

BYLAWS and RULES

OF THE

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

As of June 18, 2004

BYLAWS AND RULES

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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BYLAWS

**ARTICLE I
NAME**

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

**ARTICLE II
OBJECT**

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

**ARTICLE III
OFFICES**

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

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

**ARTICLE IV
GOVERNING BOARD**

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

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

4.3. Quorum and Majority. A majority of the members of the Governing Board shall constitute a quorum. An act approved by majority vote of the members of the Governing Board present at a meeting of the Board at which a quorum is present shall

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

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

ARTICLE V BOARD MEETINGS

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

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

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

5.4. Telephonic Participation. The Governing Board may meet via telephone or teleconference, and any member may participate in a meeting by telephone, provided

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that, in the case of a meeting that is open to the public, at least one Board member shall be present at the location specified in the meeting notice.

**ARTICLE VI
OFFICERS**

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

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

6.3. Powers of the Chief Executive Officer.

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

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

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

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

- (3) Each Governing Board member has responsibility and authority for the appointment, dismissal, and supervision of personnel employed regularly and full-time within the immediate office of the Board member, subject to the Governing Board's overall personnel policies.
- (4) The Chief Executive Officer has the responsibility and authority to develop, and present to the Board for approval, an annual budget as well as mid-year adjustments, if any. There is reserved to the Governing Board its responsibility and authority with respect to determining the distribution of funds according to major programs and purposes, including those related to salary schedules and other conditions of employment.

**ARTICLE VII
LIABILITY AND INDEMNIFICATION**

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

7.2. Indemnification.

- (a) Unless otherwise prohibited by law and as provided in section 7.2(b), the Corporation shall indemnify any employee, officer, or Governing Board member, or any former employee, officer, or Governing Board member,

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against any and all expenses and liabilities actually and necessarily incurred by him or her, or imposed on him or her, in connection with any claim, action, suit, or proceeding (whether actual or threatened, civil, criminal, administrative, or investigative, including appeals), to which he or she may be or is made a party by reason of being or having been such employee, officer, or Board member.

- (b) Notwithstanding section 7.2(a), there shall be no indemnification in relation to matters as to which the Board finds that the employee, officer, or Board member acted in bad faith or engaged in willful misconduct in the performance of a duty to the Corporation.
- (c) Amounts paid in indemnification of expenses and liabilities may include, but shall not be limited to, counsel and other related fees; costs and disbursements; and judgments, fines, and penalties against, and amounts paid in settlement by, such employee, officer, or Board member.
- (d) The Corporation may advance expenses to, or where appropriate may itself, at its expense, undertake the defense of any employee, officer, or Board member; provided, however, that such employee, officer, or Board member shall undertake to repay or to reimburse such expense if it should be ultimately determined that he or she is not entitled to indemnification under this Article.
- (e) The provisions of this Article shall be applicable to claims, actions, suits, or proceedings made or commenced after the adoption hereof, whether arising from acts or omissions to act occurring before or after adoption hereof.
- (f) The indemnification provided by this Article shall not be deemed exclusive of any other rights to which such employee, officer, or Board member may be entitled under any applicable law.
- (g) The indemnification provided by this Article shall not restrict the power of the Governing Board to provide any additional indemnification permitted by law.

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

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

**ARTICLE VIII
BYLAW AMENDMENTS AND RULES OF THE CORPORATION**

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

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

**ARTICLE IX
MISCELLANEOUS PROVISIONS**

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

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

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

ETHICS CODE

EC1. Application of Code

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

- (a) present and former Board members and staff;
- (b) the spouse, spousal equivalent, and dependents of Board members and staff; and
- (c) designated contractors and consultants to the Board.

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

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

EC2. Definitions

- (a) Reference to Rules of the Board

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

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

- (b) Code

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

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

- (c) Dependent

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

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

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(d) Designated Contractors and Consultants

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

- (1) with which the Board enters into contracts for services, including contracts that provide for both goods and services;
- (2) which the Board, or its designate, has determined should be subject to this Code, in whole or in part; and
- (3) for which the contract contains a provision expressly incorporating this Code, in whole or in part.

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

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

(e) Honoraria

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

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

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

(f) Practice

The term "practice" means –

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

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

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

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

- (g) Professional Staff or Professional Staff of the Board

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

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

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

- (h) Staff or Staff of the Board

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

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

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

EC3. General Principles

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

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- (1) Board members and staff should at all times be mindful of their responsibilities to the Board, the sensitivity of their positions, and the need for public confidence in the objectivity and deliberative process of the Board.
- (2) Board members and staff should take great care to conduct themselves and all of their activities in such a manner so that their personal investments or other personal activities will not affect their professional independence or objectivity, or otherwise hinder the interests or reputation of the Board.
- (3) Board members and staff should recognize that the degree of public confidence in the function and activities of the Board depends heavily upon the observance of both the letter and spirit of this Code.

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

- (1) using his or her official position with the Board, or confidential information obtained through service for the Board, for the private gain of any person;
- (2) giving preferential treatment to any person with respect to the Board member or employee's work for the Board;
- (3) losing independence or objectivity with respect to his or her work for the Board;
- (4) adversely affecting the public confidence in, or the integrity, independence or objectivity of the Board; or
- (5) otherwise hindering the interests or reputation of the Board.

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

EC4. Financial and Employment Interests

- (a) While employed by the Board, no Board member or professional staff shall –
 - (1) be owed, directly or indirectly, any financial or other obligation by any former employer, business partner, client, or publisher except –
 - (A) routine banking and other routine commercial relationships;

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- (B) securities and other investments permitted by this Code;
 - (C) benefits under a bona fide pension, retirement, group life, health or accident insurance, or other employee welfare or benefit plan maintained by a former employer and related to prior services for the former employer, business partner or client;
 - (D) profit-sharing, stock bonus or other payments related to prior services for the former employer, business partner or client;
 - (E) royalties or other like payments with respect to writings and recordings completed prior to commencement of employment with the Board; or
 - (F) such other obligations permitted by this Code, or as may be specifically and expressly approved by the Board; or
- (2) owe, directly or indirectly, any financial or other obligation to any former employer, business partner or client, except –
- (A) routine banking and other routine commercial relationships;
 - (B) covenants not to compete;
 - (C) non-disclosure agreements; or
 - (D) such other obligations permitted by this Code, or as may be specifically and expressly approved by the Board.

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

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

EC5. Investments

(a) Except as provided in this Section, nothing in this Code prohibits Board members and staff, or their spouses, spousal equivalents, or dependents, from owning and holding securities (including futures), real estate, commodities (including futures), exchange-traded options and other investments held for personal investment purposes,

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except that no Board member or staff may have any financial interest in a public accounting firm.

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

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

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

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

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

- (1) For initial disclosures, statements shall be filed with the Ethics Officer within the first 60 days of commencement of service with the Board, or 60 days from the effective date of this Code, whichever is later.
- (2) Subsequent disclosures shall be filed with the Ethics Officer on May 1, commencing the first year following the initial disclosure.
- (3) Disclosure statements by Board Members shall be made available to the public.
- (4) Disclosure statements by professional staff shall remain confidential.

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

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

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EC6. Outside Activities

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

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

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

- (1) affects or reasonably creates the appearance of affecting his or her independence or objectivity;
- (2) interferes with his or her responsibilities to the Board; or
- (3) otherwise hinders the interests or reputation of the Board.

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

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

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

- (1) interfering with his or her independence, objectivity or responsibilities to the Board; or
- (2) otherwise hindering the interests or reputation of the Board.

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

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

- (1) for travel that is in direct connection with the employee's participation in an educational forum; and
- (2) the educational forum is principally sponsored by and the travel-related expenses are paid or reimbursed by –

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- (A) a federal, state or local governmental body, or an association of such bodies,
- (B) an accredited institution of higher learning,
- (C) an organization exempt from taxation under 501(c)(3) of the Internal Revenue Code, provided such organization is not principally funded from one or more public accounting firms or issuers, or
- (D) institutions equivalent to those in EC 7(b)(2)(A) – (C) outside the United States.

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

EC8. Disqualification

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

- (1) disclose such circumstances and facts, as set forth in subsection (b); and
- (2) recuse himself or herself from further Board functions or activities involving or affecting the financial interest or relationship.

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

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

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

(c) For a period of 12 months commencing on date of appointment or employment, no Board member or professional staff may participate in the making of a

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decision which is reasonably likely to have a material effect, direct or indirect, on the Board or professional staff member's former employer, business partner or client, when such prior employment terminated within five years from the date of appointment or employment with the Board. For purposes of this section, participating in the making of a decision which affects a former employer, business partner or client to the same degree as similarly situated people or business organizations, does not constitute an "indirect" effect.

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

EC9. Non-Public Information

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

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

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

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

EC10. Speaking for the Board

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

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

EC11. Ethics Officer

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

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

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

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

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

EC12. Post-Employment Restrictions

(a) Negotiating Prospective Employment

- (1) Board members and professional staff may not negotiate prospective employment with a public accounting firm or issuer, without first disclosing (pursuant to the procedures in Section EC8(b)) the identity of the prospective employer and recusing himself or herself from all Board matters directly affecting that prospective employer.
- (2) For purposes of this section, "negotiating prospective employment" means participating in an employment interview; discussing an offer of employment; or accepting an offer of employment, even if the precise terms are still to be developed. Submitting a resume or job application to a group of employers or receiving an unsolicited inquiry of interest that is rejected, do not alone constitute "negotiating prospective employment."

(b) Prohibition on Practice Before the Board or Commission

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

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

EC13. Waiver

Unless otherwise prohibited by law, the Board (or person to whom the Board may delegate this responsibility as to staff) may grant a request for waiver of any provision of this Code. Such waivers must be requested in writing by the Board member or staff,

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and evaluated by the Ethics Officer. The Board will only grant waiver requests after a finding that the waiver would not otherwise hinder the interests or reputation of the Board. Waivers will be made available to the public, subject to the withholding of information that would constitute a clearly unwarranted invasion of personal privacy.

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

EC14. Certification

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

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

RULES

SECTION 1. GENERAL PROVISIONS

Rule 1000. [Reserved]

[Reserved]

Rule 1001. Definitions of Terms Employed in Rules.

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

(a)(i) Accounting Support Fee

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

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

(a)(ii) Accountant

The term "accountant" means a natural person –

- (1) who is a certified public accountant, or
- (2) who holds –
 - (i) a college, university, or higher professional degree in accounting, or
 - (ii) a license or certification authorizing him or her to engage in the business of auditing or accounting, or
- (3) who –
 - (i) holds a college, university, or higher professional degree in a field, other than accounting, and
 - (ii) participates in audits;

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

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

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(a)(iii) Act

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

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

(a)(iv) Associated Entity

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

- (1) any entity that directly, indirectly, or through one or more intermediaries, controls, or is controlled by, or is under common control with, such public accounting firm; or
- (2) any "associated entity," as used in Rule 2-01(f)(2) of Regulation S-X, 17 C.F.R. 210.2-01(f)(2), that would be considered part of that firm for purposes of the Commission's auditor independence rules.

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

(a)(v) Audit

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

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

(a)(vi) Audit Report

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

- (1) prepared following an audit performed for purposes of compliance by an issuer with the requirements of the securities laws; and
- (2) in which a public accounting firm either –
 - (i) sets forth the opinion of that firm regarding a financial statement, report or other document; or
 - (ii) asserts no such opinion can be expressed.

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

(a)(vii) Audit Services

The term "audit services" means –

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

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

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

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

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

(a)(ix) Accounting Board Demand

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

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

(a)(x) Accounting Board Request

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

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

(a)(xi) Appropriate State Regulatory Authority

The term "appropriate state regulatory authority" means the State agency or other authority responsible for the licensure or other regulation of the practice of

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accounting in the State or States having jurisdiction over a registered public accounting firm or associated person thereof, with respect to the matter in question.

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

(b)(i) Board

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

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

(b)(ii) Bar

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

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

(c)(i) Commission

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

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

(c)(ii) Counsel

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

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

(d)(i) Disciplinary Proceeding

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

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

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(d)(ii) Document

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

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

(e)(i) Exchange Act

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

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

(f)(i) Foreign Public Accounting Firm

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

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

(h)(i) Hearing Officer

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

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

(i)(i) Issuer Market Capitalization

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

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

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

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

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

(i)(ii) Investment Company Act

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

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

(i)(iii) Issuer

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

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

(i)(iv) Interested Division

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

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

(n)(i) Notice

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

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

(n)(ii) Non-Audit Services

The term "non-audit services" means –

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

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

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

(o)(i) Other Accounting Services

The term "other accounting services" means –

- (1) subject to paragraph (o)(i)(2) of this Rule, services that are normally provided by the public accounting firm that audits the issuer's financial statements in connection with statutory and regulatory filings or engagements and assurance and related services that are reasonably related to the performance of the audit or review of the issuer's financial statements, other than audit services.
- (2) effective after December 15, 2003, assurance and related services that are reasonably related to the performance of the audit or review of the issuer's financial statements, other than audit services.

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

(o)(ii) Order Instituting Proceedings

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

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

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

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

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

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

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

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

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

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

- (1) to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, or
- (2) to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer.

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

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

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

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

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(p)(iii) Public Accounting Firm

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

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

(p)(iii) Party

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

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

(p)(iv) Person

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

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

(p)(vi) Professional Standards

The term "professional standards" means –

(A) accounting principles that are –

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

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

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

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

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

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

(r)(i) Registered Public Accounting Firm

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

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

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

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

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

(r)(iii) Revocation

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

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

(s)(i) Securities Act

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

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

(s)(ii) Securities Laws

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

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

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(s)(iii) State

The term "State" means any state of the United States, the District of Columbia, Puerto Rico, the Virgin Islands, or any other territory or possession of the United States.

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

(s)(iii) Secretary

The term "Secretary" means the Secretary of the Board.

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

(s)(iv) Suspension

The term "suspension" means a temporary disciplinary sanction, which lapses by its own terms, prohibiting –

(1) a registered public accounting firm from preparing or issuing, or participating in the preparation or issuance of, any audit report with respect to any issuer; or

(2) a person from being associated with a registered public accounting firm.

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

(t)(i) Tax Services

The term "tax services" means professional services rendered for tax compliance, tax advice, and tax planning.

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

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Rule 1002. Time Computation

In computing any period of time prescribed in or allowed by these Rules or by order of the Board, the day of the act, event, or default from which the designated period of time begins to run shall not be included. The last day of the period so computed shall be included unless it is a Saturday, Sunday, or federal legal holiday, in which event the period runs until the end of the next day that is not a Saturday, Sunday, or federal legal holiday. Intermediate Saturdays, Sundays, and federal legal holidays shall be excluded from the computation when the period of time prescribed or allowed is seven days or less, not including any additional time allowed by rule or order for service by mail. If on the day a filing is to be made, weather or other conditions have caused the Secretary's office or other designated filing location to close, the filing deadline shall be extended to the end of the next day that is neither a Saturday, a Sunday, nor a federal legal holiday.

Note: The Secretary will maintain a list of federal legal holidays.

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

SECTION 2. REGISTRATION AND REPORTING

Part 1 – Registration of Public Accounting Firms

Rule 2100. Registration Requirements for Public Accounting Firms.

Effective October 22, 2003 (or, for foreign public accounting firms, July 19, 2004), each public accounting firm that –

- (a) prepares or issues any audit report with respect to any issuer; or
- (b) plays a substantial role in the preparation or furnishing of an audit report with respect to any issuer

must be registered with the Board.

Note 1: As set forth in Section 106(a)(1) of the Act, registration with the Board pursuant to this Rule will not by itself provide a basis for subjecting a foreign public accounting firm to the jurisdiction of the U.S. federal or State courts, other than with respect to controversies between such firms and the Board.

Note 2: The issuance of a consent to include an audit report for a prior period by a public accounting firm, which does not currently have and does not expect to have an engagement with an issuer to prepare or issue, or to play a substantial role in the preparation or furnishing of an audit report with respect to any issuer, will not by itself require a public accounting firm to register under Rule 2100.

[Effective pursuant to SEC Release 34-49473; File No. PCAOB 2004-01; March 25, 2004 and SEC Release No. 34-48180; File No. PCAOB-2003-03; July 16, 2003]

Rule 2101. Application for Registration.

Any public accounting firm applying to the Board for registration pursuant to Rule 2100 must complete and file an application for registration on Form 1 by following the instructions to that form. Unless directed otherwise by the Board, the applicant must file such application and exhibits thereto electronically with the Board through the Board's web-based registration system. An applicant may withdraw its application for registration by written notice to the Board at any time before the approval or disapproval of the application.

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

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Rule 2102. Date of Receipt.

Unless the Board directs otherwise, the date of receipt of an application for registration will be the later of (a) the date on which the registration fee has been paid, or (b) the date on which the application is submitted to the Board through its web-based registration system.

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

Rule 2103. Registration Fee.

Each applicant for registration must pay a registration fee. The Board will, from time to time, announce the current registration fee. No portion of the registration fee is refundable, regardless of whether the application for registration is approved, disapproved, or withdrawn.

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

Rule 2104. Signatures.

Each signatory to an application for registration (including, without limitation, each signatory to the consents required by such application) shall manually sign a signature page or other document authenticating, acknowledging or otherwise adopting his or her signature that appears in typed form within the electronic filing. Such document shall be executed before or at the time the electronic filing is made and shall be retained by the filer for a period of seven years. Upon request, an electronic filer shall furnish to the Board or its staff a copy of all documents retained pursuant to this Rule.

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

Rule 2105. Conflicting Non-U.S. Laws.

(a) An applicant may withhold information from its application for registration when submission of such information would cause the applicant to violate a non-U.S. law if that information were submitted to the Board.

(b) An applicant that claims that submitting information as part of its application would cause it to violate non-U.S. laws must –

- (1) identify, in accordance with the instructions on Form 1, the information that it claims would cause it to violate non-U.S. laws if submitted; and
- (2) include as an exhibit to Form 1 –

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- (i) a copy of the relevant portion of the conflicting non-U.S. law;
- (ii) a legal opinion that submitting the information would cause the applicant to violate the conflicting non-U.S. law; and
- (iii) an explanation of the applicant's efforts to seek consents or waivers to eliminate the conflict, if the withheld information could be provided to the Board with a consent or a waiver, and a representation that the applicant was unable to obtain such consents or waivers to eliminate the conflict.

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

Rule 2106. Action on Applications for Registration.

(a) Standard for Approval.

After reviewing the application for registration, any additional information provided by the applicant, and any other information obtained by the Board, the Board will determine whether approval of the application for registration is consistent with the Board's responsibilities under the Act to protect the interests of investors and to further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors.

(b) Action on Application.

Unless the applicant consents otherwise, the Board will take action on an application for registration not later than 45 days after the date of receipt of the application by the Board.

- (1) If the Board makes the determination in paragraph (a) of this Rule, the Board will approve the application.
- (2) If the Board is unable to determine that the standard for approval in paragraph (a) of this Rule is met, or if the Board determines that the application may be materially inaccurate or incomplete, the Board will:
 - (i) request more information from the applicant; or
 - (ii) provide the applicant with written notice of a hearing, pursuant to the Board's procedural rules governing disciplinary proceedings, to determine whether to approve or

disapprove the application. Such notice will specify, in reasonable detail, the proposed grounds for disapproval. Such notice may, at the applicant's election, be treated as a written notice of disapproval for purposes of Section 102(c) of the Act.

(c) Requests for More Information.

If the Board requests more information from an applicant, and such applicant submits the requested information to the Board, the Board will treat the application, as supplemented by the requested information, as if it were a new application for purposes of paragraph (b) of this Rule. The Board will take action on such supplemented applications as soon as practicable, and not later than 45 days after receipt of the supplemented application by the Board. If such firm declines to provide the requested information, or fails to do so within a reasonable amount of time, the Board may deem the application incomplete for purposes of paragraph (b)(2) of this Rule, may deem the application not to have been received in accordance with Rule 2102, or may take such other action as the Board deems appropriate.

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

Rule 2107. Withdrawal from Registration

(a) Request for Leave to Withdraw

Subject to the limitation described in paragraph (e), a registered public accounting firm's registration with the Board shall be deemed withdrawn if the firm requests leave to withdraw by filing a completed Form 1-WD and

- (1) the Board grants leave to withdraw, or
- (2) the Board does not, within 60 days of receipt of the request, order that withdrawal of the firm's registration be delayed.

(b) Form 1-WD

(1) A request for leave to withdraw shall be filed on Form 1-WD in accordance with the instructions contained therein. A completed Form 1-WD shall include, among other things, a statement signed by an authorized partner or officer of the firm certifying that the firm is not currently, and will not during the pendency of its request for leave to withdraw be, engaged in the preparation or issuance of, or playing a substantial role in the preparation or furnishing of, an audit report, other than to issue a consent to the use of an audit report for a prior period.

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(2) The contents of a completed Form 1-WD shall be non-public. The Board shall publicly disclose the identity of any firm as to which a request for leave to withdraw is pending and the date that the Board received a completed Form 1-WD.

(c) Effect of Filing

(1) Beginning on the date of Board receipt of a completed Form 1-WD, the firm that filed the Form 1-WD shall not engage in the preparation or issuance of, or play a substantial role in the preparation or furnishing of, an audit report, other than to issue a consent to the use of an audit report for a prior period, unless it first withdraws its Form 1-WD.

(2) Beginning on the fifth day following the Board's receipt of a completed Form 1-WD, and continuing for as long as the Form 1-WD is pending –

(i) the firm may satisfy the annual reporting requirement by submitting a report stating that a completed Form 1-WD has been filed and is pending;

(ii) any annual fee assessed shall be zero;

(iii) the Board shall have the discretion to forego any regular inspection that would otherwise commence pursuant to Rule 4003(a) or Rule 4003(b); and

(iv) the firm's registration status shall be designated as "registered – withdrawal request pending," and the firm shall not publicly represent its registration status without specifying it as "registered – withdrawal request pending."

(d) Board Action

Within 60 days of Board receipt of a completed Form 1-WD, the Board may order that withdrawal of registration be delayed for a period of up to eighteen months from the date of such receipt if the Board determines that such withdrawal would be inconsistent with the Board's responsibilities under the Act, including its responsibilities to conduct –

(1) inspections to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with the Act, the rules of the Board, the rules of the Commission, or professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers; or

(2) investigations or disciplinary proceedings with respect to any act or practice, or omission to act, by a registered public accounting firm, any associated person of such firm, or both, that may violate any provision of the Act, the rules of the

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Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards.

(e) Automatic Delay of Withdrawal for Pending Disciplinary Proceedings

If, on the 60th day after the Board's receipt of a Form 1-WD or at the conclusion of any period for which the Board has ordered that withdrawal be delayed, there is pending any Board disciplinary proceeding against the firm that filed the Form 1-WD or against any associated person of that firm, or there is pending any Commission or court review of a Board sanction against such firm or person, the requested withdrawal from registration shall not take effect before the completion of all such disciplinary proceedings and reviews, unless the Board orders otherwise.

(f) Withdrawal of Form 1-WD

A registered public accounting firm that has submitted a Form 1-WD may withdraw the form at any time by filing with the Board a written notice of intent to withdraw the Form 1-WD along with any annual fee and annual report that the firm would have been required to submit during the period that the Form 1-WD was pending if not for the provisions of paragraph (c)(2).

(g) Withdrawal Voided for Material Inaccuracies or Omissions

If the Board determines, within three years after the date a firm's registration is deemed withdrawn, that there are reasonable grounds to believe that a firm that has withdrawn from registration filed with the Board a Form 1-WD that was materially incomplete or materially inaccurate on the date of filing, such firm's registration shall be reinstated, effective retroactively to the date the registration was deemed withdrawn.

[Effective pursuant to SEC Release No. 34-49694; File No. PCAOB-2003-09; May 13, 2004]

Part 2 – Reporting

[Reserved]

Part 3 – Public Availability Of Applications And Reports

Rule 2300. Public Availability of Information Submitted to the Board; Confidential Treatment Requests.

(a) Except as provided in paragraph (b) below, an application for registration will be publicly available as soon as practicable after the Board approves or disapproves such application.

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(b) Confidential Treatment Requests.

A public accounting firm may request confidential treatment of any information submitted to the Board in connection with its application for registration, provided that the information as to which confidential treatment is requested –

- (1) has not otherwise been publicly disclosed, and
- (2) either (i) contains information reasonably identified by the public accounting firm as proprietary information, or (ii) is protected from public disclosure by applicable laws related to the confidentiality of proprietary, personal, or other information.

(c) Application Procedures.

To request confidential treatment of information submitted to the Board in connection with an application for registration, the applicant must –

- (1) identify in accordance with the instructions on Form 1 the information that it desires to keep confidential; and
- (2) include as an exhibit to Form 1 a detailed explanation as to why, based on the facts and circumstances of the particular case, the information meets the requirements of paragraph (b) of this Rule.

(d) Pending a determination by the Board as to whether to grant the request for confidential treatment, the information for which confidential treatment has been requested will not be made available to the public.

(e) If the Board determines to deny a confidential treatment request, the requestor will be notified in writing of the Board's decision, and of the date on which the information in question will be made public, a reasonable time in advance of such date.

(f) Unless the applicant requests otherwise, the exhibit containing an explanation supporting a confidential treatment request will be afforded confidential treatment without the need for a request for confidential treatment.

(g) Information as to which the Board grants confidential treatment under this rule will not be made available to the public by the Board. The granting of confidential treatment will not, however, limit the ability of the Board (1) to provide the information as to which confidential treatment was granted to the Commission, or (2) to comply with any subpoena validly issued by a court or other body of competent jurisdiction. In the event the Board receives such a subpoena, the Board will notify the applicant of such

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subpoena, to the extent permitted by law, to allow the applicant the opportunity to object to such subpoena.

(h) Pursuant to Section 101(g)(2) of the Act, the Board hereby delegates, until the Board orders otherwise, to the Director of Registration and Inspection the Board's functions under this Rule.

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

SECTION 3. PROFESSIONAL STANDARDS

Part 1 – General Requirements

Rule 3100. Compliance with Auditing and Related Professional Practice Standards.

A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards.

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

Rule 3200T. Interim Auditing Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95, as in existence on April 16, 2003 (Codification of Statements on Auditing Standards, AU § 150 (AICPA 2002)), to the extent not superseded or amended by the Board.

Note: Under Section 102(a) of the Act, public accounting firms are not required to be registered with the Board until 180 days after the date of the determination of the Commission under section 101(d) that the Board has the capacity to carry out the requirements of Title I of the Act (the "mandatory registration date"). The Board intends that, during the period preceding the mandatory registration date, the Interim Auditing Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 34-47746; April 25, 2003]

Rule 3300T. Interim Attestation Standards.

In connection with an engagement (i) described in the AICPA's Auditing Standards Board's Statement on Standards for Attestation Engagements No. 10 (Codification of Statements on Auditing Standards, AT § 101.01 (AICPA 2002)) and (ii) related to the preparation or issuance of audit reports for issuers, a registered public accounting firm, and its associated persons, shall comply with the AICPA Auditing Standards Board's Statements on Standards for Attestation Engagements, and related interpretations and Statements of Position, as in existence on April 16, 2003, to the extent not superseded or amended by the Board.

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Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Attestation Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 34-47746; April 25, 2003]

Rule 3400T. Interim Quality Control Standards.

A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in –

(a) the AICPA's Auditing Standards Board's Statements on Quality Control Standards, as in existence on April 16, 2003 (AICPA Professional Standards, QC §§ 20-40 (AICPA 2002)), to the extent not superseded or amended by the Board; and

(b) the AICPA SEC Practice Section's Requirements of Membership (d), (f)(first sentence), (l), (m), (n)(1) and (o), as in existence on April 16, 2003 (AICPA SEC Practice Section Manual § 1000.08(d), (f), (j), (m), (n)(1) and (o)).

Note: The second sentence of requirement (f) of the AICPA SEC Practice Section's Requirements of Membership provided for the AICPA's peer review committee to "authorize alternative procedures" when the requirement for a concurring review could not be met because of the size of the firm. This provision is not adopted as part of the Board's Interim Quality Control Standards. After the effective date of the Interim Quality Control Standards, requests for authorization of alternative procedures to a concurring review may, however, be directed to the Board.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Quality Control Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 34-47746; April 25, 2003]

Rule 3500T. Interim Ethics Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with ethics standards, as described in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA

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Professional Standards, ET §§ 102 and 191 (AICPA 2002)), to the extent not superseded or amended by the Board.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Ethics Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 34-47746; April 25, 2003]

Rule 3600T. Interim Independence Standards.

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with independence standards –

(a) as described in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, as in existence on April 16, 2003 (AICPA Professional Standards, ET §§ 101 and 191 (AICPA 2002)), to the extent not superseded or amended by the Board; and

(b) Standards Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2, of the Independence Standards Board, to the extent not superseded or amended by the Board.

Note: The Board's Interim Independence Standards do not supercede the Commission's auditor independence rules. See Rule 2-01 of Reg. S-X, 17 C.F.R. 240.2-01. Therefore, to the extent that a provision of the Commission's rule is more restrictive – or less restrictive – than the Board's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive rule.

Note: The Board intends that, during the period preceding the mandatory registration date, the Interim Independence Standards apply to public accounting firms that would be required to be registered after the mandatory registration date and to associated persons of those firms, as if those firms were registered public accounting firms.

[Effective pursuant to SEC Release No. 34-49624; File No. PCAOB-2003-11; April 28, 2004 and SEC Release Nos 33-8233 & 34-47746; April 25, 2003]

Part 7 – Establishment of Professional Standards

Rule 3700. Advisory Groups.

(a) Formation.

To assist it in carrying out its responsibility to establish auditing and related professional practice standards, the Board will convene one or more advisory groups, in accordance with Section 103(a)(4) of the Act.

(b) Composition.

Advisory groups, in combination or as sub-groups designated by the Board within one advisory group, will contain individuals with expertise in one or more of the following areas –

- (1) accounting;
- (2) auditing;
- (3) corporate finance;
- (4) corporate governance;
- (5) investing in public companies; and

(6) other areas that the Board deems to be relevant to one or more auditing or related professional practice standards.

(c) Selection of Members of Advisory Groups.

Members of advisory groups will be selected by the Board, in its sole discretion, based upon nominations, including self-nominations, received from any person or organization.

Note: The Board will announce, from time to time, periods during which it will receive nominations to an advisory group. During those periods, nominations may be submitted by any person or organization, including, but not limited to, any investor, any accounting firm, any issuer, and any institution of higher learning.

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(d) Personal Membership.

Membership in an advisory group will be personal to the individuals selected to serve on the advisory group. A member's functions and responsibilities, including attendance at meetings, may not be delegated to others.

(e) Ethical Duties of Advisory Group Members.

Members of an advisory group shall comply with EC3, EC8(a), EC9, and, with respect to any private publication or public statement about the Board or any advisory group or any of the activities of the Board or any advisory group, EC10 of the Board's Ethics Code.

(f) Ad Hoc Task Forces.

The Board may, in its discretion, establish ad hoc task forces. The membership of such task forces may include, but is not limited to, advisory group members. To the extent not otherwise required, members of ad hoc task forces shall comply with paragraph (e) of this Rule.

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

SECTION 4. INSPECTIONS

Rule 4000. General

Every registered public accounting firm shall be subject to all such regular and special inspections as the Board may from time-to-time conduct in order to assess the degree of compliance of each registered public accounting firm and associated persons of that firm with the Act, the Board's rules, the rules of the Commission, and professional standards, in connection with its performance of audits, issuance of audit reports, and related matters involving issuers. Inspection steps and procedures shall be performed by the staff of the Division of Registration and Inspections, and by such other persons as the Board may authorize to participate in particular inspections or categories of inspections.

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

Rule 4001. Regular Inspections

In performing a regular inspection, the staff of the Division of Registration and Inspections and any other person authorized by the Board to participate in the inspection shall take such steps, and perform such procedures, as the Board determines are necessary or appropriate. Such steps and procedures must include, but need not be limited to, those set forth in Section 104(d)(1) and (2) of the Act and such other tests of the audit, supervisory, and quality control procedures of the firm as the Director of the Division of Registration and Inspections or the Board determines.

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

Rule 4002. Special Inspections

In performing a special inspection, the staff of the Division of Registration and Inspections and any other person authorized by the Board to participate in the inspection shall take such steps, and perform such procedures, as are necessary or appropriate concerning the issue or issues specified by the Board in connection with its authorization of the special inspection.

Note: Under Section 104(b)(2) of the Act, the Board may authorize a special inspection on its own initiative or at the request of the Commission.

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

Rule 4003. Frequency of Inspections

(a) During each calendar year, beginning no later than the calendar year following the calendar year in which its application for registration with the Board is

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approved, a registered public accounting firm that, during the prior calendar year, issued audit reports with respect to more than 100 issuers shall be subject to a regular inspection.

(b) At least once in every three calendar years, beginning with the three-year period following the calendar year in which its application for registration with the Board is approved, a registered public accounting firm that, during any of the three prior calendar years, issued an audit report with respect to at least one, but no more than 100, issuers, or that played a substantial role in the preparation or furnishing of an audit report with respect to at least one issuer, shall be subject to a regular inspection.

(c) With respect to a registered public accounting firm that has filed a completed Form 1-WD under Rule 2107, the Board shall have the discretion to forego any regular inspection that would otherwise commence during the period beginning on the fifth day following the filing of the completed Form 1-WD and continuing until the firm's registration is deemed withdrawn or the firm withdraws the Form 1-WD.

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

Rule 4004. Procedure Regarding Possible Violations

If the Board determines that information obtained by the Board's staff during any inspection indicates that the registered public accounting firm subject to such inspection, any associated person thereof, or any other person, may have engaged, or may be engaged, in any act, practice, or omission to act that is or may be in violation of the Act, the rules of the Board, any statute or rule administered by the Commission, the firm's own quality control policies, or any professional standard, the Board shall, if it determines appropriate –

(a) report information concerning such act, practice, or omission to –

(1) the Commission; and

(2) each appropriate state regulatory authority; and

(b) commence an investigation of such act, practice, or omission in accordance with Section 105(b) of the Act and the Board's rules thereunder or a disciplinary proceeding in accordance with Section 105(c) of the Act and the Board's rules thereunder.

Note: The Board may, as appropriate, make referrals or report information to regulatory and law enforcement agencies other than those specifically described in Rule 4004.

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

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Rule 4005. Record Retention and Availability

[Reserved]

Rule 4006. Duty to Cooperate With Inspectors

Every registered public accounting firm, and every associated person of a registered public accounting firm, shall cooperate with the Board in the performance of any Board inspection. Cooperation shall include, but is not limited to, cooperating and complying with any request, made in furtherance of the Board's authority and responsibilities under the Act, to –

- (1) provide access to, and the ability to copy, any record in the possession, custody, or control of such firm or person, and
- (2) provide information by oral interviews, written responses, or otherwise.

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

Rule 4007. Procedures Concerning Draft Inspection Reports

(a) The Director of the Division of Registration and Inspections shall make a draft inspection report available for review by the firm that is the subject of the report. The firm may, within the 30 days after the draft inspection report is first made available for the firm's review, or such longer period as the Board may order, submit to the Board a written response to the draft report.

(b) (1) In submitting a response pursuant to paragraph (a), the firm may indicate any portions of the response for which the firm requests confidential treatment under Section 104(f) of the Act, and may supply any supporting authority or other justification for according confidential treatment to the information.

(2) The Board shall attach to, and make part of the inspection report, any response submitted pursuant to paragraph (a), but shall redact from the response attached to the inspection report any information for which the firm requested confidential treatment and which it is reasonable to characterize as confidential.

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(c) After receiving and reviewing any response letter pursuant to paragraph (a) of this rule, the Board may take such action with respect to the draft inspection report as it considers appropriate, including adopting the draft report as the final report, revising the draft report, or continuing or supplementing the inspection before issuing a final report. In the event that, prior to issuing a final report, the Board directs the staff to continue or supplement the inspection or revise the draft report, the Board may, in its discretion, afford the firm the opportunity to review any revised draft inspection report.

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

Rule 4008. Procedures Concerning Final Inspection Reports

Promptly following the Board's issuance of a final inspection report, the Board shall –

(a) make the final report available for review by the firm that is the subject of the report;

(b) transmit to the Commission the final report, any additional letter or comments by the Board or the Board's inspectors that the Board deems appropriate, and any response submitted by the firm to a draft inspection report; and

(c) transmit to each appropriate state regulatory authority, in appropriate detail, the final report, any additional letter or comments by the Board or the Board's inspectors that the Board deems appropriate, and any response submitted by the firm to a draft inspection report.

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

Rule 4009. Firm Response to Quality Control Defects

(a) With respect to any final inspection report that contains criticisms of, or potential defects in, the quality control systems of the firm under inspection, the firm may submit evidence or otherwise demonstrate to the Director of the Division of Registration and Inspections that it has improved such systems, and remedied such defects no later than 12 months after the issuance of the Board's final inspection report. After reviewing such evidence, the Director shall advise the firm whether he or she will recommend to the Board that the Board determine that the firm has satisfactorily addressed the criticisms or defects in the quality control system of the firm identified in the final inspection report and, if not, why not.

(b) If the Board determines that the firm has satisfactorily addressed the criticisms or defects in the quality control system, the Board shall provide notice of that determination to the Commission and to any appropriate state regulatory authority to which the Board had supplied any portion of the final inspection report.

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(c) The Board shall notify the firm of its final determination concerning whether the firm has addressed the criticisms or defects in the quality control system of the firm identified in the final inspection report to the satisfaction of the Board.

(d) The portions of the Board's inspection report that deal with criticisms of or potential defects in quality control systems that the firm has not addressed to the satisfaction of the Board shall be made public by the Board –

(1) upon the expiration of the 12-month period described in paragraph (a) of this rule if the firm fails to make any submission pursuant to paragraph (a); or

(2) upon the expiration of the period in which the firm may seek Commission review of any board determination made under paragraph (b) of this rule, if the firm does not seek Commission review of the Board determination; or

(3) unless otherwise directed by Commission order or rule, 30 days after the firm formally requests Commission review pursuant to Section 104(h)(1)(B) of the Act.

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

Rule 4010. Board Public Reports

Notwithstanding any provision of Rules 4007, 4008, and 4009, the Board may, at any time, publish such summaries, compilations, or other general reports concerning the procedures, findings, and results of its various inspections as the Board deems appropriate. Such reports may include discussion of criticisms of, or potential defects in, quality control systems of any firm or firms that were the subject of a Board inspection, provided that no such published report shall identify the firm or firms to which such criticisms relate, or at which such defects were found, unless that information has previously been made public in accordance with Rule 4009, by the firm or firms involved, or by other lawful means.

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

SECTION 5. INVESTIGATIONS AND ADJUDICATIONS

Rule 5000. General

A registered public accounting firm, and any person associated with such a firm, shall comply with all Board orders to which the firm or person is subject.

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

Part 1 – Inquiries and Investigations

Rule 5100. Informal Inquiries

(a) Commencement of an Informal Inquiry

The Director of Enforcement and Investigations may undertake an informal inquiry where it appears that, or to determine whether, an act or practice, or omission to act, by a registered public accounting firm, any associated person of that firm, or both, may violate –

- (1) any provision of the Act;
- (2) the Rules of the Board;
- (3) the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act; or
- (4) professional standards.

(b) Informal Inquiry Activities

In an informal inquiry, the Director of Enforcement and Investigations may request documents, information or testimony from, or an interview with, any person.

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

Rule 5101. Commencement and Closure of Investigations

(a) Commencement of Investigations

(1) Order of Formal Investigation

Upon the recommendation of the Director of Enforcement and Investigations or the Director of Registration and Inspections, or upon the Board's own initiative, or

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otherwise, the Board may issue an order of formal investigation when it appears that an act or practice, or omission to act, by a registered public accounting firm or any person associated with a registered public accounting firm may violate any provision of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards.

(2) Designation of Staff

In an order of formal investigation, the Board may designate members, or groups of members, of the Board's staff to issue accounting board demands to, and otherwise require or request cooperation of, any person pursuant to Section 105(b)(2) of the Act, and the Board's Rules thereunder, to the extent the information sought is relevant to the matters described in the Board's order of investigation.

(b) Closure of Investigations

Upon the recommendation of the Director of Enforcement and Investigations, or on its own initiative, the Board may issue an order terminating or suspending, for a specified period of time, a formal investigation.

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

Rule 5102. Testimony of Registered Public Accounting Firms and Associated Persons in Investigations

(a) General

The Board, and the staff of the Board designated in an order of formal investigation, may require the testimony of any registered public accounting firm or any person associated with a registered public accounting firm, with respect to any matter that the Board considers relevant or material to an investigation.

(b) Accounting Board Demand for Testimony

The Board, and the staff of the Board designated in an order of formal investigation, shall require testimony by serving an accounting board demand that –

(1) gives reasonable notice of the time and place for the taking of testimony;

(2) states the method or methods by which the testimony shall be recorded, which may be by sound or sound-and-visual, but shall include by stenographic means; and

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(3) if the person to be examined is a registered public accounting firm, a description with reasonable particularity of the matters on which examination is requested.

(c) Conduct of Examination

(1) Oath or Affirmation

Before testifying, every witness shall be required to declare that the witness will testify truthfully, by oath or affirmation administered in a form calculated to awaken the witness's conscience and impress the witness's mind with the duty to do so.

(2) General

Examinations shall be conducted before a reporter designated by the Board's staff.

(3) Persons Permitted to be Present

Persons permitted to be present at an examination pursuant to this Rule are limited to –

- (i) the person being examined and his or her counsel, subject to Rule 5109(b);
- (ii) any Board member or member of the staff of the Board;
- (iii) the reporter; and
- (iv) such other persons as the Board, or the staff of the Board designated in the order of formal investigation, determine are appropriate to permit to be present; provided, however, that in no event shall a person other than the witness who has been or is reasonably likely to be examined in the investigation be present.

(4) Examinations of Registered Public Accounting Firms

A registered public accounting firm subject to an accounting board demand shall designate one or more individuals who consent to testify on its behalf, and may set forth, for each individual designated, the matters on which the individual will testify. The individuals so designated shall testify as to matters known or reasonably available to the registered public accounting firm.

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(d) Transcript

A witness shall have 15 days, or such longer period as the Director of Enforcement and Investigations may allow, after being notified by the reporter that the transcript, or, where applicable, video or other recording, is available in which to review the transcript or other recording and, if there are changes in form or substance, to sign a statement reciting such changes and the reasons given by the witness for making them. The reporter shall make a certificate in writing to accompany the transcript, which shall indicate –

(1) that the witness was duly sworn by the officer and that the transcript is a true record of the testimony given by the witness; and

(2) whether the witness requested to review the transcript and, if so, that the reporter has appended any changes made by the witness during the period allowed.

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

Rule 5103. Demands for Production of Audit Workpapers and Other Documents from Registered Public Accounting Firms and Associated Persons

(a) General

The Board, and the staff of the Board designated in an order of formal investigation, may issue an accounting board demand for the production of audit work papers or any other document or information in the possession of a registered public accounting firm or any associated person thereof, wherever domiciled, that the Board or its staff considers relevant or material to the investigation.

(b) Time and Manner of Production

An accounting board demand shall set forth a reasonable time and place for production. Unless an accounting board demand expressly requires the production of original documents, copies of the requested documents may be produced. If the originals are not produced, they shall be maintained in a reasonably accessible manner, shall be readily available for inspection by the staff, and shall not be destroyed without the staff's consent. Unless an accounting board demand expressly requests or permits printed copies of electronic documents, documents that exist in electronic form shall be produced in that form.

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

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Rule 5104. Examination of Books and Records in Aid of Investigations

Upon demand and without regard to the Board's Rules under Section 104 of the Act, the Board, and, with the approval of the Director of Enforcement and Investigations, the staff of the Board designated in an order of formal investigation, may examine the books and records of any registered public accounting firm or associated person to verify the accuracy of any documents or information supplied in the course of an informal inquiry or formal investigation.

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

Rule 5105. Requests for Testimony or Production of Documents from Persons Not Associated With Registered Public Accounting Firms

(a) Testimony

The Board, and the staff of the Board designated in an order of formal investigation, may issue an accounting board request for the testimony of any person, including any client of a registered public accounting firm, that the Board considers relevant or material to an investigation.

(1) Requests for Testimony

An accounting board request for testimony pursuant to subparagraph (a) of this Rule shall –

(i) give appropriate notice, subject to the needs of the investigation of the time and place for the taking of testimony;

(ii) state the method or methods by which the testimony shall be recorded, which may be by sound or sound-and-visual, but shall include by stenographic means; and

(iii) if the person to be examined is an issuer, an association, a governmental agency, or other organized entity, provide a description with reasonable particularity of the matters on which examination is requested.

(2) Conduct of Examination and Transcript

An examination requested pursuant to this Rule shall be conducted consistent with Rules 5102(c) and a transcript shall be prepared consistent with Rule 5102(d). If the person to be examined is an issuer, or a partnership or association or governmental agency, the person to be examined shall designate one or more individuals who consent to testify on its behalf and may set forth, for each individual designated, the matters on which the individual will testify. The individuals so designated shall testify as to matters known or reasonably available to the organization.

(b) Documents

The Board, and the staff of the Board designated in an order of formal investigation, may issue an accounting board request to any person, including any issuer, for the production of any document that is relevant or material to an investigation, with appropriate notice, subject to the needs of the investigation. A request issued pursuant to this Rule shall set forth a reasonable time and place for production, subject to the needs of the investigation.

Note: Failure to comply with an accounting board request pursuant to Rule 5105 may result in a Board request for the issuance of a Commission subpoena, pursuant to Rule 5111.

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

Rule 5106. Assertion of Claim of Privilege

(a) Required Information Supporting Assertion

When a claim of privilege is asserted in objecting to any accounting board demand for information, including but not limited to testimony or an examination under Rule 5104, and an answer or document is not provided on the basis of such assertion,

(1) the person asserting the privilege, or his or her attorney, shall identify the nature of the privilege (including attorney work product) that is being claimed and indicate the relevant jurisdiction's privilege rule being invoked; and

(2) the following information shall be provided in the objection, unless divulgence of such information would cause disclosure of the allegedly privileged information –

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(i) for documents: (A) the type of document, (e.g., letter or memorandum); (B) the general subject matter of the document; (C) the date of the document; and (D) such other information as is sufficient to identify the document for a Commission subpoena duces tecum, including, where appropriate, the author of the document, the addressees of the document, and any other recipients shown in the document, and, where not apparent, the relationship of the author, addressees, and recipients to each other; and

(ii) for oral communications: (A) the name of the person making the communication and the names of persons present while the communication was made and, where not apparent, the relationship of the persons present to the person making the communication; (B) the date and place of communication; and (C) the general subject matter of the communication.

(b) Claims During Testimony

Where a claim of privilege is asserted during testimony, and information is not provided on the basis of such assertion, the information set forth in paragraph (a) shall be furnished –

(1) at the deposition, to the extent it is readily available from the witness or otherwise; or

(2) to the extent the information is not readily available at the deposition, in writing within five business days after the deposition session at which the privilege is asserted, unless otherwise agreed by the staff of the Board.

(c) Claims Other than During Testimony

Where a claim of privilege is asserted in response to an accounting board demand for information other than during testimony, the information set forth in paragraph (a) shall be furnished in writing at the time of the response to such accounting board demand, unless otherwise agreed by the Board or its staff.

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

Rule 5107. Uniform Definitions in Demands and Requests for Information

(a) General

The full text of the definitions and rules of construction set forth in paragraphs (c) and (d) is deemed incorporated by reference into all accounting board demands. This Rule shall not preclude (1) the definition of other terms specific to the particular inquiry or investigation, (2) the use of abbreviations, or (3) a more narrow definition of a term defined in paragraph (c).

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(b) Scope

This Rule is not intended to broaden or narrow the scope of the Board's authority to request information permitted by the Act.

(c) Definitions

The following definitions apply to all accounting board demands –

(1) Communication

The term "communication" means the transmittal of information (in the form of facts, ideas, inquiries or otherwise).

(2) Document

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

(3) Identify (with respect to person)

When referring to a person, to "identify" means to give, to the extent known, the person's full name, present or last known address, and when referring to a natural person, additionally, the present or last known place of employment. Once a person has been identified in accordance with this subparagraph, only the name of that person need be listed in response to subsequent requests for the identification of that person.

(4) Identify (with respect to documents)

When referring to documents, to "identify" means to give, to the extent known, the (i) type of document, (ii) general subject matter, (iii) date of the document; and (iv) author(s), addressee(s) and recipients(s).

(5) Person

The term "person" is defined as any natural person or any business, legal or governmental entity or association.

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(6) Concerning

The term "concerning" means relating to, referring to, describing, evidencing or constituting.

(d) Rules of Construction

The following rules of construction apply to all discovery requests –

(1) All/Each

The terms "all" and "each" shall be construed as all and each.

(2) And/Or

The connectives "and" and "or" shall be construed either conjunctively or disjunctively as necessary to bring within the scope of the request for information all responses that might otherwise be construed outside of its scope.

(3) Number

The use of the singular form of any word includes the plural and vice versa.

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

Rule 5108. Confidentiality of Investigatory Records

(a) Informal inquiries and formal investigations, and any documents, testimony or other information prepared or received by or specifically for the Board or the staff of the Board in connection with such inquiries and investigations, shall be confidential in the hands of the Board, unless and until presented in connection with a public proceeding or released in accordance with Section 105(c) of the Act, and the Board's Rules thereunder; provided, however, that the Board may make such information available –

(1) to the Commission; and

(2) in the discretion of the Board, when determined by the Board to be necessary to accomplish the purposes of the Act or to protect investors, to the following –

(a) the Attorney General of the United States;

(b) the appropriate Federal functional regulator (as defined in section 509 of the Gramm-Leach-Bliley Act), other than the Commission, with respect to an audit report for an institution subject to the jurisdiction of such regulator;

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(c) State attorneys general in connection with any criminal investigation; and

(d) any appropriate State regulatory authority.

(b) Nothing in paragraph (a) of this rule shall prohibit the Board or the staff of the Board from disclosing any documents, testimony, or other information to any other person as is reasonably necessary to carry out the Board's responsibility, under Section 105 of the Act, to conduct investigations according to fair procedures.

Note: Under Section 105(b)(5) of the Act, the documents described in Rule 5108 "shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any federal or State court or administrative agency, and shall be exempt from disclosure, in the hands of an agency or establishment of the federal government, under the Freedom of Information Act (5 U.S.C. 552a), or otherwise, unless and until presented in connection with a public proceeding or released in accordance with subsection (c)" of Section 105 of the Act.

Note: The Director of Enforcement and Investigations may engage in and may authorize members of the Board's staff to engage in discussions with persons identified in Rule 5108, or their staff, concerning information obtained in an informal inquiry or a formal investigation.

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

Rule 5109. Rights of Witnesses in Inquiries and Investigations

(a) Review of Order of Formal Investigation

Any person who is compelled to testify or produce documents pursuant to a subpoena issued pursuant to Rule 5111, or who testifies or produces documents pursuant to an accounting board demand or request, shall, upon request, be shown the Board's order of formal investigation. In the discretion of the Director of Enforcement and Investigations, a copy of the order of formal investigation may also be furnished to such a person for his or her retention, subject to such limits on dissemination as the Director may require.

(b) Right to Counsel

Any person compelled to testify pursuant to a subpoena issued pursuant to Rule 5111, or who appears pursuant to an accounting board demand or request, may be accompanied, represented and advised by counsel, subject to Rule 5102(c)(3), provided, however, that the counsel provide the Board's staff with a notice of

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appearance that states, or state on the record at the commencement of testimony, that the counsel represents the witness.

(c) Inspection and Copying

Upon written request to the Director of Enforcement and Investigations and proper identification, a witness may inspect the official transcript of the witness's own testimony. Upon written request and payment of the appropriate fees to cover the cost of production or reproduction, a person who has submitted documentary evidence or testimony in an informal inquiry or formal investigation may procure a copy of such evidence or the transcript of such testimony, except that prior to such evidence or testimony being presented in connection with a proceeding or released in accordance with Section 105(c) of the Act, and the Board's Rules thereunder, the Director of Enforcement and Investigations may for good cause deny such request.

(d) Statements of Position

Registered public accounting firms, and persons associated with firms, who become involved in an informal inquiry or a formal investigation may, on their own initiatives, submit a written statement to the Board setting forth their interests and positions in regard to the subject matter of the investigation. Upon request, the Board's staff, in its discretion, may advise such persons of the general nature of the investigation, including the indicated violations as they pertain to those persons and the amount of time that may be available for preparing and submitting a statement prior to the presentation of a staff recommendation to the Board for the commencement of a disciplinary proceeding. In the event a recommendation for the commencement of a disciplinary proceeding is presented by the staff, any submissions by interested persons will be forwarded to the Board in conjunction with the staff recommendation.

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

Rule 5110. Noncooperation with an Investigation

(a) Grounds for Instituting Proceedings

The Board may institute a disciplinary proceeding pursuant to Rule 5200(a)(3) for noncooperation with an investigation if it appears to the Board, on the recommendation of the Director of Enforcement and Investigations or otherwise, that a registered public accounting firm, or a person associated with a such a firm –

- (1) may have failed to comply with an accounting board demand;
- (2) may have knowingly made any false material declaration or made or used any other information, including any book, paper, document,

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record, recording, or other material, knowing the same to contain any false material declaration;

(3) may have abused the Board's processes for the purpose of obstructing an investigation; or

(4) may otherwise have failed to cooperate in connection with an investigation.

(b) Special and Expedited Procedures

Disciplinary proceedings instituted pursuant to Rule 5200(a)(3) for noncooperation with an investigation shall be subject to special and expedited procedures as described in Rules 5201(b)(3), 5300(b), 5302(d), 5421(b), 5422(a)(2), 5422(d), 5445(b), and 5460(a)(2)(ii).

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

Rule 5111. Requests for Issuance of Commission Subpoenas in Aid of an Investigation

(a) General

The Board may seek issuance by the Commission, in a manner established by the Commission, of a subpoena to require the testimony of, and the production of, any document in the possession of, any person, including any client of a registered public accounting firm, that the Board considers relevant or material to an investigation.

(b) Application for a Subpoena

An application for a subpoena submitted to the Commission shall include –

- (1) a completed form of subpoena; and
- (2) such other information as the Commission may require.

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

Rule 5112. Coordination and Referral of Investigations

(a) Commission Notification of Order of Formal Investigation

As soon as practicable after entry of an order of formal investigation pursuant to Rule 5101 that involves a potential violation of the securities laws, the Secretary of the

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Board shall send a copy of the order to the Commission, or any staff of the Commission designated to receive orders of formal investigation by the Board, and Board staff shall thereafter coordinate their work with the work of the Commission's Division of Enforcement, as necessary to protect any ongoing Commission investigation.

(b) Board Referrals of Investigations

The Board may refer any investigation to the Commission and, in the case of an investigation that concerns an audit report for an institution that is subject to the jurisdiction of any other Federal functional regulator (as defined in section 509 of the Gramm-Leach-Bliley Act), to such regulator.

(c) Commission-directed Referrals of Investigations

At the direction of the Commission, the Board may refer any investigation to –

- (1) the Attorney General of the United States;
- (2) the attorney general of one or more States; and
- (3) an appropriate State regulatory authority.

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

Part 2 – Disciplinary Proceedings

Rule 5200. Commencement of Disciplinary Proceedings

(a) Grounds for Commencement of Disciplinary Proceedings

The Board may commence a disciplinary proceeding when –

(1) it appears to the Board, as the result of an investigation or otherwise, that a hearing is warranted to determine whether a registered public accounting firm, or an associated person of such a firm, has engaged in any act or practice, or omitted to act, in violation of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards;

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(2) it appears to the Board, as the result of an investigation or otherwise, that a hearing is warranted to determine whether a registered public accounting firm, or the supervisory personnel of such a firm, has failed reasonably to supervise an associated person, either as required by the Rules of the Board relating to auditing or quality control standards, or otherwise, with a view to preventing violations of this Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission under the Act, or professional standards, and such associated person commits a violation of the Act, or any of such rules, laws, or standards;

(3) it appears to the Board that a hearing is warranted pursuant to Rule 5110.

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

(b) Appointment of a Hearing Officer

As soon as practicable after the Board has issued an order instituting proceedings, or after a registration applicant has requested a hearing pursuant to Rule 5500(b), the Secretary shall assign a hearing officer to preside over the proceeding and shall serve the parties with notice of the hearing officer's assignment. Subject to Rules 5402 and 5403, the hearing officer shall have the authority to do all things necessary and appropriate to discharge his or her duties. The powers of the hearing officer include, but are not limited to, the following –

- (1) obtaining a court reporter to administer oaths and affirmations;
- (2) issuing accounting board demands pursuant to Rule 5424;
- (3) receiving relevant evidence and ruling upon the admission of evidence and offers of proof;
- (4) regulating the course of a proceeding and the conduct of the parties and their counsel;
- (5) holding prehearing and other conferences and requiring the attendance at any such conference of at least one representative of each party who has authority to negotiate concerning the resolution of issues in controversy;
- (6) recusing himself or herself upon motion made by a party or upon his or her own motion;

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(7) ordering, in his or her discretion, in a proceeding involving more than one respondent, that the interested division indicate, on the record, at least one day prior to the presentation of any evidence, each respondent against whom that evidence will be offered;

(8) subject to any limitations set forth elsewhere in these Rules, considering and ruling upon all procedural and other motions;

(9) preparing an initial decision as provided in Rule 5204;

(10) upon notice to all parties, reopening any hearing prior to the filing of an initial decision therein, or, if no initial decision is to be filed, prior to the time fixed for the filing of final briefs with the Board;

(11) informing the parties as to the availability of one or more alternative means of dispute resolution, and encouraging the use of such methods; and

(12) scheduling hearing dates, except that a hearing officer may not, absent the approval of the Board, change a hearing date set by Board order.

(c) Separation of Functions

The staff of the Division of Enforcement and Investigations may not participate or advise in the decision, or in Board review of the decision, in any proceeding in which the Division of Enforcement and Investigations is the interested division, except as a witness or counsel in the proceeding. Any other employee or agent of the Board engaged in the performance of investigative or prosecutorial functions for the Board in a proceeding may not, in that proceeding or one that is factually related, participate or advise in the decision, or in Board review of the decision, except as a witness or counsel in the proceeding. A hearing officer may not be responsible to or subject to the supervision or direction of an employee or agent engaged in the performance of investigative or prosecuting functions for the Board.

(d) Consolidation of Proceedings

By order of the Board or a hearing officer, proceedings involving a common question of law or fact may be consolidated for hearing of any or all the matters at issue in such proceedings. The Board or the hearing officer may make such orders concerning the conduct of such proceedings as it deems appropriate to avoid unnecessary cost or delay. Consolidation shall not prejudice any rights under these Rules and shall not affect the right of any party to raise issues that could have been raised if consolidation had not occurred. For purposes of this Rule, no distinction is made between joinder and consolidation of proceedings.

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

Rule 5201. Notification of Commencement of Disciplinary Proceedings

(a) Notice

Whenever an order instituting proceedings is issued by the Board, the Secretary shall give each firm or person charged appropriate notice of the order within a time reasonable in light of the circumstances. If the order instituting proceedings sets a hearing date, each party shall be given notice of the hearing within a time reasonable, in light of the circumstances, in advance of the hearing.

Note: Paragraph (a) requires that appropriate notice of an order instituting proceedings be given. Where emergency or expedited action is sought, notice of a hearing may be given prior to formal service of the order instituting proceedings by any means calculated to give actual notice that a hearing will be held.

(b) Content of Order Instituting Proceedings

An order instituting proceedings issued pursuant to subparagraph (a) shall include a short and plain statement of the matters of fact and law to be considered and determined with respect to each person charged, including –

(1) in the case of a proceeding instituted pursuant to Rule 5200(a)(1) –

(i) the conduct alleged to have violated the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports or the obligations and liabilities of accountants with respect thereto, including the rules of the Commission under the Act and professional standards; and

(ii) the rule, statute or standard violated;

(2) in the case of a proceeding instituted pursuant to Rule 5200(a)(2) –

(i) the failure to supervise alleged to have violated the Rules of the Board or to have failed to prevent violations of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports or the obligations and liabilities of accountants with respect thereto, including the rules of the Commission under the Act and applicable professional standards; and

(ii) the violative conduct of the supervised associated person and the rule, statute or standard violated; or

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- (3) in the case of a proceeding instituted pursuant to Rule 5200(a)(3) –
- (i) the conduct alleged to constitute the failure to cooperate with an investigation; and
 - (ii) a hearing date.

(c) Notice of a Hearing on a Registration Application

In the case of a proceeding pursuant to Rule 5500, the notice of a hearing shall state proposed grounds for disapproving the registration application.

(d) Amendment to Order Instituting Proceedings

(1) By the Board

Upon motion by the interested division, the Board may, at any time, amend an order instituting proceedings, or a notice of a hearing, to include new matters of fact or law.

(2) By the Hearing Officer

Upon motion by the interested division, the hearing officer may, at any time prior to the filing of an initial decision or, if no proposed initial decision is to be filed, prior to the time fixed for the filing of final briefs with the Board, amend an order instituting proceedings to include new matters of fact or law that are within the scope of the original order instituting proceedings.

Note: Where amendments to an order instituting proceedings are intended to correct an error, to conform the order to the evidence or to take into account subsequent developments which should be considered in disposing of the proceeding, and the amendments are within the scope of the original order, either a hearing officer or the Board has authority to amend the order. Since, however, the Board has not delegated its authority to authorize orders instituting proceedings, hearing officers do not have authority to initiate new charges or to expand the scope of matters set down for hearing beyond the framework of the original order instituting proceedings.

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

Rule 5202. Record of Disciplinary Proceedings

(a) Contents of the Record

(1) Record of a Disciplinary Proceeding

A hearing record shall consist of –

- (i) the order instituting proceedings, each notice of hearing and any amendments;
- (ii) each application, supplemental application, motion, submission or other paper, and any amendments, motions, objections, and exceptions to or regarding them;
- (iii) each stipulation, transcript of testimony and document or other information admitted into evidence;
- (iv) each written communication accepted by the hearing officer pursuant to Rule 5420;
- (v) with respect to a request to disqualify a hearing officer or to allow the hearing officer's withdrawal pursuant to Rule 5402, each affidavit or transcript of testimony taken and the decision made in connection with the request;
- (vi) all motions, briefs and other papers filed on interlocutory appeal;
- (vii) any proposed findings and conclusions;
- (viii) each written order or notice issued by the hearing officer or the Board; and
- (ix) any other document or item accepted into the record by the Board or the hearing officer.

(2) Record on Disapproval of Application for Registration

The record on a disapproval of an application with respect to which the applicant has elected to waive its opportunity for a hearing pursuant to Rule 5500 shall consist of –

- (i) the application for registration, and any supplemented application;

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- (ii) any additional information provided by the applicant;
- (iii) any other information obtained by the Board in connection with the application;
- (iv) the notice of a hearing and any written order issued by the Board; and
- (v) any other document or item accepted into the record by the Board.

(b) Documents Not Admitted

Any document offered in evidence but excluded, and any document marked for identification but not offered as an exhibit, shall not be considered a part of the record. The Secretary shall retain any documents offered in evidence but excluded until all opportunities for Commission and judicial review have been exhausted or waived.

(c) Substitution of Copies

A true copy of a document may be substituted for any document in the record or any document retained pursuant to paragraph (b) of this Rule.

(d) Preparation of Record and Certification of Record Index

Promptly after the close of a hearing, the hearing officer shall transmit to the Secretary an index of any motions, exhibits or any other documents submitted to, or accepted into evidence by, the hearing officer that have not been previously transmitted to the Secretary, and the Secretary shall prepare a record index. Prior to issuance of an initial decision, the Secretary shall transmit the record index to the hearing officer and serve a copy of the record index on each party. Any party may file proposed corrections to the record index with the hearing officer within 15 days of service of the record index. The hearing officer shall, by order, direct whether any corrections to the record index shall be made. The Secretary shall make such corrections, if any, and issue a revised record index. The initial decision shall include a certification that the record consists of the items set forth in the record index or revised record index issued by the Secretary.

(e) Final Transmittal of Record Items to the Secretary

After the close of a hearing, the hearing officer shall transmit to the Secretary originals of exhibits or any other documents submitted to, or accepted into evidence by, the hearing officer, and any other portions of the record that have not already been transmitted to the Secretary. Prior to service of the initial decision by the Secretary, the

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Secretary shall inform the hearing officer if any portions of the record are not in the Secretary's custody.

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

Rule 5203. Public and Private Hearings

No hearing shall be public unless ordered by the Board. In any proceeding commenced pursuant to Rule 5200(a), the Board shall not order that a hearing be public except for good cause shown and with consent of the parties.

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

Rule 5204. Determinations in Disciplinary Proceedings

(a) Burden of Proof

In any disciplinary proceeding instituted pursuant to Rule 5200(a)(1), Rule 5200(a)(2), or Rule 5200(a)(3), the interested division shall bear the burden of proving an alleged violation or failure to supervise by a preponderance of the evidence.

(b) Initial Decision of a Hearing Officer

Unless the Board directs otherwise, a hearing officer shall prepare an initial decision in any proceeding in which the Board directs a hearing officer to preside at a hearing. An initial decision shall include findings and conclusions, including sanctions, if appropriate, and the reasons or basis therefor, as to all the material issues of fact, law or discretion presented on the record and such other information as the Board may require.

Note: Unless the Board has directed otherwise, the Board expects hearing officers in proceedings instituted pursuant to Rule 5200(a)(1) or Rule 5200(a)(2) to prepare initial decisions within 60 days after the deadline for filing post-hearing briefs or other submissions; the Board expects hearing officers in proceedings instituted pursuant to Rule 5200(a)(3) to prepare initial decisions within 30 days after deadline for filing post-hearing briefs; and the Board expects hearing officers in proceedings pursuant to Rule 5500 to prepare initial decisions within 45 days after the deadline for filing post-hearing briefs or other submissions.

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(c) Filing, Service and Publication

The hearing officer shall file the initial decision with the Secretary. The Secretary shall promptly serve the initial decision upon the parties. In a public proceeding, the Secretary shall as soon as practicable thereafter publish the initial decision, unless the Board otherwise directs.

(d) When Final

(1) An initial decision as to a party shall become the final decision of the Board as to that party upon issuance of a notice of finality by the Secretary.

(2) Subject to subparagraph (3) of this paragraph, the Secretary shall issue a notice of finality no later than 20 days after the lapsing of the time period for filing a petition for review of the initial decision.

(3) The Secretary shall not issue a notice of finality as to any party

- (i) who has filed a timely petition for review; or
- (ii) with respect to whom the Board has ordered review of the initial decision pursuant to Rule 5460(b).

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

Rule 5205. Settlement of Disciplinary Proceedings Without a Determination After Hearing

(a) Availability

Any firm or person who is notified that a proceeding may or will be instituted against him or her, or any firm or person that is a party to a proceeding already instituted, may, at any time, propose in writing an offer of settlement.

(b) Procedure

An offer of settlement shall state that it is made pursuant to this Rule; shall recite or incorporate as a part of the offer the provisions of paragraphs (c)(2) and (3) of this Rule; shall be signed by the person making the offer, not by counsel; and shall be submitted to the Director of Enforcement and Investigations.

(c) Consideration of Offers of Settlement

(1) The Director of Enforcement and Investigations shall present an offer of settlement to the Board with his or her recommendation, except that, if the

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recommendation is unfavorable, the offer shall not be presented to the Board unless the person making the offer so requests.

(2) By submitting an offer of settlement, the person making the offer waives, subject to acceptance of the offer –

(i) all hearings pursuant to the statutory provisions under which the proceeding is to be or has been instituted;

(ii) the filing of post-hearing briefs or other submissions, proposed findings of fact and conclusions of law;

(iii) proceedings before, and an initial decision by, a hearing officer;

(iv) all post-hearing procedures; and

(v) judicial review by any court.

(3) By submitting an offer of settlement the person further waives –

(i) such provisions of the Rules of Board Procedure or other requirements of law as may be construed to prevent any member of the Board's staff from participating in the preparation of, or advising the Board as to, any order, opinion, finding of fact, or conclusion of law to be entered pursuant to the offer; and

(ii) any right to claim bias or prejudice by the Board based on the consideration of or discussions concerning settlement of all or any part of the proceeding.

(4) If the Board rejects the offer of settlement, the person making the offer shall be notified of the Board's action and the offer of settlement shall be deemed withdrawn. The rejected offer shall not constitute a part of the record in any proceeding against the person making the offer. Rejection of an offer of settlement does not affect the continued validity of waivers pursuant to paragraph (c)(3) of this Rule with respect to any discussions concerning the rejected offer of settlement.

(5) Final acceptance of any offer of settlement will occur only upon the issuance of findings and an order by the Board.

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Note: In a hearing on disapproval of registration, an offer of settlement will be considered and handled by the Director of Registration and Inspections in accordance with Rule 5206 as if the Director of Registration and Inspections were the Director of Enforcement and Investigations.

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

Rule 5206. Automatic Stay of Final Disciplinary Actions

No final disciplinary sanction of the Board shall be effective until the later of –

- (a) Commission action to dissolve the stay provided by Section 105(e) of the Act; or
- (b) the expiration of the period during which, on its own motion, or upon application pursuant to Section 19(d)(2) of the Exchange Act, the Commission may institute review of the sanction.

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

Part 3 – Disciplinary Sanctions

Rule 5300. Sanctions

(a) Sanctions in Proceedings Instituted Pursuant to Rule 5200(a)(1) or Rule 5200(a)(2)

If the Board finds, based on all of the facts and circumstances, that a registered public accounting firm or associated person thereof has engaged in any act or practice, or omitted to act, in violation of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards, the Board may impose such disciplinary or remedial sanctions as it determines appropriate, subject to the applicable limitations under Section 105(c)(5) of the Act, including –

- (1) temporary suspension or permanent revocation of registration;
- (2) temporary or permanent suspension or bar of a person from further association with any registered public accounting firm;
- (3) temporary or permanent limitation on the activities, functions or operations of such firm or person (other than in connection with required additional professional education or training);

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Note: Limitations on the activities, functions or operations of a firm may include prohibiting a firm from accepting new audit clients for a period of time, requiring a firm to assign a reviewer or supervisor to an associated person, requiring a firm to terminate one or more audit engagements, and requiring a firm to make functional changes in supervisory personnel organization and/or in engagement team organization.

- (4) a civil money penalty for each such violation, in an amount equal to –
 - (i) not more than \$100,000 for a natural person or \$2,000,000 for any other person; and
 - (ii) in any case to which Section 105(c)(5) of the Act applies, not more than \$750,000 for a natural person or \$15,000,000 for any other person;
- (5) censure;
- (6) require additional professional education or training;
- (7) require a registered public accounting firm to engage an independent monitor, subject to the approval of the Board, to observe and report on the firm's compliance with the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, or professional standards;
- (8) require a registered public accounting firm to engage counsel or another consultant to design policies to effectuate compliance with the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, or professional standards;
- (9) require a registered public accounting firm, or a person associated with such a firm, to adopt or implement policies, or to undertake other actions, to improve audit quality or to effectuate compliance with the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, or professional standards; and
- (10) require a registered public accounting firm to obtain an independent review and report on one or more engagements.

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(b) Sanctions in Proceedings Instituted Pursuant to Rule 5200(a)(3)

If the Board finds, based on all of the facts and circumstances, that a registered public accounting firm, or a person associated with such a firm, has failed to comply with an accounting board demand, has given false testimony or has otherwise failed to cooperate in an investigation, the Board may impose such disciplinary or remedial sanctions as it determines appropriate, including –

(1) the sanctions described in subparagraphs (1) – (5) of paragraph (a) of this Rule;

(2) requiring a registered public accounting firm to engage a special master or independent monitor, appointed by the hearing officer, to monitor and report on the firms' compliance with an accounting board demand or with future accounting board demands; or

(3) authorizing the hearing officer to retain jurisdiction to monitor compliance with an accounting board demand or with future account board demands and to rule on future disputes, if any, related to such demands.

Note: Rule 5300 does not preclude the imposition of any sanction, on consent, in the context of a settlement, notwithstanding that the sanction is not listed in the Rule.

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

Rule 5301. Effect of Sanctions

(a) Effect on Persons

No person that is suspended or barred from being associated with a registered public accounting firm, or has failed to comply with any sanction pursuant to Rule 5300, may willfully become or remain associated with any registered public accounting firm, without the consent of the Board, pursuant to Rule 5302, or the Commission.

Note: A person who is suspended or barred from being associated with a registered public accounting firm may not, in connection with the preparation or issuance of any audit report, (i) share in the profits of, or receive compensation in any other form from, any registered public accounting firm, or (ii) participate as agent on behalf of such a firm in any activity of that firm. See Rule 1001(p)(i).

(b) Effect on Registered Public Accounting Firms

No registered public accounting firm that knows, or, in the exercise of reasonable care should have known, of the suspension or bar of a person may permit such person to become or remain associated with it, without the consent of the Board, pursuant to Rule 5302, or the Commission.

Note: Rule 5301(b) prohibits a registered public accounting firm from permitting a person subject to a suspension or bar, in connection with the preparation or issuance of any audit report, to (i) share in the profits of, or receive compensation in any other form from, such firm, or (ii) participate as agent on behalf of such a firm in any activity of that firm. See Rule 1001(p)(i).

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

Rule 5302. Applications for Relief From, or Modification of, Revocations and Bars

(a) Application for Registration After a Revocation of Registration

Unless the Board orders otherwise, any public accounting firm whose registration has been revoked pursuant to a Board determination that permitted the firm an opportunity to reapply for registration after a specified time period has lapsed may file an application for registration pursuant to Rule 2101 after the specified time period has lapsed. The revocation of the firm's registration shall continue, however, unless and until an application for registration is approved pursuant to Rule 2106(b)(1).

(b) Petition to Terminate a Bar

(1) Scope

Any person subject to a bar imposed by an order that contains a proviso that a petition to terminate the bar may be made to the Board after a specific period of time may file a petition for Board consent to associate, or to change the terms and conditions of association, with a registered public accounting firm.

(2) Form of Petition

A petition to terminate a bar shall be supported by an affidavit that addresses the factors set forth in subparagraph (b)(4) of this Rule and shall include as exhibits –

- (i) a copy of the Board order imposing the bar;
- (ii) a copy of any Commission or court order concerning the bar;

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(iii) a written statement by the proposed registered public accounting firm with which the petitioner wishes to associate that describes –

(A) the terms and conditions of employment and supervision to be exercised over such petitioner and, where applicable, by such petitioner;

(B) the qualifications, experience, and disciplinary records of the proposed supervisor(s) of the petitioner;

(C) the compliance and disciplinary history, during the two years preceding the filing of the petition, of the registered public accounting firm with which the petitioner wishes to be associated; and

(D) the names of any other associated persons in the same registered public accounting firm who have previously been barred by the Board or the Commission, and whether they are to be supervised by the petitioner.

(3) Required Showing

The petitioner shall make a showing satisfactory for the Board to be able to determine that the proposed association would be consistent with the public interest.

(4) Factors to be Addressed

The affidavit required by paragraph (b)(2) of this Rule shall address each of the following –

(i) the time period since the imposition of the bar;

(ii) any restitution or similar action taken by the petitioner to recompense any person injured by the misconduct that resulted in the bar;

(iii) the petitioner's compliance with the order imposing the bar;

(iv) the petitioner's employment during the period subsequent to the imposition of the bar;

(v) the capacity or position in which the applicant proposes to be associated;

(vi) the manner and extent of supervision to be exercised over such petitioner and, where applicable, by such petitioner;

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(vii) any relevant courses, seminars, examinations or other actions completed by the applicant subsequent to imposition of the bar to prepare for his or her reassociation; and

(viii) any other information material to the petition.

(5) Notification to Petitioner and Written Statement

In the event an adverse recommendation is proposed by the staff with respect to an application made pursuant to this rule, the applicant shall be so advised and provided with a written statement of the reasons for such recommendation. The applicant shall have 30 days to submit a written statement in response.

(c) Application for Termination of Other Revocations and Bars

Unless the Board orders otherwise, any firm or person that is subject to a revocation or bar pursuant to a Board determination that does not provide for an opportunity to reapply for registration, or to terminate a bar, may request leave to file an application for registration, or a petition to terminate a bar, at any time. The sanction shall continue, however, unless and until the Board has permitted and granted such an application or petition for good cause shown.

(d) Application for Termination of Sanctions for Noncooperation

Unless the Board orders otherwise, any firm or person that has remedied the noncooperation that formed the basis for a disciplinary sanction may file an application for termination of any such sanction that is ongoing. The sanction shall continue, however, unless and until it has been terminated by the Board.

(e) Applications for Termination of Other Sanctions

Unless the Board orders otherwise, any firm or person subject to a sanction pursuant to subparagraphs (3), (6), (7), (8), (9) or (10) of Rule 5300(a) may file an application for termination of any continuing sanction at any time, and the applicant may, in the Board's discretion, be afforded a hearing. The sanction shall continue, however, unless and until it has been terminated by the Board for good cause shown.

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

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Rule 5303. Use of Money Penalties

Subject to the availability in advance in an appropriations act, all civil money penalties shall be used to fund a merit scholarship program for undergraduate and graduate students enrolled in accredited accounting degree programs, administered by the Board or by an entity or agent identified by the Board.

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

Rule 5304. Summary Suspension for Failure to Pay Money Penalties

(a) Registered Public Accounting Firms

If, thirty days after exhaustion of all reviews and appeals, and the termination of any stay authorized by law or the Rules of the Board, a registered public accounting firm has failed to pay a money penalty imposed pursuant to Rule 5300(a)(4), the Board may, after seven days' notice in writing, summarily suspend the registration of the registered public accounting firm. Such a suspension of registration shall lapse upon payment, within 90 days, of the money penalty, plus interest. If payment is not made within 90 days, a suspension of registration shall be lifted only upon –

(1) payment of the money penalty, plus interest; and

(2) the filing of an application for registration pursuant to Rule 2101, and Board approval of that application pursuant to the Board's Rules relating to registration.

(b) Associated Persons

If, thirty days after exhaustion of all reviews and appeals, and the termination of any stay, authorized by law or the Rules of the Board, an associated person has failed to pay a money penalty imposed pursuant to Rule 5300(a)(4), the Board may, after seven days' notice in writing, summarily suspend the associated person. If such a money penalty is not paid within 90 days of such notice, the Board may summarily bar such person.

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

Part 4 – Rules of Board Procedure

GENERAL

Rule 5400. Hearings

Hearings for the purpose of taking evidence shall be held only upon order of the Board. All hearings shall be conducted in a fair, impartial, expeditious and orderly manner.

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

Rule 5401. Appearance and Practice Before the Board

A person shall not be represented before the Board or a hearing officer except as stated in paragraphs (a) or (b) of this Rule or as otherwise permitted by the Board or a hearing officer.

(a) Representing Oneself

In any proceeding, an individual may appear on his or her own behalf.

(b) Representing Others

In any proceeding, a person may be represented by counsel; a member of a partnership may represent the partnership; a bona fide officer of a corporation, trust or association may represent the corporation, trust or association.

(c) Designation of Address for Service; Notice of Appearance; Power of Attorney; Withdrawal

(1) Representing Oneself

When an individual first makes any filing or otherwise appears on his or her own behalf before the Board or a hearing officer, he or she shall file with the Secretary both an electronic and a mailing address at which any notice or other written communication required to be served upon him or her or furnished to him or her may be sent and a telephone number where he or she may be reached during business hours, and the individual shall promptly advise the Secretary of changes to that information during the course of the proceeding.

(2) Representing Others

When a person first makes any filing or otherwise appears in a representative capacity before the Board or a hearing officer, that person shall file with the Secretary, and keep current, a written notice stating the name of the proceeding; the representative's name, mailing address, electronic address and telephone number; and the name and electronic and mailing addresses of the person or persons represented; and, if the person is an attorney, a declaration that the attorney is admitted to practice before the Supreme Court of the United States or the highest court of any state, as defined in Section 3(a)(16) of the Exchange Act.

(3) Power of Attorney

Any individual appearing or practicing before the Board in a representative capacity may be required to file a power of attorney with the Board showing his or her authority to act in such capacity.

(4) Withdrawal

Withdrawal by any individual appearing in a representative capacity shall be permitted only by order of the Board or the hearing officer. A motion seeking leave to withdraw shall state with specificity the reasons for such withdrawal. Leave to withdraw shall not be withheld absent good cause.

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

Rule 5402. Hearing Officer Disqualification and Withdrawal

(a) Motion for Withdrawal

A party who has a reasonable, good faith basis to believe that a hearing officer has a conflict of interest or personal bias, or circumstances otherwise exist such that the hearing officer's fairness may reasonably be questioned, may make a motion to the hearing officer that the hearing officer withdraw, which shall be filed with the Secretary. The motion shall be accompanied by an affidavit setting forth in detail the facts alleged to constitute grounds for disqualification. If the hearing officer finds himself or herself not disqualified, he or she shall so rule and shall continue to preside over the proceeding. A motion for withdrawal shall be filed within 15 days after the later of –

(1) when the party learned of the facts believed to constitute the basis for the disqualification; or

(2) when the party was notified of the assignment of the hearing officer.

(b) Appointment of a Replacement Hearing Officer

Upon withdrawal of a hearing officer, or in the event that a hearing officer is incapacitated or is otherwise unable to continue to serve after being appointed, the Secretary will appoint a replacement hearing officer. To ensure fairness to the parties and expedite completion of the proceeding when a replacement hearing officer is appointed after a hearing has commenced, the replacement hearing officer may recall any witness or may certify familiarity with any part or all of the record.

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

Rule 5403. Ex Parte Communications

Except to the extent permitted for the disposition of ex parte matters as authorized by law or the Board's Rules –

(a) the person presiding over an evidentiary hearing may not consult a person or party on a fact in issue, unless on notice and with opportunity for all parties to participate; and

(b) neither a party, nor any Board staff that substantially assists the interested division on the particular matter, whether before or during the hearing, may –

(1) communicate with the person presiding over an evidentiary hearing on a fact in issue, unless on notice and opportunity for all parties to participate; or

(2) communicate with the Board or any member of the Board on a fact in issue, unless on notice and opportunity for all parties to participate or under circumstances in which a party excluded from the communication has waived the rights described in Rule 5205(c)(3) with respect to the matters that are the subject of the communication.

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

Rule 5404. Service of Papers by Parties

In every proceeding, each paper, including each notice of appearance, written motion, brief, or other written communication, shall be served upon each party in a manner calculated to bring the paper to the attention of the party to be served.

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

Rule 5405. Filing of Papers With the Board: Procedure

(a) When to File

All papers required to be served by a party upon any person shall be filed with the Board at the time of service or promptly thereafter. Papers required to be filed with the Board must be received within the time limit, if any, for such filing.

(b) Where to File

Unless otherwise permitted by the Secretary, filing of papers with the Board shall be made by electronically filing them with the Secretary.

Note: When a document has been filed electronically, the official record is the electronic recording of the document as stored by the Secretary, and the filing party is bound by the document as filed. A document filed electronically is deemed filed at the date received electronically by the Secretary. Upon request, the Secretary may permit regulators granted permission to participate on a limited basis (to request a stay), amici curiae, nonparties and others to file in paper form. Where practicable, the Secretary will scan such a filing into the docket file.

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

Rule 5406. Filing of Papers: Form

(a) Specifications

Papers filed in connection with any proceeding shall –

(1) be formatted in a Portable Document Format on pages measuring 8½ x 11 inches, except that, upon consent of the Secretary for good cause, a document may be filed in paper form;

Note: To the extent that the reduction of larger documents would render them illegible, the Secretary may consent to the filing of such documents on larger paper, in electronic or paper form.

(2) include at the head of the paper, or on a title page, the name of the Board, the title of the proceeding, the names of the parties, the subject of the particular paper or pleading, and the file number assigned to the proceeding;

(3) be paginated with margins at least 1 inch wide; and

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(4) be double-spaced in a 12-point font, with single-spaced footnotes and single-spaced indented quotations.

(b) Form of Briefs

All briefs containing more than 10 pages shall include a table of contents, an alphabetized table of cases, a table of statutes, and a table of other authorities cited, with references to the pages of the brief wherein they are cited.

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

Rule 5407. Filing of Papers: Signature Requirement and Effect

Following the issuance of an order instituting proceedings, every filing of a party who represents himself or herself shall sign his or her individual name and state the date and his or her address and telephone number on every filing. A party represented by counsel shall be signed by at least one counsel of record in his or her name and shall state that counsel's business address and telephone number.

Note: If practicable, a party's or an attorney's signature should be scanned into an electronic document. In any event, however, the use of an attorney's electronic mail address, or password for the Board's electronic filing system, shall constitute the signature of that attorney.

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

Rule 5408. Motions

(a) Generally

Unless made during a hearing or conference, a motion shall be in writing, shall state with particularity the grounds therefor, shall set forth the relief or order sought, and shall be accompanied by a written brief of the points and authorities relied upon. Unless otherwise ordered by the Board or the hearing officer, if a motion is properly made to the Board concerning a proceeding to which a hearing officer is assigned, the proceeding before the hearing officer shall continue pending the determination of the motion by the Board. No oral argument shall be heard on any motion unless the Board or the hearing officer otherwise directs.

(b) Opposing and Reply Briefs

Except as provided in Rule 5427, and unless otherwise ordered by the Board or a hearing officer, a brief in opposition to a motion shall be filed within five days after service of the motion. Reply briefs are only permitted with leave of the hearing officer.

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(c) Length Limitation

Except as provided in Rule 5427, a brief in support of or opposition to a motion shall not exceed 10 pages, exclusive of pages containing any table of contents, table of authorities, and/or addendum. The hearing officer may grant requests for leave to file briefs in excess of 10 pages, upon a showing of good cause.

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

Rule 5409. Default and Motions to Set Aside Default

(a) Default

A party to a proceeding may be deemed to be in default and the Board or the hearing officer may determine the proceeding against that party upon consideration of the record, including the order instituting proceedings or notice of a hearing, the allegations of which may be deemed to be true, if that party fails –

(1) to appear, in person or through a representative, at a hearing or conference of which that party has been notified;

(2) to answer when required to do so by a Board order, to respond to a dispositive motion within the time provided, or otherwise to defend the proceeding; or

(3) to cure a deficient filing within the time specified by the Board or the hearing officer.

(b) Motion to Set Aside Default

A motion to set aside a default shall be made within a reasonable time, state the reasons for the failure to appear or defend, and specify the nature of the proposed defense in the proceeding. In order to prevent injustice and on such conditions as may be appropriate, the hearing officer, at any time prior to the filing of the initial decision, or the Board at any time, may for good cause shown set aside a default.

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

Rule 5410. Additional Time For Service by Mail

If service is made by mail, three days shall be added to the prescribed period for response.

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

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Rule 5411. Modifications of Time, Postponements and Adjournments

Except as otherwise provided by law, the Board, at any time, or the hearing officer, at any time prior to the filing of his or her initial decision, may, for good cause shown, extend or shorten any time limits prescribed by these Rules for the filing of any papers and may, postpone or adjourn any hearing.

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

Rules 5412. – 5419. [Reserved]

PREHEARING RULES

Rule 5420. Stay Requests

(a) Leave to Participate to Request a Stay

The Board or the hearing officer may grant leave to participate on a limited basis only to an authorized representative of the Commission, an authorized representative of the United States Department of Justice, an authorized representative of a United States Attorney, an appropriate state regulatory authority, or an authorized representative of any criminal prosecutorial authority of any State or any other political subdivision of a State for the purpose of requesting a stay during the pendency of a Commission investigation or proceeding, a criminal investigation or prosecution, or a state regulatory proceeding, arising out of the same or similar facts that are at issue in the pending Board or disciplinary proceeding. Motions for leave to participate shall be in writing, shall set forth the nature and extent of the movant's interest in the proceeding, and, except where good cause for late filing is shown, shall be filed not later than 20 days prior to the date fixed for the commencement of the hearing. A stay granted pursuant to this Rule may be granted for such a period and upon such conditions as the Board or the hearing officer deems appropriate.

(b) Stay to Protect Ongoing Commission Investigation

Upon a showing that a stay requested pursuant to this Rule is necessary to protect an ongoing Commission investigation, the motion for the stay shall be granted.

(c) Other Stays

Upon a showing that such a stay is in the public interest or for the protection of investors, the motion for the stay shall be favored.

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

Rule 5421. Answer to Allegations

(a) When Required

In its order instituting proceedings, the Board may require any party to file an answer to each of the allegations contained therein. Even if not so ordered, any party in any proceeding may elect to file an answer.

(b) When to File

Unless additional time is granted by the hearing officer or the Board, a party filing an answer as provided in paragraph (a) of this Rule shall do so within 20 days after service upon the party of an order instituting proceedings pursuant to Rule 5500. If the order instituting proceedings is amended, the Board or the hearing officer may require that an amended answer be filed and, if such an answer is required, shall specify a date for the filing thereof.

(c) Contents of Answer and Effect of Failure to Deny

Unless otherwise directed by the hearing officer or the Board, an answer shall specifically admit, deny, or state that the party does not have, and is unable to obtain, sufficient information to admit or deny each allegation in the order instituting proceedings. When a party intends in good faith to deny only a part of an allegation, the party shall specify so much of it as is true and shall deny only the remainder. A statement of a lack of information shall have the effect of a denial. A defense of res judicata, statute of limitations or any other matter constituting an affirmative defense shall be asserted in the answer. Any allegation not denied shall be deemed admitted.

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

Rule 5422. Availability of Documents For Inspection and Copying

(a) Documents to be Available for Inspection and Copying

(1) Proceedings Commenced Pursuant to Rule 5200(a)(1) and 5200(a)(2)

Unless otherwise provided by this Rule, or by order of the Board or the hearing officer, in proceedings pursuant to Rule 5200(a)(1) or Rule 5200(a)(2), the Division of Enforcement and Investigations shall make available for inspection and copying by any party to the proceeding –

(i) each request, subpoena, or accounting board demand for documents, testimony, or information issued in the investigation or in the informal inquiry, if any, that preceded the investigation or disciplinary proceeding;

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(ii) responses to any such requests, subpoenas, and accounting board demands, including any documents produced in response;

(iii) testimony transcripts and exhibits, and any other verbatim records of witness statements;

(iv) all other documents prepared or obtained by the Division of Enforcement and Investigations in connection with the investigation prior to the institution of proceedings, except that the Division need not produce any documents described in subparagraph (b) that it does not intend to introduce as evidence.

(2) Proceedings Commenced Pursuant to Rule 5200(a)(3)

Unless otherwise provided by this Rule, or by order of the Board, the Division of Enforcement and Investigations shall make available for inspection and copying by any party to the proceeding all documents upon which the Division intends to rely in seeking a finding of noncooperation but shall not be required to make available any other documents.

(3) Proceedings Commenced Pursuant to Rule 5500

Unless otherwise provided by this Rule, or by order of the Board or the hearing officer, in proceedings pursuant to Rule 5500, the Division of Registration and Inspections shall make available for inspection and copying by the applicant documents obtained by that division in connection with the registration application prior to the notice of hearing, except that the Division need not produce any documents described in subparagraph (b) that it does not intend to introduce as evidence.

(b) Documents That May Be Withheld

(1) The interested division may decline to make available for inspection and copying –

(i) any document prepared by a member of the Board or of the Board's staff that has not been disclosed to any person other than Board members, Board staff, or persons retained by the Board or Board staff to provide services in connection with the investigation, disciplinary proceeding, or hearing on disapproval of registration;

(ii) any other document that is privileged, including any other document protected by the attorney work product doctrine;

(iii) any document that would disclose the identity of a confidential source; and

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(iv) any other document that the staff identifies for the hearing officer's consideration as to whether the document may be withheld as not relevant to the subject matter of the proceeding or otherwise for good cause shown.

(2) Nothing in this paragraph (b), or in paragraph (a)(2) above, authorizes the interested division in connection with a disciplinary proceeding or hearing on disapproval of registration to withhold documents that contain material exculpatory evidence.

(c) Procedures Concerning Withheld Documents

(1) The interested division shall, at the time it makes documents available to a respondent under this rule, provide the respondent with a log of documents withheld pursuant to paragraph (b)(1)(ii) of this Rule. The log shall provide the same information that a person would be required to supply to the Board under Rule 5106 in connection with a privilege assertion. On a motion by any respondent, a hearing officer may, in his or her discretion, require the interested division to submit any document listed on the log for inspection by the hearing officer in camera. A hearing officer may order that any such document be made available to a respondent for inspection and copying only if the hearing officer determines that the document is not a document described in paragraph (b)(1)(ii).

(2) The interested division shall, at the time it makes documents available to a respondent under this rule, provide the hearing officer and each respondent with a list of documents withheld pursuant to paragraph (b)(1)(iii) or (b)(1)(iv) of this Rule and a brief description of the reason for withholding each document. The list provided to the respondent may be redacted as necessary to protect interests related to the interested division's reason for withholding the document. The hearing officer may require the interested division to submit any such document for inspection by the hearing officer in camera. The hearing officer may order that any such document be made available to the respondent for inspection and copying only if the hearing officer determines that –

(i) with respect to any document withheld pursuant to paragraph (b)(1)(iii) –

(A) producing the document would not have the effect of identifying a confidential source; or

(B) the document contains material, exculpatory evidence, provided, however, that to the extent such evidence can be disclosed without disclosing the identity of a confidential source, such identity shall not be disclosed.

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(ii) with respect to any document withheld pursuant to paragraph (b)(1)(iv) –

(A) the document is relevant to the subject matter of the proceeding and no good cause exists for withholding it; or

(B) the document contains material, exculpatory evidence.

(d) Timing of Inspection and Copying

Unless otherwise ordered by the Board or the hearing officer, the interested division shall make documents available for inspection and copying to any respondent who is not in default under Rule 5409 no later than 14 days after the institution of proceedings pursuant to Rule 5500.

(e) Place of Inspection and Copying

Documents subject to inspection and copying pursuant to this Rule shall be made available to a party for inspection and copying at the Board office where they are ordinarily maintained, or at such other place as the parties, in writing, may agree. A party shall not be given custody of the documents or leave to remove the documents from the Board's offices pursuant to the requirements of this Rule other than by written agreement of the interested division. Such agreement shall specify the documents subject to the agreement, the date they shall be returned and such other terms or conditions as are appropriate to provide for the safekeeping of the documents.

(f) Copying Costs and Procedures

A party may obtain a photocopy of any documents made available for inspection. The party shall be responsible for the cost of photocopying. The respondent shall be given access to the documents at the Board's offices or such other place as the parties may agree during normal business hours for copying of documents at the respondent's expense.

(g) Failure to Make Documents Available – Harmless Error

In the event that a document required to be made available to a party pursuant to this Rule is not made available by the interested division, no rehearing or rededication of a proceeding already heard or decided shall be required, unless the party shall establish that the failure to make the document available was not harmless error.

Note: The interested division's obligation under this Rule relates to documents obtained by that division. Documents located only in the files of other divisions or

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offices are beyond the scope of the Rule, except that documents located in the files of other divisions and that the interested division intends to introduce as evidence shall, for purposes of this Rule, be treated as if they have been obtained by the interested division and must therefore be made available under this Rule.

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

Rule 5423. Production of Witness Statements

(a) Availability

Upon motion by any respondent in a disciplinary proceeding, the hearing officer may order that the interested division produce for inspection and copying any statement of any person called or to be called as a witness by the division that pertains, or is expected to pertain, to his or her direct testimony and that would be required to be produced pursuant to the Jencks Act, 18 U.S.C. § 3500, if the Board were a governmental entity. Such production shall be made at a time and place fixed by the hearing officer and shall be made available to any party, provided, however, that the production shall be made under conditions intended to preserve the items to be inspected or copied.

(b) Failure to Produce - Harmless Error

In the event that a statement required to be made available for inspection and copying by a respondent is not turned over by the interested division, no rehearing or redetermination of a proceeding already heard or decided shall be required unless the respondent establishes that the failure to turn over the statement was not harmless error.

(c) Definition of Statement

For purposes of this Rule, the term "statement" shall have the meaning set forth in 18 U.S.C. § 3500(e).

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

Rule 5424. Accounting Board Demands and Commission Subpoenas

(a) Accounting Board Demands and Requests

In connection with any hearing ordered by the Board, a party may request the issuance of an accounting board demand of a registered public accounting firm or an associated person of such a firm, or an accounting board request of any other person. Such a demand or request may call for the attendance and testimony of a witness at the designated time and place of the hearing or for the production of documentary or other tangible evidence returnable at any designated time or place. Unless made on the record at a hearing, an application for issuance of such a demand or request shall be made in writing and served on each party. A party whose application for such a demand or request has been denied or modified may not submit any other application seeking substantially the same testimony or other evidence specified in the denied application or excluded from an otherwise granted application.

(1) Unavailability of Hearing Officer

In the event that the hearing officer assigned to a proceeding is unavailable, any member of the Board, or other person designated by the Board for this purpose, may grant an application for the issuance of an accounting board demand or request. A party seeking such issuance may submit the application to the Secretary, who shall direct it to a person authorized to grant the request, deny the request, or grant the request with modifications.

(2) Signing May be Delegated

A hearing officer may authorize issuance of an accounting board demand, or an accounting board request, and may delegate the manual signing of the demand or request to any other person.

(3) Standards for Issuance

Where it appears that an application for an accounting board demand or request is reasonable in scope and is reasonably calculated to encompass, or lead to the discovery of, admissible evidence, the application shall be granted. If it appears that the accounting board demand or request sought may be unreasonable, oppressive, excessive in scope, unduly burdensome, designed to seek irrelevant information, or sought for the purpose of harassment or delay, the application shall be denied. The hearing officer or other person ruling on the application may, in his or her discretion, as a condition precedent to the issuance of the demand or request, require the party seeking the demand or request to show the general relevance and reasonable scope of the testimony or other evidence sought. After consideration of all the circumstances, the hearing officer or other person ruling on the application may grant the application

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upon such conditions or with such modifications as fairness requires. In making the determination, the hearing officer or other person ruling on the application may inquire of the parties whether they will stipulate to the facts sought to be proved.

Note: Whenever possible, the parties should explore the extent to which stipulations of fact may obviate the need for issuance of accounting board demands and requests to non-parties, and the hearing officer or other person ruling on an application for issuance of an accounting board demand or request should encourage the parties to reach such stipulations when possible.

(4) Witness Fees

A witness, other than a party, who is summoned to a Board proceeding pursuant to an accounting board demand, or an accounting board request, or who is deposed pursuant to Rule 5425, shall be paid his or her reasonable expenses by the party at whose instance the witness appears.

(b) Commission Subpoenas

In connection with any hearing ordered by the Board, and upon the application of any party or on its own initiative, the Board may seek issuance by the Commission of a subpoena to any person, including any client of a registered public accounting firm, requiring the person to provide any testimony or produce any documents that the Board considers relevant or material to a Board proceeding.

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

Rule 5425. Depositions to Preserve Testimony for Hearing

(a) Procedure

Any party desiring to take the testimony of a witness by deposition shall make a written motion setting forth the reasons why such deposition should be taken including the specific reasons why the party believes the witness will be unable to attend or testify at the hearing; the name and address of the prospective witness; the matters concerning which the prospective witness is expected to be questioned; and the proposed time and place for the taking of the deposition.

Note: Depositions under the Rules of Board Procedure are used only to preserve testimony of a witness who would be unlikely to be able to attend the hearing. They are not permitted for purposes of discovery.

(b) Required Finding When Ordering a Deposition

In the discretion of the Board or the hearing officer, an order for deposition may be issued upon a finding that the prospective witness will likely give testimony material to the proceeding, that it is likely the prospective witness will be unable to attend or testify at the hearing because of age, sickness, infirmity, imprisonment or other disability, or otherwise unavailable, and that the taking of a deposition will serve the interests of justice.

(c) Procedure at Depositions

A witness whose testimony is taken by deposition shall be sworn or shall affirm before any questions are put to him or her. Examination and cross-examination of deponents may proceed as permitted at a hearing. The witness being deposed may have counsel present during the deposition.

(d) Objections to Questions or Evidence

Objections to questions or evidence shall be in short form, stating the grounds of objection relied upon. Objections to questions or evidence shall be noted in the transcript, but no person other than the hearing officer shall have the power to decide on the competency, materiality or relevance of evidence. Failure to object to questions or evidence during the deposition shall not be deemed a waiver unless the ground of the objection is one that might have been obviated or removed if presented at that time.

(e) Filing of Depositions

The questions propounded and all answers or objections shall be recorded or transcribed verbatim, and a transcript prepared by the deposition officer, or under his or her direction. The transcript shall be subscribed by the witness and certified by the deposition officer. The original deposition and exhibits shall be filed with the Secretary. A copy of the deposition shall be available to the deponent and each party for purchase at prescribed rates.

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

Rule 5426. Prior Sworn Statements of Witnesses in Lieu of Live Testimony

At a hearing, any person wishing to introduce a prior, sworn statement of a nonparty witness otherwise admissible in the proceeding, in lieu of live testimony may make a motion setting forth the reasons therefor. If only part of a statement is offered in evidence, the hearing officer may require that all relevant portions of the statement be introduced. If all of a statement is offered in evidence, the hearing officer may require that portions not relevant to the proceeding be excluded. A motion to introduce a prior sworn statement in lieu of live testimony may be granted if –

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- (a) the witness is dead;
- (b) the witness is out of the United States, unless it appears that the absence of the witness was procured by the party offering the prior sworn statement;
- (c) the witness is unable to attend or testify because of age, sickness, infirmity, imprisonment or other disability;
- (d) the party offering the prior sworn statement has been unable to procure the attendance of the witness by accounting board demand; or,
- (e) in the discretion of the Board or the hearing officer, it would be desirable, in the interests of justice, to allow the prior sworn statement to be used. In making this determination, due regard shall be given to the presumption that witnesses will testify orally in an open hearing. If the parties have stipulated to accept a prior sworn statement in lieu of live testimony, consideration shall also be given to the convenience of the parties in avoiding unnecessary expense.

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

Rule 5427. Motion for Summary Disposition

(a) For Interested Division

After a party has filed an answer and documents have been made available to that respondent for inspection and copying pursuant to Rule 5422, or after service of a motion for summary disposition by the respondent, the interested division may make a motion for summary disposition of the proceedings with respect to that respondent.

(b) For Respondent

A respondent party may at any time make a motion for summary disposition of the proceeding with respect to that respondent.

(c) Pre-motion Conference Required

A party seeking summary disposition shall request and attend a pre-motion conference with the hearing officer before filing its motion for summary disposition.

(1) Due-date for Filing

At the pre-motion conference, the hearing officer will schedule a due-date for the submission of the motion for summary disposition and may, but is not required to,

schedule a due-date for the submission of a response to the motion for summary judgment.

(2) Review and Decide Procedure

If the hearing officer has not scheduled a due-date for a response to the motion for summary judgment, upon review of the motion the hearing officer may decide to deny the motion or to require a response to the motion. A hearing officer shall not grant a motion for summary disposition until after the due-date for filing a response to the motion has passed.

(d) Decision on Motion

The hearing officer shall promptly grant a motion for summary disposition if the pleadings, depositions, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a disposition as a matter of law. A summary disposition, interlocutory in character, may be rendered on the issue of liability alone although there is a genuine issue as to a sanction. A hearing officer's decision to deny a motion for summary disposition is not subject to interlocutory appeal.

(e) Lengths of Briefs

Neither a brief in support of a motion for summary disposition, nor a brief in response to such a motion, shall exceed 25 pages in length, without leave of the hearing officer. Reply briefs are discouraged and are not permitted without leave of the hearing officer.

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Rules 5428. – 5439. [Reserved]

CONDUCT OF HEARINGS

Rule 5440. Record of Hearings

(a) Recordation

All hearings shall be recorded and a written transcript thereof shall be prepared.

(b) Availability of a Transcript

Transcripts of public hearings shall be available for purchase at prescribed rates. Transcripts of nonpublic proceedings shall be available for purchase only by parties,

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provided, however, that any person compelled to testify at a hearing may purchase a copy of that person’s own testimony.

(c) Transcript Correction

Prior to the filing of post-hearing briefs or other submissions, or within such earlier time as directed by the Board or the hearing officer, a party or witness may make a motion to correct the transcript. Proposed corrections of the transcript may be submitted to the hearing officer by stipulation or by motion. Upon notice to all parties to the proceeding, the hearing officer may, by order, specify corrections to the transcript.

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Rule 5441. Evidence: Admissibility

The Board or the hearing officer may receive relevant evidence and shall exclude all evidence that is irrelevant, immaterial or unduly repetitious.

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

Rule 5442. Evidence: Objections and Offers of Proof

(a) Objections

Objections to the admission or exclusion of evidence must be made on the record and shall be in short form, stating the grounds relied upon. Exceptions to any ruling thereon by the hearing officer need not be noted at the time of the ruling. Such exceptions will be deemed waived on appeal to the Board, however, unless raised –

- (1) pursuant to interlocutory review in accordance with Rule 5461;
- (2) in a proposed finding or conclusion filed pursuant to Rule 5445; or
- (3) in a petition for Board review of an initial decision filed in accordance with Rule 5460.

(b) Offers of Proof

Whenever evidence is excluded from the record, the party offering such evidence may make an offer of proof, which shall be included in the record. Excluded material shall be retained pursuant to Rule 5202(b).

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

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Rule 5443. Evidence: Presentation Under Oath or Affirmation

A witness at a hearing for the purpose of taking evidence shall testify under oath or affirmation.

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

Rule 5444. Evidence: Presentation, Rebuttal and Cross-examination

In any proceeding, a party may present its case or defense by oral or documentary evidence, submit rebuttal evidence, and conduct such cross-examination as, in the discretion of the Board or the hearing officer, may be required for a full and true disclosure of the facts. The scope and form of evidence, rebuttal evidence, if any, and cross-examination, if any, shall be determined by the Board or the hearing officer in each proceeding.

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

Rule 5445. Post-hearing Briefs and Other Submissions

(a) At the end of the hearing in any proceeding instituted pursuant to Rule 5200(a)(1), Rule 5200(a)(2), or Rule 5500 in which an initial decision is to be issued, the hearing officer shall, by order, after consultation with the parties, prescribe the period within which post-hearing briefs or other submissions are to be filed. Unless the hearing officer, for good cause shown, permits a different period and sets forth in the order the reasons why the different period is necessary –

(i) the party or parties directed to file first shall make its or their initial filing within 30 days of the end of the hearing; and

(ii) the total period within which all such filings and any opposition and reply submissions are to be filed shall be no longer than 90 days after the end of the hearing.

(b) In any proceeding instituted pursuant to Rule 5200(a)(3), the hearing officer may, in his or her discretion, render an initial decision without allowing for post-hearing briefs or other submissions, or may allow for such briefs or other submissions according to an expedited schedule.

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

Rules 5446. – 5459. [Reserved]

APPEALS TO THE BOARD

Rule 5460. Board Review of Determinations of Hearing Officers

(a) Petition for Review of Initial Decision by Hearing Officers

Any party to a hearing may obtain Board review of an initial decision by filing a petition for review that –

(1) sets forth specific findings and conclusions of the initial decision as to which exception is taken, together with the supporting reasons for each exception; and

(2) is filed –

(i) in a proceeding instituted pursuant to Rule 5200(a)(1), Rule 5200(a)(2), or Rule 5500, within 30 days after service of the initial decision on the petitioner or within 10 days after the filing of a petition for review by another party, whichever is later; or

(ii) in a proceeding instituted pursuant to Rule 5200(a)(3), within 10 days after service of the initial decision on the petitioner.

(b) Review on Board's Initiative

The Board may, on its own initiative, order review of any initial decision, or a portion of any initial decision, at any time before the initial decision becomes final pursuant to Rule 5204(d).

(c) De Novo Review

Based on a petition for review, or on its own initiative, the Board may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part, an initial decision by a hearing officer and may make any findings or conclusions that in its judgment are proper based on the record.

(d) Limitations on Matters Reviewed

Review by the Board of an initial decision shall be limited to the issues specified in the petition for review or the issues, if any, specified in the briefing schedule order issued pursuant to Rule 5462(a). On notice to all parties, however, the Board may, at any time prior to issuance of its decision, raise and determine any other matters that it deems material, with opportunity for oral or written argument thereon by the parties.

(e) Summary Affirmance

The Board may summarily affirm an initial decision based upon the petition for review and any response thereto, without further briefing, if it finds that no issue raised in the petition for review warrants further consideration by the Board.

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

Rule 5461. Interlocutory Review

(a) Availability

The Board will not review a hearing officer's ruling prior to its consideration of the entire proceeding in the absence of extraordinary circumstances. The Board may decline to consider a ruling certified by a hearing officer pursuant to paragraph (c) of this Rule if it determines that interlocutory review is not warranted or appropriate under the circumstances. The Board may, at any time, on its own motion, direct that any matter be submitted to it for review.

(b) Certification Process

A ruling submitted to the Board for interlocutory review shall be certified in writing by the hearing officer as appropriate for interlocutory review and shall specify the basis for certification. The hearing officer shall certify a ruling only if –

(1) the ruling would compel testimony of Board members, officers or employees or the production of documentary evidence in their custody; or

(2) upon application by a party, within five days of the hearing officer's ruling, the hearing officer is of the opinion that –

(i) the ruling involves a controlling question of law as to which there is substantial ground for difference of opinion; and

(ii) an immediate review of the order may materially advance the completion of the proceeding.

(c) Proceedings Not Stayed

The filing of an application for interlocutory review or the grant of interlocutory review shall not stay proceedings before the hearing officer unless he or she, or the Board, shall so order. The Board will not consider the motion for a stay unless the motion has first been made to the hearing officer.

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

Rule 5462. Briefs Filed with the Board

(a) Briefing Schedule Order

Upon a timely and valid petition for review, or upon its own timely motion to review an initial decision, other than review ordered pursuant to Rule 5469, the Board shall issue a briefing schedule order directing the parties to file opening briefs and specifying particular issues, if any, as to which briefing should be limited or directed. Unless otherwise provided, opening briefs shall be filed within 40 days of the date of the briefing schedule order. Opposition briefs shall be filed within 30 days after the date opening briefs are due. Reply briefs may be filed within 14 days after the date opposition briefs are due. No briefs in addition to those specified in the briefing schedule order may be filed except with leave of the Board. The briefing schedule order shall be issued –

(1) at the time the Board orders review on its own initiative pursuant to Rule 5460(b), or orders interlocutory review on its own motion pursuant to Rule 5460; or

(2) within 21 days, or such longer time as provided by the Board, after –

(i) the last day permitted for filing a petition for review pursuant to Rule 5204(d);

(ii) certification of a ruling for interlocutory review pursuant to Rule 5461(b).

(b) Contents of Briefs

Briefs shall be confined to the particular matters at issue. Each exception to the findings or conclusions being reviewed shall be stated succinctly. Exceptions shall be supported by citation to the relevant portions of the record, including references to the specific pages relied upon, and by concise argument including citation of such statutes, decisions and other authorities as may be relevant. If the exception relates to the admission or exclusion of evidence, the substance of the evidence admitted or excluded shall be set forth in the brief, in an appendix thereto, or by citation to the record. Reply briefs shall be confined to matters in opposition briefs of other parties.

(c) Length Limitation

Opening and opposition briefs shall not exceed 30 pages and reply briefs shall not exceed 15 pages, exclusive of pages containing the table of contents, table of authorities, and any addendum, except with leave of the Board.

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

Rule 5463. Oral Argument Before the Board

(a) Availability

The Board, on its own motion or the motion of a party, may order oral argument with respect to any matter. Motions for oral argument with respect to whether to affirm all or part of an initial decision by a hearing officer shall be granted unless exceptional circumstances make oral argument impractical or inadvisable. The Board will consider appeals, motions and other matters properly before it on the basis of the papers filed by the parties without oral argument unless the Board determines that the presentation of facts and legal arguments in the briefs and record and the decisional process would be significantly aided by oral argument.

(b) Procedure

Requests for oral argument shall be made by separate motion accompanying the initial brief on the merits. The Board shall issue an order as to whether oral argument is to be heard, and if so, the time and place therefor. The grant or denial of a motion for oral argument shall be made promptly after the filing of the last brief called for by the briefing schedule. If oral argument is granted, the time fixed for oral argument shall be changed only by written order of the Board, for good cause shown. The order shall state at whose request the change is made and the reasons for any such change.

(c) Time Allowed

Unless the Board orders otherwise, not more than one half-hour per side will be allowed for oral argument. The Board may, in its discretion, determine that several persons have a common interest, and that the interests represented will be considered a single side for purposes of allotting time for oral argument. Time will be divided equally among persons on a single side, provided, however, that by mutual agreement they may reallocate their time among themselves. A request for additional time must be made by motion filed reasonably in advance of the date fixed for argument.

Note: The term "side" is used in this Rule to indicate that the time allowed is afforded to opposing interests rather than to individual parties. If multiple parties have a common interest, they may constitute only a single side.

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(d) Participation of Board Members

A member of the Board who was not present at the oral argument may participate in the decision of the proceeding, provided that the member has reviewed the transcript of such argument prior to such participation. The decision shall state whether the required review was made.

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

Rule 5464. Additional Evidence

Upon its own motion or the motion of a party, the Board may allow the submission of additional evidence. A party may file a motion for leave to adduce additional evidence at any time prior to issuance of a decision by the Board. Such motion shall show with particularity that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously. Any other party may file a response to the motion within 5 days after the motion is filed, or such longer time as the Board may allow. The Board may accept or hear additional evidence, or it may remand or refer the proceeding to a hearing officer for the taking of additional evidence, as appropriate.

[Effective pursuant to SEC Release No. 34-48765; File No. PCAOB-2003-06, November 10, 2003]

Rule 5465. Record Before the Board

The Board shall determine each matter on the basis of the record.

(a) Contents of the Record

In proceedings for final decision before the Board, the record shall consist of –

- (1) all items part of the hearing record below in accordance with Rule 5202(a);
- (2) any petitions for review, cross-petitions or oppositions; and
- (3) all briefs, motions, submissions and other papers filed on appeal or review.

(b) Transmittal of Record to Board

Within 14 days after the last date set for filing briefs or such later date as the Board directs, the Secretary shall transmit the record to the Board.

(c) Review of Documents Not Admitted

Any document offered in evidence but excluded by the hearing officer or the Board and any document marked for identification but not offered as an exhibit shall not be considered a part of the record before the Board on appeal but shall be transmitted to the Board by the Secretary if so requested by the Board. In the event that the Board does not request the document, the Secretary shall retain the document not admitted into the record until the later of –

- (1) the date upon which the Board's order becomes final, or
- (2) the conclusion of any Commission and judicial review of that order.

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

Rule 5466. Reconsideration

(a) Scope of Rule

A party may file a motion for reconsideration of a final order issued by the Board.

(b) Procedure

A motion for reconsideration shall be filed within 10 days after service of the order complained of on each party, or within such time as the Board may prescribe upon motion of the person seeking reconsideration, if made within the foregoing 10-day period. The motion for reconsideration shall briefly and specifically state the matters of record alleged to have been erroneously decided, the grounds relied upon, and the relief sought. Except with permission of the Board, a motion for reconsideration shall not exceed 15 pages. No responses to a motion for reconsideration shall be filed unless requested by the Board.

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

Rule 5467. Receipt of Petitions for Commission or Judicial Review

A registered public accounting firm –

(a) that has filed a petition for Commission review of a final disciplinary sanction of the Board pursuant to Section 19(d)(2) of the Exchange Act, or a petition for court review of a Commission order with respect to such a sanction pursuant to Section 25(a)(1) of the Exchange Act, or

(b) that is associated with a person, other than a person primarily associated with another registered public accounting firm, who has filed such a petition,

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shall file a notice and copy of the petition with the Secretary within 10 days after the petition is made.

Note: Appeals of final disciplinary sanctions by the Board are instituted by the filing of a petition for review in accordance with the Commission's Rules of Practice. Unless directed otherwise by statute, appeals of Commission orders and decisions on a sanction imposed by the Board to a court of appeals are instituted by the filing of a petition for review in accordance with the Federal Rules of Appellate Procedure. See Fed. R. App. P. 15(a).

Rule 5468. Appeal of Actions Made Pursuant to Delegated Authority

(a) Notice of Intention to Petition for Review

A person intending to seek Board review of an action made pursuant to delegated authority shall file a written notice of intention to petition for review within five days after actual notice to the petitioner of the action or service of notice of the action, whichever is earlier. The notice shall identify the petitioner and the action complained of, and shall be accompanied by a notice of appearance pursuant to Rule 5401(c). The Board will allow late filing of a notice of intention to petition for review upon a showing that a delay in service, through no fault of the petitioner's, made compliance with the time limit set forth in this paragraph impossible or unreasonably burdensome.

(b) Petition for Review

Within five days after the filing of a notice of intention to petition for review pursuant to paragraph (a) of this Rule, the person seeking review shall file a petition for review containing a clear and concise statement of the issues to be reviewed and the reasons why review is appropriate. The petition shall include exceptions to any findings of fact or conclusions of law made, together with supporting reasons for such exceptions based on appropriate citations to such record as may exist. These reasons may be stated in summary form. The Board will review all actions made pursuant to delegated authority with respect to which timely notices of intention to petition for review, and timely petitions for review, have been filed.

Rule 5469. Board Consideration of Actions Made Pursuant to Delegated Authority

(a) Board Review

Upon a petition for review, or upon its own initiative, the Board may affirm, reverse, modify, set aside or remand for further proceedings, in whole or in part, any action made pursuant to delegated authority. The Board may, in its discretion, act

summarily on the basis of the petition, act on the basis of the petition and any written response provided by the staff and served on the petitioner, or request the submission of additional statements in support of or in opposition to the petition.

(b) No Stay of Effect of Delegated Action

An action made pursuant to delegated authority shall have immediate effect and be deemed the action of the Board. The effect of any action made pursuant to delegated authority shall not be stayed, and no petition for review shall operate as a stay, unless otherwise ordered by the Board.

Rules 5470. – 5499. [Reserved]

Part 5 – Hearings on Disapproval of Registration Applications

Rule 5500. Commencement of Hearing on Disapproval of a Registration Application

The Board may commence a proceeding to determine whether to approve or disapprove a public accounting firm's application for registration when, based on review of an application for registration as a registered public accounting firm –

(a) the Board determines, pursuant to Rule 2106(b)(2)(ii), to provide the applicant with written notice of a hearing to determine whether to approve or disapprove the application; and

(b) within such period, as the Board permits, after the date of service of a notice of a hearing whether to approve or disapprove an application for registration pursuant to Rule 2106(b)(2)(ii), the public accounting firm served with such notice files with the Secretary a written request for a hearing date and a notice of appearance pursuant to Rule 5401(c), and includes with the request –

(1) a statement that the public accounting firm has elected not to treat the notice as a written notice of disapproval for purposes of Section 102(c) of the Act; and

(2) a statement describing with specificity why the public accounting firm believes that the Board should not issue a written notice of disapproval.

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

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Rule 5501. Procedures for a Hearing on Disapproval of a Registration Application

Proceedings instituted pursuant to Rule 5500 shall be subject to procedures as described in Parts 2 and 4 of Section 5 of the Board's Rules.

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

SECTION 6. INTERNATIONAL

[Reserved]

SECTION 7. FUNDING

Rule 7000. [Reserved]

[Reserved]

Rule 7100. Accounting Support Fee.

The Board shall calculate an accounting support fee each year. The accounting support fee shall equal the budget of the Board, as approved by the Commission, less the sum of all registration fees and annual fees received during the preceding calendar year from public accounting firms, pursuant to Section 102(f) of the Act and the Rules of the Board.

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

Rule 7101. Allocation of Accounting Support Fee.

(a) Classes of Issuers

For purposes of allocating the accounting support fee, those entities that are issuers as of the date the accounting support fee is calculated under Rule 7100 shall be divided into four classes:

(1) Equity Issuers

All issuers whose average, monthly issuer market capitalization during the preceding calendar year is greater than \$25 million, other than those described in paragraphs (a)(2) and (a)(3) of this Rule, and whose share price on a monthly, or more frequent, basis is publicly available.

Note: Average, monthly market capitalization will be based on closing stock prices on the closest trading day on or before the last day of each calendar month measured.

(2) Investment Company Issuers

All issuers (i) who, as of the date the accounting support fee is calculated under Rule 7100, are registered under Section 8 of the Investment Company Act or have elected to be regulated as business development companies pursuant to Section 54 of the Investment Company Act, other than those described in paragraph (a)(3), (ii) whose average, monthly issuer market capitalization during the preceding calendar year is greater than \$250 million, and (iii) whose share price (or net asset value) on a monthly, or more frequent, basis is publicly-available.

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Note: Average, monthly market capitalization will be based on closing stock prices on the closest trading day on or before the last day of each calendar month measured.

(3) Issuers Permitted Not to File Audited Financial Statements and Bankrupt Issuers that File Modified Reports

All issuers that, as of the date the accounting support fee is calculated under Rule 7100, (i) have a basis, under a Commission rule or pursuant to other action of the Commission or its staff, not to file audited financial statements, (ii) are employee stock purchase, savings and similar plans, interests in which constitute securities registered under the Securities Act, or (iii) are subject to the jurisdiction of a bankruptcy court and satisfy the modified reporting requirements of Commission Staff Legal Bulletin No. 2.

Note: As of April 16, 2003, issuers within paragraph (a)(3)(i) of this Rule include (A) asset-backed issuers, (B) unit investment trusts, as defined in Section 4(2) of the Investment Company Act, that have not filed or updated a registration statement that became effective during the preceding year, and (C) Small Business Investment Companies registered on Form N-5 under the Investment Company Act, that have not filed or updated a registration statement that became effective during the preceding year.

(4) All Other Public Company Issuers

All issuers other than those described in paragraphs (a)(1), (a)(2) or (a)(3) of this Rule.

(b) Allocation of Accounting Support Fee Among Issuers

The accounting support fee shall be allocated among the classes in paragraph (a) of this Rule as follows:

(1) Equity and Investment Company Issuers

Each issuer described in paragraph (a)(1) and (a)(2) of this Rule shall be allocated a share of the accounting support fee in an amount equal to the accounting support fee multiplied by a fraction –

(i) the numerator of which is the average, monthly market capitalization of the issuer during the preceding calendar year, except that for issuers described in paragraph (a)(2) of this Rule, the numerator is one-tenth of the average, monthly market capitalization of the issuer; and

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(ii) the denominator of which is the sum of the average, monthly market capitalizations of the issuers described in paragraph (a)(1) of this Rule and one-tenth of the average, monthly market capitalizations of the issuers described in paragraph (a)(2) of this Rule.

(2) All Other Classes

Each issuer described in paragraphs (a)(3) and (a)(4) of this Rule shall be allocated a share of the accounting support fee equal to \$0.

(c) Adjustments

After the accounting support fee is calculated under Rule 7100 and allocated under this Rule, any adjustment to the share allocated to an issuer shall not affect the share allocated to any other issuer.

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

Rule 7102. Assessment of Accounting Support Fee.

(a) Amount of Assessment

Each issuer is required to pay its share of the accounting support fee, as allocated under Rule 7101, rounded to the nearest hundred.

Note: If an issuer's share of the accounting support fee is less than \$50, that issuer will not be assessed. If the issuer's share of the accounting support fee is exactly \$50 more than a multiple of \$100, then the share will be rounded up to the nearest \$100.

(b) Notice of Assessment

The Board will use its best efforts to send a notice to each issuer, either electronically or by first-class mail, at the address shown on such issuer's most recent periodic report filed with the Commission, at the address submitted to the Commission's EDGAR system, or at such other address as the issuer provides to the Board. The Board's failure to send an issuer a notice, or the issuer's failure to receive a notice sent by the Board, shall not constitute a waiver of the Board's right to assess such issuer for its share of the accounting support fee or of the issuer's responsibility to pay its share of the accounting support fee.

(c) Petition for Correction

Any issuer who disagrees with the class in which it has been placed, or with the calculation by which its share of the accounting support fee was determined, may

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petition the Board for a correction of the share of the accounting support fee it was allocated. Any such petition shall include an explanation of the nature of the claimed mistake in classification or calculation, in writing, on or before the 30th day after the notice is sent. After a review of such a petition, the Board will determine whether the allocation is consistent with Section 109 of the Act and the Board's rules thereunder and provide the issuer a written explanation of its decision. The provisions of Rule 7103 shall be suspended while such a petition is pending before the Board.

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

Rule 7103. Collection of Accounting Support Fee.

(a) Accounting Support Fee Payment Due Date

Unless the Board directs otherwise, payment shall be due on the 30th day after the notice is sent. Beginning on the 31st day, payment shall be deemed past due and interest shall accrue at a rate of 6 percent per annum.

(b) Confirmation of Payment of Accounting Support Fee by Registered Accounting Firm

(1) Except as provided in paragraph (b)(2) of this Rule, no registered public accounting firm shall sign an unqualified audit opinion with respect to an issuer's financial statements, or issue a consent to include an audit opinion issued previously, unless the registered public accounting firm has ascertained that the issuer has outstanding no past-due share of the accounting support fee or has a petition pursuant to Rule 7102(c) pending.

(2) A registered public accounting firm may sign an unqualified audit opinion with respect to an issuer's financial statements, or issue a consent to include an audit opinion issued previously, even though the issuer has outstanding a past-due share of the accounting support fee and has not filed a petition under Rule 7102(c), if the issuer needs the report or consent in order to submit a report to, or make a filing with, the Commission or to issue securities. The issuer shall submit to the Board a notice of the signing of the opinion or issuance of the consent not later than the next business day after the filing is made with the Commission. This exception to paragraph (b)(1) of this Rule shall not continue longer than 15 business days after the earlier of the date of the notice's submission or the filing of the report with the Commission, and may not be invoked for more than one such period with respect to any share of the accounting support fee that the issuer is assessed under Rule 7102.

Note 1: A registered public accounting firm may ascertain that an issuer has no outstanding past-due share of the accounting support fee by obtaining a representation from the issuer or a confirmation from the Board that no past-due share of the accounting support fee is outstanding.

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Note 2: A notice pursuant to paragraph (b)(2) of this Rule must be submitted electronically by email to rule7103stay@pcaobus.org.

(c) Report to the Commission of Non-payment of an Accounting Support Fee

If an issuer has not paid its share of the accounting support fee by the 60th day after the notice was sent, and the issuer does not have a petition pursuant to Rule 7102(c) pending, the Board may send a second notice to such issuer by certified mail. If the Board has sent such a second notice and has not been paid by the 90th day after the original notice was sent, the Board may report the issuer's nonpayment to the Commission.

Note: Section 13(b)(2) of the Exchange Act provides, in part, that: "Every issuer which has a class of securities registered pursuant to section 12 of this title and every issuer which is required to file reports pursuant to section 15(d) of this title shall – * * * (C) notwithstanding any other provision of law, pay the allocable share of such issuer of a reasonable accounting support fee or fees, determined in accordance with Section 109 of the Sarbanes-Oxley Act of 2002."

(d) Excess Fees

If in any Board fiscal year, the Board receives fees in excess of the budget for that fiscal year, the Board shall hold those excess fees in escrow. Such escrowed excess fees shall be released to the Board at the beginning of the next fiscal year and shall reduce the Board's accounting support fee in that next fiscal year.

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

Rule 7104. Service as Designated Collection Agent.

If the Board is designated to serve as collection agent for an accounting support fee of a standard-setting body designated by the Commission pursuant to Section 19(b) of the Securities Act, the assessment and collection of the accounting support fee shall be governed by Rules 7102 and 7103 as if the accounting support fee of the standard-setting body were the accounting support fee of the Board.

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

FORMS

FORM 1 – APPLICATION FOR REGISTRATION

GENERAL INSTRUCTIONS

1. The definitions in the *Board's rules* apply to this form. Italicized terms in the instructions to this form are defined in the *Board's rules*. See Rule 1001.
2. Any *public accounting firm* applying to the *Board* for registration pursuant to Section 102 of the *Act* must file this form with the *Board*. See Rule 2101.
3. In addition to these instructions, the *rules* contained in Section 2 of the *Board's rules* govern applications for registration. Please read these *rules* and the instructions carefully before completing this form.
4. Unless otherwise directed by the *Board*, applicants must submit this form, and all exhibits to the form, to the *Board* electronically by completing the Web-based version of Form 1. [Website details to be inserted before registration system is operational]. See Rule 2101.
5. This form must be accompanied by a registration fee in accordance with Section 102(f) of the *Act*. The amount of the required fee is available at [Website details to be inserted before registration system is operational]. An application for registration will not be deemed received by the *Board* until the registration fee has been paid. See Rule 2102.
6. An applicant may request confidential treatment of any portion of its application for registration that has not otherwise been publicly disclosed and that either contains information reasonably identified by the applicant as proprietary information or that is protected from public disclosure by applicable laws related to confidentiality of proprietary, personal, or other information. An applicant that requests confidential treatment must identify the portion of the application that it desires to keep confidential, and include, as Exhibit 99.1 to the application for registration, a detailed explanation as to why, based on the facts and circumstances of the particular case, the information is proprietary or is protected from disclosure by applicable laws related to the confidentiality of proprietary, personal, or other information. The *Board* will normally grant confidential treatment requests for information concerning non-public disciplinary proceedings. The *Board* will determine whether or not to grant other confidential treatment requests on a case-by-case basis. See Rule 2300(c).
7. If an applicant is prohibited by the law(s) of a non-U.S. jurisdiction from submitting to the *Board* information requested by all or a part of an Item to this

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form, the applicant shall so indicate by making a notation under the relevant item number of the form and furnishing, as Exhibit 99.2 to the application for registration, the following information: (i) a copy of the relevant portion of the conflicting non-U.S. law, (ii) a legal opinion that submitting the information would cause the applicant to violate the conflicting non-U.S. law; and (iii) an explanation of the applicant's efforts to seek consents or waivers to eliminate the conflict, if the withheld information could be provided to the *Board* with a consent or waiver, and a representation that the applicant was unable to obtain such consents or waivers to eliminate the conflict.

8. Where this form requires disclosure of a sum of money, such amount must be stated in U.S. dollars and rounded to the nearest thousand. If such amount was received or paid in a currency other than U.S. dollars, the amount must be converted to U.S. dollars.
9. Where this form requires non-historical (i.e., current) information, applicants may submit the information as of a date not earlier than 90 days prior to submission of the application. Such information will be deemed current for purposes of this form.
10. Information submitted as part of this form, including any exhibit to this form, must be in the English language.

PART I – IDENTITY OF THE APPLICANT

Item 1.1 Name of Applicant

State the legal name of the applicant; if different, also state the name or names under which the applicant (or any predecessor for which the applicant is the successor in interest with respect to the entity's liabilities) issues *audit reports*, or has issued any *audit report* during the five years prior to the date of this application.

Item 1.2 Applicant Contact Information

State the physical address (and, if different, mailing address) of the applicant's headquarters office. State the telephone number and facsimile number of the applicant's headquarters office. If available, state the Website address of the applicant.

Item 1.3 Primary Contact and Signatories

State the name, title, physical business address (and, if different, business mailing address), telephone number, fax number, and e-mail address of a partner or authorized officer of the applicant who will serve as the applicant's primary contact with the *Board* regarding this application. Provide the same information for every person whose

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signature appears in Part VIII or Part IX of this form, if any of those persons are different from the primary contact.

Item 1.4 Applicant's Form of Organization

State the applicant's legal form (e.g., proprietorship, partnership, limited liability partnership) and the jurisdiction (e.g., the *state* of the United States or comparable non-U.S. jurisdiction) under the law of which the applicant is organized or exists.

Item 1.5 Applicant's Offices

If the applicant has more than one office, furnish, as Exhibit 1.5, the physical address (and, if different, mailing address) of each of the applicant's offices.

Item 1.6 *Associated Entities* of Applicant

State the name and physical address (and, if different, mailing address) of all *associated entities* of the applicant that engage in the practice of public accounting or preparing or issuing *audit reports*, or comparable reports prepared for clients that are not *issuers*. Do not include any person listed in Item 7.1.

Item 1.7 Applicant's Licenses

List every license or certification number issued to the applicant authorizing it to engage in the business of auditing or accounting. For each such license or certification number, furnish the name of the issuing *state*, agency, board, or other authority.

PART II – LISTING OF APPLICANT'S PUBLIC COMPANY AUDIT CLIENTS AND RELATED FEES

Item 2.1 *Issuers* for Which Applicant Prepared *Audit Reports* During the Preceding Calendar Year

List the names of all *issuers* for which the applicant prepared or issued any *audit report* dated during the calendar year preceding the calendar year in which this application is filed. In addition to the *issuer's* name, this list must include, with respect to each *issuer*

- a. The *issuer's* business address (as shown on its most recent filing with the *Commission*).
- b. The date of the *audit report*.

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- c. The total amount of fees billed for *audit services* for the *issuer's* fiscal year for which the *audit report* was issued.
- d. The total amount of fees billed for *other accounting services* for the *issuer's* fiscal year for which the *audit report* was issued.
- e. The total amount of fees billed for *non-audit services* for the *issuer's* fiscal year for which the *audit report* was issued.

Note: Only fees billed by the principal accountant (i.e., the *public accounting firm* that issued the *audit report*) need be disclosed in response to this Item. To the extent not previously disclosed or known by the applicant, estimated amounts may be used in responding to this Item. For investment company *issuers*, the fees disclosed in response to paragraphs (c) – (e) of this Item should include all fees for services rendered to the *issuer*, to the *issuer's* investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and to any entity controlling, controlled by, or under common control with, the adviser that provides ongoing services to the *issuer*.

Item 2.2 *Issuers* for Which Applicant Prepared *Audit Reports* During the Current Calendar Year

List the names of all *issuers* for which the applicant prepared or issued any *audit report* dated during the current calendar year. (Do not include *audit reports* the applicant expects to prepare or issue during this calendar year, but that have not yet been issued. These are called for in Item 2.3 below.) In addition to the *issuer's* name, include, with respect to each *issuer* –

- a. The *issuer's* business address (as shown on its most recent filing with the *Commission*).
- b. The date of the *audit report*.
- c. The total amount of fees billed for *audit services* for the *issuer's* fiscal year for which the *audit report* was issued.
- d. The total amount of fees billed for *other accounting services* for the *issuer's* fiscal year for which the *audit report* was issued.
- e. The total amount of fees billed for *non-audit services* for the *issuer's* fiscal year for which the *audit report* was issued.

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Note: Only fees billed by the principal accountant (i.e., the *public accounting firm* that issued the *audit report*) need be disclosed in response to this Item. To the extent not previously disclosed or known by the applicant, estimated amounts may be used in responding to this Item. For investment company issuers, the fees disclosed in response to paragraphs (c) – (e) of this Item should include all fees for services rendered to the *issuer*, to the *issuer's* investment adviser (not including any sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser), and to any entity controlling, controlled by, or under common control with, the adviser that provides ongoing services to the *issuer*.

Item 2.3 *Issuers for Which Applicant Expects to Prepare Audit Reports During the Current Calendar Year*

List the names of all *issuers* for which the applicant expects to prepare or issue any *audit report* dated during the calendar year in which this application is filed. In addition to the *issuer's* name, include, with respect to each *issuer*, the *issuer's* business address (as shown on its most recent filing with the *Commission*).

Note: An applicant may presume that it is expected to prepare or issue an *audit report* for an *issuer* (i) if it has been engaged to do so, or (ii) if it issued an *audit report* during the preceding calendar year for an *issuer*, absent an indication from the *issuer* that it no longer intends to engage the applicant.

Item 2.4 *Issuers for Which Applicant Played, or Expects to Play, a Substantial Role in Audit*

For applicants that did not prepare or issue an *audit report* dated during the preceding or current calendar year, and that do not expect to prepare or issue an *audit report* dated during the current calendar year, list the names of all *issuers* for which the applicant *played, or expects to play, a substantial role in the preparation or furnishing of an audit report* dated during the preceding or current calendar year. In addition to the *issuer's* name, this list must include, with respect to each *issuer* –

- a. The *issuer's* business address (as shown on its most recent filing with the *Commission*).
- b. The name of the *public accounting firm* that issued, or is expected to issue, the *audit report*.
- c. The date of the *audit report*, if it has been issued.
- d. The type of substantial role played by the applicant with respect to the *audit report*.

Note: Applicants that disclosed the name of an *issuer* in response to any of Items 2.1 – 2.3 need not respond to this Item. In responding to the part of this Item that asks about *issuers* for which the applicant expects to *play a substantial role in the preparation or furnishing of an audit report*, an applicant may presume that it is *expected to play a substantial role in the preparation or furnishing of an audit report* for an *issuer* (i) if it has been engaged to do so, or (ii) if it *played a substantial role in the preparation and furnishing of an audit report* during the preceding calendar year, absent an indication from the *issuer* or principal accounting firm that it no longer intends to engage the applicant.

PART III – [RESERVED]

PART IV – STATEMENT OF APPLICANT'S QUALITY CONTROL POLICIES

Item 4.1 Applicant's Quality Control Policies

Furnish, as Exhibit 4.1, a narrative, summary description, in a clear, concise and understandable format, of the quality control policies of the applicant for its accounting and auditing practices, including procedures used to monitor compliance with independence requirements.

PART V – LISTING OF CERTAIN PROCEEDINGS INVOLVING THE APPLICANT

Item 5.1 Certain Criminal, Civil and Administrative Proceedings

- a. Indicate whether or not the applicant or any *associated person* of the applicant is a defendant or respondent –
 1. in any pending criminal proceeding, or was a defendant in any such proceeding in which a judgment was rendered against the applicant or such person, whether by plea or after trial, during the previous five years;
 2. in any pending civil or alternative dispute resolution proceeding initiated by a governmental entity (including a non-U.S. jurisdiction) arising out of the applicant's or such person's conduct in connection with an *audit report*, or a comparable report prepared for a client that is not an *issuer*, or was a defendant or respondent in any such proceeding in which a judgment or award was rendered against the applicant or such person, whether by consent or otherwise, during the previous five years;

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3. in any pending administrative or disciplinary proceeding arising out of the applicant's or such person's conduct in connection with an *audit report*, or a comparable report prepared for a client that is not an issuer, or was a respondent in any such proceeding in which a finding of violation was rendered, or a sanction entered, against the applicant or such person, whether by consent or otherwise, during the previous five years. Administrative or disciplinary proceedings include those of the *Commission*; the *Board*; any other federal, *state*, or non-U.S. agency, board, or administrative or licensing authority; and any professional association or body. Investigations that have not resulted in the commencement of a proceeding need not be included;
- b. In the event of an affirmative response to Item 5.1.a, furnish the following information with respect to each such proceeding:
1. The name, filing date, and case or docket number of the proceeding.
 2. The name and address of the court, tribunal, or body in which such proceeding was filed.
 3. The names of all defendants or respondents in such proceeding who are also the applicant, any person listed in Part VII, or any *person associated with the applicant* at the time that the events in question occurred.
 4. The name of the *issuer* or other client that was the subject of the *audit report* or comparable report.
 5. With respect to each person named in Item 5.1.b.3, the statutes, rules, or other requirements such person was found to have violated (or, in the case of a pending proceeding, is charged with having violated).
 6. With respect to each person named in Item 5.1.b.3, the outcome of the proceeding, including any sentence or sanction imposed. (If no judgment or award has yet been rendered, enter the word "pending.")

Note: *Foreign public accounting firm* applicants need only disclose such proceedings for the applicant and any proprietor, partner, principal, shareholder, officer, or manager of the applicant who provided at least ten hours of *audit services* for any *issuer* during the last calendar year.

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Item 5.2 Pending Private Civil Actions

- a. Indicate whether or not the applicant or any *associated person* of the applicant is a defendant or respondent in any pending civil proceeding or alternative dispute resolution proceeding initiated by a non-governmental entity involving conduct in connection with an *audit report*, or a comparable report prepared for a client that is not an *issuer*.
- b. In the event of an affirmative response to Item 5.2.a, furnish the following information with respect to each such proceeding:
 1. The name, filing date, and case or docket number of the proceeding.
 2. The name and address of the court, tribunal or body in which such proceeding was filed.
 3. The names of all defendants or respondents in such proceeding who are also the applicant, any person listed in Part VII, or any *person associated with the applicant* at the time that the events in question occurred.
 4. The name of the *issuer* or other client that was the subject of the *audit report* or comparable report.
 5. With respect to each person named in Item 5.2.b.3, the statutes, rules, or other requirements such person is alleged to have violated.

Note: *Foreign public accounting firm* applicants need only disclose such proceedings for the applicant and any proprietor, partner, principal, shareholder, officer, or manager of the applicant who provided at least ten hours of *audit services* for any *issuer* during the last calendar year.

Item 5.3 Applicant's Discretionary Statement Regarding Proceedings Involving the Applicant's Audit Practice

With respect to any case or proceeding listed in response to Items 5.1 or 5.2, the applicant may, at its discretion, furnish, as Exhibit 5.3, a statement or statements describing the proceeding and the reasons that, in the applicant's view, such proceeding should not be a basis for the denial of its application for registration.

PART VI – LISTING OF FILINGS DISCLOSING ACCOUNTING DISAGREEMENTS WITH PUBLIC COMPANY AUDIT CLIENTS

Item 6.1 Existence of Disagreements With *Issuers*

- a. Indicate whether or not the applicant has been the former accountant with respect to any disclosure of a disagreement with an *issuer* made by such *issuer* during the current or preceding calendar year in a filing with the *Commission* pursuant to Item 304(a)(1)(iv) of Regulation S-K, 17 C.F.R. 229.304(a)(1)(iv).
- b. Indicate whether or not the applicant has been the former accountant with respect to any filing made by an *issuer* during the current or preceding calendar year with the *Commission* containing a letter submitted by the applicant to the *Commission* pursuant to Item 304(a)(3) of Regulation S-K, 17 C.F.R. 229.304(a)(3), in which the applicant stated that it disagreed with a statement of the issuer in response to Item 304(a).

Item 6.2 Listing of Disagreements With *Issuers*

In the event of an affirmative response to Items 6.1.a or 6.1.b, furnish the following information with respect to each such filing:

- a. The name of the *issuer*.
- b. The name and date of the filing containing the disclosure of the disagreement or the applicant's letter.

Item 6.3 Copies of Filings

Furnish, as Exhibit 6.3, a copy of every filing described in Item 6.2.

PART VII – ROSTER OF ASSOCIATED ACCOUNTANTS

Item 7.1 Listing of *Accountants* Associated with Applicants

List the names of all *accountants* associated with the applicant who participate in or contribute to the preparation of *audit reports*. For each such person, list every license or certification number (if any) authorizing him or her to engage in the business of auditing or accounting. For each such license or certification number, furnish the name of the issuing *state*, agency, board, or other authority.

Note: For purposes of this Item, applicants that are not *foreign public accounting firms* must list all *accountants* who are *persons associated with the applicant* and who provided at least ten hours of *audit services* for any *issuer* during the last

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calendar year. Applicants that are *foreign public accounting firms* must list all *accountants* who are a proprietor, partner, principal, shareholder, officer, or manager of the applicant and who provided at least ten hours of *audit services* for any *issuer* during the last calendar year.

Item 7.2 Number of Firm Personnel

State the –

- a. Total number of *accountants* employed by the applicant.
- b. Total number of certified public accountants, or *accountants* with comparable licenses from non-U.S. jurisdictions, employed by the applicant.
- c. Total number of personnel employed by the applicant.

PART VIII – CONSENTS OF APPLICANT

Item 8.1 Consent to Cooperate with the *Board* and Statement of Acceptance of Registration Condition

Furnish, as Exhibit 8.1, a statement, signed on behalf of the applicant by an authorized partner or officer of the applicant in accordance with Rule 2104, in the following form –

- a. [Name of applicant] consents to cooperate in and comply with any request for testimony or the production of documents made by the Public Company Accounting Oversight Board in furtherance of its authority and responsibilities under the Sarbanes-Oxley Act of 2002.
- b. [Name of applicant] agrees to secure and enforce similar consents from each of its *associated persons* as a condition of their continued employment by or other association with the firm.
- c. [Name of applicant] understands and agrees that cooperation and compliance, as described in the firm's consent in paragraph (a), and the securing and enforcement of such consents from its *associated persons* in accordance with paragraph (b), shall be a condition to the continuing effectiveness of the registration of the firm with the Public Company Accounting Oversight Board.

Note 1: Other than the insertion of the name of the applicant in paragraphs (a), (b), and (c) of this Item, Exhibit 8.1 must be in the exact words contained in this instruction. The consents required by paragraph (b) of this Item must be in the exact words of Note 2 below and must be secured by the applicant not later than 45 days after

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submitting this application or, for persons who become *associated persons* of the firm subsequent to the submission of this application, at the time of the person's association with the firm. Consents required by paragraph (b) of this Item are not required to be furnished as an exhibit to this form.

Note 2: Other than the insertion of the name of the *associated person*, the consents required by paragraph (b) of this Item must state: [Name of *associated person*] consents to cooperate in and comply with any request for testimony or the production of documents made by the Public Company Accounting Oversight Board in furtherance of its authority and responsibilities under the Sarbanes-Oxley Act of 2002. [Name of *associated person*] understands and agrees that this consent is a condition of their continued employment by or other association with [name of applicant].

Note 3: For applicants that are *foreign public accounting firms*, the term "*associated persons*" as used in this Item means all *accountants* who are a proprietor, partner, principal, shareholder, officer, or manager of the applicant and who provided at least ten hours of *audit services* for any *issuer* during the last calendar year.

PART IX – SIGNATURE OF APPLICANT

Item 9.1 Signature of Partner or Authorized Officer

The application must be signed on behalf of the applicant by an authorized partner or officer of the applicant in accordance with Rule 2104. The signer must certify that he or she has reviewed the application; that the application is, based on the signer's knowledge, complete and does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading, and that the signer is authorized to execute the application on behalf of the applicant. The signature must be accompanied by the name of the signer, the capacity in which the signer signed the application, and the date of signature.

PART X – EXHIBITS

To the extent applicable under the foregoing instructions, each application must be accompanied by the following exhibits:

Exhibit 1.5 Listing of Offices

Exhibit 4.1 Statement of Quality Control Policies

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- Exhibit 5.3 Discretionary Statements Regarding Proceedings Involving Audit Practice
- Exhibit 6.3 Securities and Exchange Commission Filings Disclosing Accounting Disagreements With Public Company Audit Clients
- Exhibit 8.1 Consent of Applicant for Registration
- Exhibit 99.1 Request for Confidential Treatment
- Exhibit 99.2 Evidence of Conflicting Non-U.S. Law

Note: Where an exhibit consists of more than one document, each document must be numbered consecutively (e.g., Exhibit 4.1.1, Exhibit 4.1.2, Exhibit 4.1.3, etc.), and the applicant must provide a list of the title or description of each document comprising the exhibit.

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

FORMS

FORM 1-WD REQUEST FOR LEAVE TO WITHDRAW FROM REGISTRATION

GENERAL INSTRUCTIONS

1. The definitions in the *Board's* rules apply to this form. Italicized terms in the instructions to this form are defined in the *Board's* rules. See Rule 1001.
2. Any *registered public accounting firm* seeking to withdraw from registration with the *Board* must file this form with the *Board*.
3. In addition to these instructions, the *Board's* Rule 2107 governs applications for leave to withdraw from registration. Please read Rule 2107 and the instructions carefully before completing this form.
4. Unless otherwise directed by the *Board*, a *registered public accounting firm* seeking to withdraw from registration must submit this form to the *Board* electronically by completing the Web-based version of Form 1-WD. The date of such submission shall be deemed the date of *Board* receipt of the Form. The registered public accounting firm must also submit an original hard copy of the form with manual signatures in Item 3.1 and Item 5.1, with such signatures dated not later than the date of electronic submission.
5. Pursuant to Rule 2107, any Form 1-WD filed with the *Board* shall be non-public. A registered public accounting firm may submit with Form 1-WD a request for *Board* notification in the event that the *Board* is requested by subpoena or other legal process to disclose the Form 1-WD. The *Board* will make reasonable attempts to honor any such request, although the *Board* will make public the fact that the firm has requested to withdraw from registration.
6. Information submitted as part of this form must be in the English language.

PART I – IDENTITY OF THE REGISTERED PUBLIC ACCOUNTING FIRM

Item 1.1 Name of the Firm Requesting Leave to Withdraw

State the legal name of the firm requesting leave to withdraw; if different, also state the name or names under which the firm (or any predecessor) issues *audit reports*, or has issued any *audit report* during the period of the firm's registration with the *Board*.

Item 1.2 Firm Contact Information

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State the physical address (and, if different, mailing address) of the firm's headquarters office. State the telephone number and facsimile number of the firm's headquarters office.

Item 1.3 Primary Contact and Signatories

State the name, title, physical business address (and, if different, business mailing address), telephone number, facsimile number, and e-mail address of a partner or authorized officer of the firm who will serve as the firm's primary contact with the *Board* regarding this application. Provide the same information for every person whose signature appears in Part III or Part V of the form, if any of those persons are different from the primary contact.

PART II – DESCRIPTION OF ONGOING REGULATORY OR LAW ENFORCEMENT PROCEEDINGS

Item 2.1 Description of Ongoing Regulatory or Law Enforcement Proceedings

Identify all ongoing federal, state, or local investigative, disciplinary, regulatory, criminal, or other law enforcement proceedings that are known to the firm, including to any of the firm's partners or officers, and that address in whole or in part (1) conduct of the firm or (2) *audit*-related conduct of any of the firm's associated persons. For each such proceeding, state –

- a. The identity of the federal, state, or local authority conducting the proceeding;
- b. The caption or other identifying information of the proceeding;
- c. The date that the firm or a partner or officer of the firm first became aware of the proceeding;
- d. The firm's understanding of the current status of the proceeding; and
- e. The conduct of the firm and the firm's associated persons that the proceeding addresses.

PART III – CERTIFICATION OF NONPARTICIPATION IN AUDITS

Item 3.1 Statement of Nonparticipation in *Audits*

Furnish a statement, dated and signed on behalf of the firm by an authorized partner or officer of the firm, in the following form –

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On behalf of [name of firm], I certify that [name of firm] is not currently, and will not during the pendency of its request for leave to withdraw be, engaged in the preparation or issuance of, or playing a substantial role in the preparation or furnishing of, an audit report, other than to issue a consent to the use of an audit report for a prior period.

Note: Other than the insertion of the name of the firm the statement must be in the exact words contained in this instruction.

Part IV – REASONS FOR SEEKING LEAVE TO WITHDRAW (Optional)

Item 4.1 Description of Reasons for Seeking Leave to Withdraw

Describe, if you choose to do so, the reason or reasons that the firm seeks leave to withdraw from registration.

PART V – SIGNATURE OF FIRM SEEKING LEAVE TO WITHDRAW

Item 5.1 Signature of Authorized Partner or Officer

The request for leave to withdraw from registration must be signed on behalf of the firm by an authorized partner or officer of the firm. The signer must certify that he or she has reviewed the application; that the application is, based on the signer's knowledge, complete and does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statement made, in light of the circumstances under which such statements were made, not misleading, and that the signer is authorized to execute the application on behalf of the firm. The signature must be accompanied by the title of the signer and the date of the signature.

[Effective pursuant to SEC Release No. 34-49694; File No. PCAOB-2003-09; May 13, 2004]

**AUDITING STANDARD No. 1 – References in Auditors' Reports to the Standards
of the Public Company Accounting Oversight Board**

May 14, 2004

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 1 –

***REFERENCES IN AUDITORS' REPORTS TO THE
STANDARDS OF THE PUBLIC COMPANY
ACCOUNTING OVERSIGHT BOARD***

PCAOB

Public Company Accounting Oversight Board

[Effective pursuant to SEC Release No. 34-49707; File No. PCAOB-2003-10, May 14, 2004]

References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board

1. The Sarbanes-Oxley Act of 2002 authorized the Public Company Accounting Oversight Board ("PCAOB") to establish auditing and related professional practice standards to be used by registered public accounting firms. PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards*, requires the auditor to comply with all applicable auditing and related professional practice standards of the PCAOB.
2. The Board has adopted as interim standards, on an initial, transitional basis, the generally accepted auditing standards, described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, in existence on April 16, 2003.^{1/}
3. Accordingly, in connection with any engagement performed in accordance with the auditing and related professional practice standards of the PCAOB, whenever the auditor is required by the interim standards to make reference in a report to generally accepted auditing standards, U.S. generally accepted auditing standards, auditing standards generally accepted in the United States of America, or standards established by the AICPA, the auditor must instead refer to "the standards of the Public Company Accounting Oversight Board (United States)." An auditor must also include 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.
4. This auditing standard is effective for auditors' reports issued or reissued on or after the 10th day following approval of this auditing standard by the Securities and Exchange Commission.
5. Audit reports issued prior to the effective date of this standard were required to state that the audits that supported those reports were performed in accordance with generally accepted auditing standards. The PCAOB adopted those generally accepted auditing standards, including their respective effective dates, as they existed on April 16, 2003, as interim standards. Therefore, reference to "the standards of the Public Company Accounting Oversight Board (United States)" with respect to audits of financial statements performed prior to the effective date of this standard is equivalent to the previously-required reference to generally accepted auditing standards. Accordingly, upon adoption of this standard, a reference to generally accepted auditing standards in auditors' reports is no longer appropriate or necessary.

^{1/} The Board's rules on interim standards were adopted by the Board on April 16, 2003, and approved by the Commission on April 25, 2003. See SEC Rel. No. 33-8222 (April 25, 2003).

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Note: The term "auditor" in this standard is intended to include both registered public accounting firms and associated persons thereof.

**APPENDIX
Illustrative Reports**

The following is an illustrative report on an audit of financial statements:

Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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 audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

[Signature]

[City and State or Country]

[Date]

**Public Company Accounting Oversight Board
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The following is an illustrative report on a review of interim financial information:

Report of Independent Registered Public Accounting Firm

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of X Company as of September 30, 20X3 and 20X2, and for the three-month and nine-month periods then ended. This (these) interim financial information (statements) is (are) the responsibility of the Company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial (statements) for it (them) to be in conformity with U.S. generally accepted accounting principles.

[*Signature*]

[City and State or Country]

[*Date*]

AUDITING STANDARD No. 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements

March 9, 2004

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Auditing Standard No. 2 –

An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements



[Effective pursuant to SEC Release No. 34-49884; File No. PCAOB-2004-03, June 17, 2004]

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Applicability of Standard

1. This standard establishes requirements and provides directions that apply when an auditor is engaged to audit both a company's financial statements and management's assessment of the effectiveness of internal control over financial reporting.

Note: The term *auditor* includes both public accounting firms registered with the Public Company Accounting Oversight Board ("PCAOB" or the "Board") and associated persons thereof.

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

Note: The term issuer means an issuer (as defined in Section 3 of the Securities Exchange Act of 1934), the securities of which are registered under Section 12 of that Act, or that is required to file reports under Section 15(d) of that Act, or that files or has filed a registration statement with the Securities and Exchange Commission ("SEC" or "Commission") that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.

Note: Various parts of this standard summarize legal requirements imposed on issuers by the SEC, as well as legal requirements imposed on auditors by regulatory authorities other than the PCAOB. These parts of the standard are intended to provide context and to promote the auditor's understanding of the relationship between his or her obligations under this standard and his or her other legal responsibilities. The standard does not incorporate these legal requirements by reference and is not an interpretation of those other requirements and should not be so construed. (This Note does not apply to references in the standard to the existing professional standards and the Board's interim auditing and related professional practice standards.)

3. This standard is the standard on attestation engagements referred to in Section 404(b) of the Act. This standard is also the standard referred to in Section

103(a)(2)(A)(iii) of the Act. Throughout this standard, the auditor's attestation of management's assessment of the effectiveness of internal control over financial reporting required by Section 404(b) of the Act is referred to as the *audit of internal control over financial reporting*.

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

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

4. The auditor's objective in an audit of internal control over financial reporting is to express an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. The auditor also must audit the company's financial statements as of the date specified in management's assessment because the information the auditor obtains during a financial statement audit is relevant to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting. Maintaining effective internal control over financial reporting means that no material weaknesses exist; therefore, the objective of the audit of internal control over financial reporting is to obtain reasonable assurance that no material weaknesses exist as of the date specified in management's assessment.

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

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

as the audit committee and regulators in specialized industries. Additionally, Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a),^{1/} whichever applies, require management, with the participation of the principal executive and financial officers, to make quarterly and annual certifications with respect to the company's internal control over financial reporting.

Definitions Related to Internal Control Over Financial Reporting

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

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 generally accepted accounting principles and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Note: This definition is the same one used by the SEC in its rules requiring management to report on internal control over financial reporting, except the word "registrant" has been changed to "company" to conform to the wording in this standard. (See Securities Exchange Act Rules 13a-15(f) and 15d-15(f).^{2/})

^{1/} See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

^{2/} See 17 C.F.R. 240, 13a-15(f) and 15d-15(f).

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Note: Throughout this standard, *internal control over financial reporting* (singular) refers to the process described in this paragraph. Individual controls or subsets of controls are referred to as *controls* or *controls over financial reporting*.

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

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

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

Note: The term "remote likelihood" as used in the definitions of *significant deficiency* and *material weakness* (paragraph 10) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

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

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

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

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

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

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in paragraphs 8, 9 and 10, and the directions in paragraphs 130 through 137. As explained in paragraph 23, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

11. Controls over financial reporting may be *preventive controls* or *detective controls*.

- Preventive controls have the objective of preventing errors or fraud from occurring in the first place that could result in a misstatement of the financial statements.
- Detective controls have the objective of detecting errors or fraud that have already occurred that could result in a misstatement of the financial statements.

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

Framework Used by Management to Conduct Its Assessment

13. Management is required to base its assessment of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework established by a body of experts that followed due-process procedures, including the broad distribution of the framework for public comment. In addition to being available to users of management's reports, a framework is suitable only when it:

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

Committee of Sponsoring Organizations Framework

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

15. The COSO framework identifies three primary objectives of internal control: efficiency and effectiveness of operations, financial reporting, and compliance with laws and regulations. The COSO perspective on internal control over financial reporting does not ordinarily include the other two objectives of internal control, which are the effectiveness and efficiency of operations and compliance with laws and regulations. However, the controls that management designs and implements may achieve more than one objective. Also, operations and compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements are encompassed in internal control over financial reporting. Additionally, not all controls relevant to financial reporting are accounting controls. Accordingly, all controls that

could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and also have a material effect on the reliability of financial reporting, are a part of internal control over financial reporting. More information about the COSO framework is included in the COSO report and in AU sec. 319, Consideration of Internal Control in a Financial Statement Audit.^{3/} The COSO report also discusses special considerations for internal control over financial reporting for small and medium-sized companies.

Inherent Limitations in Internal Control Over Financial Reporting

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

The Concept of Reasonable Assurance

17. Management's assessment of the effectiveness of internal control over financial reporting is expressed at the level of *reasonable assurance*. The concept of reasonable assurance is built into the definition of internal control over financial reporting and also is integral to the auditor's opinion.^{4/} Reasonable assurance includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance.

^{3/} The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards*, as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in this standard to AU sections refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

^{4/} See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636] for further discussion of reasonable assurance.

18. Just as there are inherent limitations on the assurance that effective internal control over financial reporting can provide, as discussed in paragraph 16, there are limitations on the amount of assurance the auditor can obtain as a result of performing his or her audit of internal control over financial reporting. Limitations arise because an audit is conducted on a test basis and requires the exercise of professional judgment. Nevertheless, the audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control over financial reporting, and performing such other procedures as the auditor considers necessary to obtain reasonable assurance about whether internal control over financial reporting is effective.

19. There is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting. In either case, the auditor must obtain sufficient evidence to provide a reasonable basis for his or her opinion and the use and evaluation of management's assessment is inherent in expressing either opinion.

Note: The auditor's report on internal control over financial reporting does not relieve management of its responsibility for assuring users of its financial reports about the effectiveness of internal control over financial reporting.

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

20. For the auditor to satisfactorily complete an audit of internal control over financial reporting, management must do the following:^{5/}

- a. Accept responsibility for the effectiveness of the company's internal control over financial reporting;
- b. Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria;
- c. Support its evaluation with sufficient evidence, including documentation; and
- d. Present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

^{5/} Management is required to fulfill these responsibilities. See Items 308(a) and (c) of Regulation S-B and S-K, 17 C.F.R. 228.308 (a) and (c) and 229.308 (a) and (c), respectively.

21. If the auditor concludes that management has not fulfilled the responsibilities enumerated in the preceding paragraph, the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. Paragraphs 40 through 46 provide information for the auditor about evaluating management's process for assessing internal control over financial reporting.

Materiality Considerations in an Audit of Internal Control Over Financial Reporting

22. The auditor should apply the concept of materiality in an audit of internal control over financial reporting at both the financial-statement level and at the individual account-balance level. The auditor uses materiality at the financial-statement level in evaluating whether a deficiency, or combination of deficiencies, in controls is a significant deficiency or a material weakness. Materiality at both the financial-statement level and the individual account-balance level is relevant to planning the audit and designing procedures. Materiality at the account-balance level is necessarily lower than materiality at the financial-statement level.

23. The same conceptual definition of materiality that applies to financial reporting applies to information on internal control over financial reporting, including the relevance of both quantitative and qualitative considerations.^{6/}

- The quantitative considerations are essentially the same as in an audit of financial statements and relate to whether misstatements that would not be prevented or detected by internal control over financial reporting, individually or collectively, have a quantitatively material effect on the financial statements.
- The qualitative considerations apply to evaluating materiality with respect to the financial statements and to additional factors that relate to the perceived needs of reasonable persons who will rely on the information. Paragraph 6 describes some qualitative considerations.

Fraud Considerations in an Audit of Internal Control Over Financial Reporting

24. The auditor should evaluate all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the company's financial statements. These controls may be a part of any of the five

^{6/} AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, provides additional explanation of materiality.

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components of internal control over financial reporting, as discussed in paragraph 49. Controls related to the prevention and detection of fraud often have a pervasive effect on the risk of fraud. Such controls include, but are not limited to, the:

- Controls restraining misappropriation of company assets that could result in a material misstatement of the financial statements;
- Company's risk assessment processes;
- Code of ethics/conduct provisions, especially those related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board;
- Adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee, as well as the extent of the audit committee's involvement and interaction with internal audit; and
- Adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters.

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

26. In an audit of internal control over financial reporting, the auditor's evaluation of controls is interrelated with the auditor's evaluation of controls in a financial statement audit, as required by AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. Often, controls identified and evaluated by the auditor during the audit of internal control over financial reporting also address or mitigate fraud risks, which the auditor is required to consider in a financial statement audit. If the auditor identifies deficiencies in controls designed to prevent and detect fraud during the audit of internal control over financial reporting, the auditor should alter the nature, timing, or extent of procedures to be performed during the financial statement audit to be responsive to such deficiencies, as provided in paragraphs .44 and .45 of AU sec. 316.

Performing an Audit of Internal Control Over Financial Reporting

27. In an audit of internal control over financial reporting, the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements. The auditor must plan and perform the audit to obtain reasonable assurance that deficiencies that, individually or in the aggregate, would represent material weaknesses are identified. Thus, the audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness. Because of the potential significance of the information obtained during the audit of the financial statements to the auditor's conclusions about the effectiveness of internal control over financial reporting, the auditor cannot audit internal control over financial reporting without also auditing the financial statements.

Note: However, the auditor may audit the financial statements without also auditing internal control over financial reporting, for example, in the case of certain initial public offerings by a company. See the discussion beginning at paragraph 145 for more information about the importance of auditing both internal control over financial reporting as well as the financial statements when the auditor is engaged to audit internal control over financial reporting.

28. The auditor must adhere to the general standards (See paragraphs 30 through 36) and fieldwork and reporting standards (See paragraph 37) in performing an audit of a company's internal control over financial reporting. This involves the following:

- a. Planning the engagement;
- b. Evaluating management's assessment process;
- c. Obtaining an understanding of internal control over financial reporting;
- d. Testing and evaluating design effectiveness of internal control over financial reporting;
- e. Testing and evaluating operating effectiveness of internal control over financial reporting; and
- f. Forming an opinion on the effectiveness of internal control over financial reporting.

29. Even though some requirements of this standard are set forth in a manner that suggests a sequential process, auditing internal control over financial reporting involves a process of gathering, updating, and analyzing information. Accordingly, the auditor

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may perform some of the procedures and evaluations described in this section on "Performing an Audit of Internal Control Over Financial Reporting" concurrently.

Applying General, Fieldwork, and Reporting Standards

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

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

32. *Independence.* The applicable requirements of independence are largely predicated on four basic principles: (1) an auditor must not act as management or as an employee of the audit client, (2) an auditor must not audit his or her own work, (3) an auditor must not serve in a position of being an advocate for his or her client, and (4) an auditor must not have mutual or conflicting interests with his or her audit client.^{7/} If the auditor were to design or implement controls, that situation would place the auditor in a management role and result in the auditor auditing his or her own work. These requirements, however, do not preclude the auditor from making substantive recommendations as to how management may improve the design or operation of the company's internal controls as a by-product of an audit.

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

34. Maintaining independence, in fact and appearance, requires careful attention, as is the case with all independence issues when work concerning internal control over financial reporting is performed. Unless the auditor and the audit committee are diligent in evaluating the nature and extent of services provided, the services might violate basic principles of independence and cause an impairment of independence in fact or appearance.

^{7/} See the Preliminary Note of Rule 2-01 of Regulation S-X, 17 C.F.R. 210.2-01.

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

36. *Due Professional Care.* The auditor must exercise due professional care in an audit of internal control over financial reporting. One important tenet of due professional care is exercising professional skepticism. In an audit of internal control over financial reporting, exercising professional skepticism involves essentially the same considerations as in an audit of financial statements, that is, it includes a critical assessment of the work that management has performed in evaluating and testing controls.

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

38. The concept of materiality, as discussed in paragraphs 22 and 23, underlies the application of the general and fieldwork standards.

Planning the Engagement

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

- Knowledge of the company's internal control over financial reporting obtained during other engagements.
- Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes.
- Matters relating to the company's business, including its organization, operating characteristics, capital structure, and distribution methods.

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- The extent of recent changes, if any, in the company, its operations, or its internal control over financial reporting.
- Management's process for assessing the effectiveness of the company's internal control over financial reporting based upon control criteria.
- Preliminary judgments about materiality, risk, and other factors relating to the determination of material weaknesses.
- Control deficiencies previously communicated to the audit committee or management.
- Legal or regulatory matters of which the company is aware.
- The type and extent of available evidence related to the effectiveness of the company's internal control over financial reporting.
- Preliminary judgments about the effectiveness of internal control over financial reporting.
- The number of significant business locations or units, including management's documentation and monitoring of controls over such locations or business units. (Appendix B, paragraphs B1 through B17, discusses factors the auditor should evaluate to determine the locations at which to perform auditing procedures.)

Evaluating Management's Assessment Process

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

- Determining which controls should be tested, including controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. Generally, such controls include:
 - Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.
 - Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles.

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- Antifraud programs and controls.
- Controls, including information technology general controls, on which other controls are dependent.
- Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.
- Company level controls (as described in paragraph 53), including:
 - The control environment and
 - Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, authorize, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

Note: References to the period-end financial reporting process in this standard refer to the preparation of both annual and quarterly financial statements.

- Evaluating the likelihood that failure of the control could result in a misstatement, the magnitude of such a misstatement, and the degree to which other controls, if effective, achieve the same control objectives.
- Determining the locations or business units to include in the evaluation for a company with multiple locations or business units (See paragraphs B1 through B17).
- Evaluating the design effectiveness of controls.
- Evaluating the operating effectiveness of controls based on procedures sufficient to assess their operating effectiveness. Examples of such procedures include testing of the controls by internal audit, testing of controls by others under the direction of management, using a service organization's reports (See paragraphs B18 through B29), inspection of evidence of the application of controls, or testing by means of a self-assessment process, some of which might occur as part of management's ongoing monitoring activities. Inquiry alone is not adequate to complete this evaluation. To evaluate the effectiveness of the company's internal control over financial reporting, management must have evaluated

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

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

41. As part of the understanding and evaluation of management's process, the auditor should obtain an understanding of the results of procedures performed by others. Others include internal audit and third parties working under the direction of management, including other auditors and accounting professionals engaged to perform procedures as a basis for management's assessment. Inquiry of management and others is the beginning point for obtaining an understanding of internal control over financial reporting, but inquiry alone is not adequate for reaching a conclusion on any aspect of internal control over financial reporting effectiveness.

Note: Management cannot use the auditor's procedures as part of the basis for its assessment of the effectiveness of internal control over financial reporting.

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

- The design of controls over all relevant assertions related to all significant accounts and disclosures in the financial statements. The documentation should include the five components of internal control over financial reporting as discussed in paragraph 49, including the control environment and company-level controls as described in paragraph 53;
- Information about how significant transactions are initiated, authorized, recorded, processed and reported;
- Sufficient information about the flow of transactions to identify the points at which material misstatements due to error or fraud could occur;
- Controls designed to prevent or detect fraud, including who performs the controls and the related segregation of duties;
- Controls over the period-end financial reporting process;

- Controls over safeguarding of assets (See paragraphs C1 through C6); and
- The results of management's testing and evaluation.

43. Documentation might take many forms, such as paper, electronic files, or other media, and can include a variety of information, including policy manuals, process models, flowcharts, job descriptions, documents, and forms. The form and extent of documentation will vary depending on the size, nature, and complexity of the company.

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

45. Inadequate documentation of the design of controls over relevant assertions related to significant accounts and disclosures is a deficiency in the company's internal control over financial reporting. As discussed in paragraph 138, the auditor should evaluate this documentation deficiency. The auditor might conclude that the deficiency is only a deficiency, or that the deficiency represents a significant deficiency or a material weakness. In evaluating the deficiency as to its significance, the auditor should determine whether management can demonstrate the monitoring component of internal control over financial reporting.

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

Obtaining an Understanding of Internal Control Over Financial Reporting

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

- Making inquiries of appropriate management, supervisory, and staff personnel;
- Inspecting company documents;
- Observing the application of specific controls; and

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- Tracing transactions through the information system relevant to financial reporting.

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

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

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

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as the period-end financial reporting process (discussed further beginning at paragraph 76).

- *Monitoring.* The auditor's understanding of management's monitoring of controls extends to and includes its monitoring of all controls, including control activities, which management has identified and designed to prevent or detect material misstatement in the accounts and disclosures and related assertions of the financial statements.

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

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

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

53. Company-level controls are controls such as the following:

- Controls within the control environment, including tone at the top, the assignment of authority and responsibility, consistent policies and procedures, and company-wide programs, such as codes of conduct and fraud prevention, that apply to all locations and business units (See paragraphs 113 through 115 for further discussion);
- Management's risk assessment process;

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- 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;
- The period-end financial reporting process; and
- Board-approved policies that address significant business control and risk management practices.

Note: The controls listed above are not intended to be a complete list of company-level controls nor is a company required to have all the controls in the list to support its assessment of effective company-level controls. However, ineffective company-level controls are a deficiency that will affect the scope of work performed, particularly when a company has multiple locations or business units, as described in Appendix B.

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

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

Note: Although the audit committee plays an important role within the control environment and monitoring components of internal control over financial reporting, management is responsible for maintaining effective internal control over financial reporting. This standard does not suggest that this responsibility has been transferred to the audit committee.

Note: If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.^{8/} The auditor should be aware that companies whose securities are

^{8/} See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

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not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors at these companies indicative, by itself, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3^{9/} are not applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).^{10/} Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).^{11/} Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X^{12/} (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

56. The company's board of directors is responsible for evaluating the performance and effectiveness of the audit committee; this standard does not suggest that the auditor is responsible for performing a separate and distinct evaluation of the audit committee. However, because of the role of the audit committee within the control environment and monitoring components of internal control over financial reporting, the auditor should assess the effectiveness of the audit committee as part of understanding and evaluating those components.

57. The aspects of the audit committee's effectiveness that are important may vary considerably with the circumstances. The auditor focuses on factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting, such as the independence of the audit committee members from management and the clarity with which the audit

^{9/} See 17 C.F.R. 240.10A-3.

^{10/} See 17 C.F.R. 240.10A-3(c)(2).

^{11/} See 17 C.F.R. 240.10A-3(c)(2).

^{12/} See 17 C.F.R. 210.2-01(c)(7).

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committee's responsibilities are articulated (for example, in the audit committee's charter) and how well the audit committee and management understand those responsibilities. The auditor might also consider the audit committee's involvement and interaction with the independent auditor and with internal auditors, as well as interaction with key members of financial management, including the chief financial officer and chief accounting officer.

58. The auditor might also evaluate whether the right questions are raised and pursued with management and the auditor, including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, and the responsiveness to issues raised by the auditor.

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

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

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

Note: For purposes of determining significant accounts, the assessment as to likelihood should be made without giving any consideration to the effectiveness of internal control over financial reporting.

62. Components of an account balance subject to differing risks (inherent and control) or different controls should be considered separately as potential significant accounts. For instance, inventory accounts often consist of raw materials (purchasing process), work in process (manufacturing process), finished goods (distribution process), and an allowance for obsolescence.

63. In some cases, separate components of an account might be a significant account because of the company's organizational structure. For example, for a

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company that has a number of separate business units, each with different management and accounting processes, the accounts at each separate business unit are considered individually as potential significant accounts.

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

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

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

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

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

68. Identifying Relevant Financial Statement Assertions. For each significant account, the auditor should determine the relevance of each of these financial statement assertions:^{13/}

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

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

- The nature of the assertion;
- The volume of transactions or data related to the assertion; and

^{13/} See AU sec. 326, *Evidential Matter*, which provides additional information on financial statement assertions.

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- The nature and complexity of the systems, including the use of information technology by which the company processes and controls information supporting the assertion.

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

71. *Identifying Significant Processes and Major Classes of Transactions.* The auditor should identify each significant process over each major class of transactions affecting significant accounts or groups of accounts. Major classes of transactions are those classes of transactions that are significant to the company's financial statements. For example, at a company whose sales may be initiated by customers through personal contact in a retail store or electronically through use of the internet, these types of sales would be two major classes of transactions within the sales process if they were both significant to the company's financial statements. As another example, at a company for which fixed assets is a significant account, recording depreciation expense would be a major class of transactions.

72. Different types of major classes of transactions have different levels of inherent risk associated with them and require different levels of management supervision and involvement. For this reason, the auditor might further categorize the identified major classes of transactions by transaction type: routine, nonroutine, and estimation.

- Routine transactions are recurring financial activities reflected in the accounting records in the normal course of business (for example, sales, purchases, cash receipts, cash disbursements, payroll).
- Nonroutine transactions are activities that occur only periodically (for example, taking physical inventory, calculating depreciation expense, adjusting for foreign currencies). A distinguishing feature of nonroutine transactions is that data involved are generally not part of the routine flow of transactions.
- Estimation transactions are activities that involve management judgments or assumptions in formulating account balances in the absence of a precise means of measurement (for example, determining the allowance for doubtful accounts, establishing warranty reserves, assessing assets for impairment).

73. Most processes involve a series of tasks such as capturing input data, sorting and merging data, making calculations, updating transactions and master files, generating transactions, and summarizing and displaying or reporting data. The processing procedures relevant for the auditor to understand the flow of transactions generally are those activities required to initiate, authorize, record, process and report transactions. Such activities include, for example, initially recording sales orders, preparing shipping documents and invoices, and updating the accounts receivable master file. The relevant processing procedures also include procedures for correcting and reprocessing previously rejected transactions and for correcting erroneous transactions through adjusting journal entries.

74. For each significant process, the auditor should:

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

Note: The auditor frequently obtains the understanding and identifies the controls described above as part of his or her performance of walkthroughs (as described beginning in paragraph 79).

75. The nature and characteristics of a company's use of information technology in its information system affect the company's internal control over financial reporting. AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit*, paragraphs .16 through .20, .30 through .32, and .77 through .79, discuss the effect of information technology on internal control over financial reporting.

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

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

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

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

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

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

79. *Performing Walkthroughs.* The auditor should perform at least one walkthrough for each major class of transactions (as identified in paragraph 71). In a walkthrough, the auditor traces a transaction from origination through the company's information systems until it is reflected in the company's financial reports. Walkthroughs provide the auditor with evidence to:

- Confirm the auditor's understanding of the process flow of transactions;

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

Note: The auditor can often gain an understanding of the transaction flow, identify and understand controls, and conduct the walkthrough simultaneously.

80. The auditor's walkthroughs should encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified, including controls intended to address the risk of fraud. During the walkthrough, at each point at which important processing procedures or controls occur, the auditor should question the company's personnel about their understanding of what is required by the company's prescribed procedures and controls and determine whether the processing procedures are performed as originally understood and on a timely basis. (Controls might not be performed regularly but still be timely.) During the walkthrough, the auditor should be alert for exceptions to the company's prescribed procedures and controls.

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

- What they do when they find an error or what they are looking for to determine if there is an error (rather than simply asking them if they perform listed procedures and controls); what kind of errors they have

found; what happened as a result of finding the errors, and how the errors were resolved. If the person being interviewed has never found an error, the auditor should evaluate whether that situation is due to good preventive controls or whether the individual performing the control lacks the necessary skills.

- Whether they have ever been asked to override the process or controls, and if so, to describe the situation, why it occurred, and what happened.

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

Note: Unless significant changes in the process flow of transactions, including the supporting computer applications, make it more efficient for the auditor to prepare new documentation of a walkthrough, the auditor may carry his or her documentation forward each year, after updating it for any changes that have taken place.

83. *Identifying Controls to Test.* The auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others)^{14/} for all relevant assertions related to all significant accounts and disclosures in the financial statements. After identifying significant accounts, relevant assertions, and significant processes, the auditor should evaluate the following to identify the controls to be tested:

- Points at which errors or fraud could occur;
- The nature of the controls implemented by management;
- The significance of each control in achieving the objectives of the control criteria and whether more than one control achieves a particular objective or whether more than one control is necessary to achieve a particular objective; and
- The risk that the controls might not be operating effectively. Factors that affect whether the control might not be operating effectively include the following:

^{14/} See paragraphs 108 through 126 for additional direction on using the work of others.

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- Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness;
- Whether there have been changes in the design of controls;
- The degree to which the control relies on the effectiveness of other controls (for example, the control environment or information technology general controls);
- Whether there have been changes in key personnel who perform the control or monitor its performance;
- Whether the control relies on performance by an individual or is automated; and
- The complexity of the control.

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

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

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

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

87. Appendix B, paragraphs B1 through B17, provide additional direction to the auditor in determining which controls to test when a company has multiple locations or business units. In these circumstances, the auditor should determine significant accounts and their relevant assertions, significant processes, and major classes of transactions based on those that are relevant and significant to the consolidated financial statements. Having made those determinations in relation to the consolidated financial statements, the auditor should then apply the directions in Appendix B.

Testing and Evaluating Design Effectiveness

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

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

89. Procedures the auditor performs to test and evaluate design effectiveness include inquiry, observation, walkthroughs, inspection of relevant documentation, and a specific evaluation of whether the controls are likely to prevent or detect errors or fraud that could result in misstatements if they are operated as prescribed by appropriately qualified persons.

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

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

Testing and Evaluating Operating Effectiveness

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

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

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

95. Evaluating responses to inquiries is an integral part of the inquiry procedure. Examples of information that inquiries might provide include the skill and competency of those performing the control, the relative sensitivity of the control to prevent or detect errors or fraud, and the frequency with which the control operates to prevent or detect errors or fraud. Responses to inquiries might provide the auditor with information not previously possessed or with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information the auditor obtains (for example, information regarding the possibility of management override of controls). In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional procedures.

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

97. The nature of the control also influences the nature of the tests of controls the auditor can perform. For example, the auditor might examine documents regarding controls for which documentary evidence exists. However, documentary evidence regarding some aspects of the control environment, such as management's philosophy and operating style, might not exist. In circumstances in which documentary evidence of controls or the performance of controls does not exist and is not expected to exist,

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the auditor's tests of controls would consist of inquiries of appropriate personnel and observation of company activities. As another example, a signature on a voucher package to indicate that the signer approved it does not necessarily mean that the person carefully reviewed the package before signing. The package may have been signed based on only a cursory review (or without any review). As a result, the quality of the evidence regarding the effective operation of the control might not be sufficiently persuasive. If that is the case, the auditor should reperform the control (for example, checking prices, extensions, and additions) as part of the test of the control. In addition, the auditor might inquire of the person responsible for approving voucher packages what he or she looks for when approving packages and how many errors have been found within voucher packages. The auditor also might inquire of supervisors whether they have any knowledge of errors that the person responsible for approving the voucher packages failed to detect.

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

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

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

- The specific controls tested prior to the "as of" date and the results of those tests;

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

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

102. Prior to the date specified in management's report, management might implement changes to the company's controls to make them more effective or efficient or to address control deficiencies. In that case, the auditor might not need to evaluate controls that have been superseded. For example, if the auditor determines that the new controls achieve the related objectives of the control criteria and have been in effect for a sufficient period to permit the auditor to assess their design and operating effectiveness by performing tests of controls,^{15/} he or she will not need to evaluate the design and operating effectiveness of the superseded controls for purposes of expressing an opinion on internal control over financial reporting.

103. As discussed in paragraph 207, however, the auditor must communicate all identified significant deficiencies and material weaknesses in controls to the audit committee in writing. In addition, the auditor should evaluate how the design and operating effectiveness of the superseded controls relates to the auditor's reliance on controls for financial statement audit purposes.

104. *Extent of Tests of Controls.* Each year the auditor must obtain sufficient evidence about whether the company's internal control over financial reporting, including the controls for all internal control components, is operating effectively. This means that each year the auditor must obtain evidence about the effectiveness of controls for all relevant assertions related to all significant accounts and disclosures in the financial statements. The auditor also should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances. For example, each year the auditor might test

^{15/} Paragraph 179 provides reporting directions in these circumstances when the auditor has not been able to obtain evidence that the new controls were appropriately designed or have been operating effectively for a sufficient period of time.

the controls at a different interim period; increase or reduce the number and types of tests performed; or change the combination of procedures used.

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

- *Nature of the control.* The auditor should subject manual controls to more extensive testing than automated controls. In some circumstances, testing a single operation of an automated control may be sufficient to obtain a high level of assurance that the control operated effectively, provided that information technology general controls also are operating effectively. For manual controls, sufficient evidence about the operating effectiveness of the controls is obtained by evaluating multiple operations of the control and the results of each operation. The auditor also should assess the complexity of the controls, the significance of the judgments that must be made in connection with their operation, and the level of competence of the person performing the controls that is necessary for the control to operate effectively. As the complexity and level of judgment increase or the level of competence of the person performing the control decreases, the extent of the auditor's testing should increase.
- *Frequency of operation.* Generally, the more frequently a manual control operates, the more operations of the control the auditor should test. For example, for a manual control that operates in connection with each transaction, the auditor should test multiple operations of the control over a sufficient period of time to obtain a high level of assurance that the control operated effectively. For controls that operate less frequently, such as monthly account reconciliations and controls over the period-end financial reporting process, the auditor may test significantly fewer operations of the control. However, the auditor's evaluation of each operation of controls operating less frequently is likely to be more extensive. For example, when evaluating the operation of a monthly exception report, the auditor should evaluate whether the judgments made with regard to the disposition of the exceptions were appropriate and adequately supported.

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

- *Importance of the control.* Controls that are relatively more important should be tested more extensively. For example, some controls may

address multiple financial statement assertions, and certain period-end detective controls might be considered more important than related preventive controls. The auditor should test more operations of such controls or, if such controls operate infrequently, the auditor should evaluate each operation of the control more extensively.

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

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

Using the Work of Others

108. In all audits of internal control over financial reporting, the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. The auditor may, however, use the work of others to alter the nature, timing, or extent of the work he or she otherwise would have performed. For these purposes, the work of others includes relevant work performed by internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee that provides information about the effectiveness of internal control over financial reporting.

Note: Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to

precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work he or she performed on pervasive controls and in areas such as the control environment than on other controls, such as controls over low-risk, routine transactions.

109. The auditor should evaluate whether to use the work performed by others in the audit of internal control over financial reporting. To determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor would have otherwise performed, in addition to obtaining the principal evidence for his or her opinion, the auditor should:

- a. Evaluate the nature of the controls subjected to the work of others (See paragraphs 112 through 116);
- b. Evaluate the competence and objectivity of the individuals who performed the work (See paragraphs 117 through 122); and
- c. Test some of the work performed by others to evaluate the quality and effectiveness of their work (See paragraphs 123 through 125).

Note: AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, applies to using the work of internal auditors in an audit of the financial statements. The auditor may apply the relevant concepts described in that section to using the work of others in the audit of internal control over financial reporting.

110. The auditor must obtain sufficient evidence to support his or her opinion. Judgments about the sufficiency of evidence obtained and other factors affecting the auditor's opinion, such as the significance of identified control deficiencies, should be those of the auditor. Evidence obtained through the auditor's direct personal knowledge, observation, reperformance, and inspection is generally more persuasive than information obtained indirectly from others, such as from internal auditors, other company personnel, or third parties working under the direction of management.

111. The requirement that the auditor's own work must provide the principal evidence for the auditor's opinion is one of the boundaries within which the auditor determines the work he or she must perform himself or herself in the audit of internal control over financial reporting. Paragraphs 112 through 125 provide more specific and definitive direction on how the auditor makes this determination, but the directions allow the auditor significant flexibility to use his or her judgment to determine the work necessary to obtain the principal evidence and to determine when the auditor can use the work of others rather than perform the work himself or herself. Regardless of the auditor's determination of the work that he or she must perform himself or herself, the auditor's

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responsibility to report on the effectiveness of internal control over financial reporting rests solely with the auditor; this responsibility cannot be shared with the other individuals whose work the auditor uses. Therefore, when the auditor uses the work of others, the auditor is responsible for the results of their work.

112. *Evaluating the Nature of the Controls Subjected to the Work of Others.* The auditor should evaluate the following factors when evaluating the nature of the controls subjected to the work of others. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance, the need for the auditor to perform his or her own work on those controls decreases.

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.
- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).
- The pervasiveness of the control.
- The level of judgment or estimation required in the account or disclosure.
- The potential for management override of the control.

113. Because of the nature of the controls in the control environment, the auditor should not use the work of others to reduce the amount of work he or she performs on controls in the control environment. The auditor should, however, consider the results of work performed in this area by others because it might indicate the need for the auditor to increase his or her work.

114. The control environment encompasses the following factors:^{16/}

- Integrity and ethical values;
- Commitment to competence;
- Board of directors or audit committee participation;

^{16/} See the COSO report and paragraph .110 of AU sec. 319, *Internal Control in a Financial Statement Audit*, for additional information about the factors included in the control environment.

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- Management's philosophy and operating style;
- Organizational structure;
- Assignment of authority and responsibility; and
- Human resource policies and procedures.

115. Controls that are part of the control environment include, but are not limited to, controls specifically established to prevent and detect fraud that is at least reasonably possible to result in material misstatement of the financial statements.

Note: The term "reasonably possible" has the same meaning as in FAS No. 5. See the first note to paragraph 9 for further discussion.

116. The auditor should perform the walkthroughs (as discussed beginning at paragraph 79) himself or herself because of the degree of judgment required in performing this work. However, to provide additional evidence, the auditor may also review the work of others who have performed and documented walkthroughs. In evaluating whether his or her own evidence provides the principal evidence, the auditor's work on the control environment and in performing walkthroughs constitutes an important part of the auditor's own work.

117. *Evaluating the Competence and Objectivity of Others.* The extent to which the auditor may use the work of others depends on the degree of competence and objectivity of the individuals performing the work. The higher the degree of competence and objectivity, the greater use the auditor may make of the work; conversely, the lower the degree of competence and objectivity, the less use the auditor may make of the work. Further, the auditor should not use the work of individuals who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of individuals who have a low level of competence regardless of their degree of objectivity.

118. When evaluating the competence and objectivity of the individuals performing the tests of controls, the auditor should obtain, or update information from prior years, about the factors indicated in the following paragraph. The auditor should determine whether to test the existence and quality of those factors and, if so, the extent to which to test the existence and quality of those factors, based on the intended effect of the work of others on the audit of internal control over financial reporting.

119. Factors concerning the competence of the individuals performing the tests of controls include:

- Their educational level and professional experience.

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- Their professional certification and continuing education.
- Practices regarding the assignment of individuals to work areas.
- Supervision and review of their activities.
- Quality of the documentation of their work, including any reports or recommendations issued.
- Evaluation of their performance.

120. Factors concerning the objectivity of the individuals performing the tests of controls include:

- The organizational status of the individuals responsible for the work of others ("testing authority") in testing controls, including—
 - a. Whether the testing authority reports to an officer of sufficient status to ensure sufficient testing coverage and adequate consideration of, and action on, the findings and recommendations of the individuals performing the testing.
 - b. Whether the testing authority has direct access and reports regularly to the board of directors or the audit committee.
 - c. Whether the board of directors or the audit committee oversees employment decisions related to the testing authority.
- Policies to maintain the individuals' objectivity about the areas being tested, including—
 - a. Policies prohibiting individuals from testing controls in areas in which relatives are employed in important or internal control-sensitive positions.
 - b. Policies prohibiting individuals from testing controls in areas to which they were recently assigned or are scheduled to be assigned upon completion of their controls testing responsibilities.

121. Internal auditors normally are expected to have greater competence with regard to internal control over financial reporting and objectivity than other company personnel. Therefore, the auditor may be able to use their work to a greater extent than the work of other company personnel. This is particularly true in the case of internal auditors who

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follow the *International Standards for the Professional Practice of Internal Auditing* issued by the Institute of Internal Auditors. If internal auditors have performed an extensive amount of relevant work and the auditor determines they possess a high degree of competence and objectivity, the auditor could use their work to the greatest extent an auditor could use the work of others. On the other hand, if the internal audit function reports solely to management, which would reduce internal auditors' objectivity, or if limited resources allocated to the internal audit function result in very limited testing procedures on its part or reduced competency of the internal auditors, the auditor should use their work to a much lesser extent and perform more of the testing himself or herself.

122. When determining how the work of others will alter the nature, timing, or extent of the auditor's work, the auditor should assess the interrelationship of the nature of the controls, as discussed in paragraph 112, and the competence and objectivity of those who performed the work, as discussed in paragraphs 117 through 121. As the significance of the factors listed in paragraph 112 increases, the ability of the auditor to use the work of others decreases at the same time that the necessary level of competence and objectivity of those who perform the work increases. For example, for some pervasive controls, the auditor may determine that using the work of internal auditors to a limited degree would be appropriate and that using the work of other company personnel would not be appropriate because other company personnel do not have a high enough degree of objectivity as it relates to the nature of the controls.

123. *Testing the Work of Others.* The auditor should test some of the work of others to evaluate the quality and effectiveness of the work. The auditor's tests of the work of others may be accomplished by either (a) testing some of the controls that others tested or (b) testing similar controls not actually tested by others.

124. The nature and extent of these tests depend on the effect of the work of others on the auditor's procedures but should be sufficient to enable the auditor to make an evaluation of the overall quality and effectiveness of the work the auditor is considering. The auditor also should assess whether this evaluation has an effect on his or her conclusions about the competence and objectivity of the individuals performing the work.

125. In evaluating the quality and effectiveness of the work of others, the auditor should evaluate such factors as to whether the:

- Scope of work is appropriate to meet the objectives.
- Work programs are adequate.
- Work performed is adequately documented, including evidence of supervision and review.

- Conclusions are appropriate in the circumstances.
- Reports are consistent with the results of the work performed.

126. The following examples illustrate how to apply the directions discussed in this section:

- *Controls over the period-end financial reporting process.* Many of the controls over the period-end financial reporting process address significant risks of misstatement of the accounts and disclosures in the annual and quarterly financial statements, may require significant judgment to evaluate their operating effectiveness, may have a higher potential for management override, and may affect accounts that require a high level of judgment or estimation. Therefore, the auditor could determine that, based on the nature of controls over the period-end financial reporting process, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the work is high; therefore, the auditor might use the work of internal auditors to some extent but not the work of others within the company.
- *Information technology general controls.* Information technology general controls are part of the control activities component of internal control; therefore, the nature of the controls might permit the auditor to use the work of others. For example, program change controls over routine maintenance changes may have a highly pervasive effect, yet involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. Therefore, the auditor could determine that, based on the nature of these program change controls, the auditor could use the work of others to a moderate extent so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. On the other hand, controls to detect attempts to override controls that prevent unauthorized journal entries from being posted may have a highly pervasive effect, may involve a high degree of judgment in evaluating their operating effectiveness, may involve a subjective evaluation, and may have a reasonable possibility for management override. Therefore, the auditor could determine that, based on the nature of these controls over systems access, he or she would need to perform more of the tests of those controls himself or herself. Further, because of the nature of the controls, the auditor should use the work of others only if the degree of competence and objectivity of the individuals performing the tests is high.

- *Management self-assessment of controls.* As described in paragraph 40, management may test the operating effectiveness of controls using a self-assessment process. Because such an assessment is made by the same personnel who are responsible for performing the control, the individuals performing the self-assessment do not have sufficient objectivity as it relates to the subject matter. Therefore, the auditor should not use their work.
- *Controls over the calculation of depreciation of fixed assets.* Controls over the calculation of depreciation of fixed assets are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, and can be subjected to objective testing. If these conditions describe the controls over the calculation of depreciation of fixed assets and if there is a low potential for management override, the auditor could determine that, based on the nature of these controls, the auditor could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level.
- *Alternating tests of controls.* Many of the controls over accounts payable, including controls over cash disbursements, are usually not pervasive, involve a low degree of judgment in evaluating their operating effectiveness, can be subjected to objective testing, and have a low potential for management override. When these conditions describe the controls over accounts payable, the auditor could determine that, based on the nature of these controls, he or she could use the work of others to a large extent (perhaps entirely) so long as the degree of competence and objectivity of the individuals performing the test is at an appropriate level. However, if the company recently implemented a major information technology change that significantly affected controls over cash disbursements, the auditor might decide to use the work of others to a lesser extent in the audit immediately following the information technology change and then return, in subsequent years, to using the work of others to a large extent in this area. As another example, the auditor might use the work of others for testing controls over the depreciation of fixed assets (as described in the point above) for several years' audits but decide one year to perform some extent of the work himself or herself to gain an understanding of these controls beyond that provided by performing a walkthrough.

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

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

- The adequacy of the assessment performed by management and the results of the auditor's evaluation of the design and tests of operating effectiveness of controls;
- The negative results of substantive procedures performed during the financial statement audit (for example, recorded and unrecorded adjustments identified as a result of the performance of the auditing procedures); and
- Any identified control deficiencies.

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

129. *Issuing an Unqualified Opinion.* The auditor may issue an unqualified opinion only when there are no identified material weaknesses and when there have been no restrictions on the scope of the auditor's work. The existence of a material weakness requires the auditor to express an adverse opinion on the effectiveness of internal control over financial reporting (See paragraph 175), while a scope limitation requires the auditor to express a qualified opinion or a disclaimer of opinion, depending on the significance of the limitation in scope (See paragraph 178).

130. *Evaluating Deficiencies in Internal Control Over Financial Reporting.* The auditor must evaluate identified control deficiencies and determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses. The evaluation of the significance of a deficiency should include both quantitative and qualitative factors.

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

- The likelihood that a deficiency, or a combination of deficiencies, could result in a misstatement of an account balance or disclosure; and

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

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

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

- The nature of the financial statement accounts, disclosures, and assertions involved; for example, suspense accounts and related party transactions involve greater risk.
- The susceptibility of the related assets or liability to loss or fraud; that is, greater susceptibility increases risk.
- The subjectivity, complexity, or extent of judgment required to determine the amount involved; that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk.
- The cause and frequency of known or detected exceptions for the operating effectiveness of a control; for example, a control with an observed non-negligible deviation rate is a deficiency.
- The interaction or relationship of the control with other controls; that is, the interdependence or redundancy of the control.
- The interaction of the deficiencies; for example, when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement accounts and assertions.
- The possible future consequences of the deficiency.

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

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

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

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

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

Note: Paragraphs 9 and 10 provide the definitions of significant deficiency and material weakness, respectively.

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

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

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

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

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

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

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

- Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)
- Oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective. (Paragraphs 55 through 59 present factors to evaluate when determining whether the audit committee is ineffective.)
- The internal audit function or the risk assessment function is ineffective at a company for which such a function needs to be effective for the

company to have an effective monitoring or risk assessment component, such as for very large or highly complex companies.

Note: The evaluation of the internal audit or risk assessment functions is similar to the evaluation of the audit committee, as described in paragraphs 55 through 59, that is, the evaluation is made within the context of the monitoring and risk assessment components. The auditor is not required to make a separate evaluation of the effectiveness and performance of these functions. Instead, the auditor should base his or her evaluation on evidence obtained as part of evaluating the monitoring and risk assessment components of internal control over financial reporting.

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

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

- Significant deficiencies that have been communicated to management and the audit committee remain uncorrected after some reasonable period of time.
- An ineffective control environment.

141. Appendix D provides examples of significant deficiencies and material weaknesses.

Requirement for Written Representations

142. 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 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 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 assessment, 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 material fraud and any other fraud that, although not material, involves senior management or management or other employees who have a significant role in the company's internal control over financial reporting;
- g. Stating whether control deficiencies identified and communicated to the audit committee during previous engagements pursuant to paragraph 207 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.

143. The failure to obtain written representations from management, including management's refusal to furnish them, constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion. As discussed further in paragraph 178, when management limits the scope of the audit, the auditor should either withdraw from the engagement or disclaim an opinion. Further, the auditor should evaluate the effects of management's refusal on his or her ability to rely on other representations, including, if applicable, representations obtained in an audit of the company's financial statements.

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

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

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

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

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

147. 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 whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole*.

148. To express an opinion on internal control over financial reporting effectiveness as of a *point in time*, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting effectiveness *taken as a whole*, the auditor must obtain evidence about the effectiveness of controls over all relevant assertions related to all significant accounts and disclosures in the financial

statements. 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.

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

Tests of Controls in an Audit of Financial Statements

150. 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.^{18/}

151. 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 management's assessment, as discussed in paragraphs 147 through 149. 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.

Effect of Tests of Controls on Substantive Procedures

152. 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 related to all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

153. The substantive procedures that the auditor should perform consist of tests of details of transactions and balances and analytical procedures. Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the

^{18/} See paragraph 160 for additional documentation requirements when the auditor assesses control risk as other than low.

substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information. For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

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

155. The auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements. Also, other auditing standards require auditors to perform specific tests of details in the financial statement audit. For instance, AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to perform certain tests of details to further address the risk of management override, whether or not a specific risk of fraud has been identified. Paragraph .34 of AU Sec. 330, *The Confirmation Process*, states that there is a presumption that the auditor will request the confirmation of accounts receivable. Similarly, paragraph .01 of AU Sec. 331, *Inventories*, states that observation of inventories is a generally accepted auditing procedure and that the auditor who issues an opinion without this procedure "has the burden of justifying the opinion expressed."

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

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

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

- The auditor's risk evaluations in connection with the selection and application of substantive procedures, especially those related to fraud (See paragraph 26);

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

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

Documentation Requirements

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

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

160. For a company that has effective internal control over financial reporting, the auditor ordinarily will be able to perform sufficient testing of controls to be able to assess control risk for all relevant assertions related to significant accounts and disclosures at a low level. If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that

conclusion. Examples of when it is appropriate to assess control risk as other than low include:

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

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

Reporting on Internal Control Over Financial Reporting

Management's Report

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

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

^{19/} See Item 308(a) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

163. Management should provide, both in its report on internal control over financial reporting and in its representation letter to the auditor, a written conclusion about the effectiveness of the company's internal control over financial reporting. The conclusion about the effectiveness of a company's internal control over financial reporting can take many forms; however, management is required to state a direct conclusion about whether the company's internal control over financial reporting is effective. This standard, for example, includes the phrase "management's assessment that W Company maintained effective internal control over financial reporting as of [date]" to illustrate such a conclusion. Other phrases, such as "management's assessment that W Company's internal control over financial reporting as of [date] is sufficient to meet the stated objectives," also might be used. However, the conclusion should not be so subjective (for example, "very effective internal control") that people having competence in and using the same or similar criteria would not ordinarily be able to arrive at similar conclusions.

164. Management is precluded from concluding that the company's internal control over financial reporting is effective if there are one or more material weaknesses.^{20/} In addition, management is required to disclose all material weaknesses that exist as of the end of the most recent fiscal year.

165. Management might be able to accurately represent that internal control over financial reporting, as of the end of the company's most recent fiscal year, is effective even if one or more material weaknesses existed during the period. To make this representation, management must have changed the internal control over financial reporting to eliminate the material weaknesses sufficiently in advance of the "as of" date and have satisfactorily tested the effectiveness over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation of internal control over financial reporting is effective.^{21/}

²⁰ See Item 308(a)(3) of Regulation S-B and S-K, 17 C.F.R. 228.308(a) and 17 C.F.R. 229.308(a), respectively.

²¹ However, when the reason for a change in internal control over financial reporting is the correction of a material weakness, management and the auditor should evaluate whether the reason for the change and the circumstances surrounding the change are material information necessary to make the disclosure about the change not misleading in a filing subject to certification under Securities Exchange Act Rule 13a-14(a) or 15d-14(a), 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a). See discussion beginning at paragraph 200 for further direction.

Auditor's Evaluation of Management's Report

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

- a. Whether management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting.
- b. Whether the framework used by management to conduct the evaluation is suitable. (As discussed in paragraph 14, the framework described in COSO constitutes a suitable and available framework.)
- c. Whether management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year, is free of material misstatement.
- d. Whether management has expressed its assessment in an acceptable form.
 - Management is required to state whether the company's internal control over financial reporting is effective.
 - A negative assurance statement indicating that, "Nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective," is not acceptable.
 - Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.
- e. Whether material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed, including material weaknesses corrected during the period.^{22/}

^{22/} See paragraph 206 for direction when a material weakness was corrected during the fourth quarter and the auditor believes that modification to the disclosures about changes in internal control over financial reporting are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of the Act.

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

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

- a. A title that includes the word *independent*;
- b. An identification of management's conclusion about the effectiveness of the company's internal control over financial reporting as of a specified date based on the control criteria [for example, criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)];
- c. An identification of the title of the management report that includes management's assessment (the auditor should use the same description of the company's internal control over financial reporting as management uses in its report);
- d. A statement that the assessment is the responsibility of management;
- e. A statement that the auditor's responsibility is to express an opinion on the assessment and an opinion on the company's internal control over financial reporting based on his or her audit;
- f. A definition of internal control over financial reporting as stated in paragraph 7;
- g. A statement that the audit was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States);
- h. A statement that the standards of the Public Company Accounting Oversight Board require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;
- i. A statement that an audit includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the auditor considered necessary in the circumstances;

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- j. A statement that the auditor believes the audit provides a reasonable basis for his or her opinions;
- k. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;
- l. The auditor's opinion on whether management's assessment of the effectiveness of the company's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria (See discussion beginning at paragraph 162);
- m. 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;
- n. The manual or printed signature of the auditor's firm;
- o. 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
- p. The date of the audit report.

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

169. *Separate or Combined Reports.* The auditor may choose to issue a combined report (that is, one report containing both an opinion on the financial statements and the opinions on internal control over financial reporting) or separate reports on the company's financial statements and on internal control over financial reporting. Example A-7 in Appendix A is an illustrative combined audit report on internal control over financial reporting. Appendix A also includes examples of separate reports on internal control over financial reporting.

170. 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:

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

and add the following paragraph to the report on internal control over financial reporting:

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

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

172. When the auditor elects to issue a combined report on the audit of the financial statements and the audit of internal control over financial reporting, the audit opinion will address multiple reporting periods for the financial statements presented but only the end of the most recent fiscal year for the effectiveness of internal control over financial reporting and management's assessment of the effectiveness of internal control over financial reporting. See a combined report in Example A-7 in Appendix A.

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

- a. Management's assessment is inadequate or management's report is inappropriate. (See paragraph 174.)
- b. There is a material weakness in the company's internal control over financial reporting. (See paragraphs 175 through 177.)
- c. There is a restriction on the scope of the engagement. (See paragraphs 178 through 181.)
- d. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report. (See paragraphs 182 through 185.)
- e. A significant subsequent event has occurred since the date being reported on. (See paragraphs 186 through 189.)

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- f. There is other information contained in management's report on internal control over financial reporting. (See paragraphs 190 through 192.)

174. *Management's Assessment Inadequate or Report Inappropriate.* If the auditor determines that management's process for assessing internal control over financial reporting is inadequate, the auditor should modify his or her opinion for a scope limitation (discussed further beginning at paragraph 178). If the auditor determines that management's report is inappropriate, the auditor should modify his or her report to include, at a minimum, an explanatory paragraph describing the reasons for this conclusion.

175. *Material Weaknesses.* Paragraphs 130 through 141 describe significant deficiencies and material weaknesses. If there are significant deficiencies that, individually or in combination, result in one or more material weaknesses, management is precluded from concluding that internal control over financial reporting is effective. In these circumstances, the auditor must express an adverse opinion on the company's internal control over financial reporting.

176. When expressing an adverse opinion on the effectiveness of 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 10.
- A statement that a material weakness has been identified and included in management's assessment. (If the material weakness has not been included in management's assessment, this sentence should be modified to state that the material weakness has been identified but not included in management's assessment. In this case, the auditor also is required to communicate in writing to the audit committee that the material weakness was not disclosed or identified as a material weakness in management's report.)
- A description of any material weaknesses identified in a company's internal control over financial reporting. This description should provide the users of the audit report with specific information about the nature of any material weakness, and its actual and potential effect on the presentation of the company's financial statements issued during the existence of the weakness. This description also should address requirements described in paragraph 194.

177. Depending on the circumstances, the auditor may express both an unqualified opinion and an other-than-unqualified opinion within the same report on internal control over financial reporting. For example, if management makes an adverse assessment because a material weakness has been identified and not corrected ("...internal control

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over financial reporting is not effective..."), the auditor would express an unqualified opinion on management's assessment ("...management's assessment that internal control over financial reporting is not effective is fairly stated, in all material respects..."). At the same time, the auditor would express an adverse opinion about the effectiveness of internal control over financial reporting ("In our opinion, because of the effect of the material weakness described..., the company's internal control over financial reporting is not effective."). Example A-2 in Appendix A illustrates the form of the report that is appropriate in this situation. Example A-6 in Appendix A illustrates a report that reflects disagreement between management and the auditor that a material weakness exists.

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

179. For example, management might have identified a material weakness in its internal control over financial reporting prior to the date specified in its report and implemented controls to correct it. If management believes that the new controls have been operating for a sufficient period of time to determine that they are both effectively designed and operating, management would be able to include in its assessment its conclusion that internal control over financial reporting is effective as of the date specified. However, if the auditor disagrees with the sufficiency of the time period, he or she would be unable to obtain sufficient evidence that the new controls have been operating effectively for a sufficient period. In that case, the auditor should modify the opinion on the effectiveness of internal control over financial reporting and the opinion on management's assessment of internal control over financial reporting because of a scope limitation.

180. 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 should include:

- The definition of a material weakness, as provided in paragraph 10.

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- 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 194.

181. Example A-3 in Appendix A illustrates the form of report when there is a limitation on the scope of the audit causing the auditor to issue qualified opinions. Example A-4 illustrates the form of report when restrictions on the scope of the audit cause the auditor to disclaim opinions.

182. *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 opinions. AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, provides direction on the auditor's decision of whether to serve as the principal auditor of the financial statements. If the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. This relationship results from the requirement that an audit of the financial statements must be performed to audit internal control over financial reporting; only the principal auditor of the financial statements can be the principal auditor of internal control over financial reporting. In this circumstance, the principal auditor of the financial statements needs to participate sufficiently in the audit of internal control over financial reporting to provide a basis for serving as the principal auditor of internal control over financial reporting.

183. 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 similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on a company's financial statements as described in AU sec. 543.

184. 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

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management's evaluation of internal control over financial reporting ordinarily would not extend to controls at the equity method investee.^{23/}

185. When the auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinions, the auditor should refer to the report of the other auditor when describing the scope of the audit and when expressing the opinions.

186. *Subsequent Events.* Changes in internal control over financial reporting or other factors that might significantly affect internal control over financial reporting might occur subsequent to the date as of which internal control over financial reporting is being audited but before the date of the auditor's report. The auditor should inquire of management whether there were any such changes or factors. As described in paragraph 142, the auditor should obtain written representations from management relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the company's internal control over financial reporting and, therefore, the auditor's report, the auditor should inquire about and examine, for this subsequent period, the following:

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

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

188. 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 the effectiveness of internal control over financial reporting (and issue an adverse opinion on management's assessment of internal control over financial reporting if management's report does not appropriately assess the affect of the

^{23/} See Appendix B, paragraph B15, for further discussion of the evaluation of the controls over financial reporting for an equity method investment.

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subsequent event). 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 opinions. As described in paragraph 190, 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.

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

190. *Management's Report Containing Additional Information.* Management's report on internal control over financial reporting may contain information in addition to management's assessment of the effectiveness of its internal control over financial reporting. Such information might include, for example:

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

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

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

192. If the auditor believes that management's additional information contains a material misstatement of fact, he or she should discuss the matter with management. If the auditor concludes that there is a valid basis for concern, he or she should propose that management consult with some other party whose advice might be useful, such as the company's legal counsel. If, after discussing the matter with management and

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those management has consulted, the auditor concludes that a material misstatement of fact remains, the auditor should notify management and the audit committee, in writing, of the auditor's views concerning the information. The auditor also should consider consulting the auditor's legal counsel about further actions to be taken, including the auditor's responsibility under Section 10A of the Securities Exchange Act of 1934.^{24/}

Note: If management makes the types of disclosures described in paragraph 190 outside its 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, as described in paragraph 191. However, in that situation, the auditor's responsibilities are the same as those described in paragraph 192 if the auditor believes that the additional information contains a material misstatement of fact.

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

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

This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements, and this report does not affect our report dated [*date of report*] on those financial statements. [*Revise this wording appropriately for use in a combined report.*]

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

^{24/} See Section 10A of the Securities Exchange Act of 1934, 15 U.S.C. 78j-1.

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196. Disclosure is also important when the auditor's opinion on the financial statements is affected by the adverse opinion on the effectiveness of internal control over financial reporting. In that circumstance, the report on internal control over financial reporting (or the combined report, if a combined report is issued) should include the following or similar language in the paragraph that describes the material weakness:

This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 20X3 financial statements.

197. *Subsequent Discovery of Information Existing at the Date of the Auditor's Report on Internal Control Over Financial Reporting.* After the issuance of the report on internal control over financial reporting, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinions had he or she been aware of them. The auditor's evaluation of such subsequent information is similar to the auditor's evaluation of information discovered subsequent to the date of the report on an audit of financial statements, as described in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*. That standard requires the auditor to determine whether the information is reliable and whether the facts existed at the date of his or her report. If so, the auditor should determine (1) whether the facts would have changed the report if he or she had been aware of them and (2) whether there are persons currently relying on or likely to rely on the auditor's report. For instance, if previously issued financial statements and the auditor's report have been recalled and reissued to reflect the correction of a misstatement, the auditor should presume that his or her report on the company's internal control over financial reporting as of same specified date also should be recalled and reissued to reflect the material weakness that existed at that date. Based on these considerations, paragraph .06 of AU sec. 561 provides detailed requirements for the auditor.

198. *Filings Under Federal Securities Statutes.* AU sec. 711, *Filings Under Federal Securities Statutes*, describes the auditor's responsibilities when an auditor's report is included in registration statements, proxy statements, or periodic reports filed under the federal securities statutes. The auditor should also apply AU sec. 711 with respect to the auditor's report on management's assessment of the effectiveness of internal control over financial reporting included in such filings. In addition, the direction in paragraph .10 of AU sec. 711 to inquire of and obtain written representations from officers and other executives responsible for financial and accounting matters about whether any events have occurred that have a material effect on the audited financial statements should be extended to matters that could have a material effect on management's assessment of internal control over financial reporting.

199. When the auditor has fulfilled these responsibilities and intends to consent to the inclusion of his or her report on management's assessment of the effectiveness of internal control over financial reporting in the securities filing, the auditor's consent

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

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

Required Management Certifications

200. Section 302 of the Act, and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies,^{25/} requires a company's management, with the participation of the principal executive and financial officers (the certifying officers), to make the following quarterly and annual certifications with respect to the company's internal control over financial reporting:

- A statement that the certifying officers are responsible for establishing and maintaining internal control over financial reporting;
- A statement that the certifying officers have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles; and
- A statement that the report discloses any changes in the company's internal control over financial reporting that occurred during the most recent fiscal quarter (the company's fourth fiscal quarter in the case of an annual report) that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting.

201. When the reason for a change in internal control over financial reporting is the correction of a material weakness, management has a responsibility to determine and the auditor should evaluate whether the reason for the change and the circumstances surrounding that change are material information necessary to make the disclosure about the change not misleading.^{26/}

^{25/} See 17 C.F.R., 240.13a-14a or 15d-14a, whichever applies.

^{26/} See Securities Exchange Act Rule 12b-20, 17 C.F.R. 240.12b-20.

Auditor Evaluation Responsibilities

202. 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.

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

- Inquire of management about significant changes in the design or operation of internal control over financial reporting as it relates to the preparation of annual as well as interim financial information that could have occurred subsequent to the preceding annual audit or prior review of interim financial information;
- Evaluate the implications of misstatements identified by the auditor as part of the auditor's required review of interim financial information (See AU sec. 722, *Interim Financial Information*) as it relates to effective internal control over financial reporting; and
- Determine, 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.

Note: Foreign private issuers filing Forms 20-F and 40-F are not subject to quarterly reporting requirements, therefore, the auditor's responsibilities would extend only to the certifications in the annual report of these companies.

204. When matters come to auditor's attention that lead him or her to believe that modification to the disclosures about changes in internal control over financial reporting 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,^{27/} the auditor should communicate the matter(s) to the appropriate level of management as soon as practicable.

^{27/} See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

205. If, in the auditor's judgment, management does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should inform the audit committee. If, in the auditor's judgment, the audit committee does not respond appropriately to the auditor's communication within a reasonable period of time, the auditor should evaluate whether to resign from the engagement. The auditor should evaluate whether to consult with his or her attorney when making these evaluations. In these circumstances, the auditor also has responsibilities under AU sec. 317, *Illegal Acts by Clients*, and Section 10A of the Securities Exchange Act of 1934.^{28/} The auditor's responsibilities for evaluating the disclosures about changes in internal control over financial reporting do not diminish in any way management's responsibility for ensuring that its certifications comply with the requirements of Section 302 of the Act and Securities Exchange Act Rule 13a-14(a) or 15d-14(a), whichever applies.^{29/}

206. 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,^{30/} the auditor should follow the same communication responsibilities as described in paragraphs 204 and 205. However, if management and the audit committee do not respond appropriately, in addition to the responsibilities described in the preceding two paragraphs, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons the auditor believes management's disclosures should be modified.

Required Communications in An Audit of Internal Control Over Financial Reporting

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

^{28/} See 15 U.S.C. 78j-1.

^{29/} See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

^{30/} See 17 C.F.R. 240.13a-14(a) or 17 C.F.R. 240.15d-14(a), whichever applies.

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those considered to be material weaknesses, as defined in paragraphs 9 and 10, respectively.

208. If a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

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

Note: As part of his or her evaluation of the effectiveness of internal control over financial reporting, the auditor should determine whether control deficiencies identified by internal auditors and others within the company, for example, through ongoing monitoring activities and the annual assessment of internal control over financial reporting, are reported to appropriate levels of management in a timely manner. The lack of an internal process to report deficiencies in internal control to management on a timely basis represents a control deficiency that the auditor should evaluate as to severity.

210. These written communications should state that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory agencies may be made.

211. These written communications also should include the definitions of control deficiencies, significant deficiencies, and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.

212. Because of the potential for misinterpretation of the limited degree of assurance associated with the auditor issuing a written report representing that no significant deficiencies were noted during an audit of internal control over financial reporting, the auditor should not issue such representations.

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213. When auditing internal control over financial reporting, the auditor may become aware of fraud or possible illegal acts. If the matter involves fraud, it must be brought to the attention of the appropriate level of management. If the fraud involves senior management, the auditor must communicate the matter directly to the audit committee as described in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*. If the matter involves possible illegal acts, the auditor must assure himself or herself that the audit committee is adequately informed, unless the matter is clearly inconsequential, in accordance with AU sec. 317, *Illegal Acts by Clients*. The auditor also must determine his or her responsibilities under Section 10A of the Securities Exchange Act of 1934.^{31/}

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

Effective Date

215. Companies considered *accelerated filers* under Securities Exchange Act Rule 12b-2^{32/} are required to comply with the internal control reporting and disclosure requirements of Section 404 of the Act *for fiscal years ending on or after November 15, 2004*. (Other companies have until fiscal years ending on or after July 15, 2005, to comply with these internal control reporting and disclosure requirements.) Accordingly, independent auditors engaged to audit the financial statements of accelerated filers for fiscal years ending on or after November 15, 2004, also are required to audit and report on the company's internal control over financial reporting as of the end of such fiscal year. This standard is required to be complied with for such engagements, except as it relates to the auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting. The auditor's responsibilities for evaluating management's certification disclosures about internal control over financial reporting described in paragraphs 202 through 206 take effect beginning with the first quarter after the auditor's first audit report on the company's internal control over financial reporting.

216. Early compliance with this standard is permitted.

^{31/} See 15 U.S.C. 78j-1.

^{32/} See 17 C.F.R. 240.12b-2.

APPENDIX A

Illustrative Reports on Internal Control Over Financial Reporting

A1. Paragraphs 167 through 199 of this standard provide direction on the auditor's report on management's assessment of internal control over financial reporting. The following examples illustrate how to apply that direction in several different situations.

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Example A-1

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

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

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

[Scope paragraph]

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

[Definition paragraph]

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

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

[Inherent limitations paragraph]

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

[Opinion paragraph]

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

[Explanatory paragraph]

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

[Signature]

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[City and State or Country]

[Date]

Example A-2

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

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

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

[Scope paragraph]

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

[Definition paragraph]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in

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reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

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

[Explanatory paragraph]

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

[Opinion paragraph]

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

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

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

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-3

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

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

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

[Scope paragraph]

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

[Explanatory paragraph that describes scope limitation]

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

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

[Definition paragraph]

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

[Inherent limitations paragraph]

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

[Opinion paragraph]

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

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

[*Explanatory paragraph*]

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

[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-4

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

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

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

[Omit scope paragraph]

[Explanatory paragraph that describes scope limitation]^{1/}

[Definition paragraph]

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

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

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

[Inherent limitations paragraph]

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

[Opinion paragraph]

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

[Explanatory paragraph]

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

[Signature]

[City and State or Country]

[Date]

Example A-5

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

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

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

[Scope paragraph]

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

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[Definition paragraph]

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

[Inherent limitations paragraph]

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

[Opinion paragraph]

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

[Explanatory paragraph]

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

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[*Signature*]

[*City and State or Country*]

[*Date*]

Example A-6

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

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

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

[Scope paragraph]

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

[Definition paragraph]

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

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assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

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

[Explanatory paragraph]

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

[Opinion paragraph]

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

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

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

[Signature]

[City and State or Country]

[Date]

Example A-7

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

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

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

[Scope paragraph]

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

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[Definition paragraph]

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

[Inherent limitations paragraph]

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

[Opinion paragraph]

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

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[Date]

APPENDIX B

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

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

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

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

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

Locations or Business Units That Are Financially Significant

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

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

Locations or Business Units That Involve Specific Risks

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

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

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

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

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

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

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

- The effectiveness of the control environment, particularly management's direct control over the exercise of authority delegated to others and its ability to effectively supervise activities at the various locations or business units. An ineffective control environment over the locations or business units might constitute a material weakness.
- The nature and amount of transactions executed and related assets at the various locations or business units.
- The potential for material unrecognized obligations to exist at a location or business unit and the degree to which the location or business unit could create an obligation on the part of the company.
- Management's risk assessment process and analysis for excluding a location or business unit from its assessment of internal control over financial reporting.

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

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

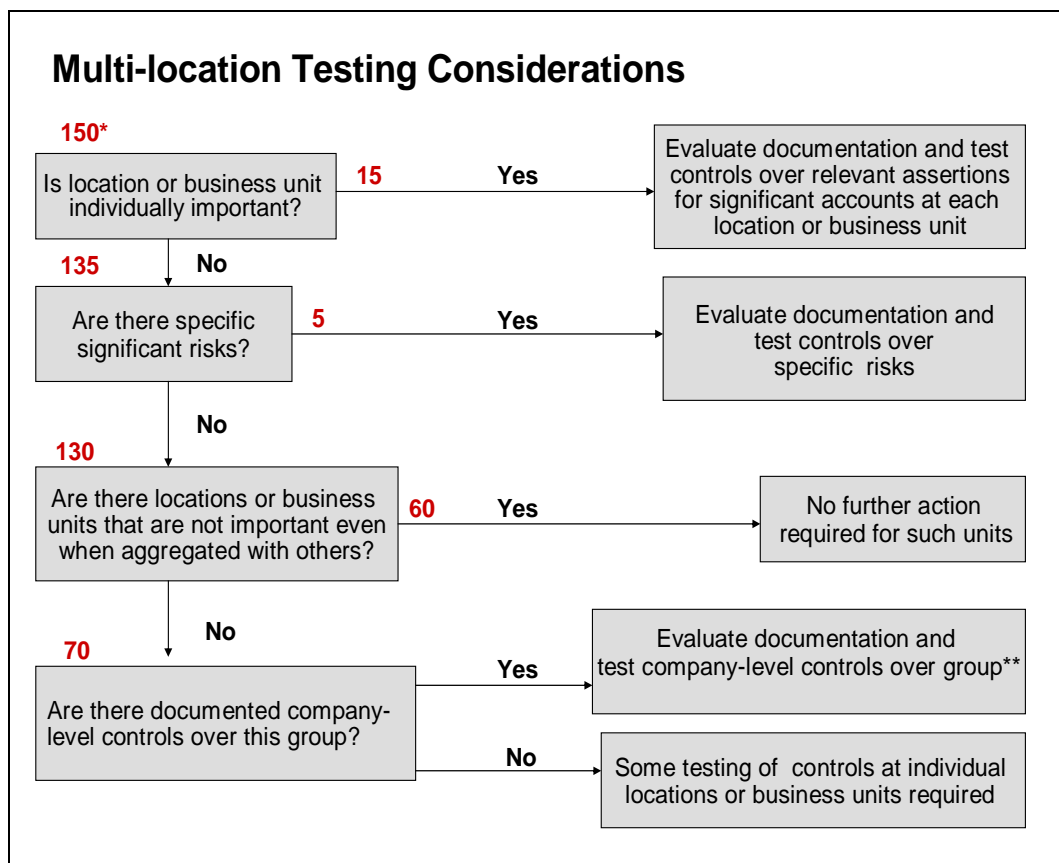
Locations and Business Units That Do Not Require Testing

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

Multi-Location Testing Considerations Flowchart

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

Illustration B-1



* Numbers represent number of locations affected.

** See paragraph B7.

Special Situations

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

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

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

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

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

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

Use of Service Organizations

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

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

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

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

- a. Obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control and the controls at the user organization over the activities of the service organization, and
- b. Obtaining evidence that the controls that are relevant to management's assessment and the auditor's opinion are operating effectively.

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

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- a. Performing tests of the user organization's controls over the activities of the service organization (for example, testing the user organization's independent reperformance of selected items processed by the service organization or testing the user organization's reconciliation of output reports with source documents).
- b. Performing tests of controls at the service organization.
- c. Obtaining a service auditor's report on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.

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

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

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

Note: These factors are similar to factors the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed

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level of control risk in an audit of the financial statements as described in paragraph .16 of AU sec. 324.

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

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

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

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

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

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- Whether there are errors that have been identified in the service organization's processing, and
- The nature and significance of any changes in the service organization's controls identified by management or the auditor.

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

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

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

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

Examples of Extent-of-Testing Decisions

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

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

<p>Example B-1 – <i>Daily Programmed Application Control and Daily Information Technology-Dependent Manual Control</i></p>

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

- a. The company receives a download of cash receipts from the banks.
- b. The information technology system applies cash received in the lockbox to individual customer accounts.
- c. Any cash received in the lockbox and not applied to a customer's account is listed on an exception report (Unapplied Cash Exception Report).
 - Therefore, the application of cash to a customer's account is a programmed application control, while the review and follow-up of unapplied cash from the exception report is a manual control.

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

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

- Identified, through discussion with company personnel, the software used to receive the download from the banks and to process the transactions and determined that the banks supply the download software.
 - The company uses accounting software acquired from a third-party supplier. The software consists of a number of modules. The client modifies the software only for upgrades supplied by the supplier.
- Determined, through further discussion with company personnel, that the cash module operates the lockbox functionality and the posting of cash to the general ledger. The accounts receivable module posts the cash to individual customer accounts and produces the Unapplied Cash Exception Report, a standard report supplied with the package. The auditor agreed this information to the supplier's documentation.
- Identified, through discussions with company personnel and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of these programs and agreed them to the original installation date of the application.

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

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

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

- a. Selected one customer and agreed the amount billed to the customer to the cash received in the lockbox.
- b. Agreed the total of the lockbox report to the posting of cash receipts in the general ledger.
- c. Agreed the total of the cash receipt download from the bank to the lockbox report and supporting documentation.
- d. Selected one customer's remittance and agreed amount posted to the customer's account in the accounts receivable subsidiary ledger.

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

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

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day selected contained four exceptions – three related to payments made by a customer without an invoice number, and one related to an underpayment due to a pricing discrepancy.

- For the pricing discrepancy, the employee determined, through discussions with a sales person, that the customer had been billed an incorrect price; a price break that the sales person had granted to the customer was not reflected on the customer's invoice. The employee resolved the pricing discrepancy, determined which invoices were being paid, and entered a correction into the system to properly apply cash to the customer's account and reduce accounts receivable and sales accounts for the amount of the price break.
- c. Reperformed the control. Finally, the auditor selected 25 Daily Unapplied Cash Exception Reports from the period January to September. For the reports selected, the auditor reperformed the follow-up procedures that the employee performed. For instance, the auditor inspected the documents and sources of information used in the follow-up and determined that the transaction was properly corrected in the system. The auditor also scanned other Daily Unapplied Cash Exception Reports to determine that the control was performed throughout the period of intended reliance.

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

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

Example B-2 – *Monthly Manual Reconciliation*

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

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

To test the reconciliation process, the auditor:

- a. Made inquiries of personnel performing the control. The auditor asked the employee performing the reconciliation a number of questions, including the following:
 - What documentation describes the account reconciliation process?
 - How long have you been performing the reconciliation work?
 - What is the reconciliation process for resolving reconciling items?
 - How often are the reconciliations formally reviewed and signed off?
 - If significant issues or reconciliation problems are noticed, to whose attention do you bring them?
 - On average, how many reconciling items are there?
 - How are old reconciling items treated?
 - If need be, how is the system corrected for reconciling items?
 - What is the general nature of these reconciling items?
- b. Observed the employee performing the control. The auditor observed the employee performing the reconciliation procedures. For nonrecurring reconciling items, the auditor observed whether each item included a clear explanation as to its nature, the action that had been taken to resolve it, and whether it had been resolved on a timely basis.
- c. Reperformed the control. Finally, the auditor inspected the reconciliations and reperformed the reconciliation procedures. For the May and July reconciliations, the auditor traced the reconciling amounts to the source documents on a test basis. The only reconciling item that appeared on these reconciliations was cash received in the lockbox the previous day that had not been applied yet to the customer's account. The auditor pursued the items in each month's reconciliation

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to determine that the reconciling item cleared the following business day. The auditor also scanned through the file of all reconciliations prepared during the year and noted that they had been performed on a timely basis. To determine that the company had not made significant changes in its reconciliation control procedures from interim to year-end, the auditor made inquiries of company personnel and determined that such procedures had not changed from interim to year-end. Therefore, the auditor verified that controls were still in place by scanning the monthly account reconciliations to determine that the control was performed on a timely basis during the interim to year-end period.

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

Example B-3 – *Daily Manual Preventive Control*

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

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

- a. After obtaining the related voucher package, the auditor examined the invoice to see if it included the signature or initials of the accounts payable clerk, evidencing the clerk's performance of the matching control. However, a signature on a voucher package to indicate signor approval does not necessarily

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mean that the person carefully reviewed it before signing. The voucher package may have been signed based on only a cursory review, or without any review.

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

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

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

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

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

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

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

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- a. Identified, through discussion with company personnel, the software used to process receipts and purchase invoices. The software used was a third-party package consisting of a number of modules.
- b. Determined, through further discussion with company personnel, that they do not modify the core functionality of the software, but sometimes make personalized changes to reports to meet the changing needs of the business. From previous experience with the company's information technology environment, the auditor believes that such changes are infrequent and that information technology process controls are well established.
- c. Established, through further discussion, that the inventory module operated the receiving functionality, including the matching of receipts to open purchase orders. Purchase invoices were processed in the accounts payable module, which matched them to an approved purchase order against which a valid receipt has been made. That module also produced the Unmatched Items Report, a standard report supplied with the package to which the company has not made any modifications. That information was agreed to the supplier's documentation and to documentation within the information technology department.
- d. Identified, through discussions with the client and review of the supplier's documentation, the names, file sizes (in bytes), and locations of the executable files (programs) that operate the functionality under review. The auditor then identified the compilation dates of the programs and agreed them to the original installation date of the application. The compilation date of the report code was agreed to documentation held within the information technology department relating to the last change made to that report (a change in formatting).
- e. Identified the objectives of the programs to be tested. The auditor wanted to determine whether appropriate items are received (for example, match a valid purchase order), appropriate purchase invoices are posted (for example, match a valid receipt and purchase order, non-duplicate reference numbers) and unmatched items (for example, receipts, orders or invoices) are listed on the exception report. The auditor then reperformed all those variations in the packages on a test-of-one basis to determine that the programs operated as described.

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

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

- a. Receiving cannot record the receipt of goods without matching the receipt to a purchase order on the system. The auditor tested that control by attempting to record the receipt of goods into the system without a purchase order. However, the system did not allow the auditor to do that. Rather, the system produced an error message stating that the goods could not be recorded as received without an active purchase order.
- b. An invoice will not be paid unless the system can match the receipt and vendor invoice to an approved purchase order. The auditor tested that control by attempting to approve an invoice for payment in the system. The system did not allow the auditor to do that. Rather, it produced an error message indicating that invoices could not be paid without an active purchase order and receiver.
- c. The system disallows the processing of invoices with identical vendor and identical invoice numbers. In addition, the system will not allow two invoices to be processed against the same purchase order unless the sum of the invoices is less than the amount approved on the purchase order. The auditor tested that control by attempting to process duplicate invoices. However, the system produced an error message indicating that the invoice had already been processed.
- d. The system compares the invoice amounts to the purchase order. If there are differences in quantity/extended price, and such differences fall outside a pre-approved tolerance, the system does not allow the invoice to be processed. The auditor tested that control by attempting to process an invoice that had quantity/price differences outside the tolerance level of 10 pieces, or \$1,000. The system produced an error message indicating that the invoice could not be processed because of such differences.
- e. The system processes payments only for vendors established in the vendor master file. The auditor tested that control by attempting to process an invoice for a vendor that was not established in the vendor master file. However, the system did not allow the payment to be processed.
- f. The auditor tested user access to the vendor file and whether such users can make modifications to such file by attempting to access and make changes to the vendor tables. However, the system did not allow the auditor to perform that function and produced an error message stating that the user was not authorized to perform that function.

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

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

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

- a. Made inquiries of company personnel. To gain an understanding of the procedures in place to ensure that all unmatched items are followed-up properly and that corrections are made on a timely basis, the auditor made inquiries of the employee who follows up on the weekly-unmatched items reports. On a weekly basis, the control required the employee to review the Unmatched Items Report to determine why items appear on it. The employee's review includes proper follow-up on items, including determining whether:
- All open purchase orders are either closed or voided within an acceptable amount of time.
 - The requesting party is notified periodically of the status of the purchase order and the reason for its current status.
 - The reason the purchase order remains open is due to incomplete shipment of goods and, if so, whether the vendor has been notified.
 - There are quantity problems that should be discussed with purchasing.
- b. Observed the performance of the control. The auditor observed the employee performing the control for the Unmatched Items Reports generated during the first week in July.
- c. Reperformed the control. The auditor selected five weekly Unmatched Items Reports, selected several items from each, and reperformed the procedures that the employee performed. The auditor also scanned other Unmatched Items Reports to determine that the control was performed throughout the period of intended reliance.

To determine that the company had not made significant changes in their controls from interim to year-end, the auditor discussed with company personnel the procedures in

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

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

APPENDIX C

Safeguarding of Assets

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

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

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

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

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

C4. Material weaknesses relating to controls over the safeguarding of assets would only exist when the company does not have effective controls (considering both

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safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

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

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

APPENDIX D

Examples of Significant Deficiencies and Material Weaknesses

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

- Paragraphs 22 through 23 of this standard discuss materiality in an audit of internal control over financial reporting, and paragraphs 130 through 140 provide additional direction on evaluating deficiencies in internal control over financial reporting.
- The following examples illustrate how to evaluate the significance of internal control deficiencies in various situations. These examples are for illustrative purposes only.

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

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

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

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

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

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

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

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

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

Based only on these facts, the auditor should determine that this deficiency represents a significant deficiency for the following reasons: The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to

be more than inconsequential, but less than material, because individual sales transactions are not material and the compensating detective controls operating monthly and at the end of each financial reporting period should reduce the likelihood of a material misstatement going undetected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms as opposed to broader sources of error in revenue recognition. However, the compensating detective controls are only designed to detect material misstatements. The controls do not effectively address the detection of misstatements that are more than inconsequential but less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there is a more than remote likelihood that a misstatement that is more than inconsequential but less than material could occur.

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

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

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

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

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

Example D-3—*Identification of Several Deficiencies*

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

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

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

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

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

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

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

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

APPENDIX E

BACKGROUND AND BASIS FOR CONCLUSIONS

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Introduction

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

Background

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

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

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

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

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

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

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

^{1/} Panel on Audit Effectiveness, *Report and Recommendations*, sec. 2.228 (August 31, 2000).

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

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

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

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

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

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

E11. Virtually all investors and auditors who submitted comment letters expressed support for this approach. Other commenters, primarily issuers, expressed concerns that this approach was contrary to the intent of Congress and, therefore, beyond what was specifically required by Section 404 of the Act. Further, issuers stated their views that this approach would lead to unnecessary and excessive costs. Some commenters in this group suggested the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and internal audit. Others acknowledged that the auditor would need to test at least some controls directly in addition to evaluating and testing management's assessment process. However, these commenters described various ways in which the auditor's own testing could be significantly reduced from the scope expressed in the proposed standard. For instance, they proposed that the auditor could be permitted to use the work of management and others to a much greater degree; that the auditor could use a "risk analysis" to identify only a few controls to be tested; and a variety of other methods to curtail the extent of

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the auditor's work. Of those opposed to the scope, most cited their belief that the scope of work embodied in the standard would lead to a duplication of effort between management and the auditor which would needlessly increase costs without adding significant value.

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

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

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

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

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

- (l) the findings of the auditor from such testing;

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- (II) an evaluation of whether such internal control structure and procedures—
 - (aa) include maintenance of records that in reasonable detail accurately reflect the transactions and dispositions of the assets of the issuer;
 - (bb) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
- (III) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing. [emphasis added].

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

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

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

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

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

Reference to Audit vs. Attestation

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

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

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

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

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

Form of the Auditor's Opinion

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

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

E27. A number of commenters were supportive of the model described in the previous paragraph, as they agreed with the Board's reasoning. However, several commenters believed that report users would be confused as to why the form of the auditor's opinion would be different in various circumstances. These commenters thought that the auditor's opinion should be consistently expressed in all reports. Several auditors recommended that auditors always report directly on the effectiveness of the company's internal control over financial reporting. They reasoned that the scope of the audit—which always would require the auditor to obtain reasonable assurance about whether the internal control over financial reporting was effective—would be more clearly

communicated, in all cases, by the auditor reporting directly on the effectiveness of internal control over financial reporting. Other commenters suggested that the auditor always should express two opinions: one on management's assessment and one directly on the effectiveness of internal control over financial reporting. They believed the Act called for two opinions: Section 404 calls for an opinion on management's assessment, while Section 103 calls for an opinion directly on the effectiveness of internal control over financial reporting.

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

Use of the Work of Others

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

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

- Controls for which the auditor should not rely on the work of others, such as controls in the control environment and controls specifically intended to prevent or detect fraud that is reasonably likely to have a material effect on the company's financial statements,
- Controls for which the auditor may rely on the work of others, but his or her reliance on the work of others should be limited, such as controls over nonroutine transactions that are considered high risk because they involve judgments and estimates, and
- Controls for which the auditor's reliance on the work of others is not specifically limited, such as controls over routine processing of significant accounts.

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

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

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

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

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

- Controls that are part of the control environment, including controls specifically established to prevent and detect fraud that is reasonably likely to result in material misstatement of the financial statements.
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate,

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record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

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

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

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

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

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

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

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

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

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

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

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

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

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

- The materiality of the accounts and disclosures that the control addresses and the risk of material misstatement.
- The degree of judgment required to evaluate the operating effectiveness of the control (that is, the degree to which the evaluation of the effectiveness of the control requires evaluation of subjective factors rather than objective testing).
- The pervasiveness of the control.
- The level of judgment or estimation required in the account or disclosure.
- The potential for management override of the control.

E47. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. As these factors decrease in significance,

the auditor may rely more on the work of others. Because of the nature of controls in the control environment, however, the standard does not allow the auditor to use the work of others to reduce the amount of work he or she performs on such controls. In addition, the standard also does not allow the auditor to use the work of others in connection with the performance of walkthroughs of major classes of transactions because of the high degree of judgment required when performing them (See separate discussion in paragraphs E51 through E57).

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

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

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

testing the work of others should be clearly linked to an evaluation of the quality and effectiveness of their work.

Walkthroughs

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

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

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

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

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

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

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

E57. Although judgments of risk and materiality are inherent in identifying major classes of transactions, the Board decided to also remove from the standard the statement, "walkthroughs are required procedures" as a means of further clarifying that auditor judgment plays an important role in determining the major classes of transactions for which to perform a walkthrough. The Board observed that leading off the discussion of walkthroughs in the standard with such a sentence could be read as

setting a tone that diminished the role of judgment in selecting the transactions to walk through. As a result, the directions in the standard on performing walkthroughs begin with, "The auditor should perform at least one walkthrough for each major class of transactions..." The Board's decision to eliminate the statement "walkthroughs are required procedures" should not be viewed as an indication that performing walkthroughs are optional under the standard's directions. The Board believes the auditor might be able to achieve the objectives of a walkthrough by performing a combination of procedures, including inquiry, inspection, observation, and reperformance; however, performing a walkthrough represents the most efficient and effective means of doing so. The auditor's work on the control environment and walkthroughs is an important part of the principal evidence that the auditor must obtain himself or herself.

Small Business Issues

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

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

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

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

Evaluation of the Effectiveness of the Audit Committee

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

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

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

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

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

E66. The Board concluded that this provision should be retained but decided that clarification was needed to emphasize that the auditor's evaluation of the audit committee was not a separate evaluation but, rather, was made as part of the auditor's evaluation of the control environment and monitoring components of internal control over financial reporting. The Board reasoned that clarifying both this context and limitation on the auditor's evaluation of the audit committee would also address, to some degree, the conflict-of-interest concerns raised by other commenters. The Board also observed, however, that conflict is, to some extent, inherent in the duties that society

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expects of auditors. Just as auditors were expected in the past to challenge management when the auditor believed a material misstatement of the financial statements or material weakness in internal control over financial reporting existed, the auditor similarly is expected to speak up when he or she believes the audit committee is ineffective in its oversight.

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

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

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

E69. The Board also concluded that the standard should explicitly acknowledge that the board of directors is responsible for evaluating the effectiveness of the audit committee and that the auditor's evaluation of the control environment is not intended to

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supplant those evaluations. In addition, the Board concluded that, in the event the auditor determines that the audit committee's oversight is ineffective, the auditor should communicate that finding to the full board of directors. This communication should occur regardless of whether the auditor concludes that the condition represents a significant deficiency or a material weakness, and the communication should take place in addition to the normal communication requirements that attach to those deficiencies.

Definitions of Significant Deficiency and Material Weakness

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

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

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

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

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

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

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

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

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

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

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

E79. Most commenters, however, objected to these definitions. The primary, overarching objection was that these definitions set too low a threshold for the reporting of significant deficiencies. Some commenters focused on "more than remote" likelihood as the driver of an unreasonably low threshold, while others believed "more than inconsequential" in the definition of significant deficiency was the main culprit. While some commenters understood "more than inconsequential" well enough, others indicated significant concerns that this represented a new term of art that needed to be accompanied by a clear definition of "inconsequential" as well as supporting examples. Several commenters suggested retaining the likelihood and magnitude approach to a definition but suggested alternatives for likelihood (such as reasonably likely,

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reasonably possible, more likely than not, probable) and magnitude (such as material, significant, insignificant).

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

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

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

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

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

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could constitute a material weakness in a company's internal control over financial reporting.^{4/}

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

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

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

^{4/} See footnote 73 to *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636].

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

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

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

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

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

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

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

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

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

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

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

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

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

Strong Indicators of Material Weaknesses and DeFacto Significant Deficiencies

E94. The proposed standard identified a number of circumstances that, because of their likely significant negative effect on internal control over financial reporting, are significant deficiencies as well as strong indicators that a material weakness exists. The Board developed this list to promote increased rigor and consistency in auditors' evaluations of weaknesses. For the implementation of Section 404 of the Act to achieve its objectives, the public must have confidence that all material weaknesses that exist as of the company's year-end will be publicly reported. Historically, relatively few material weaknesses have been reported by the auditor to management and the audit committee. That condition is partly due to the nature of a financial statement audit. In an audit of only the financial statements, the auditor does not have a detection

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responsibility for material weaknesses in internal control; such a detection responsibility is being newly introduced for all public companies through Sections 103 and 404 of the Act. However, the Board was concerned about instances in which auditors had identified a condition that should have been, but was not, communicated as a material weakness. The intention of including the list of strong indicators of material weaknesses in the proposed standard was to bring further clarity to conditions that were likely to be material weaknesses in internal control and to create more consistency in auditors' evaluations.

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

- *Restatement of previously issued financial statements to reflect the correction of a misstatement.* Some commenters expressed concern about the kinds of restatements that would trigger this provision. A few mentioned the specific instance in which the restatement reflected the SEC's subsequent view of an accounting matter when the auditor, upon reevaluation, continued to believe that management had reasonable support for its original position. They believed this specific circumstance would not necessarily indicate a significant deficiency in internal control over financial reporting. Others commented that a restatement of previously issued financial statements would indicate a significant deficiency and strong indicator of a material weakness *in the prior period* but not necessarily in the current period.
- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the misstatement).* Several commenters, issuers and auditors alike, expressed concern about including this circumstance on the list. They explained that, frequently, management is completing the preparation of the financial statements at the same time that the auditor is completing his or her auditing procedures. In the face of this "strong indicator" provision, a lively debate of "who found it first" would ensue whenever the auditor identifies a misstatement that management subsequently corrects. Another argument is that the company's controls would have detected a misstatement identified by the auditor if the controls had an opportunity to operate (that is, the auditor performed his or her testing before the company's controls had an opportunity to operate). Several issuers indicated

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that they would prevent this latter situation by delaying the auditor's work until the issuers had clearly completed their entire period-end financial reporting process – a delay they viewed as detrimental.

- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective.* Several commenters asked for specific factors the auditor was expected to use to assess the effectiveness of these functions.
- *For complex entities in highly regulated industries, an ineffective regulatory compliance function.* Several commenters, particularly issuers in highly regulated industries, objected to the inclusion of this circumstance because they believed this to be outside the scope of internal control over financial reporting. (They agreed that this would be an internal control-related matter, but one that falls into operating effectiveness and compliance with laws and regulations, not financial reporting.) Many of these commenters suggested that this circumstance be deleted from the list altogether. Fewer commenters suggested that this problem could be addressed by simply clarifying that this circumstance is limited to situations in which the ineffective regulatory function relates solely to those aspects for which related violations of laws and regulations could have a direct and material effect on the financial statements.
- *Identification of fraud of any magnitude on the part of senior management.* Several commenters expressed concern that the inclusion of this circumstance created a detection responsibility for the auditor such that the auditor would have to plan and perform procedures to detect fraud *of any magnitude* on the part of senior management. Others expressed concern that identification of fraud on the part of senior management by the company's system of internal control over financial reporting might indicate that controls were operating effectively rather than indicating a significant deficiency or material weakness. Still others requested clarification on how to determine who constituted "senior management."

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

E97. The Board concluded that the list of significant deficiencies and strong indicators of material weakness should be retained. Such a list will promote consistency in auditors' and managements' evaluations of deficiencies consistent with the definitions of significant deficiency and material weakness. The Board also decided to retain the existing structure of the list. Although the standard leaves auditor judgment to determine whether those deficiencies are material weaknesses, the existence of one of the listed deficiencies is by definition a significant deficiency. Furthermore, the "strong indicator" construct allows the auditor to factor extenuating or unique circumstances into

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the evaluation and possibly to conclude that the situation does not represent a material weakness, rather, only a significant deficiency.

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

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

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

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

- *Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting (even if management subsequently corrects the*

misstatement). Regarding the "who-found-it-first" dilemma, the Board recognizes that this circumstance will present certain implementation challenges. However, the Board decided that none of those challenges were so significant as to require eliminating this circumstance from the list.

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

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

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

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- *For larger, more complex entities, the internal audit function or the risk assessment function is ineffective.* Relatively few commenters requested clarification on how to evaluate these functions. The Board expects that most auditors will not have trouble making this evaluation. Similar to the audit committee evaluation, this evaluation is not a separate evaluation of the internal audit or risk assessment functions but, rather, is a way of requiring the auditor to speak up if either of these functions is obviously ineffective at an entity that needs them to have an effective monitoring or risk assessment component. Unlike the audit committee discussion, most commenters seemed to have understood that this was the context for the internal audit and risk assessment function evaluation. Nonetheless, the Board decided to add a clarifying note to this circumstance emphasizing the context.
- *For complex entities in highly regulated industries, an ineffective regulatory compliance function.* The Board decided that this circumstance, as described in the proposed standard, would encompass aspects that are outside internal control over financial reporting (which would, of course, be inappropriate for purposes of this standard given its definition of internal control over financial reporting). The Board concluded that this circumstance should be retained, though clarified, to only apply to those aspects of an ineffective regulatory compliance function that could have a material effect on the financial statements.
- *Identification of fraud of any magnitude on the part of senior management.* The Board did not intend to create any additional detection responsibility for the auditor; rather, it intended that this circumstance apply to fraud on the part of senior management that came to the auditor's attention, regardless of amount. The Board decided to clarify the standard to make this clear. The Board noted that identification of fraud by the company's system of internal control over financial reporting might indicate that controls were operating effectively, except when that fraud involves senior management. Because of the critical role of tone-at-the-top in the overall effectiveness of the control environment and due to the significant negative evidence that fraud of any magnitude on the part of senior management reflects on the control environment, the Board decided that it is appropriate to include this circumstance in the list, regardless of whether the company's controls detected the fraud. The Board also decided to clarify who is included in "senior management" for this purpose.

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

Independence

E101. The proposed standard explicitly prohibited the auditor from accepting an engagement to provide an internal control-related service to an audit client that has not

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

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

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

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

Requirement for Adverse Opinion When a Material Weakness Exists

E105. The existing attestation standard (AT sec. 501) provides that, when the auditor has identified a material weakness in internal control over financial reporting, depending on the significance of the material weakness and its effect on the achievement of the objectives of the control criteria, the auditor may qualify his or her opinion ("except for the effect of the material weakness, internal control over financial reporting was effective") or express an adverse opinion ("internal control over financial reporting was not effective").

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E106. The SEC's final rules implementing Section 404 state that, "Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting." In other words, in such a case, management must conclude that internal control over financial reporting is not effective (that is, a qualified or "except-for" conclusion is not acceptable).

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

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

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

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

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

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

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

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

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

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

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

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

Rotating Tests of Controls

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

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

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

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

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

E121. However, the auditor needs to test controls every year, regardless of whether controls have obviously changed. Even if nothing else changed about the company – no changes in the business model, employees, organization, etc. – controls that were

effective last year may not be effective this year due to error, complacency, distraction, and other human conditions that result in the inherent limitations in internal control over financial reporting.

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

Mandatory Integration with the Audit of the Financial Statements

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

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

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

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

E127. Others recognized the implications of this prohibition and expressed concern: What if a company wanted or needed an opinion on the effectiveness of internal control

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

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

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

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

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separate rulemaking to AT sec. 501 would be to supplement the performance directions to be comparable to those in this standard. Auditors should remain alert for additional rulemaking by the Board that affects AT sec. 501.