SECURITIES AND EXCHANGE COMMISSION

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Public Company Accounting Oversight Board; Notice of Filing of Proposed Rule on Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and Conforming Amendments

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), notice is hereby given that on May 25, 2007, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons. The text of the proposed rules consist of proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements, and Related Independence Rule and conforming amendments to its auditing standards.

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

On May 24, 2007, the Board adopted Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements ("Auditing Standard No. 5"); Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting, and conforming amendments to its auditing standards. The proposed rule text is set out below.

Auditing Standard No. 5 –

<u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>

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APPENDICES

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/]

2. Effective internal control over financial reporting provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes.[3/] If one or more **material weakness**es exist, the company's internal control over financial reporting cannot be considered effective.[4/]

3. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform

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[1/] Terms defined in Appendix A, Definitions, are set in **boldface type** (italics in the Federal Register printing) the first time they appear.

[2/] This auditing standard supersedes Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements, and is the standard on attestation engagements referred to in Section 404(b) of the Act. It also is the standard referred to in Section 103(a)(2)(A)(iii) of the Act.

[3/] 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); Paragraph A5.

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

the audit to obtain competent evidence that is sufficient to obtain reasonable assurance[5/] about whether material weaknesses 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.

4. The general standards[6/] 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.[7/]

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

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

[7/] 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 Financial Reporting Council, Internal Control Revised Guidance for Directors on the Combined Code, October 2005 (known as the Turnbull Report).

Integrating the Audits

6. 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.

7. 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 assessments for purposes of the audit of financial statements.

8. Obtaining sufficient evidence to support control risk assessments 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. (See Appendix B for additional direction on integration.)

Note: In some circumstances, particularly in some audits of smaller and less complex companies, the auditor might choose not to assess control risk as low for purposes of the audit of the financial statements. In such circumstances, the auditor's tests of the operating effectiveness of controls would be performed principally for the purpose of supporting his or her opinion on whether the company's internal control over financial reporting is effective as of year-end. The results of the auditor's financial statement auditing procedures also should inform his or her risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

Planning the Audit

9. The auditor should properly plan the audit of internal control over financial reporting and properly supervise any assistants. When planning an integrated 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 performed by the auditor;
- 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[8/] or management;

- Legal or regulatory matters of which the company is aware;

- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting;

- Preliminary judgments about the effectiveness of internal control over financial reporting;

- Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

[8/] If no audit committee exists, all references to the audit committee in this standard apply to the entire board of directors of the company. See 15 U.S.C. §§ 78c(a)58 and 7201(a)(3).

- Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

- The relative complexity of the company's operations.

  Note: Many smaller companies have less complex operations. Additionally, some larger, complex companies may have less complex units or processes. Factors that might indicate less complex operations include: fewer business lines; less complex business processes and financial reporting systems; more centralized accounting functions; extensive involvement by senior management in the day-to-day activities of the business; and fewer levels of management, each with a wide span of control.

Role of Risk Assessment

10. Risk assessment underlies the entire audit process described by this standard, including the determination of **significant accounts and disclosures** and **relevant assertion**s, the selection of controls to test, and the determination of the evidence necessary for a given control.

11. 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 that should be devoted to that area. In addition, the risk that a

company's internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk of failure to prevent or detect error. The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.

12. The complexity of the organization, business unit, or process, will play an important role in the auditor's risk assessment and the determination of the necessary procedures.

Scaling the Audit

13. The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its **control objective**s. The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks. Scaling is most effective as a natural extension of the risk-based approach and applicable to the audits of all companies. Accordingly, a smaller, less complex company, or even a larger, less complex company might achieve its control objectives differently than a more complex company.[9/]

[9/] The SEC Advisory Committee on Smaller Public Companies considered a company's size with respect to compliance with the internal control reporting provisions of the Act. See Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission, Final Report, at p. 5 (April 23, 2006).

Addressing the Risk of Fraud

14. When planning and performing the audit of internal control over financial reporting, the auditor should take into account the results of his or her fraud risk assessment.[10/] As part of identifying and testing entity-level controls, as discussed beginning at paragraph 22, and selecting other controls to test, as discussed beginning at paragraph 39, the auditor should evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls. Controls that might address these risks include –

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls over journal entries and adjustments made in the period-end financial reporting process;
- Controls over related party transactions;
- Controls related to significant management estimates; and
- Controls that mitigate incentives for, and pressures on, management to falsify or inappropriately manage financial results.

[10/] See paragraphs .19 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.

15. If the auditor identifies deficiencies in controls designed to prevent or detect fraud during the audit of internal control over financial reporting, the auditor should take into account those deficiencies when developing his or her response to risks of material misstatement during the financial statement audit, as provided in AU sec. 316.44 and .45.

Using the Work of Others

16. The auditor should evaluate the extent to which he or she will use the work of others to reduce the work the auditor might otherwise perform himself or herself. AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, applies in an integrated audit of the financial statements and internal control over financial reporting.

17. For purposes of the audit of internal control, however, the auditor may use the work performed by, or receive direct assistance from, internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides evidence about the effectiveness of internal control over financial reporting. In an integrated audit of internal control over financial reporting and the financial statements, the auditor also may use this work to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of the financial statements.

18. The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use to determine the extent to which the auditor may use their work. The higher

the degree of competence and objectivity, the greater use the auditor may make of the work. The auditor should apply paragraphs .09 through .11 of AU sec. 322 to assess the competence and objectivity of internal auditors. The auditor should apply the principles underlying those paragraphs to assess the competence and objectivity of persons other than internal auditors whose work the auditor plans to use.

> Note: For purposes of using the work of others, competence means the attainment and maintenance of a level of understanding and knowledge that enables that person to perform ably the tasks assigned to them, and objectivity means the ability to perform those tasks impartially and with intellectual honesty. To assess competence, the auditor should evaluate factors about the person's qualifications and ability to perform the work the auditor plans to use. To assess objectivity, the auditor should evaluate whether factors are present that either inhibit or promote a person's ability to perform with the necessary degree of objectivity the work the auditor plans to use.

> Note: The auditor should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.

19. The extent to which the auditor may use the work of others in an audit of internal control also depends on the risk associated with the control being tested. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases.

Materiality

20. 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.[11/]

Using a Top-Down Approach

21. 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 with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. 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**. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion.

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

Note: The top-down approach describes the auditor's sequential thought process in identifying risks and the controls to test, not necessarily the order in which the auditor will perform the auditing procedures.

Identifying Entity-Level Controls

22. The auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on other controls.

23. Entity-level controls vary in nature and precision –

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls.

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.

24. Entity-level controls include –

- Controls related to the control environment;

- Controls over management override;

Note: Controls over management override are important to effective internal control over financial reporting for all companies, and may be particularly important at smaller companies because of the increased involvement of senior management in performing controls and in the period-end financial reporting process. For smaller companies, the controls that address the risk of management override might be different from those at a larger company. For example, a smaller company might rely on more detailed oversight by the audit committee that focuses on the risk of management override.

- The company's risk assessment process;

- 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.

25. Control Environment. Because of its importance to effective internal control over financial reporting, the auditor must evaluate the control environment at the company. 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 sound integrity and ethical values, particularly of top management, are developed and understood; and

- Whether the Board or audit committee understands and exercises oversight responsibility over financial reporting and internal control.

26. 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 related to the selection and application of accounting policies;
- 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 preparing annual and quarterly financial statements and related disclosures.

Note: Because the annual period-end financial reporting process normally occurs after the "as-of" date of management's assessment, those controls usually cannot be tested until after the as-of date.

27. 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 ("IT") 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.

Note: The auditor should obtain sufficient evidence of the effectiveness of those quarterly controls that are important to determining whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion as of the date of management's assessment. However, the auditor is not required to obtain sufficient evidence for each quarter individually.

Identifying Significant Accounts and Disclosures and Their Relevant Assertions

28. The auditor should identify significant accounts and disclosures and their relevant assertions. Relevant assertions are those financial statement assertions that have a reasonable possibility of containing a misstatement that would cause the financial statements to be materially misstated. The financial statement assertions include[12/] –

- Existence or occurrence
- Completeness
- Valuation or allocation
- Rights and obligations

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

- Presentation and disclosure

Note: 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 disclosure that have a reasonable possibility of containing misstatements that would cause the financial statements to be materially misstated.

29. To identify significant accounts and disclosures and their relevant assertions, the auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures. Risk factors relevant to the identification of significant accounts and disclosures and their relevant assertions include –

- Size and composition of the account;
- Susceptibility to misstatement due to errors or fraud;
- Volume of activity, complexity, and homogeneity of the individual transactions processed through the account or reflected in the disclosure;
- Nature of the account or disclosure;
- Accounting and reporting complexities associated with the account or disclosure;

- Exposure to losses in the account;

- Possibility of significant contingent liabilities arising from the activities reflected in the account or disclosure;

- Existence of related party transactions in the account; and

- Changes from the prior period in account or disclosure characteristics.

30. As part of identifying significant accounts and disclosures and their relevant assertions, the auditor also should determine the likely sources of potential misstatements 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 or disclosure.

31. The risk factors that the auditor should evaluate in the identification of significant accounts and disclosures and their relevant assertions are the same in the audit of internal control over financial reporting as in the audit of the financial statements; accordingly, significant accounts and disclosures and their relevant assertions are the same for both audits.

Note: In the financial statement audit, the auditor might perform substantive auditing procedures on financial statement accounts, disclosures and assertions that are not determined to be significant accounts and disclosures and relevant assertions.[13/]

32. The components of a potential significant account or disclosure might be subject to significantly differing risks. If so, different controls might be necessary to adequately address those risks.

33. When a company has multiple locations or business units, the auditor should identify significant accounts and disclosures and their relevant assertions 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.

Understanding Likely Sources of Misstatement

34. To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;

[13/] This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see paragraph 61 and AU sec. 316.50 for further discussion about predictability of auditing procedures).

- Verify that the auditor has identified the points within the company's processes 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. Because of the degree of judgment required, the auditor should either perform the procedures that achieve the objectives in paragraph 34 himself or herself or supervise the work of others who provide direct assistance to the auditor, as described in AU sec. 322.

36. The auditor also should understand how IT affects the company's flow of transactions. The auditor should apply paragraphs .16 through .20, .30 through .32, and .77 through .79, of AU sec. 319, Consideration of Internal Control in a Financial Statement Audit, which discuss the effect of information technology on internal control over financial reporting and the risks to assess.

Note: The identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by this standard.

37. Performing Walkthroughs. Performing walkthroughs will frequently be the most effective way of achieving the objectives in paragraph 34. 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, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

38. In performing a walkthrough, at the points at which important processing procedures occur, the auditor questions the company's personnel about their understanding of what is required by the company's prescribed procedures and controls. These probing questions, combined with the other walkthrough procedures, allow the auditor 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. Additionally, probing questions that go beyond a narrow focus on the single transaction used as the basis for the walkthrough allow the auditor to gain an understanding of the different types of significant transactions handled by the process.

Selecting Controls to Test

39. 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.

40. 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.

41. The decision as to whether a control should be selected for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement to a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, **preventive control**, **detective control**).

Testing Controls

Testing Design Effectiveness

42. The auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, 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.

> Note: A smaller, less complex company might achieve its control objectives in a different manner from a larger, more complex organization. For example, a smaller, less complex company might have fewer 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 should evaluate whether those alternative controls are effective.

43. 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. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

44. 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.

> Note: In some situations, particularly in smaller companies, a company might use a third party to provide assistance with certain financial reporting functions. When assessing the competence of personnel responsible for a company's financial reporting and associated controls, the auditor may take into account the combined competence of company personnel and other parties that assist with functions related to financial reporting.

45. 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, and re-performance of the control.

Relationship of Risk to the Evidence to be Obtained

46. For each control selected for testing, the evidence necessary to persuade the auditor that the control is effective depends upon the risk associated with the control. The risk associated with a control consists of the risk that the control might not be effective and, if not effective, the

risk that a material weakness would result. 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.

47. 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 entity-level controls, especially controls that monitor other controls;

- The nature of the control and the frequency with which it operates;

- 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

Note: A less complex company or business unit with simple business processes and centralized accounting operations might have 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 might 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.

- The complexity of the control and the significance of the judgments that must be made in connection with its operation.

  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.

48. When the auditor identifies deviations from the company's 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, an individual control does not necessarily have to operate without any deviation to be considered effective.

49. 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 an 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.

> Note: Walkthroughs usually consist of a combination of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control and might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough and the results of those procedures.

50. 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 re-performance of a control.

> Note: Inquiry alone does not provide sufficient evidence to support a conclusion about the effectiveness of a control.

51. The nature of the tests of effectiveness that will provide competent evidence depends, to a large degree, on the nature of the control to be tested, 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.

Note: A smaller, less complex company or unit might have less formal documentation regarding the operation of its controls. In those situations, testing controls through inquiry combined with other procedures, such as observation of activities, inspection of less formal documentation, or re-performance of certain controls, might provide sufficient evidence about whether the control is effective.

52. 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. 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.

53. 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. If the operating effectiveness of the superseded controls is important to the auditor's control risk assessment, the auditor should test

the design and operating effectiveness of those superseded controls, as appropriate. (See additional direction on integration beginning at paragraph B1.)

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

55. 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 additional evidence concerning the operation of the controls for the remaining period is necessary.

56. The additional evidence that is necessary to update the results of testing from an interim date to the company's year-end depends on the following factors –

- The specific control tested prior to the as-of date, including the risks associated with the control and the nature of the control, and the results of those tests;
- The sufficiency of the evidence of effectiveness obtained at an interim date;
- The length of the remaining period; and
- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.

Note: In some circumstances, such as when evaluation of the foregoing factors indicates a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

Special Considerations for Subsequent Years' Audits

57. 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 46 through 56.

58. Factors that affect the risk associated with a control in subsequent years' audits include those in paragraph 47 and the following –

- 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 process in which it operates since the previous audit.

59. After taking into account the risk factors identified in paragraphs 47 and 58, the additional information available in subsequent years' audits might permit the auditor to assess the risk as lower than in the initial year. This, in turn, might permit the auditor to reduce testing in subsequent years.

60. The auditor may also use a benchmarking strategy for automated application controls in subsequent years' audits. Benchmarking is described further beginning at paragraph B28.

61. 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

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

63. The severity of a deficiency depends on –

- 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.

64. The severity of a deficiency 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.

65. 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; 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.

Note: Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may individually be less severe. Therefore, the auditor should determine whether individual control deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a material weakness.

66. 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.

67. In evaluating the magnitude of the potential misstatement, 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.

68. The auditor should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is 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 could be material.

Indicators of Material Weaknesses

69. Indicators of material weaknesses in internal control over financial reporting include –

- Identification of fraud, whether or not material, on the part of senior management;[14/]

14/ For the purpose of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under

- Restatement of previously issued financial statements to reflect the correction of a material misstatement;[15]

- Identification by the auditor of a material misstatement of 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; and

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

70. When evaluating the severity of a deficiency, or combination of deficiencies, 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 a deficiency, or combination of deficiencies, might 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

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Section 302 of the Act as well as any other members of senior management who play a significant role in the company's financial reporting process.

[15] See Financial Accounting Standards Board Statement No. 154, Accounting Changes and Error Corrections, regarding the correction of a misstatement.

accounting principles, then the auditor should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

Wrapping-Up

Forming an Opinion

71. 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.

> Note: As part of this evaluation, the auditor should review reports issued during the year by internal audit (or similar functions) that address controls related to internal control over financial reporting and evaluate control deficiencies identified in those reports.

72. 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.[16/]

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

73. 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.

74. 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

75. 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;

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 paragraphs 77 and 79 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.

76. 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 the audit of the company's financial statements.

77. 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.

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[*] PCAOB staff have told the Commission staff that the references to paragraphs 77 and 79 in paragraph 75.g. of the proposed rule should instead refer to paragraphs 78 and 80, and that this typographical error will be corrected. Telephone conversation between Sharon Virag, Associate Chief Auditor, PCAOB, and Brian Croteau, Associate Chief Accountant, SEC, on June 4, 2007.

Communicating Certain Matters

78. The auditor must communicate, in writing, to management and the audit committee all 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.

79. 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.

80. The auditor also should consider whether there are any deficiencies, or combinations of deficiencies, that have been identified during the audit that are **significant deficiencies** and must communicate such deficiencies, in writing, to the audit committee.

81. The auditor also 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 material weaknesses) 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.

82. The auditor is not required to perform procedures that are sufficient to identify all control deficiencies; rather, the auditor communicates deficiencies in internal control over financial reporting of which he or she is aware.

83. Because the audit of internal control over financial reporting does not provide the auditor with assurance that he or she has identified all deficiencies less severe than a material weakness, the auditor should not issue a report stating that no such deficiencies were noted during the audit.

84. 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.[17/]

Reporting on Internal Control

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18/] –

a. A title that includes the word independent;

[17/] See 15 U.S.C. § 78j-1.

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

b. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

c. An identification of management's report on internal control;

d. 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;

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

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

g. 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;

h. 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;

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

j. 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;

k. 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;

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

m. 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

n. The date of the audit report.

Separate or Combined Reports

86. 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.

87. 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 W Company's 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, included in the accompanying [title of management's report]. 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, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included 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]

88. 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

89. 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

90. Paragraphs 62 through 70 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.[19/]

91. 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 A7.

- 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, the report 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

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

presentation of the company's financial statements issued during the existence of the weakness. In this case, the auditor also should 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.

92. 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.

> Note: If the auditor issues a separate report on internal control over financial reporting in this circumstance, the disclosure required by this paragraph may be combined with the report language described in paragraphs 88 and 91. The auditor may present the combined language either as a separate paragraph or as part of the paragraph that identifies the material weakness.

Subsequent Events

93. 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 and obtain written representations from management relating to such matters, as described in paragraph 75h.

94. To obtain additional 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 deficiencies in internal control,

- 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.

95. 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.

96. 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.

97. 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 and before issuance of the auditor's report. 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.

98. 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.

APPENDIX A – Definitions

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

A2. 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.

A3. A **deficiency** in internal control over financial reporting 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 <u>design</u> 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 <u>operation</u> 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.

A4. **Financial statements and related disclosures** refers to a company's financial statements and notes to the financial statements as presented in accordance with generally accepted accounting principles ("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 purposes in accordance with 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.

A6. **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/]

[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).

A7. A **material weakness** is a deficiency, or a combination of deficiencies, in internal control over financial reporting, 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 on a timely basis.

Note: There is a **reasonable possibility** of an event, as used in this standard, 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 5").[3/]

A8. 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.

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

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

[3/] See FAS 5, paragraph 3.

A9. 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 is based on inherent risk, without regard to the effect of controls.

A10. An account or disclosure is a **significant account or disclosure** if there is a reasonable possibility that the account or disclosure 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 or disclosure is significant is based on inherent risk, without regard to the effect of controls.

A11. A **significant deficiency** is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

APPENDIX B – Special Topics

Integration of Audits

B1. 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.

B2. 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.

B3. 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.

B4. 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.

B5. 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 B2. 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.

B6. Effect of Tests of Controls on Substantive Procedures. If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, 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.

B7. 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.

B8. 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.

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

B9. 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

B10. 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.

B11. 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 entity-level controls, including controls in place to provide assurance that appropriate controls exist throughout the organization, provides the auditor with sufficient evidence.

B12. In determining the locations or business units at which to perform tests of controls, the auditor may take into account work performed by others on behalf of management. For example, if the internal auditors' planned procedures include 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.

B13. The direction in paragraph 61 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.

B14. <u>Special Situations</u>. 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 direction in this multiple-locations discussion describes how to determine whether it is necessary to test controls at these entities or operations.

B15. 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.

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. 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 requires modification.

Use of Service Organizations

B17. 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 the company's information system. The auditor may apply the relevant concepts described in AU sec. 324 to the audit of internal control over financial reporting.

B18. 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.

B19. 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.

B20. 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. 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.

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

c. Performing tests of controls at the service organization.

B21. 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.

B22. 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.

B23. 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.

B24. 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.

B25. 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.

B26. If the auditor concludes that additional evidence about the operating effectiveness of controls at the service organization is required, the auditor's additional procedures might 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.

B27. 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

B28. Entirely automated application controls are generally not subject to breakdowns due to human failure. This feature allows the auditor to use a "benchmarking" strategy.

B29. 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.

B30. The consistent and effective functioning of the automated application controls may be dependent upon the related files, tables, data, and parameters. 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.

B31. 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 might be well-suited for benchmarking. As these factors indicate increased risk, the control being evaluated is less 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).

- 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.)

B32. 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.

B33. 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.
- The nature and timing of other related tests.
- The consequences of errors associated with the application control that was benchmarked.
- 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.

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, or

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 91.

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.

C4. When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. 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 85 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 A7.

- 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 paragraph 91.

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 89 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 must 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

[1/] See paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

financial reporting may contain information in addition to the elements described in paragraph 72 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 paragraph if the auditor believes that the additional information contains a material misstatement of fact.

[2/] See 15 U.S.C. § 78j-1.

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 internal control over

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

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 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 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 internal control over financial reporting (or both opinions if a combined report is issued) are included in his or her consent.

Rule 3525: Audit Committee Pre-approval of Non-audit 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.

Conforming Amendments to PCAOB 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," section 230, "Due Professional Care in the Performance of Work" (AU sec. 230, "Due Professional Care in the Performance of Work"), as amended, 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, or 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 exists 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).

<u>AU sec. 310, "Appointment of the Independent Auditor"</u>

SAS No. 1, "Codification of Auditing Standards and Procedures," section 310, "Appointment of the Independent Auditor" (AU sec. 310, "Appointment of the Independent Auditor"), as amended, 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 –

> 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" (AU sec. 311, "Planning and Supervision"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraph 39 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 9 of PCAOB Auditing Standard No. 5, 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" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), as amended, 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 paragraph 20 of PCAOB Auditing Standard No. 5, 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 14-15 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

c. The note to paragraph 12 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 9 and 20 of

PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, regarding planning considerations and materiality, respectively.

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 B10-B16 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, 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 6-8 and paragraphs B1-B5 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

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

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

Within the note to paragraph 1, the reference to paragraphs 98-103 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 52-53 of

PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 315, "Communications Between Predecessor and Successor Auditors"

SAS No. 84, "Communications Between Predecessor and Successor Auditors" (AU sec. 315, "Communications Between Predecessor and Successor Auditors"), as amended, is amended as follows –

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 AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements, or paragraphs 16-19 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

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 –

Within the note to paragraph 1, the reference to paragraphs 24-26 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 14-15 of

PCAOB Auditing Standard No. 5, 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" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), as amended, is amended as follows –

a. The note to paragraph 2 is replaced with –

   Note: Refer to paragraph A9 of Appendix A, Definitions, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements for the definition of a relevant assertion and paragraphs 28-33 of PCAOB Auditing Standard No. 5, 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 B10-B16 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

c. The last sentence of paragraph 33 is deleted.

d. The note to paragraph 65 is deleted.

e. The note to paragraph 83 is deleted.

f. Within the note to paragraph 97, the reference to paragraphs 104-105 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 54 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

g. The appendix at paragraph 110 is deleted.

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

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

a. Within the note to paragraph 1, the reference to paragraphs 108-126 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. The note to paragraph 20 is deleted.

c. Within the note to paragraph 22, the reference to paragraph 122 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 18-19 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 324, "Service Organizations"

SAS No. 70, "Service Organizations" (AU sec. 324, "Service Organizations"), as amended, is amended as follows –

Within the note to paragraph 1, 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 B17-B27 of Appendix B, Special Topics, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

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 before paragraph 1 is amended as follows –

The reference to paragraphs 207-214 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 78-84 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. The first bullet point in paragraph 1 is replaced with –

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.

c. Paragraph 2 is replaced with –

[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 78-84 of Auditing Standard No. 5, 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.

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

d. The notes to paragraph 2 are deleted.

e. Paragraph 3 is replaced with –

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, 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 on a timely basis.

> Note: There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are used in paragraph 3 of Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies.
>
> Note: In evaluating whether a deficiency exists and whether deficiencies, either individually or in combination with other deficiencies, are material weaknesses, the auditor should follow the direction in paragraphs 62-70 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

f. 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 an 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.

g. The last sentence of paragraph 9 is replaced with –

In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard.

<u>AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325"</u>

AU sec. 9325, "Communication of Internal Control Related Matters Noted in an Audit: Auditing Interpretations of Section 325" is amended as follows –

The note prior to paragraph 1 is replaced with –

Note: In an audit of financial statements only, auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," continues to apply except that the term "reportable condition" means "significant deficiency" as defined in paragraph 2 of this standard. Within the example report within paragraph 4 of the interpretation, the third sentence is replaced with the definition of a material weakness in paragraph A7 of Appendix A, Definitions, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

AU sec. 328, "Auditing Fair Value Measurements and Disclosures"

SAS No. 101, "Auditing Fair Value Measurements and Disclosures" (AU sec. 328, "Auditing Fair Value Measurements and Disclosures"), is amended as follows –

The first sentence of paragraph 41 is replaced with –

Events and transactions that occur after the balance-sheet date but before the date of the auditor's report (for example, a sale of an investment shortly after the balance-sheet date), may provide audit evidence regarding management's fair value measurements as of the balance-sheet date [7/]

[7/] The auditor's consideration of a subsequent event or transaction, as contemplated in this paragraph, is a substantive test and thus differs from the review of subsequent events performed pursuant to section 560, Subsequent Events.

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 –

The note to paragraph 11 is replaced with –

Note: When performing an integrated audit of financial statements and internal control over financial reporting, paragraph 39 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, states "[t]he 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." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if there are relevant assertions related to the company's investment in derivatives and securities, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and service organizations whose services are part of the entity's information system.

AU sec. 333, "Management Representations"

SAS No. 85, "Management Representations" (AU sec. 333, "Management Representations"), as amended, is amended as follows –

a. Within the note to paragraph 5, the reference to paragraphs 142-144 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 75-77 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. The second sentence of paragraph 9 is replaced with –

Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report.

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337"

AU sec. 9337, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337" is amended as follows –

a. The last sentence of paragraph 4 is replaced with –

What is the relationship between the effective date of the lawyer's response and the date of the auditor's report?

b. Paragraph 5 is replaced with –

Interpretation – Section 560.10 through .12 indicates that the auditor is concerned with events, which may require adjustment to, or disclosure in, the financial statements, occurring through the date of his or her report. Therefore, the latest date of the period covered by the lawyer's response (the "effective date") should be as close to the date of the auditor's report as is practicable in the circumstances. Consequently, specifying the effective date of the lawyer's response to reasonably approximate the expected date of the auditor's report will in most instances obviate the need for an updated response from the lawyer.

AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"

SAS No. 59, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern" (AU sec. 341, "The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"), as amended, is amended as follows –

The second sentence of paragraph 2 is replaced with –

The auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report.

AU sec. 342, "Auditing Accounting Estimates"

SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended as follows –

a. Subparagraph c. of paragraph 10 is replaced with –

c. Review subsequent events or transactions occurring prior to the date of the auditor's report.

b. Paragraph 13 is replaced with –

Review subsequent events or transactions. Events or transactions sometimes occur subsequent to the date of the balance sheet, but prior to the date of the auditor's report, that are important in identifying and evaluating the reasonableness of accounting estimates or key factors or assumptions used in the preparation of the estimate. In such circumstances, an evaluation of the estimate or of a key factor or assumption may be minimized or unnecessary as the event or transaction can be used by the auditor in evaluating their reasonableness.

AU sec. 380, "Communication With Audit Committees"

SAS No. 61, "Communication With Audit Committees" (AU sec. 380, "Communication With Audit Committees"), as amended, is amended as follows –

Within footnote 1 to paragraph 1, the reference to PCAOB Auditing Standard No. 2 is replaced with a reference to PCAOB Auditing Standard No. 5, 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" (AU sec. 508, "Reports on Audited Financial Statements"), as amended, is amended as follows –

Within the note to paragraph 1, the reference to paragraphs 162-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 85-98 of PCAOB Auditing Standard No. 5, 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 Auditing Standard No. 5, 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 paragraphs 86-88 of PCAOB Auditing Standard No. 5, 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," section 530, "Dating of the Independent Auditor's Report" (AU sec. 530, "Dating of the Independent Auditor's Report"), as amended, is amended as follows –

a. Paragraph .01 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 .05 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.
>
> Note: If the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion on the financial statements, then the auditor's report date is the date that the auditor has obtained sufficient competent evidence to support the representations in the auditor's report.

b. Paragraph .05 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. Within the heading before paragraph .03, the reference 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," section 543, "Part of Audit Performed by Other Independent Auditors" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraphs 182-185 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C8-C11 of Appendix C, <u>Special Reporting Situations</u>, of PCAOB Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>.

<u>AU sec. 560, "Subsequent Events"</u>

SAS No. 1, "Codification of Auditing Standards and Procedures," section 560, "Subsequent Events" (AU sec. 560, "Subsequent Events"), as amended, is amended as follows –

a. Within the note to paragraph .01, the reference to paragraphs 186-189 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs 93-97 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. The second sentence of paragraph .12 is replaced with –

These procedures should be performed at or near the date of the auditor's report.

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," section 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), as amended, is amended as follows –

Within the note to paragraph .01, the reference to paragraph 197 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraph 98 of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

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

SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended as follows –

a. Within the note to paragraph 2, the reference to paragraphs 198-199 of PCAOB Auditing Standard No. 2 is replaced with a reference to paragraphs C16-C17 of Appendix C, Special Reporting Situations, of PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. The third sentence of paragraph 10 is replaced with –

The likelihood that the auditor will discover subsequent events necessarily decreases following the date of the auditor's report, and, as a practical matter, after that time the independent auditor may rely, for the most part, on inquiries of responsible officials and employees.

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 and financial 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 –

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 with –

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 with –

A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting, that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Auditing Standard No. 3, Audit Documentation

Auditing Standard No. 3, Audit Documentation is amended as follows –

Within footnote 2 to paragraph 6, the reference to paragraphs 68-70 of Auditing Standard No. 2 is replaced with a reference to paragraphs 28-33 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Auditing Standard No. 4, Reporting on Whether a Previously Reported Material Weakness Continues to Exist is amended as follows –

a. Within note 1 to paragraph 1, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

b. Within paragraph 2, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

c. Within the note to paragraph 2, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

d. Within paragraph 4, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

e. Paragraph 9 is replaced with –

The terms <u>internal control over financial reporting</u>, <u>deficiency</u>, <u>significant deficiency</u>, and <u>material weakness</u> have the same meanings as the definitions of those terms in Appendix A, <u>Definitions</u>, of Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>.

f. The first sentence of paragraph 10 is replaced with –

Paragraph 5 of Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>, states "[t]he 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."

g. Within the note to paragraph 10, the reference to Auditing Standard No. 2 in the first sentence is replaced with a reference to Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>, and the last sentence is amended as follows –

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

h. Paragraph 11 is replaced with –

The terms relevant assertion and control objective have the same meaning as the definitions of those terms in Appendix A, Definitions, of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

i. Paragraph 13 is replaced with –

In an audit of internal control over financial reporting, the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence to perform the control effectively, 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.[2/]

[2/] See paragraph 42 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

j. Within the note to paragraph 17, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

k. Within note 2 to paragraph 18, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal

<u>Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>.

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

m. Within paragraph 23, the reference to paragraphs 22 and 23 of Auditing Standard No. 2 is replaced with a reference to paragraph 20 of Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>. Additionally, the second sentence is deleted.

n. Within paragraph 24, the reference to paragraph 39 of Auditing Standard No. 2 is replaced with a reference to paragraph 9 of Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>.

o. Within paragraph 25, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>.

p. Within the note to paragraph 25, the two references to Auditing Standard No. 2 are replaced with references to Auditing Standard No. 5, <u>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</u>.

q. 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 22-27 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

r. Subparagraph b. of paragraph 26 is replaced with –

Perform the procedures described in paragraphs 34-38 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, for those transactions that are directly affected by controls specifically identified by management as addressing the material weakness.

s. The note to subparagraph b. of paragraph 26 is deleted.

t. Within paragraph 27, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

u. The note to paragraph 28 is deleted.

v. Within paragraph 31, the reference to paragraphs 88 through 91 of Auditing Standard No. 2 is replaced with a reference to paragraphs 42-43 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

w. Paragraph 32 is replaced with –

Consistent with the direction in paragraphs 44-45 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, the auditor should test the operating effectiveness of a specified control by determining whether the specified control operated as designed and whether the person performing the control possesses the necessary authority and qualifications to perform the control effectively. In determining the nature, timing, and extent of tests of controls, the auditor should apply paragraphs 50-54 of Auditing Standard No. 5.

x. Paragraph 33 is replaced with –

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, entity-level control, such as any of those described in paragraphs 22-24 of Auditing Standard No. 5, 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.

y. 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 B10-B16 of Appendix B, Special Topics, of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

z. Within paragraph 36, the reference to paragraphs 109 through 115 and 117 through 125 of Auditing Standard No. 2 is replaced with a reference to paragraphs 16-19 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

aa. The second sentence of paragraph 37 is replaced with –

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.

bb. The first two sentences of paragraph 38 are replaced with –

Paragraphs 18-19 of Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, should be applied in the context of the engagement to report on whether a previously reported material weakness continues to exist.

cc. The note to paragraph 38 is deleted.

dd. The note to paragraph 39 is deleted.

ee. Paragraph 42 is replaced with –

Management may conclude that a previously reported material weakness no longer exists because its severity has been sufficiently reduced such that it is no longer a material weakness.

ff. Subparagraph f. of paragraph 44 is replaced with –

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.

gg. Within the note to subparagraph b. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

hh. Within the note to subparagraph l. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

ii. Within the note to the second bullet point of subparagraph o. of paragraph 51, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

jj. Within paragraph 52, the reference to Auditing Standard No. 2 is replaced with a reference to Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.

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

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

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

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

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

(a) Purpose

In 2002, Congress passed the Act, which, among other things, established new provisions related to internal control over financial reporting. Section 404 of the Act requires company management to assess and report on the effectiveness of the company's internal control. It also requires a company's independent auditor, registered with the Board, to attest to management's disclosures regarding the effectiveness of its internal control. As directed by Sections 103 and 404 of the Act, the Board established a standard to govern the newly required audit by adopting Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of

Financial Statements ("Auditing Standard No. 2"). The SEC approved Auditing Standard No. 2 on June 17, 2004.

Since Auditing Standard No. 2 became effective, the Board has closely monitored the progress registered firms have made in implementing 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.

As a result of this monitoring, two basic propositions emerged. First, the audit of internal control over financial reporting has produced significant benefits, including an enhanced focus on corporate governance and controls and higher quality financial reporting. Second, these benefits have come at a significant cost. Costs have been greater than expected and, at times, the related effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

As part of a four-point plan to improve implementation of the internal control requirements, the Board determined to amend Auditing Standard No. 2. On December 19, 2006, the Board proposed for comment a new standard on auditing internal control, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, that would replace Auditing Standard No. 2. After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board adopted the revised standard on auditing internal control as Auditing Standard No. 5, to supersede Auditing Standard No. 2.

Under Section 10A(i) of the Exchange Act, as amended by Section 202 of the 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." Rule 3525 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. Rule 3525 requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal 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.

The conforming amendments update the Board’s other auditing standards in light of Auditing Standard No. 5, move information contained in Auditing Standard No. 2 to the Board’s interim standards, and 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 change is consistent with a recent change adopted by both the

International Auditing and Assurance Standards Board and the AICPA Auditing Standards Board.

(b) Statutory Basis

The statutory basis for the proposed rule is Title I and II and Section 404 of the Act.

B. Board's Statement on Burden on Competition

The Board does not believe that the proposed rule will result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act. The proposed rules would apply equally to all registered public accounting firms and their associated persons. Moreover, Auditing Standard No. 5 explains how to tailor internal control audits to fit the size and complexity of the company being audited.

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

The Board released the proposed rules for public comment in Release No. 2006-007 (December 19, 2006). A copy of Release No. 2006-007 and the comment letters received in response to the PCAOB’s request for comment are available on the PCAOB’s Web site at www.pcaobus.org. The Board received 175 written comments. The Board also discussed the proposals with its Standing Advisory Group on February 22, 2007.[1/] The Board has clarified and modified certain aspects of the proposed rules in response to the comments it received, as discussed below.

The Board issued these proposals with the primary objectives of focusing auditors on the most important matters in the audit of internal control over financial reporting and eliminating procedures that the Board believes are unnecessary to an effective audit of internal control. The proposals were designed to both increase the likelihood that material weaknesses in companies' internal control will be found before they cause material misstatement of the financial statements and steer the auditor away from procedures that are not necessary to achieve the intended benefits. The Board also sought to make the internal control audit more clearly scalable for smaller and less complex public companies and to make the text of the standard easier to understand. In formulating these proposals, the Board re-evaluated every significant aspect of Auditing Standard No. 2.

A large majority of commenters were generally supportive of the Board's proposals, particularly the top-down, risk-based approach and focus on the most important matters. Based on the comments received, the Board believes that the proposal achieves, in large part, the objectives the Board set out when deciding to amend Auditing Standard No. 2. Many commenters also offered suggestions to improve the final standard, which the Board has carefully analyzed.

In considering the comments received and formulating a final standard, the Board closely coordinated its work with the SEC, which proposed guidance for management on

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[1/] A transcript of the portion of the meeting that related to the proposals and an archived web cast of the entire meeting are available on the Board's Web site at http://www.pcaobus.org/Standards/Standing_Advisory_Group/Meetings/2007/02-22/SAG_Transcript.pdf.

evaluating internal control at the same time that the Board issued its proposals.[2/] In addition to its role in implementing Section 404(a) of the Act, the SEC must approve new PCAOB auditing standards before they can become effective.[3/] On April 4, 2007, the Commission held a public meeting to discuss the Board's proposals and the coordination of those proposals with the Commission's proposed management guidance. At the meeting, the SEC staff provided the Commission its analysis of the public comments on the PCAOB's proposal and the proposed management guidance. The Commission endorsed the recommendations of its staff and directed its staff to focus its remaining work in four areas:

- "Aligning the PCAOB's new auditing standard … with the SEC's proposed new management guidance under Section 404, particularly with regard to prescriptive requirements, definitions, and terms";

- "Scaling the 404 audit to account for the particular facts and circumstances of companies, particularly smaller companies";

- "Encouraging auditors to use professional judgment in the 404 process, particularly in using risk-assessment"; and

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2/ See Securities Exchange Act Release No. 54976 (Dec. 20, 2006).

3/ See Section 107 of the Act.

- "Following a principles-based approach to determining when and to what extent the auditor can use the work of others."[4/]

After careful consideration of the comments it received and the input from the SEC, the Board has refined its proposals to provide additional clarity and further help auditors to focus on the most important matters. The Board has decided to adopt the revised standard on auditing internal control as Auditing Standard No. 5, to supersede Auditing Standard No. 2. The Board has also decided to adopt the independence rule and conforming amendments to the auditing standards.[5/]

Notable Areas of Change in the Final Standard

The Board believes that the changes made to the proposal reflect refinements, rather than significant shifts in approach. This section describes the areas of change to the proposals that are most notable. Additional discussion of comments received on the proposals and the Board's response is included below.

Alignment with management guidance

On December 20, 2006, the SEC issued proposed guidance to help management evaluate internal control for purposes of its annual assessment. In formulating a new standard on auditing internal control, the Board sought to describe an audit process that would be coordinated with management's evaluation process. Many commenters

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4/ See SEC Press Release, "SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters'" (Apr. 4, 2007).

5/ As discussed below, the Board has determined not to adopt the proposed auditing standard on considering and using the work of others.

suggested, however, that the SEC's management guidance and the Board's standard should be more closely aligned.

After considering the comments in this area, the Board has decided to make changes that will improve the coordination between the SEC's management guidance and the Board's standard. In doing so, the Board has been mindful of the inherent differences in the roles of management and the auditor. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to evaluate internal control and the sufficiency of the evidence it needs for its annual assessment. Management also should be able to rely on self-assessment and, more generally, the monitoring component of internal control, provided the monitoring component is properly designed and operates effectively.

The auditor is required to provide an independent opinion on the effectiveness of the company's internal control over financial reporting. The auditor does not have the familiarity with the company's controls that management has and does not interact with or observe these controls with the same frequency as management. Therefore, the auditor cannot obtain sufficient evidence to support an opinion on the effectiveness of internal control based solely on observation of or interaction with the company's controls. Rather, the auditor needs to perform procedures such as inquiry, observation, and inspection of documents, or walkthroughs, which consist of a combination of those procedures, in order to fully understand and identify the likely sources of potential misstatements, while management might be aware of those risk areas on an on-going basis.

The Board believes, however, that the general concepts necessary to an understanding of internal control should be described in the same way in the Board's standard and in the SEC's guidance. Accordingly, the Board has decided to use the same definition of material weakness in its standard that the SEC uses in its final management guidance and related rules. In addition, the Board is adopting the definition of significant deficiencies that the SEC has proposed. The final standard and final management guidance also describe the same indicators of a material weakness. In addition, as described more fully below, the final standard on auditing internal control uses the term "entity-level controls" instead of "company-level controls," which was used in the proposed standard, in order to use the same term as the SEC uses in its final management guidance.[6/] Auditing Standard No. 5's discussion of the effect of these controls is also consistent with the discussion of the same topic in the SEC's final guidance.

The top-down approach

The proposed standard on auditing internal control was structured around the top-down approach to identifying the most important controls to test. This approach follows the same principles that apply to the financial statement audit – the auditor determines the areas of focus through the identification of significant accounts and disclosures and relevant assertions. Under the proposed standard, the auditor would specifically identify major classes of transactions and significant processes before identifying the controls to test.

In response to comments about the level of detail in the requirements of the proposed standard, the Board has reconsidered whether the final standard should include the identification of major classes of transactions and significant processes as a

[6/] These terms were used interchangeably in the proposed standard and SEC's proposed management guidance and, for these purposes, they mean the same thing. See Securities Exchange Act Release No. 54976 (Dec. 20, 2006), at 12 fn. 29.

specifically required step in the top-down approach. As a practical matter, the auditor will generally need to understand the company's processes to appropriately identify the correct controls to test. The Board believes, however, that specific requirements directing the auditor how to obtain that understanding are unnecessary and could contribute to a "checklist approach" to compliance, particularly for auditors who have a long-standing familiarity with the company. Accordingly, the Board has removed the requirements to identify major classes of transactions and significant processes from the final standard. While this should allow auditors to apply more professional judgment as they work through the top-down approach, the end point is the same as in the proposed standard – the requirement to test those controls that address the assessed risk of misstatement to each relevant assertion.[7/]

Emphasis on fraud controls

The proposed standard on auditing internal control discussed fraud controls and the auditor's procedures related to these controls among the testing concepts included near the end of the standard. Commenters suggested that the placement of the discussion, or the lack of specificity regarding the controls that should be deemed fraud controls, failed to properly emphasize these controls or provide auditors with sufficient direction on how to test fraud controls. In response, the Board has made several changes in the final standard.

First, the discussion of fraud risk and anti-fraud controls has been moved closer to the beginning of the standard to emphasize to auditors the relative importance of these

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[7/] See paragraph 21.

matters in assessing risk throughout the top-down approach.[8/] Incorporating the auditor's fraud risk assessment – required in the financial statement audit – into the auditor's planning process for the audit of internal control should promote audit quality as well as better integration. While internal control cannot provide absolute assurance that fraud will be prevented or detected, these controls should help to reduce instances of fraud, and, therefore, a concerted focus on fraud controls in the internal control audit should enhance investor protection. Second, management fraud has also been identified in the final standard as an area of higher risk; accordingly, the auditor should focus more of his or her attention on this area.[9/] Finally, the standard, as adopted, provides additional guidance on the types of controls that might address fraud risk.[10/]

Entity-level controls

The proposed standard on auditing internal control emphasized entity-level controls because of their importance both to the auditor's ability to appropriately tailor the audit through a top-down approach – specifically by identifying and testing the most important controls – and to effective internal control. Additionally, the proposed standard emphasized that these controls might, depending on the circumstances, allow the auditor to reduce the testing of controls at the process level. Commenters suggested that the proposed standard did not provide enough direction on how entity-level controls can significantly reduce testing, and some suggested that controls that operate at the level of precision necessary to do so are uncommon. Many commenters suggested incorporating

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[8/] See paragraphs 14 and 15.

[9/] See paragraph 11.

[10/] See paragraph 14.

in the final standard the discussion of direct versus indirect entity-level controls that was included in the SEC's proposed management guidance.

The Board continues to believe that entity-level controls, depending on how they are designed and operate, can reduce the testing of other controls related to a relevant assertion. This is either because the entity-level control sufficiently addresses the risk related to the relevant assertion, or because the entity-level controls provide some assurance so that the testing of other controls related to that assertion can be reduced. In response to comments and in order to clarify these concepts, the Board included in the final standard a discussion of three broad categories of entity-level controls, which vary in nature and precision, along with an explanation of how each category might have a different effect on the performance of tests of other controls.[11/]

The final standard explains that some controls, such as certain control environment controls, have an important, but indirect effect, on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

The final standard explains that other entity-level controls may not operate at the level of precision necessary to eliminate the need for testing of other controls, but can reduce the required level of testing of other controls, sometimes substantially. This is because the auditor obtains some of the supporting evidence related to a control from an

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[11/] See paragraph 23. The Board believes that expertise of auditors and companies in the area of entity-level controls will continue to evolve. For example, the Committee of Sponsoring Organizations of the Treadway Commission has begun a project on the monitoring component of internal control that may provide some guidance in this area.

entity-level control and the remaining necessary evidence from the testing of the control at the process level. Controls that monitor the operation of other controls are the best example of these types of controls. These monitoring controls help provide assurance that the controls that address a particular risk are effective and, therefore, they can provide some evidence about the effectiveness of those lower-level controls, reducing the testing of those controls that otherwise would be necessary.

Lastly, the final standard explains that some entity-level controls might operate at a level of precision that, without the need for other controls, sufficiently addresses the risk of misstatement to a relevant assertion. If a control sufficiently addresses the risk in this manner, the auditor does not need to test other controls related to that risk.

Walkthroughs

The proposed standard on auditing internal control would have required auditors to perform a walkthrough of each significant process each year. This proposed requirement represented a change from Auditing Standard No. 2, which required a walkthrough of each major class of transactions within a significant process. Commenters were split on the question of whether the re-calibration from major class of transactions to significant process in the proposed standard would result in a reduction of effort. Some issuers and auditors suggested that walkthroughs are already being performed on significant processes, while other issuers and auditors commented that this proposed requirement would make a difference. A few commenters suggested that a walkthrough of each significant process was insufficient and would negatively affect audit quality, but many others stated that walkthroughs should not be required at all.

In evaluating these comments, the Board focused principally on the objectives it believes are achieved through a properly performed walkthrough. The Board firmly believes that those objectives should be met for the auditor to verify that he or she has a sufficient understanding of the points within the processes where misstatements could occur and to properly identify the controls to test.[12/] Procedures that fulfill those objectives also play an important role in the evaluation of the effectiveness of the design of the controls. The Board believes that, in some instances, the requirement to perform a walkthrough may have overshadowed the objectives it was meant to achieve. This may have resulted in some walkthroughs being performed to meet the requirement but failing to achieve the intended purpose.

The final standard, therefore, focuses specifically on achieving certain important objectives, and the performance requirement is based on fulfilling those objectives as they relate to the understanding of likely sources of misstatement and the selection of controls to test.[13/] While a walkthrough will frequently be the best way of attaining these goals, the auditor's focus should be on the objectives, not on the mechanics of the walkthrough. In some cases, other procedures may be equally or more effective means of achieving them.

Evaluation and communication of deficiencies

The proposed standard on auditing internal control required the auditor to evaluate the severity of identified control deficiencies to determine whether they are significant deficiencies or material weaknesses. It then required the auditor to

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[12/] See paragraph 34, which describes these objectives.

[13/] See paragraph 34.

communicate, in writing, to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The proposed standard defined "significant deficiency" as "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." The term "significant misstatement" was defined, in turn, to mean "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Commenters generally supported the proposed definition of the term "significant misstatement," though some were concerned that it was too subjective. Other commenters questioned whether the standard should include a definition of significant deficiency and a requirement to communicate significant deficiencies to the audit committee. At least one commenter suggested that the term be removed from the standard.

After considering these comments, the Board has determined to make changes to the definition of significant deficiency and related requirements.[14/] The Board continues to believe that the standard should require auditors to provide relevant information about important control deficiencies – even those less severe than a material weakness – to management and to the audit committee. The final standard, therefore, requires the auditor to consider and communicate any identified significant deficiencies to the audit

[14/] The Board also made minor changes to the definition of material weakness in order to use the same definition in the SEC's management guidance and related rule. In the final standard, material weakness is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting, 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 on a timely basis."

committee. In order to emphasize that the auditor need not scope the audit to identify all significant deficiencies, however, the Board placed these provisions in the section of the final standard that describes communications requirements.[15/]

The relatively minor changes that the Board made to the definition of significant deficiency are also intended to focus the auditor on the communication requirement and away from scoping issues. The final definition is based on the proposed definition of "significant misstatement," which commenters generally supported, and is aligned with the SEC's proposed definition of the same term. Under the final standard, a significant deficiency is "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting."

Scaling the audit

The proposed standard on auditing internal control indicated that a company's size and complexity are important considerations and that the procedures an auditor should perform depend upon where along the size and complexity continuum a company falls. The proposed standard included a section on scaling the audit for smaller, less complex companies and would have required auditors to evaluate and document the effect of the company's size and complexity on the audit. This documentation requirement applied to

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[15/] See paragraph 80. The final standard also includes the proposed requirement for the auditor to communicate, in writing, to management, all deficiencies in internal control identified during the audit and inform the audit committee when such a communication has been made, and the proposed requirement to inform, when applicable, the board of directors of the auditor's conclusion that the audit committee's oversight is ineffective. See paragraphs 79 and 81. Some commenters believed that the requirement to communicate all identified deficiencies to management would result in an unnecessary administrative exercise. The Board continues to believe, however, that auditors should provide information about identified control deficiencies to management.

audits of companies of all sizes. The proposed standard also included a list of the attributes of smaller, less complex companies and a description of how the auditor might tailor his or her procedures when these attributes are present. In general, commenters were supportive of the proposed standard's general approach to scalability, but had several recommendations for change.

Some commenters suggested that scalability should not be covered as a stand-alone discussion applicable only to smaller companies and that other companies, regardless of size, might have areas that are less complex. The Board agrees that the direction on scaling will be most effective if it is a natural extension of the risk-based approach and applicable to all companies. Consequently, the Board shortened the separate section on "scaling the audit," and incorporated a discussion of scaling concepts, similar to what was proposed, throughout the final standard. Specifically, notes to relevant paragraphs describe how to tailor the audit to the particular circumstances of a smaller, less complex company or unit. The Board also retained the list of attributes of smaller, less complex companies and acknowledged that, even within larger companies, some business units or processes may be less complex than others. Discussion of these attributes has been incorporated in the section on the auditor's planning procedures in the final standard.[16/] As described in the proposing release, the provisions on scalability in the final standard will form the basis for guidance on auditing internal control in smaller companies to be issued this year.

Several commenters, mostly auditors, suggested that the performance requirements that applied to all companies, including large, complex companies, would

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[16/] See paragraph 9.

lead to unnecessary and costly documentation requirements. These commenters were particularly concerned about the requirement to document the effects of size and complexity on all aspects of the audit, even if a particular engagement could not be tailored as a result of these factors. After considering these comments, the Board agreed that this documentation requirement is not necessary to promote audit quality and, therefore, has not included it in the final standard.

Use of the work of others in an integrated audit

At the time the Board proposed Auditing Standard No. 5 for public comment, the Board also proposed an auditing standard entitled Considering and Using the Work of Others in an Audit that would have superseded 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 replaced the direction on using the work of others in an audit of internal control in Auditing Standard No. 2. As discussed in the proposing release, the Board had several objectives in proposing this standard. The first was to better integrate the financial statement audit and the audit of internal control by having only one framework for using the work of others in both audits. Additionally, the Board wanted to encourage auditors to use the work of others to a greater extent when the work is performed by sufficiently competent and objective persons. Among other things, under the proposed standard, auditors would have been able to use the work of sufficiently competent and objective company personnel – not just internal auditors – and third parties working under the direction of management or the audit committee for purposes of the financial statement audit as well as the audit of internal control.

The Board received numerous comments on the proposed standard on using the work of others. Commenters generally indicated support for a single framework regarding the auditor's use of the work of others in an integrated audit. Some, however, suggested retaining existing AU sec. 322 as the basis for that single framework. They expressed the view that the objective of removing barriers to integration and using the work of others to the fullest extent appropriate could be achieved by retaining AU sec. 322 and going forward with the proposed removal of the "principal evidence" provision.

At the same time, some other commenters suggested that the proposed standard did not go far enough in encouraging auditors to use the work of others.

After considering these comments, the Board continues to believe that a single framework for the auditor's use of the work of others is preferable to separate frameworks for the audit of internal control and the audit of financial statements. The factors used to determine whether and to what extent it is appropriate to use the work of others should be the same for both audits. At the same time, the Board agreed with those commenters who suggested that better integration of the audits could be achieved without replacing the existing auditing standard. The Board therefore has decided to retain AU sec. 322 for both audits and incorporate language into Auditing Standard No. 5 that establishes these integration concepts rather than adopt the proposed standard on considering and using the work of others.

Consistent with the proposal, however, Auditing Standard No. 5 allows the auditor to use the work of others to obtain evidence about the design and operating effectiveness of controls and eliminates the principal evidence provision. Recognizing that issuers might employ personnel other than internal auditors to perform activities relevant to management's assessment of internal control over financial reporting, the final standard allows the auditor to use the work of company personnel other than internal auditors, as well as third parties working under the direction of management or the audit committee.[17/]

In line with the overall risk-based approach to the audit of internal control over financial reporting, the extent to which the auditor may use the work of others depends,

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[17/] See paragraph 17.

in part, on the risk associated with the control being tested. As the risk decreases, so does the need for the auditor to perform the work him or herself. The impact of the work of others on the auditor's work also depends on the relationship between the risk and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases as well.[18/] Likewise, in higher risk areas (for example, controls that address specific fraud risks), use of the work of others would be limited, if it could be used at all.

Finally, the Board understands that some of the work performed by others for the purposes of management's assessment of internal controls can be relevant to the audit of financial statements. Therefore, in an integrated audit, the final standard allows the auditor to use the work of these sufficiently competent and objective others – not just internal auditors – to obtain evidence supporting the auditor's assessment of control risk for purposes of the audit of financial statements.[19/] The Board believes that this provision will promote better integration of the audit of internal control with the audit of financial statements.

Rule 3525 – Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

The Board also proposed a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related non-audit services. As

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[18/] See paragraph 18.

[19/] See paragraph 17.

proposed, the rule required a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal 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. Most commenters were supportive of the rule as proposed, though some offered suggestions about what should be included in the required communication. After considering the comments on the proposed rule, the Board has adopted it without change.

Conforming Amendments

As part of the proposal issued for public comment, the Board proposed amendments to certain of the Board's other auditing standards. Only one comment letter specifically addressed the proposed amendments. That letter expressed support for the amendments and suggested a few additional amendments that might be necessary. The Board has considered this comment and added these additional amendments, as well as others, as necessary based on the final standard.

Effective Date

The proposing release solicited commenters' feedback on how the Board could structure the effective date of the final requirements so as to best minimize disruption to ongoing audits, but make greater flexibility available to auditors as early as possible.

Most commenters on this topic suggested making the final standard on auditing internal control effective as soon as possible in order to be available for 2007 audits.

The Board agrees that the improvements in Auditing Standard No. 5 should be available as soon as possible. Accordingly, the Board has determined that Auditing Standard No. 5, Rule 3525, and the conforming amendments will be effective, subject to approval by the SEC, for audits of fiscal years ending on or after November 15, 2007. Earlier adoption is permitted, however, at any point after SEC approval. Auditors who elect to comply with Auditing Standard No. 5 after SEC approval but before its effective date must also comply, at the same time, with Rule 3525 and other PCAOB standards as amended by this release.

Auditing Standard No. 2 will be superseded when Auditing Standard No. 5 becomes effective. Auditors who do not elect to comply with Auditing Standard No. 5 before that date (but after SEC approval) must continue to comply with Auditing Standard No. 2 until it is superseded. Such auditors should, however, apply the definition of "material weakness" contained in Auditing Standard No. 5, rather than the one contained in Auditing Standard No. 2. The SEC has adopted a rule to define the term "material weakness," and the definition in Auditing Standard No. 5 parallels the new SEC definition.

Additional Discussion of Comments and the Board's Response

Alignment of Board's Internal Control Auditing Standard and the SEC's Guidance to Management

Many commenters suggested that the SEC's guidance to management and the Board's auditing standard should be more closely aligned. The commenters appeared to hold different opinions, however, about what alignment should mean in this context. Some commenters suggested that the most important issue was the need to use the same definitions of important terms in both documents. Some focused on perceived differences in scope, testing, and documentation requirements, while others suggested that the tone of the two documents was different and that the Board's proposals were more prescriptive. A few commenters suggested that the standard on auditing internal control should merely refer to the SEC management guidance without providing additional direction to the auditor.

As discussed above, in formulating a new standard on auditing internal control, the Board intended to describe an audit process that would be coordinated with management's evaluation process. After considering the comments in this area, the Board made several changes, described above, that improve coordination while recognizing the inherent differences in the roles of management and the independent auditor under Section 404. The Board also adopted, as proposed, the final standard without a requirement for the auditor to perform an evaluation of management's assessment process. Commenters generally supported this aspect of the proposal, which was intended to respond to concerns that the requirements of Auditing Standard No. 2 had become *de facto* guidance for management's process. The absence of this requirement in the final standard should also allow for improved coordination between management and the auditor.

Level of Prescriptive Detail

Some commenters suggested that there remained too many instances of the use of the terms "should" and "must" in the proposed standard and that this might drive excessive documentation and possibly unnecessary work. The Board's Rule 3101 describes the level of responsibility that these imperatives impose on auditors when used in PCAOB standards, and the Board uses these terms in its standards to clearly convey its expectations. In response to these comments, the Board analyzed each requirement in the proposed standard to determine whether more reliance could be placed on general principles rather than detailed requirements. Where appropriate, the Board made modifications to make the final standard more principles-based. As discussed more fully above, areas in which changes were made include the focus on fulfilling the objectives of a walkthrough and in the description of the top-down approach. Some of these changes also contributed to better coordination with the SEC's guidance for management.

In addition, several commenters expressed concern over the creation of presumptively mandatory responsibilities related to efficiency concepts. The example cited most often was the note to paragraph 3 of the proposed standard on auditing internal control, which stated –

> 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.

Commenters suggested that because of this requirement for the auditor to select "only those controls that are important" for testing, an auditor would have violated the Board's standards if he or she tested even one control that was later shown to be not important. Commenters believed that this would undermine audit effectiveness and recommended removal of such statements.

One of the objectives of the revised standard is to encourage auditors to focus on those areas that present the greatest risk of allowing a material misstatement in the financial statements. However, the Board agrees that its standards should not define a ceiling or maximum amount of work which the auditor may not exceed. While this statement (and others like it) in the proposed standard was not intended to imply that the Board would, with hindsight, suggest that an auditor violated the standard through testing of a control that was later determined to be not important to the audit, the Board has removed the note to paragraph 3 in response to these comments. Similar statements throughout the standard have also either been removed or modified.

Walkthroughs

The proposed standard required that the auditor perform a walkthrough of each significant process each year and allowed the auditor to use others, such as management personnel and internal auditors, to directly assist the auditor in this work. The proposed standard also indicated that the walkthrough provides audit evidence but did not prescribe further requirements regarding the circumstances in which a walkthrough might provide the auditor with sufficient evidence of operating effectiveness for a particular control. The proposing release, however, noted that a walkthrough could be sufficient for some low-risk controls in subsequent years.

As discussed above, the Board received a significant number of comments on this topic. While several commenters expressed support for the importance of the walkthrough to audit quality, many commenters suggested that the proposed provisions in this area were more prescriptive than necessary, and suggested risk concepts as a way to add flexibility. While these commenters acknowledged the value of a walkthrough and its importance to the evaluation of design effectiveness, many stated that the requirement to perform a walkthrough in an area that is either low-risk, not complex, or unchanged appears inconsistent with the other areas in the proposed standard that rely upon auditor judgment to a much greater extent.

Use of others in achieving the objectives of a walkthrough

Commenters supported allowing the auditor to use others to provide the auditor with direct assistance, particularly in low-risk areas, with only a few commenters believing that this change could jeopardize the quality of the audit. In addition, many commenters believed that the standard should allow full use of the work of others in performing walkthroughs, although some commenters strongly disagreed with this point.

As discussed above, the final standard focuses the auditor on achieving four objectives related to the identification of where within the company's processes misstatements could arise, rather than specifically on performing walkthroughs. Due to the importance of achieving these objectives to the auditor's conclusion about internal control, the Board believes that allowing the use of the work of others to a greater extent than what was proposed would not provide the auditor with an adequate understanding of the relevant risks and the related controls. Therefore, similar to the proposed standard, Auditing Standard No. 5 allows the auditor to use the work of others in achieving the objectives of a walkthrough, but only as direct assistance. That is, the auditor will be required to supervise, review, evaluate, and test the work performed by others.[20/]

Using walkthroughs to test operating effectiveness

On the subject of using walkthroughs to test operating effectiveness, commenters suggested that walkthroughs can provide sufficient evidence of operating effectiveness, but held different views about situations in which this would be the case. Some commenters supported the use of walkthroughs in low-risk areas, while others focused on whether the control itself should be low-risk. Several commenters suggested that a walkthrough could provide sufficient evidence of operating effectiveness for lower-risk controls but only when entity-level controls are strong. Almost all commenters agreed that the proposed standard focused on the appropriate conditions for using such an approach – specifically, when risk is low, when past audits indicate effective design and operation of the control, and when no changes have been made to the control or process in which the control resides.

After considering these comments, the Board has decided that the risk-based approach that is described in the final standard is the appropriate framework for determining the evidence necessary to support the auditor's opinion. Therefore, Auditing Standard No. 5 articulates the principle that performance of a walkthrough might provide sufficient evidence of operating effectiveness, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthroughs and the results of the procedures performed.[21/] The Board believes that establishing more

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[20/] See paragraph 27 of AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.

[21/] See paragraph 49.

detailed requirements in this area is not necessary, because application of the general principle in the standard will depend on the particular facts and circumstances presented.

Assessing Risk

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 was incorporated and enhanced in the proposed standard. The proposed standard required risk assessment at each of the decision points in a top-down approach, including the auditor's identification of significant accounts and disclosures and their relevant assertions. The proposed standard also required an assessment of risk at the individual control level, and required that the auditor determine the evidence necessary for a given control based on this risk assessment.

The Board received many comments on the risk assessment provisions in the proposed standard. Comments on the proposed risk assessment approach were generally supportive, with some commenters suggesting ways for improving the risk assessment emphasis in the standard. Many commenters discussed the requirement in the proposed standard for the auditor to assess the risk that the control might not be effective and, if not effective, the risk that a material weakness would result for each control the auditor selected for testing. Commenters suggested that this requirement conflicted with both current practice and the requirements within the interim standards for the financial statement audit, which involve risk assessment at the financial statement assertion level. These commenters believed that this requirement would result in risk assessments at both the assertion level and the individual control level and suggested that assessing (and documenting) risk at the relevant assertion level is sufficiently precise to drive appropriate audits. Furthermore, they believed that a specific requirement to assess risk at the individual control level and its associated documentation requirement would be unnecessary.

After considering these comments, the Board continues to believe that the auditor may vary the nature, timing, and extent of testing based on the assessed risk related to a control. Making this assessment a presumptively mandatory requirement, as it was in the proposed standard, however, does not appear necessary to achieve the intended benefits of varied testing based on the risk associated with a control. Auditing Standard No. 5, therefore, requires the auditor to assess the risk related to the relevant assertion, but not the risk at the individual control level. The standard permits the auditor to consider the risk at the control level, however, and alter the nature, timing, and extent of testing accordingly.

Several commenters expressed concern about the advisability of taking a risk-based approach and the adequacy of the Board's interim standards regarding risk assessment. These commenters suggested that auditors have frequently been unsuccessful at applying a risk-based approach to the financial statement audit in the past.

The Board has found the arguments for a more principles-based approach to internal control auditing convincing, and the principle that the auditor should vary the testing to respond to the risk is one of the most important in the standard. Early implementation of Auditing Standard No. 2 demonstrated that, when internal control is audited without adequate consideration of risk, the areas that pose the greatest danger of material misstatement may be obscured or lost. The emphasis on risk, therefore, drives an audit that is more effective and focused. While the Board believes that auditors can appropriately assess risk based on the interim auditing standards, it has committed to examining the existing standards in this area to see where improvements can be made. This is currently one of the Board's standard setting priorities.

Evaluation of Deficiencies

The Board received a substantial number of comments on the topic of evaluating deficiencies, including comments on the proposed definitions of material weakness and significant deficiency, the "strong indicators" of a material weakness, and the requirement to evaluate all identified deficiencies. While a number of commenters stated that auditors do identify material weaknesses in the absence of an actual material misstatement, some noted that, in many cases, material weaknesses are identified only when material misstatements are discovered. Several commenters suggested that the proposed standard, with its focus on using a top-down approach and scoping to identify material weaknesses, would allow auditors to do a more thorough review of the most important controls with less effort expended on reviewing lower risk controls. These commenters often stated that this approach should increase the likelihood of the auditor detecting material weaknesses before a material misstatement occurs.

Definition of a material weakness

The proposed standard retained the basic framework in Auditing Standard No. 2 that described material weaknesses by reference to the likelihood and magnitude of a potential misstatement. While the Board believed that framework to be sound, it made an effort to clarify the definition in the proposed standard by replacing the reference to "more than remote likelihood" with "reasonable possibility." Financial Accounting Standards Board ("FASB") Statement No. 5 describes the likelihood of a future event occurring as "probable," "reasonably possible," or "remote." The definition in Auditing Standard No. 2 referred 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."

As the Board noted in the proposing release, however, some auditors and issuers have misunderstood the term "more than remote" to mean something significantly less likely than a reasonable possibility. This, in turn, could have caused these issuers and auditors to evaluate the likelihood of a misstatement at a much lower threshold than the Board intended. Because the term "more than remote" could have resulted in auditors and issuers evaluating likelihood at a more stringent level than originally intended, the Board proposed changing the definition to refer to a "reasonable possibility."

Commenters on this change were split between those that felt the change would reduce unnecessary effort spent on identifying and analyzing deficiencies, and those who believed it would not. Several commenters noted that the replacement of the term "more than remote likelihood" with the term "reasonable possibility" does not raise the auditor's threshold for classifying deficiencies. According to those commenters, the change simply attempts to align the description of the threshold for identifying deficiencies with previous guidance issued by the PCAOB. The Board continues to believe that the proposed definition – as well as Auditing Standard No. 2 – established an appropriate threshold for the likelihood part of the definition of material weakness. While the Board agrees that, as a definitional matter, "reasonable possibility" and "more than remote" describe the same threshold, it believes that "reasonable possibility" describes that threshold more appropriately and clearly, and will therefore avoid the misunderstanding of the threshold created by the way it was described in Auditing Standard No. 2. As a result, it retained that term in the final definition in the standard.

In addition, some commenters noted that the definitions of material weakness and significant deficiency in the proposed standard, like the definitions in Auditing Standard No. 2, referred to the likelihood of a material misstatement in both the interim and annual financial statements. Most of these commenters suggested that the Board remove the term "interim" from the definitions of material weakness and significant deficiency because, according to the commenters, it causes confusion when scoping the audit of internal control and unnecessarily complicates the evaluation of deficiencies, particularly in the absence of guidance from the SEC and FASB regarding interim materiality. Some commenters, however, said that the Board should not remove the term "interim" from the definitions because the evaluation of deficiencies should be performed to consider the effectiveness of internal control for both the interim and annual financial statements. After carefully considering these comments, and in order to use the same definition that the SEC uses in its guidance to management, the Board determined to retain the reference to interim financial statements in the final definition of material weakness.[22/]

Indicators of a material weakness

The proposed standard described circumstances that should be regarded as strong indicators of a material weakness in internal control. The proposing release noted that the identification of one of these strong indicators should bias the auditor toward a

[22/] The provisions in the final standard relating to significant deficiencies are discussed above. As discussed above, the Board also made minor wording changes to the definition of material weakness in order to use the same definition as the SEC in its guidance to management and related rules.

conclusion that a material weakness exists but does not require the auditor to reach that conclusion. Under the proposal, the auditor could determine that these circumstances do not rise to the level of a material weakness, and in some cases, are not deficiencies at all.

Many commenters supported the proposed changes from Auditing Standard No. 2 relating to strong indicators, agreeing that, by allowing greater use of professional judgment in this area, practice will improve. A few commenters stated that these changes may lead to some inconsistency in practice, but consistent with other commenters, they still supported the use of greater professional judgment in the evaluation of deficiencies. At least one commenter suggested that several of the strong indicators were not indicators of a material weakness but should be, under all circumstances, a material weakness. A few commenters also suggested that the list of strong indicators in Auditing Standard No. 2 actually stifles the auditor's judgment to the point that auditors fail to identify material weaknesses that exist because the deficiency is not on the list of strong indicators. These commenters suggested that removing the list of strong indicators entirely would be best.

The Board believes that auditor judgment is imperative in determining whether a deficiency is a material weakness and that the standard should encourage auditors to use that judgment. At the same time, the Board continues to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information about the application of the standard. As a result, the Board has included this information in the final standard but has taken a more principles-based approach. Additionally, the Board has coordinated with the SEC so that the indicators in the auditing standard parallel those in the SEC's management guidance.

Rather than referring to "strong indicators," the final standard refers simply to "indicators" of material weakness.[23/] The standard also makes clear that the list of indicators is not exhaustive and should not be used as a checklist. Specifically, under the final standard, the presence of one of the indicators does not mandate a conclusion that a material weakness exists. At the same time, a deficiency that is not a listed indicator may be a material weakness.

The Board did not adopt as indicators in the final standard certain proposed strong indicators. The Board believes, as at least one commenter suggested, that some of these proposed strong indicators are better characterized as material weaknesses rather than as indicators of a material weakness.[24/] Including them in the list of indicators, as adopted, would therefore be inconsistent with the degree of judgment required to evaluate whether an indicator of a material weakness is, under particular facts and circumstances, a material weakness.

[23/] The Board included as an indicator the proposed standard's requirement to determine the level 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. In the proposal, if the auditor determined that a deficiency would prevent prudent officials from concluding that they have such reasonable assurance, the auditor was required to deem the deficiency to be at least a significant deficiency. Under the final standard, if the auditor determines that a deficiency might prevent prudent officials from concluding that they have such reasonable assurance, this circumstance is an indicator of material weakness.

[24/] One such proposed strong indicator was an ineffective control environment. Under the proposal, indicators of an ineffective control environment included identification of fraud on the part of senior management and significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time. The final standard includes the identification of fraud on the part of senior management as an indicator of a material weakness. In order to simplify the list and make it more principles-based, as well as to align it with the SEC management guidance, however, the Board did not include significant deficiencies that remain uncorrected as an indicator in the final standard.

Requirement to evaluate all identified deficiencies

The proposed standard required the auditor to evaluate the severity of each control deficiency that comes to his or her attention. The same provision in the proposed standard made clear, however, that the auditor need not scope the audit to find control deficiencies that are less severe than material weaknesses. A few commenters believed that this requirement is not necessary and suggested that an acceptable alternative would be for the auditor to verify that management has evaluated all deficiencies.

The Board continues to believe that the auditor needs to evaluate all deficiencies that come to his or her attention. Without such an evaluation, there would not be a sufficient basis for the auditor's opinion.

Additional Scoping and Materiality Issues

The proposed standard clarified 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. This direction was intended to address concerns that auditors have interpreted Auditing Standard No. 2 as directing them to search for potential defects in internal control at a lower materiality level than that used in the audit of the annual financial statements.

The Board received many comments on materiality and scoping, and a large portion of the commenters expressed support for the proposed standard's approach. Some commenters, however, recommended providing clear quantitative guidelines for calculating materiality. Other commenters expressed concern about such an approach, fearing that material areas would be inappropriately excluded from the audit scope. Finally, some commenters suggested that the Board should provide additional guidance on scoping and extent of control testing decisions, such as guidance on sample sizes related to testing of high-risk controls versus low-risk controls or more specific guidance on the scope of the internal control audit for entities with multiple locations.[25/]

After considering these comments, the Board has determined to adopt its discussion of materiality in the internal control audit as proposed. The Board believes that the auditing standard on internal control is an inappropriate place to redefine or refine the meaning of materiality, which is a long-established concept in the federal securities laws. With respect to requests for more specific guidance on scoping or extent of testing issues, the Board has, as discussed above, endeavored to adopt a standard that relies more on general principles than detailed requirements. Accordingly, the Board believes that auditors should make specific determinations of how to comply with the general scoping and testing requirements in the standard using professional judgment in the particular circumstances presented.

[25/] The proposed standard focused on the auditor's assessment of risk of material misstatement and how the auditor could carry that assessment process into the scoping of a multi-location audit. Commenters were very supportive of the Board's approach in this area and, consequently, the Board has determined to adopt these provisions as proposed.

Scaling the Audit for Smaller Companies

As discussed above, the Board received many comments on the proposed section on scaling the audit from commenters with a variety of perspectives. The comments covered a wide range of issues. In addition to the matters discussed above, commenters suggested:

- That the proposed section on scalability should be focused more closely on how complexity relates to a risk-based audit;

- That the proposed standard did not provide sufficient flexibility for smaller companies and that the standard should provide for more "credit" for control testing based on work done as part of the financial statement audit;

- That the resulting costs of these proposed changes would need to be studied for several years to determine if they are appropriate;

- That the attributes of smaller, less complex companies that were included in the proposed standard were appropriate and that the tailoring directions for auditors were adequate;

- That some of the attributes of smaller, less complex companies that might allow the auditor to tailor the audit might be, instead, risk factors that require more testing;

- That the emphasis on entity-level controls might not be appropriate; and

- That the Board's project to develop guidance on auditing internal control in smaller public companies is necessary.

As discussed above, the Board made several changes in response to comments in the final standard. The new standard provides direction on how to tailor internal control audits to fit the size and complexity of the company being audited. It does so by including notes throughout the standard on how to apply the principles in the standard to smaller, less complex companies, and by including a discussion of the relevant attributes of smaller, less complex companies as well as less complex units of larger companies. The Board believes that the final standard appropriately considers the circumstances of smaller and less complex public companies (and other companies with less complex business units) while requiring a high-quality audit regardless of company size or complexity. The planned guidance on this topic will provide additional practical information for auditors of smaller companies.

Information Technology Principles

In gaining an understanding of the effect of information technology ("IT") on internal control over financial reporting and the risks the auditor should assess, the proposed standard directed the auditor to apply guidance in AU sec. 319, Consideration of Internal Control in a Financial Statement Audit. Additionally, the proposed standard included a discussion of IT operations at smaller and less complex companies. A number of commenters discussed the importance of IT risks to determining the scope of the audit and recommended that the final standard include additional guidance on how the risk assessment related to IT is incorporated in the audit of internal control.

In response to these comments, the Board included in Auditing Standard No. 5 a note to paragraph 36 that clarifies that the identification of risks and controls within IT should not be a separate evaluation but, rather, an integral part of the auditor's top-down risk assessment, including identification of significant accounts and disclosures and their relevant assertions, as well as the controls to test.

Roll-forward Procedures

The proposed standard discussed the procedures the auditor should perform to obtain additional evidence concerning the operation of the control when the auditor reports on the effectiveness of the control "as of" a specific date, but has tested the effectiveness of the control at an interim date. The Board received a few comments on this topic, mainly from auditors. The comments were consistent in their view that the proposed standard improperly implies, by using the expression "if any" in relation to additional evidence the auditor is required to obtain, that the auditor may not need to do any roll-forward work. Commenters suggested that such an approach would be inconsistent with paragraph .99 of AU sec. 319 and suggested that the words "if any" be removed from the final standard. The Board believes that its standard should be consistent with AU sec. 319.99 in that the auditor should perform some level of roll-forward procedures. Consequently, the Board removed the words "if any" from the relevant paragraphs of Auditing Standard No. 5 to correct the inconsistency. The Board also noted that, in some circumstances, inquiry alone might be a sufficient roll-forward procedure.

Cumulative Knowledge and Rotation

The proposed standard on auditing internal control allowed the auditor to incorporate knowledge from previous years' audits into his or her decision making process for determining the nature, timing, and extent of testing necessary. The section in the proposed standard on special considerations for subsequent years' audits built upon the risk-based framework in the proposed standard for determining the nature, timing, and extent of testing by describing certain additional factors for the auditor to evaluate in subsequent years. These factors included the results of prior years' testing and any change that may have taken place in the controls or the business since that testing was performed. This section retained the requirement in Auditing Standard No. 2 that each control deemed important to the auditor's conclusion be tested every year, but allowed for a reduction in testing when the additional risk factors indicated that the risk was lower than in the past.

Many commenters strongly supported these provisions as proposed. Many investors, in particular, stated that while they supported the proposed approach, they would not be supportive of rotation of control testing over a multiple-year period. These commenters were generally concerned that rotation of control testing would negatively affect audit quality. Among supporters of the approach in the proposed standard, several requested further clarification in the standard or additional guidance on how this approach should affect the level of testing.

Many issuers suggested that the standard should allow for full rotation – which exempts some important controls from testing each year – of at least controls in low-risk areas. Other commenters recommended that all controls should be tested on a multi-year rotating basis. These comments often focused on the fact that while the proposed standard required the auditor to evaluate whether there had been any relevant changes since the control was tested, it still required testing at some level even when there had been no change. These commenters considered this requirement to be unnecessary.

The Board shares the concern that multi-year rotation of control testing would not provide sufficient evidence for the auditor's opinion on internal control effectiveness, which is required by the Act to be issued each year. In the financial statement audit, control testing plays a supporting role – to the extent that controls have been tested and are effective, the auditor can reduce the level of (but not eliminate) the necessary substantive testing. In contrast, in the internal control audit, control testing does not play a supporting role but is the sole basis for the auditor's opinion. Additionally, even if the design of the control and its related process does not change from the prior year, it is not possible to assess the control's operating effectiveness without performing some level of testing. For these reasons, rotation is not a viable option in the audit of internal control. Instead, the approach described in the proposed standard has been clarified in the final standard and continues to focus the auditor on relevant changes since a particular control was last tested, as many commenters suggested. Under this approach, the auditor would consider, in addition to the risk factors described in the standard that are always relevant to determining the nature, timing, and extent of testing, whether there has been a change in the controls or in the business that might necessitate a change in controls; the nature, timing, and extent of procedures performed in previous audits; and the results of the previous years' testing of the control.[26/] After taking into account these additional factors, the additional information in subsequent years' audits might permit the auditor to assess risk as lower than in the initial year and, thus, might permit the auditor to reduce testing.

This treatment of cumulative knowledge is analogous to the roll-forward provisions in the final standard. In the case of subsequent years, the auditor, in essence, rolls forward the prior years' testing when the control was found to be effective in the past and no change has occurred (or would have been expected to occur due to changes in the environment or process that contains the control). Because the auditor might be able

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[26/] See paragraph 55.

to assess the risk lower in the subsequent years, a walkthrough, or equivalent procedures, might be sufficient for low-risk controls. This approach appropriately factors in the effect of cumulative knowledge, while maintaining audit quality and providing a sufficient basis for the auditor's opinion.

Reporting the Results of the Audit

In the proposed standard, the Board attempted to address concerns that the separate opinion on management's assessment required by Auditing Standard No. 2 contributed to the complexity of the standard and caused confusion regarding the scope of the auditor's work.[27/] Accordingly, to emphasize the proper scope of the audit and to simplify the reporting, the proposed standard required 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. The proposal eliminated the separate opinion on management's assessment because it was redundant of the opinion on internal control itself and because the opinion on the effectiveness of controls more clearly conveys the same information – specifically, whether the company's internal control is effective.

Many commenters agreed with the Board that eliminating the separate opinion on management's assessment would reduce confusion and clarify the reporting. Some commenters, however, suggested that the Board should instead require only an opinion on management's assessment. These commenters expressed their belief that the Act

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[27/] Although Auditing Standard 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 control 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.

requires only that the auditor review management's assessment process and not the company's internal control. Additionally, a few commenters expressed confusion about why the proposed standard continued to reference an audit of management's assessment in paragraph 1 of the proposed standard and the auditor's report.

The Board has determined, after considering these comments, to adopt the provision requiring only an opinion on internal control.[28/] The Board continues to believe that the overall scope of the audit that was described by Auditing Standard No. 2 and the proposed standard is correct; that is, to attest to and report on management's assessment, as required by Section 404(b) of the Act, the auditor must test controls directly to determine whether they are effective.[29/] Accordingly, paragraphs 1 and 2 of the proposed standard provided that the auditor audits management's assessment – the statement in management's annual report about whether internal control is effective – by auditing whether that statement is correct – that is, whether internal control is, in fact, effective. The final standard similarly makes this clear. In response to commenters, however, the Board has clarified the auditor's report so that it will consistently refer to the required audit as the audit of internal control.

[28/] The SEC has adopted changes to its rules that require the auditor to express an opinion directly on internal control.

[29/] 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 …."

Implementation

Some commenters urged the Board to focus on implementation issues after it adopts a final standard, and noted that effective implementation by the Board is crucial to the internal control reporting process. Some of these commenters focused on the inspections process, which they suggested is key to promoting audit efficiency. Some stated that auditors would be unlikely to change their audit approach until they are confident that the inspections will be similarly focused. The Board is committed to effective monitoring of firms' compliance with the new standard and will continue to promote proper implementation through other means, including the Board's Forums on Auditing in the Small Business Environment and guidance for auditors of smaller companies.

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

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

(a) by order approve such proposed rule; or

(b) institute proceedings to determine whether the proposed rule should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov); or

- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2007-02 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File No. PCAOB-2007-02. This file number should be included on the subject line if e-mail is used. To help process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Website (http://www.sec.gov). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Section, 100 F Street, NE, Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number PCAOB-2007-02. In light of the significant public interest in the implementation of section 404 of the Sarbanes-Oxley Act, the Commission is providing a 30-day comment period. Comments should be submitted on or before July 12, 2007. The Commission intends to act on the proposed rule no later than 45 days after publication in the Federal Register.

By the Commission.

Florence E. Harmon
Deputy Secretary