsequent to the period covered by the service auditor's report (such as changes communicated to management from the service organization, changes in personnel at the service organization with whom management interacts, changes in reports or other data received from the service organization, changes in contracts or service level agreements with the service organization, or errors identified in the service organization's processing). If management has identified such changes, the auditor should evaluate the effect of such changes on the effectiveness of the company's internal control over financial reporting. The auditor also should evaluate whether the results of other procedures he or she performed indicate that there have been changes in the controls at the service organization.

B27. The auditor should determine whether to obtain additional evidence about the operating effectiveness of controls at the service organization based on the procedures performed by management or the auditor and the results of those procedures and on an evaluation of the following risk factors. As risk increases, the need for the auditor to obtain additional evidence increases.

- The elapsed time between the time period covered by the tests of controls in the service auditor's report and the date specified in management's assessment,
- The significance of the activities of the service organization,
- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

RELEASE

B28. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures may include –

- Evaluating procedures performed by management and the results of those procedures.
- Contacting the service organization, through the user organization, to obtain specific information.
- Requesting that a service auditor be engaged to perform procedures that will supply the necessary information.
- Visiting the service organization and performing such procedures.

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

Benchmarking of Automated Controls

B30. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B31. If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor established a baseline (i.e., last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

B32. When using a benchmarking strategy for a particular control, the auditor should take into account the importance of the effect of related files, tables, data, and parameters on the consistent and effective functioning of the automated application

control. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

B33. To determine whether to use a benchmarking strategy, the auditor should assess the following risk factors. As these factors indicate lower risk, the control being evaluated should be viewed as well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated should be viewed as less well-suited for benchmarking. These factors are –

- The extent to which the application control can be matched to a defined program within an application;
- The extent to which the application is stable (i.e., there are few changes from period to period); and
- The availability and reliability of a report of the compilation dates of the programs placed in production. (This information may be used as evidence that controls within the program have not changed.)

B34. Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote—e.g., when the vendor does not allow access or modification to the source code.

B35. After a period of time, the length of which depends upon the circumstances, the baseline of the operation of an automated application control should be reestablished. To determine when to reestablish a baseline, the auditor should evaluate the following factors –

- The effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations;
- The auditor's understanding of the nature of changes, if any, on the specific programs that contain the controls;

RELEASE

- The nature and timing of other related tests;
- The consequences of errors associated with the application control that was benchmarked; and
- Whether the control is sensitive to other business factors that may have changed. For example, an automated control may have been designed with the assumption that only positive amounts will exist in a file. Such a control would no longer be effective if negative amounts (credits) begin to be posted to the account.

RELEASE

APPENDIX C* – *Special Reporting Situations

Report Modifications

C1. The auditor should modify his or her report if any of the following conditions exist.

a. Elements of management's annual report on internal control are incomplete or improperly presented.

b. There is a restriction on the scope of the engagement.

c. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report.

d. There is other information contained in management's annual report on internal control over financial reporting.

e. Management's annual certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

C2. *Elements of Management's Annual Report on Internal Control Over Financial Reporting Are Incomplete or Improperly Presented.* If the auditor determines that elements of management's annual report on internal control over financial reporting are incomplete or improperly presented, the auditor should modify his or her report to include an explanatory paragraph describing the reasons for this determination. If the auditor determines that the required disclosure about a material weakness is not fairly presented in all material respects, the auditor should follow the direction in paragraph 100.

C3. *Scope Limitations*. The auditor can express an opinion on the company's internal control over financial reporting only if the auditor has been able to apply the procedures necessary in the circumstances. If there are restrictions on the scope of the engagement, the auditor should withdraw from the engagement or disclaim an opinion. A disclaimer of opinion states that the auditor does not express an opinion on the effectiveness of internal control over financial reporting.

RELEASE

C4. When disclaiming an opinion because of a scope limitation, the auditor should state, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph 94, g, h, and i); to do so might overshadow the disclaimer.

C5. When the auditor plans to disclaim an opinion and the limited procedures performed by the auditor caused the auditor to conclude that a material weakness exists, the auditor's report also should include –

- The definition of a material weakness, as provided in paragraph A8.

- A description of any material weaknesses identified in the company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address the requirements in paragraphs 102 and 103.

C6. The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion. The auditor is not required to perform any additional work prior to issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion.

> Note: In this case, in following the direction in paragraph 98 regarding dating the auditor's report, the report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

C7. If the auditor concludes that he or she cannot express an opinion because there has been a limitation on the scope of the audit, the auditor should communicate, in

writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

C8. *Opinions Based, in Part, on the Report of Another Auditor*. When another auditor has audited the financial statements and internal control over financial reporting of one or more subsidiaries, divisions, branches, or components of the company, the auditor should determine whether he or she may serve as the principal auditor and use the work and reports of another auditor as a basis, in part, for his or her opinion. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements needs to participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

C9. When serving as the principal auditor of internal control over financial reporting, the auditor should decide whether to make reference in the report on internal control over financial reporting to the audit of internal control over financial reporting performed by the other auditor. In these circumstances, the auditor's decision is based on factors analogous to those of the auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

C10. The decision about whether to make reference to another auditor in the report on the audit of internal control over financial reporting might differ from the corresponding decision as it relates to the audit of the financial statements. For example, the audit report on the financial statements may make reference to the audit of a significant equity investment performed by another independent auditor, but the report on internal control over financial reporting might not make a similar reference because

management's assessment of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.[1/]

C11. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the company's internal control over financial reporting, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinion.

C12. *Management's Annual Report on Internal Control Over Financial Reporting Containing Additional Information*. Management's annual report on internal control over financial reporting may contain information in addition to the elements described in paragraph 81 that are subject to the auditor's evaluation.

C13. If management's annual report on internal control over financial reporting could reasonably be viewed by users of the report as including such additional information, the auditor should disclaim an opinion on the information.

C14. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If, after discussing the matter with management, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. AU sec. 317, *Illegal Acts by Clients* and Section 10A of the Securities Exchange Act of 1934 may also require the auditor to take additional action.[2/]

> Note: If management makes the types of disclosures described in paragraph C12 outside its annual report on internal control over financial reporting and includes them elsewhere within its annual report on the company's financial statements, the auditor would not need to disclaim an opinion. However, in that situation, the auditor's responsibilities are the same as those described in this

---

[1/] See paragraph B17, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

[2/] See 15 U.S.C. § 78j-1.

paragraph if the auditor believes that the additional information contains a material misstatement of fact.

C15. *Management's Annual Certification Pursuant to Section 302 of the Sarbanes-Oxley Act is Misstated.* If matters come to the auditor's attention as a result of the audit of internal control over financial reporting that lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,[3/] the auditor should follow the communication responsibilities as described in AU sec. 722 *Interim Financial Information*, for any interim period. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in AU sec. 722, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Filings Under Federal Securities Statutes

C16. AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the auditor should extend the direction in AU sec. 711.10 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements to matters that could have a material effect on management's assessment of internal control over financial reporting.

C17. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of

---

[3/] See 17 C.F.R. §§ 240.13a-14(a) and 240.15d-14(a).

RELEASE

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

Appendix 2 – Proposed Auditing Standard

December 19, 2006
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard –

Considering and Using the Work of Others in an Audit

This proposed auditing standard will supersede 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") if it is adopted by the Board and approved by the Securities and Exchange Commission.

Table of Contents

Introduction

1. This standard establishes requirements for and provides direction on the auditor's consideration and use of relevant work performed by others in an integrated audit of financial statements and internal control over financial reporting ("integrated audit") or in an audit of financial statements only. For these purposes, the work of others includes work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee.

> Note: The use of the work of others, as described within this standard does not include the auditor's use of the work of other independent auditors, as described in AU sec. 543*, Part of Audit Performed by Other Independent Auditors*, the auditor's use of a service auditor as described in AU sec. 324, *Service Organizations,* or the auditor's use of the work of a specialist, as described in AU sec. 336, *Using the Work of a Specialist*.

2. This standard distinguishes between two general types of work performed by others: 1) the auditor's consideration and use of work performed by others in the ordinary course of business (paragraphs 3 through 19); and, 2) work performed by others to directly assist the auditor in achieving the auditor's objectives in his or her audit (paragraphs 20 and 21).

The Effects of the Work of Others

3. The auditor should obtain an understanding of work performed by others sufficient to identify relevant activities.

4. *Relevant activities* are tests performed by others that provide evidence about the design and operating effectiveness of a company's internal control over financial reporting or that provide evidence about potential misstatements of the company's financial statements. Tests performed by others that provide such evidence typically are similar in nature, timing, and extent to the procedures that the auditor would have performed himself or herself as part of obtaining sufficient competent evidence to support the auditor's opinion.

> Note: Certain activities may not be relevant to the financial statements or internal control over financial reporting. For example, procedures performed to evaluate the efficiency of management decision-making processes ordinarily are not relevant activities. In addition, not all activities are tests that provide audit evidence. Only tests that provide audit evidence may be considered relevant activities.

5. The auditor should obtain an understanding of the relevant activities undertaken by others to determine how that work might alter the nature, timing, and extent of the procedures the auditor would have otherwise performed.

6. The auditor should determine whether the results of relevant activities undertaken by others identified control deficiencies, fraud, or financial statement misstatements. If so, the auditor should determine how such findings by others might affect the auditor's procedures and conclusions.

> Note: The auditor may limit this understanding to considering relevant activities that provide information about risks of material misstatement to the financial statements or risks that material weaknesses in internal control over financial reporting exist.

7. The auditor should evaluate the extent to which he or she will use the work of others. Areas in which the auditor might use the work performed by others to reduce the procedures the auditor otherwise would have performed include –

- Procedures the auditor performs when obtaining an understanding of the company's internal control over financial reporting;
- Procedures the auditor performs when assessing risk;
- Procedures the auditor performs when testing the effectiveness of controls; and
- Substantive procedures the auditor performs when testing account balances and disclosures.

8. *Responsibilities of the Auditor*. The auditor's responsibility to report on the financial statements or management's assessment of the effectiveness of internal control over financial reporting rests solely with the auditor; this responsibility cannot be shared with the other individuals whose work the auditor uses.

9. The auditor must obtain sufficient competent evidence [1/] in support of his or her opinion. Judgments about the sufficiency of evidence obtained, assessments of risk, the

---

[1/] AU sec. 326, *Evidential Matter*, provides direction regarding the sufficiency of evidence. Evidence obtained through the auditor's direct personal knowledge, including observation, reperformance, and inspection, is generally more persuasive than information obtained indirectly from others.

materiality of misstatements, and evaluations of test results, must be those of the auditor.

Using the Work of Others

10. To use the work of others to reduce the nature, timing, or extent of the work the auditor would have otherwise performed, the auditor should –

a. Evaluate the nature of the subject matter tested by others;

b. Evaluate the competence and objectivity of the individuals who performed the work; and

c. Test some of the work performed by others to evaluate the quality and effectiveness of their work.

11. *Evaluating the Nature of the Subject Matter Tested by Others*. The auditor should assess the following risk factors when evaluating the nature of the subject matter tested by others. As these risks increase, the need for the auditor to perform more of the work himself or herself increases. As these risks decrease, the need for the auditor to perform more of the work himself or herself decreases.

- The risk of material misstatement in the accounts and disclosures subject to testing;
- The amount of judgment or estimation related to the account or disclosure subject to testing;
- The degree of judgment required to evaluate results of testing (i.e., the degree to which the evaluation relies upon subjective factors rather than objective testing); and
- The potential for management override of controls related to the subject matter of the testing.

12. When the auditor evaluates the nature of controls tested by others, he or she also should consider, as an additional risk factor, the pervasiveness of the controls being tested.

13. *Evaluating the Competence and Objectivity of Others*. The auditor should evaluate the competence and objectivity of the individuals performing tests of controls, accounts, or disclosures to determine the extent to which the auditor may use their

work. In performing this evaluation, the auditor should make judgments about the degree of competence and objectivity of the individuals rather than form an absolute conclusion about whether the individuals are competent or objective. The higher the degree of competence and objectivity, the greater use the auditor may make of the work; conversely, the lower the degree of competence and objectivity, the less use the auditor may make of the work.

> Note: The auditor should not use the work of individuals who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of individuals who have a low level of competence regardless of their degree of objectivity.

14. Factors relevant to the assessment of the competence of the individuals performing tests include, but are not limited to –

- Their educational level and professional experience;
- Their professional certification and continuing education;
- Practices regarding the assignment of individuals to areas of the business;
- Supervision and review of their activities;
- Quality of the documentation of their work, including any reports or recommendations issued; and
- Periodic evaluation of their overall performance.

15. Factors relevant to the assessment of the objectivity of the individuals performing tests include, but are not limited to –

a. Policies to address the individuals' objectivity about the areas being tested, and whether the policies are being complied with, including –

    - Policies prohibiting individuals from testing matters related to areas in which relatives are employed in important or internal control-sensitive positions.
    - Policies prohibiting individuals from testing matters in areas to which they are assigned, were recently assigned or are scheduled to be assigned upon completion of their testing responsibilities. For

purposes of this standard, "assigned" includes having supervisory responsibility for the area.

Note: The auditor should not use tests performed by the same personnel who are responsible for performing the control or for the completeness and accuracy of the information being tested because these individuals do not have sufficient objectivity as it relates to the subject matter.

b. The organizational status of the persons responsible for the work of others, including –

- Whether the board of directors or the audit committee oversees employment decisions related to the responsible persons.

- Whether the responsible persons have direct access and report regularly to the board of directors or the audit committee.

- Whether the responsible persons report to a person of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the persons performing the testing.

c. Policies designed to assure that compensation arrangements for individuals performing the work do not adversely affect objectivity, and whether the policies are being complied with.

16. Personnel whose core function involves permanently serving as a testing or compliance authority at the company, such as internal auditors or loan review in a financial institution, normally are expected to have greater competence and objectivity than company personnel whose principal duties address other business objectives. Therefore, the auditor may be able to use the work of personnel assigned to a permanent testing authority to a greater extent than the work of other company personnel.

17. When determining how the work of others will alter the nature, timing, or extent of the auditor's work, the auditor should assess the relationship between the nature of the subject matter and the competence and objectivity of those who performed the work. As the risks described in paragraphs 11 and 12 increase, the auditor's ability to use the work of others decreases and the necessary level of competence and objectivity of those who perform the work increases.

18. *Testing the Work of Others*. If the auditor uses the work of others to reduce the procedures the auditor otherwise would have performed, the auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The nature and extent of the tests that the auditor should perform depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work.

19. In evaluating the quality and effectiveness of the work of others, the auditor should evaluate such factors as –

- Nature, timing, and extent of the testing performed;
- Degree to which the testing performed by others relates to the control objectives or financial statement assertions;
- Adequacy of the work programs;
- Adequacy of documentation of the testing, including evidence of supervision and review;
- Appropriateness of the conclusions in the circumstances; and
- Consistency of the reports with the results of the testing.

Obtaining Direct Assistance from Others

20. In performing the audit, the auditor may request direct assistance from personnel that are sufficiently competent and objective to perform the work assigned. The auditor should determine whether personnel who might provide direct assistance are sufficiently competent and objective by following the direction in paragraphs 13 through 17.

21. Direct assistance means work that the auditor requests the others to perform to complete some aspect of the auditor's work, such as tests of controls or substantive tests. When direct assistance is provided, the auditor should supervise, review, evaluate, and test the work performed by others as described in AU sec. 311, *Planning and Supervision*.

RELEASE

Appendix 3

Proposed Rule 3525: Audit Committee Pre-approval of Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall –

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm; and

> Note: Independence requirements provide that an auditor is not independent of his or her audit client if the auditor is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the auditor is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. Several principles guide the application of this general standard, including whether the auditor assumes a management role or audits his or her own work. Therefore, an auditor would not be independent if, for example, management had delegated its responsibility for internal control over financial reporting to the auditor or if the auditor had designed or implemented the audit client's internal control over financial reporting.

(c) document the substance of its discussion with the audit committee of the issuer.

RELEASE

Appendix 4 – Amendments to Interim Standards

December 19, 2006
AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Amendments to PCAOB Interim Standards

RELEASE

Appendix 4

Amendments to PCAOB Interim Standards

Auditing Standards

AU sec. 230, "Due Professional Care in the Performance of Work"

Statement on Auditing Standards ("SAS") No. 1, "Codification of Auditing Standards and Procedures," AU sec. 230, "Due Professional Care in the Performance of Work," as amended by SAS No. 41, "Working Papers," SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," and SAS No. 99, "Consideration of Fraud in an Financial Statement Audit" (AU sec. 230, "Due Professional Care in the Performance of Work") is amended as follows –

a. Paragraph .10 is replaced with –

The exercise of due professional care allows the auditor to obtain *reasonable assurance* about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether any material weaknesses exist as of the date of management's assessment. Absolute assurance is not attainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance. Therefore, an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) may not detect a material weakness in internal control over financial reporting or a material misstatement to the financial statements.

b. The term "financial statements" within the first sentence of paragraph .13 is replaced with the term "financial statements or internal control over financial reporting."

c. The second sentence of paragraph .13 is replaced with –

Therefore, the subsequent discovery that either a material misstatement, whether from error or fraud, exists in the financial statements or a material

> weakness in internal control over financial reporting does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with the standards of the Public Company Accounting Oversight Board (United States).

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 third bullet point of paragraph .06 is replaced with –

> Management is responsible for establishing and maintaining effective internal control over financial reporting. If, in an integrated audit of financial statements and internal control over financial reporting, the auditor concludes that he or she cannot express an opinion on internal control over financial reporting because there has been a limitation on the scope of the audit, he or she should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed.

b. The eighth bullet point of paragraph .06 is amended as follows –

> Under Integrated audit of financial statements and internal control over financial reporting, the last sub-bullet point is replaced with the following –
>
> > To the board of directors—any conclusion that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.
>
> Under Audit of financial statements, the last sub-bullet is replaced with the following –

RELEASE

> 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 audit committee is ineffective, that conclusion.

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 as follows –

The reference to paragraph 39 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraph 6 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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. Within the note to paragraph 3, the reference to paragraphs 22-23 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. Within the note to paragraph 7, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 45-46 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

RELEASE

c. Within the note to paragraph 12, the references to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 are replaced with references to paragraphs 14-15 and 6, respectively, of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

d. Within the note to paragraph 18, the reference to Appendix B, *Additional Performance Requirements and Directions: Extent of Testing Examples* of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B12-B18 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Within the note to paragraph 30, the reference to paragraphs 147-149 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs B3-B5 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

<u>AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"</u>

SAS No. 45, "Omnibus Statement on Auditing Standards – 1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended as follows –

The reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 57-60 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

<u>AU sec. 315, "Communications Between Predecessor and Successor Auditors"</u>

SAS No. 84, "Communications Between Predecessor and Successor Auditors – (AU sec. 315, " Communications Between Predecessor and Successor Auditors"), as amended by SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," is amended as follows –

RELEASE

The last sentence of paragraph 16 is replaced with–

> Furthermore, the predecessor auditor is not a specialist as defined in AU sec. 336, *Using the Work of a Specialist* nor does the predecessor auditor's work constitute the work of others as described in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

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 –

> The reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 45-46 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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. The note to paragraph 2 is replaced with –

> Note: Refer to paragraph A10 of Appendix A, *Definitions,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for the definition of relevant assertions and paragraphs 30-31 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* for discussion of identifying relevant assertions.

b. Within the note to paragraph 9, the reference to Appendix B, *Additional Performance Requirements and Directions: Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 is replaced with a reference to

paragraphs B12-B18 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

c. The last sentence of paragraph 55 is replaced with –

When obtaining an understanding of relevant work performed by others, the auditor should follow the direction in paragraphs 3 through 9 of Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

d. The note to paragraph 83 is deleted.

e. Within the note to paragraph 97, the reference to paragraphs 104-105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 61-62 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. The appendix at AU sec. 319.110 is deleted.

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 –

The reference to Appendix B, *Additional Performance Requirements: Extent of Testing Examples,* of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs B19-B29 of Appendix B, *Special Topics,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

RELEASE

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements"[1/]

AU sec. 325, "Communications About Control Deficiencies in an Audit of Financial Statements" is amended as follows –

(a) The first bullet point in paragraph 1 is revised to read as follows: 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 would not be met.

(b) Paragraph 2 is replaced with –

A *significant deficiency* is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected.

Note: There is a "reasonable possibility" of an event, as used in the definitions of *significant deficiency* and *material weakness* (paragraph 3), when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5").

[1/] When the Board adopted Auditing Standard No. 2, it superseded SAS No. 60 in the context of an integrated audit of financial statements and internal control over financial reporting by paragraphs 207-214 of Auditing Standard No. 2. See PCAOB Release No. 2004-008, *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"* (Sept. 15, 2004). As a result of superseding Auditing Standard No. 2, paragraphs 83 to 89 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements,* now supersede SAS No. 60 in the context of an integrated audit.

RELEASE

Note: A significant misstatement is a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

(c) Paragraph 3 is replaced with –

A material weakness is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility 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 follow the direction in paragraphs 70-79 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

(d) Paragraph 5 is replaced with –

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 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 information in writing to the board of directors.

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of a Material Weakness," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph A12 of Appendix A, *Definitions,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.* Within the example report within paragraph .04 of the interpretation, the fourth sentence is replaced with the definition of a material weakness in paragraph A8

RELEASE

of Appendix A, *Definitions,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

AU sec. 330, "The Confirmation Process"

SAS No. 67, "The Confirmation Process" (AU sec. 330, "The Confirmation Process"), is amended as follows –

Footnote 3 to paragraph 28 is replaced with –

> The need to maintain control does not preclude the use of others in the confirmation process in accordance with Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*. That standard provides direction on considering and using the work of others and obtaining direct assistance from others.

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 as follows –

a. The last two sentences of paragraph 7 are replaced with –

> The auditor also should obtain an understanding of work performed by others sufficient to identify any relevant activities in the area of derivatives, hedging, and securities. Direction on considering and using the work of others is contained in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

b. Within the note to paragraph 11, the phrase "related to all significant accounts and disclosures in the financial statements" within the first sentence is deleted.

RELEASE

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 as follows –

The reference to paragraphs 142-144 of PCAOB Auditing Standard No. 2 within the note to paragraph 5 is replaced with a reference to paragraphs 84-85 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated 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 –

The reference to paragraphs 162-199 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 94-108 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* and Appendix C, *Special Reporting Situations,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The sentence that reads "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," is replaced with, "In addition, see paragraph 96 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* which includes an illustrative combined audit report."

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

RELEASE

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 as follows –

a. Paragraph 1 is replaced with –

The auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient competent evidence to support the auditor's opinion. Paragraph 5 describes the procedure to be followed when a subsequent event occurring after the report date is disclosed in the financial statements.

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.

b. Paragraph 5 is replaced with –

The independent auditor has two methods for dating the report when a subsequent event disclosed in the financial statements occurs after the auditor has obtained sufficient competent evidence on which to base his or her opinion, but before the issuance of the related financial statements. The auditor may use "dual dating," for example, "February 16, 20__, except for Note __, as to which the date is March 1, 20__," or may date the report as of the later date. In the former instance, the responsibility for events occurring subsequent to the original report date is limited to the specific event referred to in the note (or otherwise disclosed). In the latter instance, the independent auditor's responsibility for subsequent events extends to the later report date and, accordingly, the procedures outlined in section 560.12 generally should be extended to that date.

c. The reference within the heading before paragraph 3 to "completion of field work" is replaced with "the date of the independent auditor's report."

<u>AU sec. 543, "Part of Audit Performed by Other Independent Auditors"</u>

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,

RELEASE

"Omnibus Statement on Auditing Standards – 1990" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), is amended as follows –

The reference to paragraphs 182-185 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs C8-C11 of Appendix C, *Special Reporting Situations,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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 as follows –

The reference to paragraphs 186-189 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraphs 104-107 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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 as follows –

The reference to paragraph 197 of PCAOB Auditing Standard No. 2 within the note to paragraph 1 is replaced with a reference to paragraph 108 of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

RELEASE

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 as follows –

The reference to paragraphs 198-199 of PCAOB Auditing Standard No. 2 within the note to paragraph 2 is replaced with a reference to paragraphs C16-C17 of Appendix C, *Special Reporting Situations,* of PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

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 is inserted after the first sentence of paragraph 3 –

The SEC also requires management, with the participation of the principal executive officers (the certifying officers) to make certain quarterly and annual certifications with respect to the company's internal control over financial reporting.[2/]

[2/] See Section 302 of the Sarbanes-Oxley Act of 2002, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), (17 C.F.R. § 240.13a-14a or 17 C.F.R. § 240.15d-14a), whichever applies.

b. The note to paragraph 3 is deleted.

c. The following is added to the end of paragraph 7 –

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

order for the certifications to be accurate and to comply with the requirements of Section 302 of the Act.

Note: The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting take effect beginning with the first quarter after the company's first annual assessment of internal control over financial reporting as described in Item 308(a)(3) of Regulations S-B and S-K.

d. The following lettered section is added to the end of paragraph 18 –

g. Evaluating management's quarterly certifications about internal control over financial reporting by performing the following procedures –

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;

- Evaluating the implications of misstatements identified by the auditor as part of the auditor's other interim review procedures as they relate to effective internal control over financial reporting; and

- Determining, through a combination of observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

e. Paragraph 29 is replaced with –

RELEASE

As a result of conducting a review of interim financial information, the accountant may become aware of matters that cause him or her to believe that –

a. material modification should be made to the interim financial information for it to conform with generally accepted accounting principles;

b. modification to the disclosures about changes in internal control over financial reporting is necessary for the certifications to be accurate and to comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies; and

c. the entity filed the Form 10-Q or Form 10-QSB before the completion of the review.

In such circumstances, the accountant should communicate the matter(s) to the appropriate level of management as soon as practicable.

f. Paragraph 32 is replaced by the following –

If the auditor becomes aware of information indicating that fraud or an illegal act has or may have occurred, the auditor must also determine his or her responsibilities under AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.[1/]

[1/] See 15 U.S.C. § 78j-1

g. Within paragraph 33, the third sentence is replaced by the following –

A *significant deficiency* is a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected.

RELEASE

Auditing Standard No. 4 – *Reporting on the Elimination of a Previously Reported Material Weakness*

Auditing Standard No. 4 – *Reporting on the Elimination of a Previously Reported Material Weakness* is amended as follows –

a. Paragraph 9 is revised as follows –

The terms *internal control over financial reporting, control deficiency, significant deficiency, and material weakness* have the same meanings as the definitions of those terms in Appendix A, *Definitions,* of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

b. The first sentence of Paragraph 10 is revised as follows –

Paragraph 5 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* states that the auditor should use the same suitable, recognized control framework to perform his or her audit of internal control over financial reporting as management uses for its annual evaluation of the effectiveness of the company's internal control over financial reporting.

c. Within the note to paragraph 10, the last sentence is revised to read as follows –

More information about the COSO framework is included within the COSO report.

d. Paragraph 11 is revised to read as follows –

The terms *relevant assertion* and *control objective* have the same meaning as the definitions of those terms in Appendix A, *Definitions,* of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

e. Paragraph 13 is revised to read as follows –

RELEASE

In an audit of internal control over financial reporting, the auditor should evaluate the design effectiveness of controls by determining whether the company's controls, if operating properly, satisfy the company's control objectives and can effectively prevent or detect errors or fraud that could result in material misstatements of the financial statements.[2/]

[2/] See paragraph 47 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

f. Within paragraph 21, the last sentence is deleted.

g. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraphs 14 and 15 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the second sentence is deleted.

h. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 6 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

i. Within subparagraph a. of paragraph 26, the reference to paragraphs 47 through 51 of Auditing Standard No. 2 is replaced with a reference to paragraphs 17 through 22 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

j. Within subparagraph b. of paragraph 26, the reference to paragraphs 79 through 82 of Auditing Standard No. 2 is replaced with a reference to paragraphs 36 through 40 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

k. The note to paragraph 28 is deleted.

l. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 47 and

48 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

m. Within paragraph 32 –

- The reference to paragraph 92 of Auditing Standard No. 2 is replaced with a reference to paragraph 49 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

- The reference to paragraphs 93 through 102 and 105 through 107 of Auditing Standard No. 2 is replaced with a reference to paragraphs 55 through 62 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

n. Paragraph 33 is replaced with the following –

The auditor should perform tests of the specified controls over a period of time that is adequate to determine whether, as of the date specified in management's assertion, the controls necessary for achieving the stated control objective are operating effectively. The timing of the auditor's tests should vary with the risk associated with the control being tested. For example, a transaction-based, daily reconciliation generally would permit the auditor to obtain sufficient evidence as to its operating effectiveness in a shorter period of time than a pervasive, company-level control, such as any of those described in paragraphs 17 and 18 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. Additionally, the auditor typically will be able to obtain sufficient evidence as to the operating effectiveness of controls over the company's period-end financial reporting process only by testing those controls in connection with a period-end.

o. Within paragraph 35, the reference to paragraphs B1 through B13 of Appendix B of Auditing Standard No. 2 is replaced with a reference to paragraphs B12 through B15 of Appendix B, *Special Topics,* of Proposed

RELEASE

Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

p. The second sentence of paragraph 36 is replaced with the following –

To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor otherwise would have performed, the auditor should apply the direction in Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

q. The second sentence of paragraph 37 is replaced with the following –

Therefore, if the auditor has been engaged to report on more than one material weakness or on more than one stated control objective, the auditor must evaluate whether he or she has obtained sufficient evidence that the control objectives related to each of the material weaknesses identified in management's assertion are achieved.[4/]

[4/] See paragraphs 8 and 9 of Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit*.

r. The first two sentences of paragraph 38 are replaced with the following –

Paragraph 17 of Proposed Auditing Standard, *Considering and Using the Work of Others in an Audit,* should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist. Paragraph 17 states, in part, "As the risks described in paragraphs 11 and 12 increase, the auditor's ability to use the work of others decreases and the necessary level of competence and objectivity of those who perform the work increases."

s. The note to paragraph 39 is deleted.

t. Within paragraph 42, the reference to paragraph 140 of Auditing Standard No. 2 is replaced with a reference to paragraph 79 of Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

u. Paragraph 44f is replaced with the following –

RELEASE

Describing any fraud resulting in a material misstatement to the company's financial statements and any other fraud that does not result in a misstatement in the company's financial statements but involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting and that has occurred or come to management's attention since the date of management's most recent annual assessment of internal control over financial reporting.

v. Within paragraph 63, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29 through 32 of AU Sec. 722, *Interim Financial Information*.

w. Within paragraph 64, the reference to paragraphs 202 through 206 of Auditing Standard No. 2 is replaced with a reference to paragraphs 7 and 29 through 32 of AU Sec. 722, *Interim Financial Information*.