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Proposed statements on auditing standards; Auditing an Entity's internal control over financial reporting in conjunction with the financial statement audit; Amendment to Statement on auditing standards no. 100, Interim financial information; Proposed statement on standards for attestation engagements; Reporting on an entity's internal control over financial reporting; Exposure draft (American Institute of Certified Public Accountants), 2003, March 18

American Institute of Certified Public Accountants. Accounting Standards Board

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# **EXPOSURE DRAFT**

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## **PROPOSED STATEMENTS ON AUDITING STANDARDS**

**Auditing an Entity's Internal Control Over Financial  
Reporting in Conjunction With the Financial Statement  
Audit**

**and**

**Amendment to Statement on Auditing Standards No.  
100, *Interim Financial Information***

## **PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION ENGAGEMENTS**

**Reporting on an Entity's Internal Control Over Financial  
Reporting**

**March 18, 2003**

Prepared by the AICPA Auditing Standards Board for comment from persons interested in  
auditing and reporting issues

Comments should be sent via the Internet to Julie Anne Dilley  
at [jdilley@aicpa.org](mailto:jdilley@aicpa.org) and received by May 15, 2003

**EXPLANATORY MEMORANDUM TO INTERNAL CONTROL REPORTING EXPOSURE DRAFTS**

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## EXPLANATORY MEMORANDUM TO INTERNAL CONTROL REPORTING EXPOSURE DRAFTS

March 18, 2003

Accompanying this letter is an exposure draft, approved by the Auditing Standards Board (ASB), of the following proposed Statements on Auditing Standards (SASs) and Statement on Standards for Attestation Engagements (SSAE):

- *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*
- *Amendment to Statement on Auditing Standards No. 100, Interim Financial Information*
- *Reporting on an Entity's Internal Control Over Financial Reporting*, which will supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT section 501), as amended

This exposure draft establishes standards and provides guidance with regard to audits of financial statements included in annual reports of public companies in which the auditor engaged to perform the audit of the entity's financial statements also is required under the Sarbanes-Oxley Act of 2002 to audit the entity's internal control over financial reporting. This exposure draft also establishes standards and provides guidance to strengthen the performance requirements in all engagements to report on an entity's internal control over financial reporting.

A summary of the significant provisions of the proposed SASs and SSAE accompanies this letter.

Comments or suggestions on any aspect of this exposure draft will be appreciated. To facilitate the ASB's consideration of responses, comments should refer to specific paragraphs in specific proposed SASs and the proposed SSAE and include supporting reasons for each suggestion or comment.

In developing guidance, the ASB considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers the differences the auditor may encounter in the audit of financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Therefore, the ASB would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the offices of the AICPA after June 15, 2003, for one year. Comments should be sent via the Internet to Julie Anne Dilley, Audit and Attest Standards at [jdilley@aicpa.org](mailto:jdilley@aicpa.org) and received no later than May 15, 2003.

Sincerely,

James S. Gerson  
*Chair*  
*Auditing Standards Board*

Charles E. Landes  
*Director*  
*Audit and Attest Standards*

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The task force gratefully acknowledges the contributions of Nancy Newman-Limata and Vickie Wong in the development of these proposed Statements on Auditing Standards and Statement on Standards for Attestation Engagements.

## SUMMARY

### WHY ISSUED

The Sarbanes-Oxley Act of 2002 (the Act) requires that auditors of the financial statements of public companies also report on the effectiveness of management's internal control over financial reporting. The Auditing Standards Board (ASB) is issuing this exposure draft of proposed Statements on Auditing Standards (SASs) and Statement on Standards for Attestation Engagements (SSAE) to establish standards and provide guidance to auditors in fulfilling that responsibility.

Additionally, the ASB is issuing this exposure draft to:

- Strengthen the performance requirements applicable to all engagements to report on internal control over financial reporting.
- Define *internal control deficiency* and clarify the definitions of *significant deficiency* (formerly, reportable conditions) and *material weakness*.

The ASB believes that these proposed SASs and SSAE provide an enhanced framework in the auditing and attestation standards for auditor reporting on the effectiveness of internal control over financial reporting as required by the Act. The proposed guidance also will significantly strengthen auditor performance in all engagements to report on internal control.

### ASSUMPTIONS PENDING ISSUANCE OF FINAL SECURITIES AND EXCHANGE COMMISSION RULE AND PROPOSED ALTERNATIVES

In October 2002 the Securities and Exchange Commission (SEC) published a proposal to issue rules to implement the requirements of Section 404 of the Act, "Management Assessment of Internal Controls" (the Proposed Rule is available at [www.sec.gov/rules/proposed/33-8138.htm](http://www.sec.gov/rules/proposed/33-8138.htm)). Section 404 requires the management of certain public companies to include in their annual reports an assessment of the effectiveness of internal control over financial reporting, which is the assertion on which the auditor reports.

The AICPA's comment letter on the SEC's proposed rule (available at [www.aicpa.org/download/sarbanes/aicpa-sec-S74002-404-internal-control.pdf](http://www.aicpa.org/download/sarbanes/aicpa-sec-S74002-404-internal-control.pdf)) made several significant recommendations to enhance the reports on internal control for users and to improve implementation of the requirements of the Act by companies and by auditors. Pending issuance of a final rule, some of the proposed guidance in the exposure draft, and particularly in the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, has been developed assuming that these recommendations will be incorporated into the SEC's final rule. Footnote references are inserted where proposed guidance in the exposure draft is based on these recommendations. In addition, the ASB has considered alternative proposals in the event that the AICPA's recommendations are not incorporated into the SEC's final rule.

Following are the assumptions on which proposed guidance has been based and proposed alternatives:

- Management's and auditor's reports will include the same objectives, which are those set forth in Sarbanes-Oxley Act Section 103(a)(2)(A)(iii)(II)(aa) and (bb).

## EXPLANATORY MEMORANDUM TO INTERNAL CONTROL REPORTING EXPOSURE DRAFTS

The definition of internal control over financial reporting set forth in paragraph 1 of the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit* and described in the sample reports presented in the appendixes of that proposed SAS includes these objectives.

*Proposed alternative:* It is important that management's and the independent auditor's reports disclose the same objectives to avoid confusion by the users of these reports about the objectives encompassed by internal control over financial reporting. In that regard, if the final SEC rule does not specify the objectives of internal control that should appear in management's report, the proposed guidance would be modified to require management to use the objectives established in Section 103 of the Sarbanes Oxley Act in order for the auditor to be able to issue an unqualified opinion. If the SEC's final rule requires management's report to use objectives that are different than those in Section 103, the guidance will be modified accordingly.

- Criteria on which management's assessment and the auditor's evaluation of internal control over financial reporting are based will be suitable, recognized control criteria established through due process, such as the framework of internal control established in the Committee of Sponsoring Organizations of the Treadway Commission's report, *Internal Control—Integrated Framework* (COSO report).

Paragraph 3 of the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit* establishes this requirement.

*Proposed alternative:* Requiring the use of suitable criteria established by groups composed of experts that follow due-process procedures would provide benefits to users and to regulators similar to the benefits achieved by requiring the use of generally accepted accounting principles in the preparation of financial statements. In particular, requiring the use of such criteria would permit comparability among reporting entities. In that regard, if the final SEC rule does not require the use of criteria issued by groups composed of experts that follow due process, then the guidance in this document will be modified to require management to use such criteria in order for the auditor to issue an unqualified opinion.

- The existence of a material weakness in internal control would preclude both management and the auditor from concluding that internal control over financial reporting is effective.

Paragraph 85 of the proposed SSAE, *Reporting on an Entity's Internal Control Over Financial Reporting*, states that the existence of a material weakness in internal control precludes an unqualified opinion that internal control is effective. Paragraph 104 of the proposed SSAE requires the practitioner to modify the report and, to most effectively communicate with the reader of the report, express his or her opinion directly on the effectiveness of internal control, not on the assertion. The nature of the modification – whether a qualified opinion or an adverse opinion – depends on the weakness and its effect on the achievement of the objectives of the control criteria. Paragraph 18 of the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit* reiterates these requirements.

*Proposed alternative:* No modification of the guidance would be required. The existence of a material weakness in internal control would preclude the auditor from concluding that internal control over financial reporting is effective.

- Management's report on internal control, which will be included in the company's annual report, will disclose significant deficiencies and material weaknesses.

## EXPLANATORY MEMORANDUM TO INTERNAL CONTROL REPORTING EXPOSURE DRAFTS

Paragraphs 18 and 19 of the proposed *SAS Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit* require that the auditor's report identify material weaknesses and significant deficiencies in an entity's internal control and state whether the entity included such significant deficiencies and material weaknesses, if applicable, in its report. The sample reports in Appendixes C, D, and E illustrate both circumstances.

*Proposed alternative:* As it relates to material weaknesses, no modification of the guidance would be required. The auditor's report should describe material weaknesses and their effect on the achievement of the objectives of the control criteria, consistent with guidance in paragraphs 105 and 106 of the proposed SSAE and with paragraph 18 of the proposed *SAS Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*. As it relates to significant deficiencies, the guidance would be modified to require that the auditor communicate significant deficiencies to the audit committee and disclose in the audit report that significant deficiencies have been so communicated.

- Management has a process for identifying significant deficiencies or material weaknesses, as defined in the auditing literature, that trigger a reporting obligation.

Paragraph 15 of the proposed SSAE describes various aspects of the process by which the responsible party evaluates the effectiveness of the entity's internal control, including identifying and documenting controls over significant account balances, classes of transactions, and disclosures; determining which control deficiencies constitute significant deficiencies or material weaknesses; determining which locations or business units should be included in the evaluation; performing procedures to evaluate design and operating effectiveness; and documenting and communicating the findings to others.

*Proposed alternative:* No modification of the guidance would be required since the existing guidance describes the various aspects of the process required by management.

## WHAT THE PROPOSED SASs AND SSAE PROVIDE

A summary of the significant provisions in each of the proposed SASs and SSAE follows.

The proposed *SAS Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit* establishes standards and provides guidance with regard to audits of financial statements included in annual reports of entities, other than registered investment companies, that file with the SEC pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, in which the auditor engaged to perform the audit of the entity's financial statements also is required to audit the entity's internal control over financial reporting (public company audits). Nothing in the proposed SAS precludes its use by auditors who are performing both a financial statement audit and an audit of internal control for other entities.

The previous section, titled "Assumptions Pending Issuance of Final Securities and Exchange Commission Rule and Proposed Alternatives," discusses guidance in the proposed SAS that is based on the assumption that certain AICPA recommendations will be incorporated into the SEC's final rule, as well as proposed alternatives if they are not. In addition, the proposed SAS:

- Describes a public company audit as an integrated activity that consists of an audit of the financial statements and an audit of internal control.

## EXPLANATORY MEMORANDUM TO INTERNAL CONTROL REPORTING EXPOSURE DRAFTS

- Requires auditors in such engagements to follow the guidance in the proposed SSAE *Reporting on an Entity's Internal Control Over Financial Reporting*, which is discussed below.
- Provides guidance on the relationship of a public company audit and a financial statement audit as follows:
  - States that the auditor should recognize that the understanding of internal control and the tests of controls that may be performed solely for the purpose of expressing an opinion on the financial statements are not sufficient for the purpose of expressing an opinion on internal control, and provides guidance on how the extent of understanding and the performance of tests of controls differ.
  - States that the high level of assurance about the operating effectiveness of controls that the auditor obtains to express an opinion on internal control does not overcome the requirement in generally accepted auditing standards to perform substantive procedures for each material class of transactions and account balance, including specific tests of details that are set forth in other SASs.
  - States that the absence of misstatements does not provide evidence that controls related to the assertion being tested are effective, but that misstatements detected by performing substantive procedures should be considered when assessing the operating effectiveness of controls. In particular, a material misstatement detected by the auditor's procedures that was not identified by the entity ordinarily is indicative of the existence of a material weakness in internal control.
- Requires the auditor to use the same date for the opinion on the financial statements and the opinion about the effectiveness of internal control because the engagement to express an opinion on the financial statements and to express an opinion on internal control is an integrated activity.
- Provides for issuance of a combined report or separate reports and provides examples of both.
- Requires that when separate reports are issued, the report on the financial statements should include a paragraph referencing the audit of internal control, the date of the report (which is the same date as the report on internal control), and the nature of the opinion expressed.
- Reiterates reporting guidance that is consistent with the proposed SSAE *Reporting on an Entity's Internal Control Over Financial Reporting*, including requirements to:
  - Qualify the report for a material weakness and express the opinion directly on the effectiveness of internal control, not on the assertion, in such circumstances.
  - Include a statement in the explanatory paragraph of a qualified report that the material weakness was considered in determining the nature, timing, and extent of audit tests applied in the audit of the financial statements and that this report (that is, the report on internal control) does not affect the report on the financial statements.
  - Disclaim an opinion on information that may be included in the entity's report in addition to management's assertion about the effectiveness of the entity's internal control.
- Provides guidance on the auditor's subsequent discovery of information existing at the date of the auditor's report.

## EXPLANATORY MEMORANDUM TO INTERNAL CONTROL REPORTING EXPOSURE DRAFTS

- Requires that the auditor report material weaknesses to the audit committee, and determine that the audit committee is aware of significant deficiencies that have been identified, prior to the issuance of the auditor's report on internal control.
- Provides that the auditor should consider whether to communicate to management internal control deficiencies identified by the auditor that are of a lesser magnitude than significant deficiencies. In addition, the auditor should communicate to the audit committee that such internal control deficiencies have been communicated to management.

The proposed SAS *Amendment to Statement on Auditing Standards No. 100*, Interim Financial Information, amends SAS No. 100 to require the independent accountant conducting a review of interim financial information to inquire of management about significant changes in the design or operation of internal control, as it relates to the preparation of annual as well as interim financial information, that have occurred subsequent to the preceding annual audit or prior review of interim financial information. This Statement also amends SAS No. 100 to require the independent accountant to consider whether significant changes in internal control may introduce significant deficiencies in the design of internal control.

The proposed SSAE *Reporting on an Entity's Internal Control Over Financial Reporting* establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting, or on an assertion thereon. Auditors who perform public company audits, as defined in the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, which is discussed previously, also should follow the guidance in that proposed SAS.

The previous section, titled "Assumptions Pending Issuance of Final Securities and Exchange Commission Rule and Proposed Alternatives," discusses guidance in the proposed SSAE that is based on the assumption that certain AICPA recommendations will be incorporated into the SEC's final rule, as well as proposed alternatives if they are not. The proposed SSAE also strengthens the performance guidance for practitioners engaged to report on the effectiveness of internal control. The proposed SSAE:

- Establishes conditions for engagement performance relating to the responsible party's process by which it supports its evaluation of the effectiveness of internal control, including documentation of controls.
- Clarifies the guidance concerning which controls the practitioner should evaluate.
- Provides enhanced guidance on planning the engagement, including new or expanded discussion of the following:
  - Obtaining an understanding of management's process for evaluating the effectiveness of the entity's internal control
  - Implications for the engagement when service organizations are used
  - Factors to consider when the entity has operations in multiple locations or business units or when the reporting entity has investments accounted for by the equity method of

## EXPLANATORY MEMORANDUM TO INTERNAL CONTROL REPORTING EXPOSURE DRAFTS

- accounting. It also incorporates a graphic illustrating the auditor's decision process in identifying locations and business units for the purpose of considering what testing of controls is appropriate.
- The role of the internal audit function
  - Provides enhanced guidance on the understanding of the components of internal control that is required to perform an engagement on internal control.
  - Provides enhanced guidance on testing and evaluating the operating effectiveness of controls, including discussion of the following:
    - The nature, timing, and extent of tests of controls.
    - Using the results of the responsible party's tests, including the limits on the practitioner's ability to use such results.
  - Defines *internal control deficiency*, *significant deficiency* (this term replaces and therefore eliminates the term *reportable conditions*), and *material weakness*.
  - Provides enhanced guidance on identifying significant deficiencies and material weaknesses.
  - Expands the requirement to disclaim on management's cost-benefit statement to other information that may be presented in management's report in addition to management's assertion on the effectiveness of the entity's internal control over financial reporting.

## HOW THE PROPOSED SASs AND SSAE AFFECT EXISTING STANDARDS

*Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit* is a proposed new SAS. It does not amend or supersede any existing SASs.

*Amendment to SAS No. 100, Interim Financial Information*, amends the SAS indicated.

*Reporting on an Entity's Internal Control Over Financial Reporting* supersedes Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended.

**PROPOSED STATEMENT ON AUDITING STANDARDS**  
**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL**  
**REPORTING IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**TABLE OF CONTENTS**

Section	Paragraph
Applicability	1
Relationship of a Public Company Audit and a Financial Statement Audit	4
Extent of Understanding of Internal Control and Performance of Tests of Controls	4
Effect of Tests of Controls on Substantive Procedures	9
Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls	12
Forming an Opinion	13
Reporting	14
Required Communications	23
Effective Date	25
Appendixes: Sample Reports	A - E

AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT

**PROPOSED STATEMENT ON AUDITING STANDARDS**

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL  
REPORTING IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**APPLICABILITY**

1. This Statement establishes standards and provides guidance with regard to audits of financial statements included in annual reports of entities, other than registered investment companies, that file with the Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, in which the auditor engaged to perform the audit of the entity's financial statements also is required to audit<sup>1</sup> the entity's internal control over financial reporting (public company audits). For the purposes of this Statement, an entity's internal control over financial reporting<sup>2</sup> includes those policies and procedures that pertain to an entity's ability to initiate, record, process, and report financial data consistent with the assertions embodied in annual financial statements prepared in accordance with generally accepted accounting principles. For the purposes of this Statement, an entity's internal control specifically includes (a) maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the entity, and (b) policies and procedures that provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and (2) receipts and expenditures of the entity are being made only in accordance with authorizations of management and directors of the entity.<sup>3</sup>

2. A public company audit as defined in paragraph 1 is an integrated activity that consists of an audit of the financial statements and an audit of internal control. Accordingly, in performing a public company audit, the auditor should perform procedures to obtain sufficient evidence to express an opinion on the entity's internal control as well as an opinion on the entity's financial statements.

3. The auditor engaged to perform a public company audit also should follow the guidance in the proposed Statement on Standards for Attestation Engagements (SSAE) *Reporting on an Entity's Internal Control Over Financial Reporting* (the proposed SSAE), including the objectives of the engagement set forth in paragraphs 8 through 10 and the conditions for engagement performance set forth in paragraph 14. In addition, to satisfy the condition that the control criteria by which the responsible party evaluates the effectiveness of the entity's internal control are suitable, the criteria must be issued by groups composed of experts that follow due-process procedures, for example, the criteria in the Committee of Sponsoring Organizations of the Treadway Commission's report, *Internal Control—Integrated Framework* (the COSO criteria).<sup>4</sup>

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<sup>1</sup> The term *audit* of internal control over financial reporting in this Statement is equivalent to the term *examination* of internal control over financial reporting in the proposed Statement on Standards for Attestation Engagements (SSAE) *Reporting on an Entity's Internal Control Over Financial Reporting* (the proposed SSAE).

<sup>2</sup> Throughout this Statement, an entity's internal control over financial reporting is referred to as *internal control*.

<sup>3</sup> This definition of internal control over financial reporting may change based on the Securities and Exchange Commission's (SEC's) final rule regarding Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404 Rule). See the section titled "Assumptions Pending Issuance of Final Securities and Exchange Commission Rule and Proposed Alternatives" on pages 5 through 7 of the explanatory memorandum at the beginning of this exposure draft.

<sup>4</sup> This requirement to use control criteria issued by groups composed of experts that follow due-process procedures, for example, the criteria in the Committee of Sponsoring Organizations of the Treadway Commission's report, *Internal Control—Integrated Framework* (the COSO

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**RELATIONSHIP OF A PUBLIC COMPANY AUDIT AND A FINANCIAL STATEMENT  
AUDIT**

**Extent of Understanding of Internal Control and Performance of Tests of Controls**

4. Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended, requires the auditor to obtain an understanding of the five components of internal control<sup>5</sup> sufficient to plan the audit of financial statements by performing procedures such as inquiries, observations, and inspection of documents. The understanding of internal control should be used to identify types of potential misstatements in the financial statements; consider factors that affect the risk of material misstatement; design tests of controls, when applicable; and design substantive procedures. SAS No. 55 also provides guidance on how the auditor may perform tests of controls to obtain evidence about their operating effectiveness and use such evidence to alter the nature, timing, and extent of substantive procedures that the auditor performs to reduce the risk of material misstatement of the financial statements to an appropriately low level.

5. As stated in paragraph 2, in a public company audit the auditor should perform procedures to obtain sufficient evidence to express an opinion on the entity's internal control as well as an opinion on the entity's financial statements. In an audit of internal control, the auditor expresses an opinion about whether the entity maintained, in all material respects, effective internal control as of a point in time based on the control criteria. When considering what is sufficient evidence to provide a basis for expressing such an opinion, the auditor should recognize that the understanding of internal control required for expressing an opinion on the financial statements is not sufficient for the purpose of expressing an opinion on internal control. For example, when expressing an opinion on internal control, the auditor needs to obtain an understanding of the control activities related to all significant account balances, classes of transactions, and disclosures and related assertions in the financial statements. Furthermore, the nature, timing, and extent of tests of controls that may be performed for the purpose of expressing an opinion on the financial statements are not sufficient for the purpose of expressing an opinion on internal control because:

- The range of controls that is tested is not sufficiently broad.
- The tests of controls may not provide the appropriate level of assurance about their operating effectiveness.

6. The range of controls that need to be tested to express an opinion on internal control is significantly broader than that which may have been tested solely to express an opinion on the financial statements. For example, in performing an audit of financial statements, the auditor may

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criteria), may change based on the SEC's final Section 404 Rule. See the section titled "Assumptions Pending Issuance of Final Securities and Exchange Commission Rule and Proposed Alternatives" on pages 5 through 7 of the explanatory memorandum at the beginning of this exposure draft.

<sup>5</sup> The five components of internal control set forth in *Internal Control—Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO report), are the control environment, risk assessment, control activities, information and communication, and monitoring. The COSO report's definition of internal control, including the five components, was incorporated by amendment in 1995 into Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended.

The AICPA has issued an exposure draft of proposed SASs that, if issued, would supersede SAS No. 55, as amended. However, the guidance on the definition of internal control, including its components, is being carried forward into those proposed SASs.

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

elect to perform only substantive procedures rather than to perform tests of controls, or perform a mix of substantive procedures and tests of controls, over some or all significant accounts, classes of transactions, and disclosures, particularly those that involve nonroutine transactions or a high degree of subjectivity or judgment in measurement, or those in the financial statement closing process. For the purpose of expressing an opinion on internal control, the tests of controls should encompass significant controls related to all significant accounts, classes of transactions, and disclosures, including those that might not be tested solely for the purpose of expressing an opinion on the financial statements.

7. For the purpose of expressing an opinion on internal control, the tests of controls that the auditor performs should be sufficient to obtain a high level of assurance about their operating effectiveness. For purposes of the financial statement audit, the auditor may choose to perform tests of controls sufficient to provide only moderate or low assurance about their operating effectiveness, and obtain additional assurance from substantive procedures.

8. The knowledge about the entity's internal control obtained as part of an audit of internal control may serve as the basis for the auditor's understanding of internal control in an audit of the financial statements. Similarly, the auditor may consider the results of tests of controls performed in connection with an audit of the entity's internal control, as well as any internal control deficiencies identified, in determining the extent to which the auditor may rely on the entity's controls to alter the nature, timing, and extent of substantive procedures in a financial statement audit. The auditor also may coordinate performing tests of controls for the purposes of the financial statement audit and the audit of internal control. However, the auditor should recognize that the tests of controls performed solely for the purpose of expressing an opinion on the financial statements will not provide sufficient assurance on which to express an opinion on internal control.

**Effect of Tests of Controls on Substantive Procedures**

9. The auditor may use evidence about the operating effectiveness of controls obtained in an audit of internal control to alter the nature, timing, and extent of substantive procedures that are performed to express an opinion on the financial statements. However, generally accepted auditing standards require the auditor to perform substantive procedures, including tests of details or analytical procedures, for each material account balance and class of transactions<sup>6</sup> because of the inherent limitations of internal control, and because controls can be overridden by management. Consequently, the degree of reliance that can be placed by the auditor on internal control to reduce the risk of material misstatement in the financial statements is limited, regardless of the effectiveness of internal control. Performing procedures to express an opinion on internal control does not overcome this requirement, despite the significantly greater evidence that the auditor may obtain about the operating effectiveness of controls in performing the audit of internal control, and even though the auditor may not identify any significant deficiencies or material weaknesses in performing such procedures or from communications with management.

10. In addition, performing procedures to obtain a high level of assurance about the operating effectiveness of controls in order to express an opinion on internal control does not overcome the requirements to perform specific tests of details in the financial statement audit that are set forth in other SASs. For example, SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), 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. SAS No. 67, *The Confirmation Process* (AICPA, *Professional Standards*, vol.

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<sup>6</sup> See SAS No. 55 (AU 319.107). The exposure draft discussed in footnote 5 includes a proposed SAS, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained (Performing Procedures)* that explicitly extends this requirement to include disclosures.

## **AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

1, AU sec. 330.34), states that there is a presumption that the auditor will request the confirmation of accounts receivable. Similarly, SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 331.01, "Inventories") states that observation of inventories is a generally accepted auditing procedure and that the auditor who issues an opinion without this procedure "has the burden of justifying the opinion expressed." The proposed SAS *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* also emphasizes the importance of substantive procedures to address significant risks, which include risks of fraud and risks involving nonroutine transactions or subjective measurements, by requiring the auditor to design substantive procedures that are specifically responsive to such risks.

11. Further, if the auditor determines that there is an internal control deficiency, the auditor should consider the effect on his or her determination about the nature, timing, and extent of substantive procedures that are necessary 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**

12. The absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective. However, misstatements that the auditor detects by performing substantive procedures should be considered by the auditor when assessing the operating effectiveness of related controls. The extent of misstatements that the auditor detects by performing substantive procedures may alter his or her judgment about the effectiveness of controls. A material misstatement detected by the auditor's procedures that was not identified by the entity ordinarily is indicative of the existence of a material weakness in internal control.

### **FORMING AN OPINION**

13. When forming an opinion on management's assertion about the effectiveness of an entity's internal control, the auditor should consider all evidence obtained, including the results of the tests of controls and any identified internal control deficiencies, to evaluate the design and operating effectiveness of the entity's internal control based on the control criteria. The existence of a material weakness in internal control precludes an unqualified opinion that internal control is effective. In addition, because the entity is required to disclose significant deficiencies in its report on internal control, the auditor also should consider whether any significant deficiencies have been identified.<sup>7</sup> In making the judgment as to which internal control deficiencies are significant deficiencies or material weaknesses, the auditor should take into consideration various factors. The auditor should refer to paragraphs 82 through 89 and paragraph 95 of the proposed SSAE for guidance on evaluating internal control deficiencies.

### **REPORTING**

14. Item 307 of Regulations S-K and S-B, as well as Forms 20-F and 40-F of the SEC Rules, require that management include in its annual report its assessment of the effectiveness of the company's internal control as of the end of the most recent fiscal year along with its audited financial statements. Similarly, the auditor's separate or combined reports on the financial

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<sup>7</sup> This requirement that the entity disclose significant deficiencies in its report on internal control may change based on the SEC's final Section 404 Rule. See the section titled "Assumptions Pending Issuance of Final Securities and Exchange Commission Rule and Proposed Alternatives" on pages 5 through 7 of the Explanatory Memorandum at the beginning of this exposure draft.

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

statements and on management's assertion about internal control should be included in the entity's annual report. As stated previously, the auditor's engagement to express an opinion on the financial statements and to express an opinion on internal control is an integrated activity that consists of an audit of the financial statements and an audit of internal control. Therefore, the date of the auditor's opinion on the financial statements and the date of the auditor's opinion about internal control should be the same.

**15.** Appendix A contains an example of a combined report expressing the auditor's opinion on the financial statements and the auditor's opinion on management's written assertion about internal control. When a combined report is issued, the audit opinion will address multiple reporting periods for the financial statements presented but only the end of the most recent fiscal year for management's assertion about the effectiveness of internal control.

**16.** Alternatively, the auditor may choose to issue separate reports on the entity's financial statements and on internal control. If separate reports are used, both reports should be presented in the annual report. Appendix B includes an example of a separate audit report on management's written assertion about internal control.

**17.** In circumstances in which the auditor chooses to issue a separate report on internal control, the following paragraph should be added to the auditor's report on the financial statements:

We also have audited in accordance with auditing standards generally accepted in the United States of America management's assertion that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, and our report dated [*date of report, which should be the same as the date of the report on the financial statements*] expressed [*include nature of opinion*] on that assertion.

**18.** The auditor performing an audit of internal control under this Statement should include in his or her report a description of any material weaknesses<sup>8</sup> that have been identified in an entity's internal control, regardless of whether they have been included in management's assertion, together with a definition of material weaknesses and of significant deficiencies. The auditor may become aware of such material weaknesses by performing audit procedures or by communication from management. If the auditor has identified material weaknesses that the entity did not disclose or did not identify as material weaknesses, the auditor has an additional reporting obligation to disclose that those material weaknesses have not been disclosed or identified as material weaknesses in management's report. For a material weakness, as required by paragraph 104 of the proposed SSAE, the auditor should modify his or her report and, to most effectively communicate with the reader of the report, should express his or her opinion directly on the effectiveness of internal control, not on the assertion. Appendix C includes an example of a report on internal control that is qualified for material weaknesses. Since the audit report on internal control appears in the entity's annual report along with the audit report on the entity's financial statements, the explanatory paragraph of this sample report includes the language set forth in paragraph 108 of the proposed SSAE.

**19.** In addition, because the entity is required to disclose significant deficiencies in its report on internal control, the auditor also should indicate in the audit report if significant deficiencies have been identified and included in management's assertion, together with a definition of significant deficiencies.<sup>9</sup> If the auditor has identified significant deficiencies that the entity did not disclose or did not identify as significant deficiencies, the auditor has an additional reporting obligation to describe those significant deficiencies and indicate that they have not been disclosed or identified

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<sup>8</sup> The proposed SSAE defines and provides guidance in paragraphs 11 through 13 and 82 through 89 on *material weaknesses*, *significant deficiencies*, and *internal control deficiencies*.

<sup>9</sup> See footnote 7.

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

as significant deficiencies in management's report. In addition, when the auditor's report identifies the existence of significant deficiencies, whether or not they were identified in management's assertion, the auditor should include a statement that he or she does not believe such significant deficiencies are material weaknesses<sup>10</sup> together with a definition of material weaknesses. Appendix D includes an example of an audit report in which significant deficiencies have been identified. Appendix E includes an example of an audit report that refers to both material weaknesses and significant deficiencies.

**20.** The entity's report on internal control may contain information in addition to management's assertion about the effectiveness of the entity's internal control over financial reporting. Such information may include, for example, disclosures about corrective actions taken by the entity after the date of management's assertion; the entity's plans to implement new controls; or a statement that the entity believes the cost of correcting a significant deficiency or a material weakness would exceed the benefits to be derived from implementing new controls. If such information is included in the entity's report, the auditor's report should disclaim an opinion on the information. For example, the auditor may use the following sample language from paragraph 107 of the proposed SSAE as the last paragraph of the report to disclaim an opinion on the entity'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.

**21.** The auditor also should refer to paragraph 99 of the proposed SSAE for general reporting requirements and to the following paragraphs of the proposed SSAE for additional reporting guidance in various circumstances:

- Paragraph 106 – adverse opinion
- Paragraphs 109 through 112 – scope limitations
- Paragraphs 113 and 114 – opinion based in part on the report of another auditor
- Paragraphs 115 through 117 – subsequent events

**22.** After the issuance of the report on internal control, the auditor may become aware of conditions that existed at the report date that might have affected the auditor's opinion had he or she been aware of them. The auditor's consideration of such subsequent information is similar to the auditor's consideration of information discovered subsequent to the date of the report on an audit of financial statements as described in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"). The guidance in that AU section 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 considers (a) whether the facts would have changed the report if he or she had been aware of them and (b) whether there are persons currently relying on or likely to rely on the auditor's report. Based on these considerations, detailed guidance is provided for the auditor in AU section 561.06.

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<sup>10</sup> Paragraph 18 provides guidance about significant deficiencies that the auditor believes are material weaknesses.

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**REQUIRED COMMUNICATIONS**

**23.** Prior to the issuance of the auditor's report on internal control, the auditor should report to the audit committee material weaknesses that have been identified. The auditor also should determine that the audit committee is aware of significant deficiencies that have been identified.

**24.** The auditor should consider whether internal control deficiencies identified by the auditor that are of a lesser magnitude than significant deficiencies should be communicated to management. Such internal control deficiencies, if uncorrected, could potentially worsen or, if aggregated with other internal control deficiencies, could potentially become significant enough to lead to misstatements that are other than inconsequential. When the auditor communicates to management internal control deficiencies of a lesser magnitude than significant deficiencies, the auditor should inform the audit committee of such communication, and may wish to determine that the audit committee is aware of the nature of some or all of them.

**EFFECTIVE DATE**

**25.** This Statement is effective for public company audits for periods ending on or after September 15, 2003.<sup>11</sup>

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<sup>11</sup> The effective date is based on the effective date in the SEC's proposed rule to implement Section 404 of the Sarbanes-Oxley Act.

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**APPENDIX A**

**Sample Combined Report**

Independent Auditors' Report

*[Introductory paragraph]*

We have audited the accompanying balance sheets of W Company, Inc. 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 assertion included in the accompanying *[identify title of management's report]* that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, based on *[identify criteria]*. Management's assertion also states that effective internal control over financial reporting includes (a) maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company, and (b) policies and procedures that provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and (2) receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company. These financial statements and management's assertion about the effectiveness of internal control over financial reporting are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and management's assertion based on our audits.

*[Scope paragraph]*

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements and management's assertion are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. An audit of internal control includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

*[Inherent limitations paragraph]*

Because of the inherent limitations of internal control over financial reporting, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

*[Opinion paragraph]*

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company, Inc. 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 assertion on internal control over financial reporting referred to above is fairly stated, in all material respects, based on [*identify criteria*<sup>1</sup>].

[*Signature*]

[*Date*]

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<sup>1</sup> For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**APPENDIX B**

**Sample Separate Report on Internal Control**

Independent Auditor's Report

[Introductory paragraph]

We have audited management's assertion included in the accompanying [*title of management's report*] that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*]. Management's assertion also states that effective internal control includes (a) maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company, and (b) policies and procedures that provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and (2) receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company. W Company's management is responsible for its assertion about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our audit.

[Scope paragraph]

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform our audit to obtain reasonable assurance that management's assertion is free of material misstatement. Our audit included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[Inherent limitations paragraph]

Because of the inherent limitations of internal control over financial reporting, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control 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 assertion that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*identify criteria*].

[Signature]

[Date]

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**APPENDIX C**

**Sample Report on Internal Control Qualified for a Material Weakness**

Independent Auditor's Report

[Introductory paragraph]

We have audited management's assertion included in the accompanying *[title of management's report]* that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, except for *[material weakness identified in management's assertion]*, based on *[identify criteria]*. Management's assertion also states that effective internal control includes (a) maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company, and (b) policies and procedures that provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and (2) receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company. W Company's management is responsible for its assertion about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our audit.

*[Standard scope and inherent limitations paragraphs]*

*[Explanatory paragraph]*

A material weakness is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis. A significant deficiency is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The following material weakness has been identified and included in management's assertion.<sup>1</sup> *[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.

*[Opinion paragraph]*

In our opinion, except for the effect of the material weakness described in the preceding paragraph on the achievement of the objectives of the control criteria, W Company has maintained, in all

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<sup>1</sup> If the auditor has identified a material weakness that is not included in management's assertion, add the following to the report: "In addition, we have identified the following material weakness that has not been identified as a material weakness in management's assertion. *[Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.]*"

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

material respects, effective internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*].<sup>2</sup>

[*Signature*]

[*Date*]

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<sup>2</sup> If the auditor concludes that the material weakness results in an adverse opinion, the opinion paragraph should be replaced with the following: "In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*]."

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**APPENDIX D**

**Sample Report on Internal Control Identifying Significant Deficiencies**

Independent Auditor's Report

[Introductory paragraph]

We have audited management's assertion included in the accompanying [*title of management's report*] that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, based on [*identify criteria*]. Management's assertion also states that effective internal control includes (a) maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company, and (b) policies and procedures that provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and (2) receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company. W Company's management is responsible for its assertion about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our audit.

[Standard scope and inherent limitations paragraphs]

[Explanatory paragraph]

Significant deficiencies have been identified and included in management's assertion. A significant deficiency is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements.<sup>1</sup> A material weakness is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis. We believe that none of the significant deficiencies identified is a material weakness that would require us to modify our opinion.

[Opinion paragraph]

In our opinion, management's assertion that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on [*identify criteria*].

[Signature]

[Date]

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<sup>1</sup> If the auditor has identified a significant deficiency that is not included in management's assertion, add the following to the report: In addition, we have identified the following significant deficiency that is not included in management's assertion. [*Include a description of the significant deficiency and its effect on the achievement of the objectives of the control criteria.*]

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

**APPENDIX E**

**Sample Report on Internal Control Qualified for a Material Weakness and Identifying Significant Deficiencies**

Independent Auditor's Report

[Introductory paragraph]

We have audited management's assertion included in the accompanying *[title of management's report]* that W Company, Inc. maintained effective internal control over financial reporting as of December 31, 20X3, except for *[material weakness identified in management's assertion]*, based on *[identify criteria]*. Management's assertion also states that effective internal control includes (a) maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company, and (b) policies and procedures that provide reasonable assurance that (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and (2) receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company. W Company's management is responsible for its assertion about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our audit.

*[Standard scope and inherent limitations paragraphs]*

*[Explanatory paragraphs]*

A material weakness is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis. A significant deficiency is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The following material weakness has been identified and included in management's assertion.<sup>1</sup> *[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.

Significant deficiencies have been identified and included in management's assertion.<sup>2</sup> We believe that, with the exception of the material weakness referred to above, none of the significant deficiencies identified are material weaknesses.

*[Opinion paragraph]*

In our opinion, except for the effect of the material weakness described in the second preceding paragraph on the achievement of the objectives of the control criteria, W Company has maintained,

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<sup>1</sup> See footnote 1 in Appendix C.

<sup>2</sup> See footnote 1 in Appendix D.

**AUDITING AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING  
IN CONJUNCTION WITH THE FINANCIAL STATEMENT AUDIT**

in all material respects, effective internal control over financial reporting as of December 31, 20X3,  
based on [*identify criteria*].<sup>3</sup>

[*Signature*]

[*Date*]

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<sup>3</sup> See footnote 2 in Appendix C.

**AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 100,  
INTERIM FINANCIAL INFORMATION**

**PROPOSED STATEMENT ON AUDITING STANDARDS**

**AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 100,  
*INTERIM FINANCIAL INFORMATION***

1. This Statement amends Statement on Auditing Standards (SAS) No. 100, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), to require the independent accountant conducting a review of interim financial information to inquire of management about significant changes in the design or operation of internal control, as it relates to the preparation of annual as well as interim financial information, that have occurred subsequent to the preceding annual audit or prior review of interim financial information. This Statement also amends SAS No. 100 to require the independent accountant to consider whether significant changes in internal control may introduce significant deficiencies in the design of internal control. New language is shown in boldface italics.

**The Accountant's Knowledge of the Entity's Business and Its Internal Control**

11. In planning a review of interim financial information, the accountant should perform procedures to update his or her knowledge of the entity's business and its internal control to (a) aid in the determination of the inquiries to be made and the analytical procedures to be performed and (b) identify particular events, transactions, or assertions to which the inquiries may be directed or analytical procedures applied. Such procedures should include:

- Reading documentation of the preceding year's audit and of reviews of prior interim period(s) of the current year and corresponding quarterly and year-to-date interim period(s) of the prior year to the extent necessary, based on the accountant's judgment, to enable the accountant to identify matters that may affect the current-period interim financial information. In reading such documents, the accountant should specifically consider the nature of any (a) corrected material misstatements; (b) matters identified in any summary of uncorrected misstatements;<sup>7</sup> (c) identified risks of material misstatement due to fraud, including the risk of management override of controls; and (d) significant financial accounting and reporting matters that may be of continuing significance, such as weaknesses in internal control.
- Reading the most recent annual and comparable prior interim period financial information.
- Considering the results of any audit procedures performed with respect to the current year's financial statements.
- Inquiring of management about changes in the entity's business activities.
- Inquiring of management about whether significant changes in internal control, as it relates to the preparation of ***both annual and*** interim financial information, have occurred subsequent to the preceding annual audit or prior review of interim financial information, including changes in the entity's policies, procedures, and personnel, as well as the nature and extent of such changes.

<sup>7</sup> SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312.40), requires the auditor to document the nature and effect of misstatements

**AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 100,  
INTERIM FINANCIAL INFORMATION**

that the auditor aggregates as well as the auditor's conclusion as to whether such misstatements, individually or in the aggregate, cause the audited financial statements to be materially misstated. Paragraphs 25 and 26 of this Statement describe the accountant's consideration of such misstatements in a review of interim financial information.

**Analytical Procedures, Inquiries, and Other Review Procedures**

18. *Inquiries and other review procedures.* The following are inquiries the accountant should make and other review procedures the accountant should perform when conducting a review of interim financial information:

- a. Reading the available minutes of meetings of stockholders, directors, and appropriate committees, and inquiring about matters dealt with at meetings for which minutes are not available, to identify matters that may affect the interim financial information.
- b. Obtaining reports from other accountants, if any, who have been engaged to perform a review of the interim financial information of significant components of the reporting entity, its subsidiaries, or its other investees, or inquiring of those accountants if reports have not been issued.<sup>11</sup>
- c. Inquiring of members of management who have responsibility for financial and accounting matters concerning:
  - Whether the interim financial information has been prepared in conformity with generally accepted accounting principles consistently applied.
  - Unusual or complex situations that may have an effect on the interim financial information. (See Appendix B of this Statement for examples of unusual or complex situations about which the accountant ordinarily would inquire of management.)
  - Significant transactions occurring or recognized in the last several days of the interim period.
  - The status of uncorrected misstatements identified during the previous audit and interim review (that is, whether adjustments had been recorded subsequent to the prior audit or interim period and, if so, the amounts recorded and period in which such adjustments were recorded).
  - Matters about which questions have arisen in the course of applying the review procedures.
  - Events subsequent to the date of the interim financial information that could have a material effect on the presentation of such information.
  - Their knowledge of any fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.
  - Whether they are aware of allegations of fraud or suspected fraud affecting the entity, for example, received in communications from employees, former employees, analysts, regulators, short sellers, or others.

**AMENDMENT TO STATEMENT ON AUDITING STANDARDS NO. 100,  
INTERIM FINANCIAL INFORMATION**

- Significant journal entries and other adjustments.
  - Communications from regulatory agencies.
  - ***Significant changes in the design or operation of internal control subsequent to the preceding annual audit or prior review of interim financial information.***
  - Significant deficiencies, including material weaknesses, in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data.
- d. *Considering, through a combination of observation and inquiry, whether significant changes in internal control may introduce significant deficiencies in the design of internal control.***
- ee.** Obtaining evidence that the interim financial information agrees or reconciles with the accounting records. For example, the accountant may compare the interim financial information to (1) the accounting records, such as the general ledger; (2) a consolidating schedule derived from the accounting records; or (3) other supporting data in the entity's records. In addition, the accountant should consider inquiring of management as to the reliability of the records to which the interim financial information was compared or reconciled.
- fe.** Reading the interim financial information to consider whether, based on the results of the review procedures performed and other information that has come to the accountant's attention, the information to be reported conforms with generally accepted accounting principles.
- gf.** Reading other information that accompanies the interim financial information and is contained in reports (1) to holders of securities or beneficial interests or (2) filed with regulatory authorities under the Securities Exchange Act of 1934 (such as Form 10-Q or 10-QSB), to consider whether such information or the manner of its presentation is materially inconsistent with the interim financial information.<sup>12</sup> If the accountant concludes that there is a material inconsistency, or becomes aware of information that he or she believes is a material misstatement of fact, the action taken will depend on his or her judgment in the particular circumstances. In determining the appropriate course of action, the accountant should consider the guidance in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550.04-.06).

<sup>11</sup> In these circumstances, the accountant ordinarily is in a position similar to that of an auditor who acts as principal auditor (see SAS No. 1, *Codification of Auditing Standards and Procedures* [AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors"]) and makes use of the work or reports of other auditors in the course of an audit of financial statements.

<sup>12</sup> The principal accountant also may request other accountants involved in the engagement, if any, to read the other information.

**2.** This Statement is effective for interim periods within fiscal years beginning after September 15, 2003. Earlier application of the provisions of this Statement is permitted.

**PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION  
ENGAGEMENTS**

**REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER  
FINANCIAL REPORTING**

**TABLE OF CONTENTS**

Section	Paragraph
Applicability .....	1
Other Attest Services .....	5
Nonattest Services .....	7
Objectives of the Engagement .....	8
Definitions of Internal Control Deficiency, Significant Deficiency, and Material Weakness .....	11
Conditions for Engagement Performance .....	14
Definition of Internal Control.....	22
Limitations of an Entity's Internal Control.....	24
Examination Engagement.....	26
Planning the Engagement.....	30
Obtaining an Understanding and Evaluating the Design Effectiveness of Internal Control.....	53
Testing and Evaluating the Operating Effectiveness of Controls .....	64
Evaluating Deficiencies in an Entity's Internal Control .....	81
Significant Deficiencies .....	82
Material Weaknesses .....	85
Communicating Significant Deficiencies and Material Weaknesses .....	90
Written Representations.....	93
Forming an Opinion.....	95
Reporting Standards .....	96
Restricting the Use of the Report .....	102

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

Report Modifications .....	103
Material Weaknesses .....	104
Responsible Party's Assertion Contains Additional Information .....	107
Practitioner's Report on Internal Control Identifies a Material Weakness and Is Included in the Same Document Containing the Audit Report .....	108
Scope Limitations .....	109
Opinion Based in Part on the Report of Another Practitioner .....	113
Subsequent Events .....	115
Subsequent Discovery of Information Existing at the Date of the Practitioner's Report .....	118
Reporting on the Effectiveness of a Portion of the Entity's Internal Control .....	119
Reporting on the Suitability of Design of the Entity's Internal Control .....	120
Reporting on Internal Control Based on Criteria Specified by a Regulatory Agency .....	122
Other Information in a Client-Prepared Document Containing the Practitioner's Report on the Effectiveness of the Entity's Internal Control .....	127
Relationship to the Foreign Corrupt Practices Act .....	128
Effective Date .....	129
Appendix	

**PROPOSED STATEMENT ON STANDARDS FOR ATTESTATION  
ENGAGEMENTS**

**REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL  
REPORTING**

**APPLICABILITY**

1. This Statement establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination<sup>1</sup> report on the effectiveness of an entity's internal control over financial reporting<sup>2</sup> as of a point in time (or on an assertion thereon).<sup>3</sup> Specifically, guidance is provided regarding the following:
  - a. Conditions that must be met for a practitioner to accept an engagement to examine the effectiveness of an entity's internal control (see paragraphs 14 through 21) and the prohibition of acceptance of an engagement to review such subject matter (see paragraph 5)
  - b. Engagements to examine the design and operating effectiveness of an entity's internal control (see paragraphs 26 through 118)
  - c. Engagements to examine the design and operating effectiveness of a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable) (see paragraph 119)
  - d. Engagements to examine only the suitability of design of an entity's internal control (no assertion is made about the operating effectiveness of internal control) (see paragraphs 120 and 121)
  - e. Engagements to examine the design and operating effectiveness of an entity's internal control based on criteria established by a regulatory agency (see paragraphs 122 through 126)
2. This Statement does not provide guidance for the following:
  - a. Engagements to examine controls over operations or compliance with laws and regulations<sup>4</sup>

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<sup>1</sup> The term *examination* of internal control over financial reporting in this Statement is equivalent to the term *audit* of internal control over financial reporting in the proposed Statement on Auditing Standards (SAS) *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*.

<sup>2</sup> This Statement does not change the auditor's responsibility for considering the entity's internal control in an audit of financial statements. See paragraph 33.

<sup>3</sup> Ordinarily, the practitioner will be engaged to examine the effectiveness of the entity's internal control over financial reporting as of the end of the entity's fiscal year; however, the client may select a different date. A practitioner also may be engaged to examine the effectiveness of an entity's internal control during a period of time. In that case, the guidance in this Statement should be modified accordingly.

<sup>4</sup> A practitioner engaged to examine the effectiveness of an entity's internal control over operations or compliance with laws and regulations should refer to the guidance in Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements (SSAE)

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- b. Agreed-upon procedures engagements (see Chapter 2, "Agreed-Upon Procedures Engagements," of Statement on Standards for Attestation Engagements (SSAE) No 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 201), as amended)
- c. Certain other services in connection with an entity's internal control covered by other authoritative guidance (see paragraph 6 and the Appendix)
- d. Consulting engagements (see paragraph 7)
- e. Engagements to gather data for management (see paragraph 16)

3. An entity's internal control over financial reporting<sup>5</sup> includes those policies and procedures that pertain to an entity's ability to initiate, record, process, and report financial data consistent with the assertions embodied in either annual or interim financial statements or both. Certain controls over financial reporting may be in information systems that are primarily designed to achieve objectives other than financial reporting objectives. This Statement is concerned only with controls as they relate to the responsible party's annual or interim financial statements or both. A practitioner engaged to examine the effectiveness of an entity's internal control should comply with the general, fieldwork, and reporting standards in Chapter 1, "Attest Engagements," of SSAE No. 10 (AT sec. 101), and the specific performance and reporting standards set forth in this Statement.<sup>6</sup>

4. Auditors of financial statements included in annual reports of entities, other than registered investment companies, that file with the Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, in which the auditor engaged to perform the audit of the entity's financial statements also is required to audit the entity's internal control over financial reporting (public company audits), also should follow the guidance in the proposed Statement on Auditing Standards (SAS) *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*. For the purposes of that Statement, the audit of internal control includes those policies and procedures that pertain to an entity's ability to initiate, record, process, and report financial data consistent with the assertions embodied in annual financial statements prepared in accordance with generally accepted accounting principles. Also for the purposes of that Statement, an entity's internal control specifically includes (a) maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the entity, and (b) policies and procedures that provide reasonable assurance that (1) transactions are recorded as

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No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101), as amended. The guidance in Chapter 6, "Compliance Attestation," of SSAE No. 10 (AT sec. 601), may be helpful when performing an engagement relating to internal control over compliance with laws and regulations. A practitioner engaged to perform agreed-upon procedures on an entity's internal control over operations or compliance with laws and regulations should refer to the guidance in Chapter 2, "Agreed-Upon Procedures," of SSAE No. 10 (AT sec. 201) and Chapter 6. Further, the guidance in this Statement may be helpful in attest engagements to report on internal control over operations or compliance with laws and regulations.

<sup>5</sup> Throughout this Statement, an entity's internal control over financial reporting is referred to as *internal control*.

<sup>6</sup> A practitioner engaged to issue a report on the processing of transactions by a service organization for the use of other auditors should refer to Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and (2) receipts and expenditures of the entity are being made only in accordance with authorizations of management and directors of the entity.<sup>7</sup>

### Other Attest Services

5. A practitioner may *examine* or *perform agreed-upon procedures* relating to the effectiveness of the entity's internal control. However, he or she should not accept an engagement to *review* such subject matter or a written assertion about such subject matter. A practitioner asked to perform agreed-upon procedures relating to an entity's internal control should refer to the guidance in Chapter 2 of SSAE No. 10 (AT sec. 201).

6. The Appendix presents a listing of authoritative guidance for a practitioner engaged to provide other services in connection with an entity's internal control. In addition, Rule 17a-5 of the Securities Exchange Act of 1934 requires a report on the entity's internal control for a broker or dealer in securities. The AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* contains a sample report that a practitioner might use in such circumstances. In addition, Form N-SAR requires a report on the internal control of an investment company. A sample report that a practitioner might use in such situations is included in the AICPA Audit and Accounting Guide *Audits of Investment Companies*. This Statement does not cover such other engagements referred to in the Appendix, in Rule 17a-5, and in Form N-SAR.

### Nonattest Services

7. The practitioner also may be engaged to provide certain nonattest services in connection with the entity's internal control.<sup>8</sup> For example, the practitioner may be engaged to provide recommendations on improvements to the entity's internal control. However, the results of tests of controls that the practitioner may perform pursuant to these engagements may not be used as a basis for management's assertion about the effectiveness of internal control when that practitioner also is engaged to examine the effectiveness of the entity's internal control. A practitioner engaged to provide such nonattest services should refer to the guidance in Statements on Standards for Consulting Services, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100).

## OBJECTIVES OF THE ENGAGEMENT

8. In an examination engagement regarding the effectiveness of an entity's internal control over financial reporting, the practitioner's objective is to perform the examination to reduce attestation risk to a low level that is, in the practitioner's judgment, appropriate for expressing an opinion on (a) the effectiveness of the entity's internal control over financial reporting, in all material respects, based on suitable criteria (such criteria are referred to as *control criteria* throughout this Statement<sup>9</sup>) or (b) whether the responsible party's written assertion about the

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<sup>7</sup> This definition of internal control over financial reporting may change based on the Securities and Exchange Commission's (SEC's) final rule regarding Section 404 of the Sarbanes-Oxley Act of 2002 (Section 404 Rule). See the section titled "Assumptions Pending Issuance of Final Securities and Exchange Commission Rule and Proposed Alternatives" on pages 5 through 7 of the explanatory memorandum at the beginning of this exposure draft.

<sup>8</sup> The practitioner should be aware of the applicable independence requirements relating to nonaudit services and required audit committee approval, if relevant.

<sup>9</sup> Criteria issued by the AICPA, regulatory agencies, and other groups composed of experts that follow due-process procedures, including exposure of the proposed criteria for public

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

effectiveness of internal control over financial reporting is fairly stated, in all material respects, based on the control criteria. The practitioner also may be engaged to examine the suitability of design of an entity's internal control or the effectiveness of only a portion of an entity's internal control, as discussed later in this Statement.

9. This level of assurance is expressed as reasonable assurance in the practitioner's report. Absolute assurance is not attainable because of the nature of attestation evidence and the inherent limitations of internal control. Therefore, an examination of internal control conducted in accordance with attestation standards may not detect a material weakness. The subsequent discovery that a material weakness exists is not, in and of itself, evidence of (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with attestation standards. Since the practitioner's opinion on internal control is based on the concept of obtaining reasonable assurance, the practitioner is not an insurer and his or her report does not constitute a guarantee.

10. The effectiveness of an entity's internal control includes design and operating effectiveness. Design effectiveness relates to whether controls are suitably designed to prevent or detect material misstatements. Operating effectiveness is concerned with how the control was applied, the consistency with which it was applied, and by whom it was applied. The practitioner plans the engagement to obtain reasonable assurance that material weaknesses in internal control will be detected. The existence of a material weakness in internal control precludes an unqualified opinion that internal control is effective.

### DEFINITIONS OF INTERNAL CONTROL DEFICIENCY, SIGNIFICANT DEFICIENCY, AND MATERIAL WEAKNESS

11. An *internal control deficiency* may consist of either a design or operating deficiency. A design deficiency exists when either a necessary control is missing or an existing control is not properly designed so that even when the control is operating as designed the control objective is not always met. An operating deficiency exists when a properly designed control either is not operating as designed or the person performing a control does not possess the necessary

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comment, usually should be considered suitable criteria for this purpose. For example, the Committee of Sponsoring Organizations (COSO) of the Treadway Commission's report, *Internal Control—Integrated Framework* (the COSO criteria), provides suitable criteria against which management may evaluate and report on the effectiveness of the entity's internal control.

Criteria established by management, industry associations, or other groups that do not follow such due process procedures also may be considered suitable criteria. Management should consider the costs and benefits of utilizing criteria that are not widely known when evaluating internal control. The practitioner should determine whether such criteria are suitable by evaluating them against the attributes in Chapter 1 of SSAE No. 10 (AT sec. 101.24). In order for the practitioner to determine whether the criteria are suitable for general use reporting, those criteria should also be available to users as discussed in Chapter 1 (AT sec. 101.33).

If the practitioner concludes that the criteria are appropriate only for a limited number of parties or are available only to specified parties, the practitioner's report shall state that the use of the report is restricted to those parties specified in the report. (See Chapter 1 of SSAE No. 10 [AT sec. 101.31, 101.34, and 101.78-83].)

For an audit of internal control conducted as part of a public company audit as defined in the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, the criteria must be issued by groups composed of experts that follow due-process procedures, for example the COSO criteria.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

authority or qualifications to perform the control effectively. Internal control deficiencies range from inconsequential internal control deficiencies to material weaknesses in internal control.

**12.** A *significant deficiency* is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. A significant deficiency could arise from a single deficiency or an aggregation of deficiencies.

**13.** A *material weakness* is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis.<sup>10</sup>

### CONDITIONS FOR ENGAGEMENT PERFORMANCE

**14.** A practitioner may examine the effectiveness of an entity's internal control if the following conditions are met.

- a. Management of the entity accepts responsibility for the effectiveness of the entity's internal control. (The term *responsible party* is used in this Statement to refer to the management personnel who accept responsibility for the effectiveness of the entity's internal control.)
- b. The responsible party evaluates the effectiveness of the entity's internal control using suitable control criteria.<sup>11</sup>
- c. The responsible party supports its evaluation with sufficient evidence (see paragraphs 15 through 17).
- d. The responsible party presents a written assertion about the effectiveness of its internal control (see paragraphs 18 through 21).

**15.** The process by which the responsible party supports its evaluation of the effectiveness of the entity's internal control must include the following elements:

- Determining which controls are significant for the purpose of evaluating the effectiveness of internal control. Controls that are significant for the purpose of evaluating the effectiveness of internal control should include:
  - Controls over initiating, recording, processing, and reporting significant account balances, classes of transactions, and disclosures and related assertions embodied in the financial statements
  - Antifraud programs and controls
  - Controls, including general controls, on which other significant controls are dependent
  - Each significant control in a group of controls that functions together to achieve a control objective

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<sup>10</sup> As described in paragraph 89, the aggregate effect of individual significant deficiencies may result in a material weakness.

<sup>11</sup> See footnote 9.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- Controls over significant nonroutine and nonsystematic transactions (such as accounts involving judgments and estimates)
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

Factors the responsible party considers in determining whether controls are significant include:

- The likelihood that failure of the control could result in a misstatement
- The degree to which other controls, if effective, achieve the same control objectives
- Determining which locations or business units should be included in the evaluation for an entity with multiple locations or business units (see paragraphs 42 through 50).
- Documenting the design of significant controls that are related to the responsible party's assertion. The documentation should include each of the components of internal control;<sup>12</sup> how significant transactions are initiated, recorded, processed, and reported; the controls that are designed to prevent or detect errors or fraud in significant account balances, classes of transactions, and disclosures, including who performs the controls and the related segregation of duties; the financial statement closing process; and safeguarding controls (see paragraph 52).
- Evaluating the design effectiveness of controls.
- Evaluating the operating effectiveness of controls based on procedures sufficient to verify 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, the use of service organization reports (see paragraphs 34 through 41), or a self-assessment process that includes procedures to verify that controls are operating effectively. In evaluating the operating effectiveness of controls, inquiry alone is not adequate. The entity's risk assessment and monitoring processes may affect the selection of the procedures to be performed, controls to be tested, the timing of the procedures, and the locations to be included in the verification. All significant locations and all significant controls must be evaluated in connection with each assertion about the effectiveness of internal control. For purposes of this Statement, the responsible party cannot use the results of the practitioner's tests of controls as a basis for its conclusion about the effectiveness of controls.
- Determining which control deficiencies are of such a magnitude, quantitatively or qualitatively or both, that they constitute significant deficiencies or material weaknesses.
- Documenting the results of the evaluation.
- Communicating findings to the practitioner and to others, if applicable.

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<sup>12</sup> See paragraph 22.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

**16.** Documentation of the design of significant controls provides evidence that controls related to the responsible party's assertion about the effectiveness of internal control, including changes to those controls, have been identified and are capable of being monitored by the entity. Documentation of manual controls facilitates training of personnel and the continued functioning of controls when personnel change. At the responsible party's request, the practitioner may assist in preparing or gathering documentation as long as the responsible party directs and takes responsibility for the documentation of the controls and the process, including determining which controls should be documented.<sup>13</sup> Inadequate documentation of the design of controls may result in a significant deficiency or a material weakness, and may constitute a limitation on the scope of the engagement. As discussed in paragraphs 109 through 112, restrictions on the scope of the engagement may require the practitioner to withdraw from the engagement, disclaim an opinion, or express a qualified opinion.

**17.** The absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control constitutes a material weakness that results in a report qualification, as discussed in paragraphs 104 through 106.

**18.** The responsible party should provide a written assertion about the effectiveness of the entity's internal control. The responsible party may present its written assertion in either of the following:<sup>14</sup>

- a. A separate report that will accompany the practitioner's report
- b. A representation letter to the practitioner

**19.** The responsible party's written assertion about the effectiveness of an entity's internal control may take many forms. Throughout this Statement, for example, the phrase, "management's assertion that W Company maintained effective internal control over financial reporting as of [date]" illustrates such an assertion. Other phrases, such as "management's assertion that W Company's internal control over financial reporting as of [date] is sufficient to meet the stated objectives," may also be used. However, a practitioner should not accept an assertion that is 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.

**20.** Regardless of whether the practitioner's client is the responsible party, the responsible party's refusal to furnish a written assertion as part of an examination engagement should cause the practitioner to withdraw from the engagement. However, an exception is provided when an examination of internal control is required by law or regulation. In that circumstance, the practitioner should disclaim an opinion on internal control unless he or she obtains evidence that warrants expressing an adverse opinion. If the practitioner expresses an adverse opinion and the responsible party does not provide an assertion, the practitioner's report should be restricted as to use (see Chapter 1 of SSAE No. 10 [AT sec. 101.78–.81]).<sup>15</sup>

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<sup>13</sup> The practitioner should be aware of the applicable independence requirements relating to nonaudit services and required audit committee approval, if relevant.

<sup>14</sup> For public company audits performed in accordance with the proposed *SAS Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, the responsible party is required to present its written assertion both in a separate report and in a representation letter.

<sup>15</sup> The auditor's report should not be restricted as to use in audits of financial statements included in annual reports of entities, other than registered investment companies, that file

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

21. At the beginning of the engagement, the practitioner should discuss with the client and the responsible party the need for the responsible party to provide the practitioner with a written representation letter prior to the conclusion of the engagement. In that letter, the responsible party will be asked to provide, among other possible items, a written acknowledgment of their responsibility for establishing and maintaining internal control and their assertion stating their evaluation of the effectiveness of the entity's internal control and specifying the control criteria used. The responsible party's refusal to furnish these representations (see paragraphs 93 and 94) constitutes a limitation on the scope of the engagement.

### DEFINITION OF INTERNAL CONTROL

22. The components that constitute an entity's internal control are a function of the definition and description of internal control used by the responsible party for the purpose of assessing its effectiveness. For example, the responsible party may select the definition and description of internal control based on the internal control framework set forth in *Internal Control—Integrated Framework*,<sup>16</sup> published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.<sup>17</sup> *Internal Control—Integrated Framework* describes an entity's internal control as consisting of five components: control environment, risk assessment, control activities, information and communication, and monitoring. If the responsible party selects another definition and description of internal control, these components may not be relevant. The guidance in this Statement assumes the use of the COSO definition and description of internal control unless otherwise indicated.

23. Internal control generally includes preventive controls (those designed to prevent a misstatement from occurring) and detective controls (those designed to detect a misstatement that has occurred) to reduce the risk of misstatement. Often, entities will place more emphasis on preventive than on detective controls. Generally it is more efficient to prevent misstatements than to detect and correct them. However, no control activity can be expected to be totally effective and a well-run system of internal control should have an appropriate mixture of preventive and detective controls.

### LIMITATIONS OF AN ENTITY'S INTERNAL CONTROL

24. Internal control, no matter how well designed and operated, can provide only reasonable assurance to the responsible party and the board of directors regarding achievement of an entity's control objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgment in decision-making can be faulty, and that breakdowns in internal control can occur because of human failures such as simple errors or mistakes. Additionally, controls can be circumvented by the collusion of two or more people or management override of internal control.

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with the SEC pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, in which the auditor engaged to perform the audit of the entity's financial statements also is required to audit the entity's internal control over financial reporting as of the end of the reporting period (public company audits). See the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*.

<sup>16</sup> As noted in footnote 9, this report also contains control criteria.

<sup>17</sup> This definition and description are consistent with the definition contained in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended. However, SAS No. 55 is not intended to provide criteria for evaluating internal control effectiveness.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

**25.** Custom, culture, and the corporate governance system may inhibit fraud by management, but they are not absolute deterrents. An effective control environment, too, may help mitigate the probability of such fraud. For example, an effective board of directors, audit committee, and an internal audit function may constrain improper conduct by management. Alternatively, an ineffective control environment may negate the effectiveness of the other components. For example, when the nature of management compensation creates an incentive for management to intentionally misstate the financial statements, the effectiveness of control activities may be reduced. The effectiveness of an entity's internal control might also be adversely affected by factors such as a change in ownership or control, changes in management or other personnel, or developments in the entity's market or industry.

### EXAMINATION ENGAGEMENT

**26.** In an examination engagement regarding the effectiveness of an entity's internal control over financial reporting, the practitioner's objective is to perform the examination to reduce attestation risk to a low level that is, in the practitioner's judgment, appropriate for expressing an opinion on (a) the effectiveness of the entity's internal control over financial reporting, in all material respects, based on the control criteria or (b) whether the responsible party's written assertion about the effectiveness of internal control over financial reporting is fairly stated, in all material respects, based on the control criteria. The practitioner's opinion relates to the effectiveness of the entity's internal control taken as a whole, and not to the effectiveness of each individual component (for example, control environment, risk assessment, control activities, information and communication, and monitoring) of the entity's internal control.<sup>18</sup> The practitioner therefore considers the interrelationship of the components of an entity's internal control in achieving the objectives of the control criteria. Nonetheless, the practitioner should evaluate the design and operating effectiveness of each component of internal control. As discussed in paragraphs 82 through 92, a significant deficiency or material weakness of which the practitioner becomes aware in any of the components results in a reporting responsibility to the audit committee<sup>19</sup> and, in the case of a material weakness, a qualified or adverse opinion.

**27.** To express an opinion, the practitioner performs procedures to obtain sufficient evidence about the design effectiveness and operating effectiveness of the entity's internal control, thereby reducing attestation risk to an appropriately low level. When evaluating the design effectiveness of specific controls, the practitioner considers whether the control is suitably designed to prevent or detect material misstatements on a timely basis. When evaluating operating effectiveness, the practitioner considers how the control was applied, the consistency with which it was applied, and by whom it was applied.

**28.** The practitioner should evaluate the design and operating effectiveness of significant controls for each of the components of internal control and for each significant account balance, class of transactions, and disclosure and related assertions. This evaluation should include:

- Controls over initiating, recording, processing, and recording significant account balances, classes of transactions, and disclosures and related assertions

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<sup>18</sup> However, as discussed in paragraph 119 of this Statement, the practitioner may be engaged to examine the effectiveness of only a portion of an entity's internal control.

<sup>19</sup> Auditors subject to the guidance in the proposed *SAS Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit* should disclose significant deficiencies in the report on internal control (see paragraphs 13 and 19 of the proposed SAS).

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- Antifraud programs and controls
- Controls, including general controls, on which other significant controls are dependent
- Each significant control in a group of controls that functions together to achieve a control objective
- Controls over significant nonroutine and nonsystematic transactions (such as accounts involving judgments and estimates)
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications).

**29.** Performing an examination of the effectiveness of an entity's internal control involves the following:

- a. Planning the engagement
- b. Obtaining an understanding and evaluating the design effectiveness of internal control
- c. Testing and evaluating the operating effectiveness of controls
- d. Forming an opinion on the effectiveness of the entity's internal control, or the responsible party's assertion thereon, based on the control criteria

### Planning the Engagement

#### *General Considerations*

**30.** Planning an engagement to examine the effectiveness of the entity's internal control involves developing an overall strategy for the scope and performance of the engagement. When developing an overall strategy for the engagement, the practitioner should consider factors such as the following:

- Matters affecting the industry in which the entity operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes
- Knowledge of the entity's internal control obtained during other professional engagements
- Matters relating to the entity's business, including its organization, operating characteristics, capital structure, and distribution methods
- The extent of recent changes, if any, in the entity, its operations, or its internal control
- The responsible party's method of evaluating the effectiveness of the entity's internal control based upon control criteria
- Preliminary judgments about materiality, inherent risk, and other factors relating to the determination of material weaknesses

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- The type and extent of available evidence pertaining to the effectiveness of the entity's internal control
- The nature of specific controls designed to achieve the objectives of the control criteria, and their significance to internal control taken as a whole
- Preliminary judgments about the effectiveness of internal control
- The extent of the responsible party's documentation and monitoring of controls over locations or business units that might be significant either alone or in the aggregate

**31.** In planning the engagement, the practitioner obtains an understanding of the responsible party's process for evaluating the effectiveness of the entity's internal control, described in paragraphs 15 through 17, for the purpose of determining whether the responsible party's:

- Process for determining which controls are significant is appropriate
- Process for documenting controls and evaluating their design and operating effectiveness is appropriate
- Process for determining which control deficiencies are of such a magnitude, quantitatively or qualitatively or both, that they constitute significant deficiencies or material weaknesses is appropriate
- Findings are reasonable and support the responsible party's assertion.

**32.** The practitioner uses the understanding of the responsible party's process for evaluating the effectiveness of the entity's internal control to plan the nature, timing, and extent of the practitioner's tests of controls, including the practitioner's independent tests as well as reperformance of tests performed by others where relevant (see paragraphs 74 through 76).

### ***Relationship of the Practitioner's Examination of an Entity's Internal Control to the Audit of the Financial Statements***

**33.** While an examination of the effectiveness of the entity's internal control and an audit of the entity's financial statements may be performed by the same practitioner, each can be performed by a different practitioner, except for public company audits as defined in the proposed *SAS Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, which requires the same auditor to perform the financial statement and internal control audits. Although applicable to public company audits, the proposed SAS provides guidance about the relationship between an audit of internal control and an audit of the financial statements that is useful to a practitioner who is performing both engagements. If the practitioner does not audit the entity's financial statements, the practitioner should consider any material weaknesses and significant deficiencies identified by the financial statement auditor, any material misstatements detected by the auditor, and any disagreements between the responsible party and the auditor concerning such matters.

### ***Use of Service Organizations***

**34.** An entity's information system includes the policies and procedures involved in initiating, recording, processing, and reporting the transactions. An entity may use one or more service organizations to perform services that are part of its information system and, accordingly, that are part of its internal control. SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324.03), as amended, provides guidance on the types of services that may be

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

performed by a service organization that are part of the entity's information system. SAS No. 70 (AU sec. 324.14–.21) provides guidance on how the auditor should consider the effect of the service organization on the audit of the entity's financial statements.

**35.** If a service organization is part of the entity's information system as described in SAS No. 70 (AU sec. 324.03) and, accordingly, is part of the entity's internal control, the responsible party should consider the activities of the service organization in making its assertion on internal control, and the practitioner also should consider the activities of the service organization in determining the evidence required to support the practitioner's opinion. The procedures the responsible party and the practitioner should perform with respect to the activities performed by the service organization are similar to those described in SAS No. 70 (AU sec. 324.07–.16), and include (a) obtaining an understanding of the controls at the service organization that are relevant to the entity's internal control, and (b) obtaining evidence that the controls that are relevant to the responsible party's assertion and the practitioner's opinion are operating effectively. Such evidence may be obtained following the procedures described in SAS No. 70 (AU sec. 324.12), which include performing procedures at the service organization or obtaining a service auditor's 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 that were tested were operating effectively during the specified period (in other words, "reports on controls placed in operation and tests of operating effectiveness" described in SAS No. 70 [AU 324.24b]). A service auditor's report that does not include tests of controls, results of the tests, and the service auditor's opinion on operating effectiveness (in other words, "reports on controls placed in operation" described in SAS No. 70 [AU 324.24a]) does not provide evidence of operating effectiveness.

**36.** If a service auditor's report on controls placed in operation and tests of operating effectiveness is available, the responsible party and the practitioner may consider whether this report provides sufficient evidence to support their assertion and opinion, respectively. In considering whether such a service auditor's report provides sufficient evidence, the responsible party and the practitioner should consider the time period covered by the tests of controls and its relation to the date of the responsible party's assertion, the scope of the examination and applications covered, the controls tested and how they relate to the entity's internal controls, the results of those tests of controls, and the service auditor's opinion on the operating effectiveness of the controls. Such considerations also are similar to those the auditor would consider in determining whether the report provides sufficient evidence to support the auditor's assessed level of control risk in an audit of the financial statements as described in SAS No. 70 (AU sec. 324.16).

**37.** 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 the responsible party's assertion, additional procedures should be performed. The practitioner should inquire of the responsible party to determine whether the responsible party 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 the responsible party from the service organization, changes in personnel at the service organization with whom the responsible party 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 such changes have been identified by the responsible party, the practitioner should determine whether the responsible party has performed procedures to evaluate the effect of such changes on the effectiveness of the entity's internal control. The practitioner should also consider whether the result of other procedures performed by the practitioner indicates that there have been changes in the controls at the service organization that have not been identified by the responsible party.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

**38.** Depending on the elapsed time, the significance of the activities of the service organization, whether there are errors that have been identified in the service organization's processing, and the nature and significance of any changes in the service organization's controls that have been identified, the practitioner should determine whether additional evidence concerning changes in the service organization's controls or the operating effectiveness of the controls at the service organization should be obtained.

**39.** If the practitioner concludes that additional evidence about changes in controls at the service organization is required, the practitioner may consider:

- Determining if there have been changes in contracts or service level agreements with the service organization
- Comparing the service organization's output data during the intervening period with output data for periods covered by the service auditor's report for evidence of design changes in the system or fluctuations in volume of monetary amounts of transactions

**40.** If the practitioner concludes that additional evidence about the operating effectiveness of controls at the service organization is required (see paragraphs 77 through 80), the practitioner may consider:

- The procedures performed by the responsible party 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

**41.** In preparing the practitioner's report on internal control, the practitioner should not make reference to a service auditor's report, because the practitioner issuing the opinion on the responsible party's assertion is responsible for obtaining sufficient evidence to support the opinion. Furthermore, the use of a service organization does not reduce the responsible party's responsibility to maintain effective internal control.

### ***Multiple Locations or Business Units***

**42.** Determining the locations or business units at which the practitioner will perform audit procedures requires the practitioner to evaluate factors such as the relative financial significance of the location or business unit and the risk of material misstatement arising from the location or business unit. In making this determination the practitioner, at a minimum, should identify the locations or business units that are individually important or that contain specific risks that by themselves could create a material misstatement. With respect to other locations or business units, the practitioner should determine which locations or business units, when aggregated, could result in the group representing a level of financial significance that in the aggregate could create a material misstatement in the financial statements. The remaining locations and business units should not be able, individually or in the aggregate, to create a material misstatement in the financial statements. In analyzing the locations and business units to determine their importance and the level of testing appropriate at each, the practitioner should consider the guidance in paragraphs 43 through 46.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

**43.** Individually important locations or business units often would represent a relatively small number of locations or business units that encompass a large portion of the entity's operations and financial position. The relative financial significance of the location or business unit and the risk of material misstatement arising from the location or business unit are both factors to be considered when identifying locations or business units that are considered individually important. As a result of the importance of these locations, the practitioner should perform tests of all significant controls at each of these locations or business units based on the guidance in paragraphs 64 through 80. In determining the nature, timing, and extent of testing at the individual location or business unit, the practitioner should consider their involvement, if any, with a central processing or shared service environment.

**44.** Although a location or business unit may not be individually important from a financial standpoint, it may present specific risks that by themselves could create a material misstatement of the entity's financial statements. For example, a business unit could be responsible for foreign exchange trading and thus expose the entity to a risk of material misstatement even though the relative financial significance is not great. Although the practitioner may not test all controls at these locations or business units, the practitioner should test the controls over the specific risks that could create a material misstatement in the entity's financial statements.

**45.** Individual locations or business units that are individually not important may, when aggregated with other locations or business units, result in a group representing a level of financial significance that in the aggregate could create a material misstatement of the financial statements. In determining the nature, timing, and extent of testing, the practitioner should consider if the responsible party has entity-wide controls (see paragraph 47) documented and in place over these locations and business units, has applied such controls over this group of locations or business units, and can demonstrate that such controls were applied.

- If such entity-wide controls are in place and operating, the practitioner should test those controls to determine if they are operating effectively. In evaluating the entity-wide controls, the practitioner may conclude that he or she cannot evaluate the operating effectiveness of these controls without visiting some locations or business units.
- If the responsible party does not have such entity-wide controls, the practitioner should determine the nature, timing, and extent of testing required at each location or business unit, or combination of locations. In making this determination, the practitioner should consider factors such as the relative financial significance of the location or business unit and the practitioner's evaluation of the risk of material misstatement arising from the location or business unit.

In considering which locations or business units to visit and what controls to test, the practitioner should consider the following factors:

- The similarity of business operations and internal control 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 may constitute a material weakness

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- The nature and amount of transactions executed and related assets at the various locations or business units and to what degree the location or business unit could create an obligation on the part of the entity
- The responsible party's risk assessment process and analysis for excluding a location or business unit from its process of assessing internal control

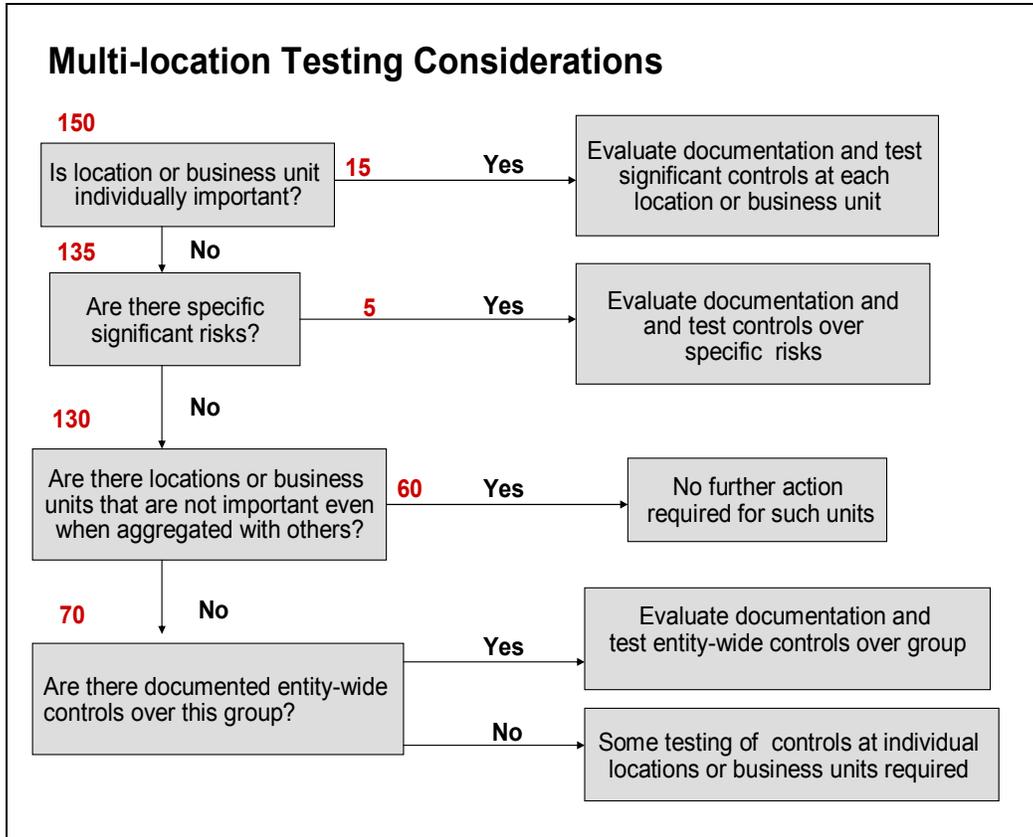
**46.** No testing would be required with respect to locations or business units that are not individually important and, when aggregated, could not result in a material misstatement to the financial statements.

**47.** For the purposes of this evaluation, entity-wide controls are controls the responsible party has in place to monitor the operations and to oversee the control environment and risk assessment process at the locations or business units. Ordinarily such controls would include a combination of the following:

- Control environment, including the assignment of authority and responsibility, consistent policies and procedures, and entity-wide programs such as codes of conduct and fraud prevention that apply to all locations and business units
- The responsible party's risk assessment process
- Centralized processing and controls, including shared service environments
- Monitoring results of operations
- Monitoring of controls, including activities of the internal audit function and self-assessment programs
- The financial reporting process as defined in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319.51), as amended

A foundation for the entity-wide controls is the significant controls at the location or business unit. Therefore, these significant controls also should be documented by the responsible party.

**48.** The following illustration demonstrates how to apply the guidance discussed in paragraphs 42 through 46 to a hypothetical entity with 150 locations or business units, and the practitioner's testing considerations for those locations or business units.



49. Situations may arise where the responsible party acquires a business at or near the date of management’s assertion. Since the assertion relates to the effectiveness of the entity’s internal control as of a point in time subsequent to the date of acquisition, the internal control of the acquired business should be evaluated pursuant to paragraphs 42 through 46. This evaluation could encompass an evaluation of internal control during the due diligence process or subsequent to the acquisition.

50. The responsible party’s evaluation of internal control does not extend to the internal control of entities in which the reporting entity has an investment that is accounted for by the equity method of accounting; therefore, the practitioner need not consider the internal control of such entities. However, the responsible party should have controls in place to ensure that the accounting for investments accounted for by the equity method is in accordance with generally accepted accounting principles, and the practitioner should evaluate those controls.

**Internal Audit Function**

51. Another factor the practitioner should consider when planning the engagement is whether the entity has an internal audit function. An important responsibility of the internal audit function is to monitor the performance of an entity’s controls. One way internal auditors monitor such performance is by performing tests that provide evidence about the effectiveness of the design and operation of specific controls. The practitioner should determine to what extent internal auditors perform such procedures. The practitioner should not rely on the results of internal auditors’ procedures as the principal evidence of the operating effectiveness of controls over significant accounts, classes of transactions, and disclosures. However, the practitioner may consider such work in determining the nature, timing, and extent of his or her testing and should follow the guidance in paragraphs 74 through 76. A practitioner should consider the guidance in

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322.09-.11), when assessing the competence and objectivity of internal auditors. SAS No. 65 (AU sec. 322.27) also provides guidance on using internal auditors to provide direct assistance to the practitioner; in supervising, reviewing, evaluating, and testing such work, the practitioner should recognize that a potential impairment of objectivity may exist when internal auditors perform a monitoring function within the entity's internal control.

### **Documentation**

**52.** The practitioner should obtain the documentation of significant controls and the control objectives that they were designed to achieve in order to understand the responsible party's internal control over financial reporting.<sup>20</sup> This documentation may take various forms: entity policy manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, or completed questionnaires. No one particular form of documentation is necessary, and the extent of documentation may vary depending upon the size and complexity of the entity.

### **Obtaining an Understanding and Evaluating the Design Effectiveness of Internal Control**

**53.** To evaluate the design effectiveness of an entity's internal control, the practitioner should obtain an understanding of the controls within each component of internal control. The components discussed in paragraphs 54 through 59 are based on the definitions of the components of internal control contained in SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), as amended.

**54.** Because of the pervasive effect of the control environment on the reliability of financial reporting, the practitioner's preliminary judgment about its effectiveness often influences the nature, timing, and extent of the tests of controls to be performed to obtain evidence about the operating effectiveness of controls. Weaknesses in the control environment may undermine the effectiveness of controls. If there are weaknesses in the control environment, the practitioner ordinarily would, for example, perform more tests of controls as of the date of the responsible party's assertion rather than at an interim date, modify the nature of the tests of controls to obtain more persuasive evidence, or increase the number of locations to be included in the scope of the examination. Conversely, an effective control environment may allow the practitioner to have some degree of increased confidence in internal control and the reliability of evidence generated internally within the entity and thus, for example, allow the practitioner to perform some tests of controls at an interim date rather than at the date of the responsible party's assertion. However, the control environment ordinarily is not specific enough to prevent or detect material misstatements in account balances, classes of transactions, or disclosures and related assertions.

**55.** In obtaining an understanding of the responsible party's control environment, the practitioner also should consider the responsible party's programs and controls to address the risk of fraud as discussed in SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), including what, if any, measures the entity has taken to mitigate the risk of management override of controls. The absence or inadequacy of such programs and controls may constitute a significant deficiency or a material weakness. For example, the practitioner should consider whether controls have been designed so they are not easily overridden and, if they are overridden, whether programs and controls exist to detect and

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<sup>20</sup> See paragraph 16.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

report such overrides. An example of such programs might be entity programs and controls to mitigate the risk of material misstatement due to fraud, such as a "hotline" for employees to report on a confidential basis any known or suspected fraudulent activity.

**56.** In obtaining an understanding of the responsible party's risk assessment process, the practitioner should consider whether the responsible party has identified the risks of material misstatement in the significant accounts, classes of transactions, and disclosures and related assertions of the financial statements and has implemented controls to prevent or detect material misstatements. For example, the risk assessment process may address how the responsible party 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. The practitioner should consider whether the responsible party's failure to identify such risks or to control them is, in the practitioner's judgment, a significant deficiency or a material weakness.

**57.** The practitioner should obtain an understanding of the control activities that the responsible party has implemented to prevent or detect material misstatement in the accounts, classes of transactions, and disclosures and related assertions of the financial statements. The practitioner's understanding of control activities for the purposes of evaluating the effectiveness of internal control encompasses a broader range of accounts, classes of transactions, and disclosures than what is normally obtained for the financial statement audit.

**58.** The practitioner's understanding of the responsible party's information and communication component involves an understanding of the same systems and processes about which the auditor obtains an understanding in an audit of financial statements, but it also includes a greater understanding of safeguarding controls and the processes for authorization of transactions and the maintenance of records.

**59.** The practitioner's understanding of the responsible party's monitoring of controls extends to its monitoring of the significant controls, including control activities, that the responsible party has identified as designed to prevent or detect material misstatement in the accounts, classes of transactions, and disclosures and related assertions of the financial statements.

**60.** A practitioner generally obtains an understanding of the design of specific controls by making inquiries of appropriate management, supervisory, and staff personnel; by inspecting entity documents; by observing the application of specific controls; and by tracing transactions through the information system relevant to financial reporting. The nature and extent of the procedures a practitioner performs vary from entity to entity and are influenced by factors such as those discussed in paragraphs 30 through 32.

**61.** Procedures to evaluate the effectiveness of the design of a specific control are concerned with whether that control is suitably designed to prevent or detect material misstatements in specific financial statement assertions. Such procedures will vary depending upon the nature of the specific control, the nature of the entity's documentation of the specific control, and the complexity and sophistication of the entity's operations and systems.

**62.** Any of the components of internal control may include controls designed to achieve the objectives of the control criteria. Some controls may have a pervasive effect on achieving many overall objectives of these criteria. For example, computer general controls over program development, program changes, computer operations, and access to programs and data help assure 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.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

**63.** The practitioner should focus on the significance of a combination of controls in achieving the objectives of the control criteria rather than on specific controls in isolation. The absence or inadequacy of a specific control designed to achieve the objectives of a specific criterion may not be a deficiency if other controls specifically address the same criterion. Further, when one or more control achieves the objectives of a specific criterion, the practitioner may not need to consider other controls designed to achieve those same objectives.

### **Testing and Evaluating the Operating Effectiveness of Controls**

**64.** To evaluate the operating effectiveness of an entity's internal control, the practitioner performs tests of relevant controls to obtain sufficient evidence to support the opinion in the report. Tests of the operating effectiveness of a control are concerned with how the control was applied, the consistency with which it was applied, and by whom it was applied. The tests ordinarily include procedures such as inquiries of appropriate personnel, inspection of relevant documentation, observation of the entity's operations, and reapplication or reperformance of the operation of the control using selected transactions.

#### ***Nature of Tests of Controls***

**65.** The nature of tests of controls refers to their type, that is, inquiry, observation, inspection, or reperformance, or combinations thereof. Evidence is more reliable when the practitioner obtains consistent evidence from a combination of procedures. Accordingly, the practitioner often uses a combination of procedures to obtain sufficient evidence regarding the operating effectiveness of a control. For example, a practitioner may 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 practitioner may supplement the observation with inquiries of entity personnel and inspection of documentation about the operation of such controls at other times.

**66.** Inquiry is a procedure that is used extensively throughout the examination and often is complementary to performing other procedures. Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, throughout the entity. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

**67.** Responses to inquiries may provide the practitioner with information not previously possessed or with corroborative evidence. Alternatively, responses might provide information that differs significantly from other information that the practitioner has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the practitioner to modify or perform additional procedures.

**68.** The practitioner ordinarily performs procedures in addition to the use of inquiry to obtain sufficient evidence. Inquiry alone does not provide sufficient evidence to support the operating effectiveness of controls. For example, if the entity implemented a control activity whereby its sales manager reviews and investigates a report of invoices with unusually high or low gross margins, mere inquiry of the sales manager as to whether he or she investigates discrepancies is inadequate. During the inquiry process, the practitioner should corroborate the responses received by performing other procedures, such as inspecting reports or other documentation used in or generated by the performance of the control.

**69.** The nature of the controls influences the nature of the tests of controls the practitioner can perform. For example, the practitioner may examine documents regarding controls for which

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

documentary evidence exists. However, documentary evidence regarding the control environment (such as management's philosophy and operating style) may not exist. In circumstances where documentary evidence of controls or the performance of controls does not exist and is not expected to exist, the practitioner's tests of controls would consist of inquiries of appropriate personnel and observation of entity activities. Inspecting selected correspondence, such as legal claims and company replies to personnel inquiries, and observing actions taken in response to asserted issues may provide additional assurance concerning the control environment.

### ***Extent of Tests of Controls***

**70.** The evidence that is sufficient to support a practitioner's opinion is a matter of professional judgment. However, the practitioner performs tests of controls for each significant account balance, class of transactions, and disclosure in each examination. In determining the controls to be tested, the practitioner should consider matters such as the following:

- The nature of the control
- The significance of the control in achieving the objectives of the control criteria and whether more than one control achieves a particular objective
- The nature and extent of tests of the operating effectiveness of the controls performed by the entity, if any
- The risk that the control might not be operating effectively, which might be assessed by considering the following:
  - Whether there have been changes in the volume or nature of transactions that might adversely affect control design or operating effectiveness
  - Whether there have been changes in the design of controls
  - The degree to which the control relies on the effectiveness of other controls (for example, the control environment or 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
  - The complexity of the control

**71.** The practitioner should perform tests of controls in each of the internal control components in each examination engagement. In addition to testing the control environment, risk assessment, and monitoring controls, the practitioner also should perform some tests of control activities for each significant account balance, class of transactions, and disclosure in each examination engagement. However, the practitioner may vary from year to year the nature, timing, and extent of testing on those controls. For example, when general controls are assessed as strong, and annually tested to confirm this, the practitioner when testing the revenue system may place more or less reliance on the work of others, including internal auditors; test the controls at a different interim period; increase or reduce the number of tests performed; or change the combination of procedures used. The tests of controls should be designed to provide evidence to enable the practitioner to conclude whether the entity's system of internal control over

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

financial reporting, including the controls in all components, is operating effectively, not necessarily to provide evidence to issue an opinion that a single component is operating effectively by itself to prevent or detect material misstatements. Because the internal control components are interrelated, the evidence produced from the combination of applying different types of procedures and testing each component provides better evidence that the entity's internal control is operating effectively than evidence from tests of only a single component. Similarly, tests of more than one control related to a significant account provide better evidence than a test of a single control for a significant account.

**72.** In performing tests of preventive and detective controls, the practitioner may 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 (a detective control) would detect an out-of-balance situation resulting from an unauthorized transaction being initiated due to an ineffective authorization procedure (a preventive control). In making a determination that the detective control is effective, the practitioner should ensure that the detective control is sufficient to achieve the control objective to which the preventive control relates. However, in this case, management's reliance on high-level analytical procedures, by themselves, would not be sufficiently precise to achieve the control objective.

**73.** Ordinarily, the practitioner should test controls on which other significant controls depend (for example, general controls) more extensively and in each examination engagement. In making a judgment about the extent of testing that is appropriate, the practitioner also should consider the account balance, class of transaction, or disclosure and related assertions that a control addresses and the implications if the control is deficient. The practitioner does not need to test insignificant controls that the responsible party or the practitioner has identified.

### ***Using the Results of the Responsible Party's Tests***

**74.** Although the practitioner may consider the results of the responsible party's tests of the operating effectiveness of certain controls, it is the practitioner's responsibility to obtain sufficient evidence to support his or her opinion. The practitioner should not rely on the results of procedures performed by others as the principal evidence of the operating effectiveness of controls over significant accounts, classes of transactions, and disclosures. If the practitioner intends to use the results of tests performed by others (such as internal audit, management, other entity personnel, or third parties working under the direction of management, including other practitioners who may have been engaged to perform procedures as a basis for the responsible party's assertion about the effectiveness of internal control) to alter the nature, timing, and extent of the tests of controls that the practitioner performs, the practitioner should:

- Reperform tests of controls on each significant account, class of transactions, and disclosure to corroborate the results of such tests; *and also*
- Perform independent tests of controls related to each significant account, class of transactions, and disclosure.

When evaluating whether sufficient evidence has been obtained, the practitioner should consider that evidence obtained through his or her direct personal knowledge, observation, reperformance, and inspection is more persuasive than information obtained indirectly, such as from management, internal auditors, or other personnel. Further, judgments about the sufficiency of evidence obtained and other factors affecting the practitioner's opinion, such as the materiality of identified control deficiencies, should be those of the practitioner.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

**75.** In considering the results of tests of the operating effectiveness of controls performed by others, the practitioner also considers such matters as:

- The materiality of the account balances, classes of transactions, and disclosures that the controls address
- The objectivity and competence of the individuals performing the tests of controls
- The degree of subjectivity involved in evaluating evidence about the effectiveness of the controls
- The pervasiveness of the controls

**76.** Evaluating evidence about the control environment, including fraud programs and controls, often involves a high degree of subjectivity. The practitioner should not use the results of tests performed by others in testing and in evaluating evidence about the control environment. The practitioner also should limit his or her use of the work of others in areas such as the following:

- Controls that have a pervasive effect on the financial statements, such as general controls on which the operating effectiveness of other controls depend
- Controls over significant nonroutine and nonsystematic transactions (such as accounts involving judgments and estimates)
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; to initiate, record, and process journal entries in the general ledger; and to record recurring and nonrecurring adjustments to the financial statements (for example, consolidating adjustments, report combinations, and reclassifications)

### ***Timing of Tests of Controls***

**77.** The period of time over which the practitioner should perform tests of controls is a matter of judgment; however, it 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 financial statements and controls over physical inventory counts). The practitioner should perform tests of controls over a period of time that is adequate to determine whether, as of the date specified in the assertion, the controls necessary for achieving the objectives of the control criteria are operating effectively.

**78.** When the practitioner reports on the effectiveness of controls “as of” a specific date and obtains evidence about the operating effectiveness of controls at an interim date, the practitioner should determine what additional evidence concerning the operation of the control should be obtained for the remaining period. In making that determination, the practitioner should consider the specific controls that were tested prior to the “as of” date and the results of the testing of those controls, the degree to which evidence about the operating effectiveness of those controls was obtained, and the length of the remaining period. The practitioner should obtain evidence about the nature and extent of any significant changes in internal control that occur subsequent to the interim date. In addition, the practitioner should obtain sufficient evidence about the operating effectiveness of such controls since the interim date, for example, by obtaining evidence about the operating effectiveness of the entity’s monitoring of controls. For controls over significant

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

nonroutine transactions, controls over accounts or classes of transactions with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments, the practitioner should consider the need to perform tests of controls closer to or at the "as of" date.

**79.** The client may request the practitioner to examine the effectiveness of controls related to the preparation of interim financial information. Depending on the period(s) specified in the assertion, the practitioner should perform tests of controls in effect during one or more interim periods to form an opinion about the effectiveness of such controls in achieving the related interim reporting objectives.

**80.** Prior to the date specified in the assertion, the responsible party may change the entity's controls to make them more effective or efficient, or to address control deficiencies. In these circumstances, the practitioner may not need to consider controls that have been superseded. For example, if the practitioner 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 practitioner to assess their design and operating effectiveness by performing tests of controls,<sup>21</sup> the practitioner will not need to consider the design and operating effectiveness of the superseded controls, except to the extent of communicating identified significant deficiencies in controls in an interim period. However, if the practitioner also is conducting an audit of the entity's financial statements, the practitioner may need to consider the design and operating effectiveness of the superseded controls as they relate to the auditor's reliance on controls for financial statement audit purposes.

## EVALUATING DEFICIENCIES IN AN ENTITY'S INTERNAL CONTROL

**81.** As described in paragraphs 11 through 13, deficiencies in an entity's internal control range from inconsequential internal control deficiencies to material weaknesses in internal control. Determining whether a deficiency is a significant deficiency or a material weakness requires professional judgment and the consideration of various factors. Paragraphs 82 through 89 provide guidance to the practitioner in making that determination.

### Significant Deficiencies

**82.** In making the judgment as to which internal control deficiencies are significant deficiencies, the practitioner should take into consideration various factors relating to the entity, such as its size, complexity and diversity of activities, and organizational structure.<sup>22</sup> A significant degree of professional judgment is required in evaluating whether an internal control deficiency is a significant deficiency. Factors the practitioner considers include:

- The likelihood that the internal control deficiency could result in a misstatement
- The magnitude of potential misstatements resulting from the internal control deficiency
- The importance of the control that is deficient, including the degree to which other effective controls achieve the same control objectives

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<sup>21</sup> Paragraph 110 provides reporting guidance in circumstances when the practitioner 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.

<sup>22</sup> See the Appendix of the proposed SAS *Communication of Internal Control Related Matters Noted in an Audit*.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- The nature of the account balances or classes of transactions affected by the internal control deficiency and the financial statement assertions involved
- If the internal control deficiency is an operating deficiency, the frequency of exceptions

**83.** In testing the operating effectiveness of controls, the practitioner may encounter exceptions or deviations to the control. If the reasons for the exception do not indicate a weakness in the general design or operation of the control, the deviation may not indicate a significant deficiency. When evaluating the reason for the exception, the practitioner considers whether the control is automated (in the presence of effective general controls, an automated application control is expected to always perform as designed), the degree of intervention by entity personnel contributing to the deviation, and, if management was aware of the deviation, its actions in response to the issue. However, regardless of the reasons for the deviation, numerous or repeated instances of the deficiency may constitute a significant deficiency. A control with an observed nonnegligible deviation rate is not an effective control.

**84.** A number of internal control deficiencies that have a common feature or attribute may constitute a significant deficiency even though such deficiencies are individually insignificant. The practitioner may identify multiple deficiencies that are common to a specific account, component, or location or business unit. For example, the practitioner may identify numerous instances in which the responsible party's risk assessment process operates deficiently with regard to accounts or locations or both. Similarly, the practitioner may determine that a reconciliation of detail to the general ledger has not been done across a range of accounts or business units. Although such deficiencies, if isolated occurrences, may not be individually evaluated as a significant deficiency, the practitioner may conclude that multiple instances of a deficiency around a common theme constitutes a significant deficiency.

### Material Weaknesses

**85.** The existence of a material weakness in internal control precludes an unqualified opinion that internal control is effective. 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.<sup>23</sup>

**86.** Evaluating whether a significant deficiency, individually or in the aggregate, is also a material weakness is a subjective process that depends on factors such as the nature of the accounting system and the financial statement amounts or transactions exposed to the significant deficiency, the overall control environment, other controls, and the judgment of those making the evaluation. The absence of identified misstatements is not a criterion for concluding that significant deficiencies do not constitute material weaknesses.

**87.** In circumstances where the practitioner performing the engagement on the effectiveness of internal control also audits the entity's financial statements, the practitioner should consider misstatements that he or she detects by performing substantive procedures when assessing the operating effectiveness of related controls. The extent of misstatements that the auditor detects by performing substantive procedures may alter his or her judgment about the effectiveness of controls. A material misstatement detected by the auditor's procedures that was not identified by the entity ordinarily is indicative of the existence of a material weakness in internal control.

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<sup>23</sup> Paragraphs 104 through 106 contain guidance the practitioner should consider when a material weakness exists.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

**88.** When evaluating whether a significant deficiency is also a material weakness, the practitioner should recognize that:

- a.* The amounts of misstatements caused by error or fraud that might occur and remain undetected range from zero to more than the gross financial statement amounts or transactions that are exposed to the significant deficiency.
- b.* The risk of misstatement due to error or fraud is likely to be different for the different possible amounts within that range. For example, the risk of misstatement due to error or fraud in amounts equal to the gross exposure might be very low, but the risk of misstatements in smaller amounts might be greater.

**89.** In addition to the guidance discussed in paragraphs 82 and 84, the practitioner should consider the following in evaluating whether the aggregate effect of individual significant deficiencies results in a material weakness:

- a.* The range or distribution of the amounts of misstatement caused by error or fraud that may result during the same accounting period from two or more individual significant deficiencies
- b.* The likelihood that such a combination of misstatements would be material

### Communicating Significant Deficiencies and Material Weaknesses

**90.** A practitioner engaged to examine the effectiveness of the entity's internal control should communicate to the client's audit committee in writing the significant deficiencies and material weaknesses identified.<sup>24</sup>

**91.** Because timely communication may be important, the practitioner may choose to communicate to his or her client significant matters during the course of the examination rather than after the examination is concluded. The decision about whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the urgency of corrective follow-up action.

**92.** If, in a multiple-party arrangement, the practitioner's client is not the responsible party, the practitioner has no responsibility to communicate significant deficiencies to the responsible party. For example, if the practitioner is engaged by his or her client to examine the effectiveness of internal control of an entity targeted for acquisition, the practitioner has no obligation to communicate any significant deficiencies to the targeted entity. However, the practitioner is not precluded from making such a communication.

### WRITTEN REPRESENTATIONS

**93.** The practitioner should obtain written representations from the responsible party.<sup>25</sup>

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<sup>24</sup> See footnote 19.

If the client does not have an audit committee, the practitioner should communicate with individuals whose authority and responsibility are equivalent to those of an audit committee, such as the board of directors, the board of trustees, an owner in an owner-managed entity, or those who engaged the practitioner.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- a. Acknowledging the responsible party's responsibility for establishing and maintaining effective internal control.
- b. Stating that the responsible party has performed an evaluation of the effectiveness of the entity's internal control and specifying the control criteria.
- c. Stating the responsible party's assertion about the effectiveness of the entity's internal control based on the control criteria as of a specified date.
- d. Stating that the responsible party has disclosed to the practitioner all significant deficiencies in the design or operation of internal control that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements and has identified those that it believes to be material weaknesses in internal control.
- e. Describing any material fraud and any other fraud that, although not material, involve management or other employees who have a significant role in the entity's internal control.
- f. Stating whether there were, subsequent to the date being reported on, any changes in internal control or other factors that might significantly affect internal control, including any corrective actions taken by the responsible party with regard to significant deficiencies and material weaknesses.

**94.** The responsible party's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause the practitioner to disclaim an opinion or withdraw from an examination engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the practitioner may conclude, in an examination engagement, that a qualified opinion is appropriate. Further, the practitioner should consider the effects of the responsible party's refusal on his or her ability to rely on other representations, including, if appropriate, representations obtained in an audit of the responsible party's financial statements.

## FORMING AN OPINION

**95.** When forming an opinion on the effectiveness of an entity's internal control or a written assertion thereon, the practitioner should consider all evidence obtained, including the results of the tests of controls and any identified internal control deficiencies, to evaluate the design and operating effectiveness of the entity's internal control based on the control criteria. The existence of a material weakness in internal control precludes an unqualified opinion that internal control is effective. As stated in paragraph 16, inadequate documentation of the design of controls may result in a significant deficiency or a material weakness, and may constitute a limitation on the scope of the engagement. In addition, as stated in paragraph 17, the absence of sufficient evidence to support the responsible party's evaluation of the operating effectiveness of internal control constitutes a material weakness that results in a report qualification, as discussed in paragraphs 104 through 106.

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<sup>25</sup> See SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), as amended for guidance on such matters as who should sign the letter, the period to be covered by the letter, and when an updating letter should be obtained.

## REPORTING STANDARDS

**96.** The practitioner may examine and report directly on an entity's effectiveness of internal control (see paragraphs 97 and 98) or he or she may examine and report on the responsible party's written assertion (see paragraphs 99 through 101), except as described in paragraph 104.

**97.** The practitioner's examination report on the effectiveness of an entity's internal control over financial reporting should include the following:

- a. A title that includes the word *independent*
- b. An identification of the subject matter (internal control over financial reporting) and the responsible party
- c. A statement that the responsible party is responsible for maintaining effective internal control over financial reporting
- d. A statement that the practitioner's responsibility is to express an opinion on the effectiveness of an entity's internal control based on his or her examination
- e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants<sup>26</sup>
- f. A statement that those standards require that the practitioner plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects
- g. A statement that an examination includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the practitioner considered necessary in the circumstances
- h. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion
- i. A paragraph stating that, because of inherent limitations of internal control over financial reporting, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected and also stating that projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate
- j. The practitioner's opinion on whether the entity has maintained, in all material respects, effective internal control over financial reporting as of the specified date based on the control criteria<sup>27</sup>

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<sup>26</sup> For an audit of internal control conducted as part of a public company audit as defined in the proposed SAS *Auditing an Entity's Internal Control Over Financial Reporting in Conjunction With the Financial Statement Audit*, this statement will indicate that the audit was conducted in accordance with auditing standards generally accepted in the United States of America.

<sup>27</sup> See paragraphs 104 through 106 for reporting when the examination discloses conditions that, individually or in combination, result in one or more material weaknesses.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- k. A statement restricting the use of the report to the specified parties (see the fourth reporting standard) under the following circumstances (see also paragraph 20):
- When the criteria used to evaluate internal control over financial reporting are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria
  - When the criteria used to evaluate internal control over financial reporting are available only to specified parties
- l. The manual or printed signature of the practitioner's firm
- m. The date of the examination report
- 98.** The following is the form of report a practitioner should use when he or she expresses an opinion directly on the effectiveness of an entity's internal control as of a specified date.

### Independent Accountant's Report

#### *[Introductory paragraph]*

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of W Company's internal control over financial reporting based on our examination.

#### *[Scope paragraph]*

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

#### *[Inherent limitations paragraph]*

Because of the inherent limitations of internal control over financial reporting, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

#### *[Opinion paragraph]*

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*<sup>28</sup>].

[*Signature*]

[*Date*]

- 99.** The practitioner's examination report on a written assertion about the effectiveness of an entity's internal control over financial reporting should include the following:
- a. A title that includes the word *independent*
  - b. An identification of the written assertion about the effectiveness of the entity's internal control over financial reporting as of a specified date and the responsible party (When the written assertion does not accompany the practitioner's report, the first paragraph of the report should also contain a statement of the assertion.)
  - c. A statement that the assertion is the responsibility of the responsible party
  - d. A statement that the practitioner's responsibility is to express an opinion on the written assertion based on his or her examination
  - e. A statement that the examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants<sup>29</sup>
  - f. A statement that those standards require that the practitioner plan and perform the examination to obtain reasonable assurance that the responsible party's assertion is free of material misstatement.
  - g. A statement that an examination includes obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as the practitioner considered necessary in the circumstances
  - h. A statement that the practitioner believes the examination provides a reasonable basis for his or her opinion
  - i. A paragraph stating that, because of inherent limitations of internal control over financial reporting, including the possibility of management override of controls, misstatements due to error or fraud may occur and not be detected and also stating that projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate
  - j. The practitioner's opinion on whether the assertion about the effectiveness of the entity's internal control over financial reporting as of the specified date is fairly stated, in all material respects, based on the control criteria<sup>30</sup>

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<sup>28</sup> For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

<sup>29</sup> See footnote 26.

<sup>30</sup> See footnote 27.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- k. A statement restricting the use of the report to specified parties (see the fourth reporting standard) under the following circumstances:
- When the criteria used to evaluate the effectiveness of internal control over financial reporting are determined by the practitioner to be appropriate only for a limited number of parties who either participated in their establishment or can be presumed to have an adequate understanding of the criteria
  - When the criteria used to evaluate the effectiveness of internal control over financial reporting are available only to specified parties
- l. The manual or printed signature of the practitioner's firm
- m. The date of the examination report
- 100.** The following is the form of report a practitioner should use when he or she expresses an opinion on a written assertion about the effectiveness of an entity's internal control as of a specified date.

### Independent Accountant's Report

#### *[Introductory paragraph]*

We have examined management's assertion, included in the accompanying *[title of management report]*, that W Company maintained effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.<sup>31</sup> W Company's management is responsible for its assertion about the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assertion based on our examination.

#### *[Scope paragraph]*

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance that management's assertion is free of material misstatement. Our examination included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

#### *[Standard inherent limitations paragraph]*

#### *[Opinion paragraph]*

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<sup>31</sup> The practitioner should identify the responsible party's report examined by referring to the title used by the responsible party in its report. Further, he or she should use the same description of the entity's internal control as the responsible party uses in its report, including the kinds of controls (that is, control over the preparation of annual financial statements, interim financial statements, or both) on which the responsible party is reporting. If the presentation of the assertion does not accompany the practitioner's report, the phrase "included in the accompanying *[title of responsible party's report]*" would be omitted.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

In our opinion, management's assertion that W Company maintained effective internal control over financial reporting as of December 31, 20XX, is fairly stated, in all material respects, based on [*identify criteria*<sup>32</sup>].

[*Signature*]

[*Date*]

**101.** Nothing precludes the practitioner from examining an assertion but opining directly on the effectiveness of internal control.

### Restricting the Use of the Report

**102.** Chapter 1 of SSAE No. 10 (AT sec. 101.78–.83) provides guidance on restricting the use of an attest report. Nothing in this Statement precludes the practitioner from restricting the use of the report.<sup>33</sup> If the practitioner is requested by one party to examine the effectiveness of another entity's internal control, he or she may want to restrict the report to the party making the request.

### Report Modifications

**103.** The practitioner should modify the standard reports if any of the following conditions exist.

- a. There is a material weakness in the entity's internal control. (See paragraphs 104 through 106.)
- b. There is a restriction on the scope of the engagement. (See paragraphs 109 through 112.)
- c. The practitioner decides to refer to the report of another practitioner as the basis, in part, for the practitioner's own report. (See paragraphs 113 and 114.)
- d. A significant subsequent event has occurred since the date being reported on. (See paragraphs 115 through 118.)
- e. The engagement relates to examining and reporting on the effectiveness of only a portion of the entity's internal control. (See paragraph 119.)
- f. The engagement only relates to examining and reporting on the suitability of design of the entity's internal control. (See paragraphs 120 and 121.)
- g. The criteria are not suitable for general use. (See paragraphs 122 through 126.)

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<sup>32</sup> For example, "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

<sup>33</sup> See footnote 15.

## Material Weaknesses

**104.** If the examination discloses significant deficiencies that, individually or in combination, result in one or more material weaknesses (paragraphs 85 through 89), the practitioner should modify the report and, to most effectively communicate with the reader of the report, should express his or her opinion directly on the effectiveness of internal control, not on the assertion. The nature of the modification depends on the weakness and its effect on the achievement of the objectives of the control criteria.

**105.** The following is the form of the report, modified with explanatory language, that a practitioner should use when there is a material weakness in an entity's internal control and, based on its significance and its effect on the achievement of the objectives of the control criteria, the practitioner concludes that a qualified opinion is appropriate.

### Independent Accountant's Report

*[Introductory paragraph]*

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of W Company's internal control over financial reporting based on our examination.

*[Standard scope and inherent limitations paragraphs]*

*[Explanatory paragraph]*

A material weakness is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis. A significant deficiency is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The following material weakness has been identified. *[Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.]*

*[Opinion paragraph]*

In our opinion, except for the effect of the material weakness described in the preceding paragraph on the achievement of the objectives of the control criteria, W Company has maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

*[Signature]*

*[Date]*

**106.** The following is the form of report, expressing an adverse opinion, that a practitioner should use when a material weakness in internal control exists and, in the practitioner's judgment,

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

the material weakness is so pervasive that the entity's internal control over financial reporting does not achieve the control objectives.

### Independent Accountant's Report

#### *[Introductory paragraph]*

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]* W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of W Company's internal control over financial reporting based on our examination.

#### *[Standard scope and inherent limitations paragraphs]*

#### *[Explanatory paragraph]*

A material weakness is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis. A significant deficiency is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The following material weakness has been identified. *[Include a description of the material weakness and its effect on the achievement of the objectives of the control criteria.]*

#### *[Opinion paragraph]*

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

*[Signature]*

*[Date]*

### **Responsible Party's Assertion Contains Additional Information**

**107.** A written assertion accompanying the practitioner's report may contain information in addition to management's assertion about the effectiveness of its internal control over financial reporting. Such information may include, for example, disclosures about corrective actions taken by the entity after the date of the responsible party's assertion; the entity's plans to implement new controls; or a statement that the responsible party believes the cost of correcting a material weakness<sup>34</sup> would exceed the benefits to be derived from implementing new controls. If such information is included in the responsible party's assertion, the practitioner should disclaim an opinion on the information. For example, the practitioner may use the following sample language

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<sup>34</sup> Paragraph 20 of the proposed SAS *Auditing an Entity's Internal Control over Financial Reporting in Conjunction With the Financial Statement Audit* requires the auditor to disclaim cost-benefit statements, if included by management, with regard to correcting significant deficiencies as well as material weaknesses.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

as the last paragraph of the report to disclaim an opinion on the responsible party'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.

However, if the practitioner believes that the responsible party's additional information contains a material misstatement of fact, he or she should consider the guidance in Chapter 1 of SSAE No. 10 (AT sec. 101.92–.94), and take appropriate action.

### **Practitioner's Report on Internal Control Identifies a Material Weakness and Is Included in the Same Document Containing the Audit Report**

**108.** If the practitioner's report on his or her examination of the effectiveness of the entity's internal control is included within the same document that includes his or her audit report on the entity's financial statements, the following sentence should be included in the paragraph of the examination report 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 20XX financial statements, and this report does not affect our report dated *[date of report]* on those financial statements.

The practitioner may also include the preceding sentence in situations where the two reports are not included within the same document.

### **Scope Limitations**

**109.** An unqualified opinion on the effectiveness of the entity's internal control or the written assertion thereon can be expressed only if the practitioner has been able to apply all the procedures he or she considers necessary in the circumstances. Restrictions on the scope of the engagement, whether imposed by the client, the responsible party, or by the circumstances, may require the practitioner to withdraw from the engagement, disclaim an opinion, or express a qualified opinion. The practitioner's decision depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the effectiveness of the entity's internal control.

**110.** For example, the responsible party may have implemented controls to correct a material weakness identified prior to the date specified by the client. However, unless the practitioner has been able to obtain evidence that the new controls were appropriately designed and have been operating effectively for a sufficient period of time,<sup>35</sup> he or she should refer to the material weakness and qualify his or her opinion on the basis of a scope limitation. The following is the form of the report a practitioner should use when restrictions on the scope of the examination cause the practitioner to issue a qualified opinion.

Independent Accountant's Report

*[Standard introductory paragraph]*

*[Scope paragraph]*

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<sup>35</sup> See guidance in paragraph 77.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

Except as described below, we conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

*[Explanatory paragraph]*

A material weakness is a significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that material misstatements in the financial statements will not be prevented or detected on a timely basis. A significant deficiency is an internal control deficiency that could adversely affect the entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. The following material weakness has been identified. Prior to December 20, 20XX, 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 at *[date]*. Although the Company implemented a new cash receipts system on December 20, 20XX, the system has not been in operation for a sufficient period of time to enable us to obtain sufficient evidence about its operating effectiveness.

*[Standard inherent limitations paragraph]*

*[Opinion paragraph]*

In our opinion, except for the effect of matters we may 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, 20XX, based on *[identify criteria]*.

*[Signature]*

*[Date]*

**111.** When restrictions that significantly limit the scope of the examination are imposed by the client or the responsible party, the practitioner generally should disclaim an opinion on the effectiveness of the entity's internal control or the written assertion thereon.

**112.** The following is the form of report that a practitioner should use when restrictions that significantly limit the scope of the examination are imposed by the client or the responsible party and cause the practitioner to issue a disclaimer of opinion.

### Independent Accountant's Report

*[Introductory paragraph]*

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

We were engaged to examine the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is responsible for maintaining effective internal control over financial reporting.

*[Scope paragraph should be omitted]*

*[Explanatory paragraph]*

*[Include paragraph to describe scope restrictions]*

*[Opinion paragraph]*

Since management *[describe scope restrictions]* and we were unable to apply other procedures to satisfy ourselves as to the entity's internal control over financial reporting, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of the entity's internal control over financial reporting.

*[Signature]*

*[Date]*

### Opinion Based in Part on the Report of Another Practitioner

**113.** When another practitioner has examined the effectiveness of internal control of one or more subsidiaries, divisions, branches, or components of the entity, the practitioner should consider whether he or she may serve as the principal practitioner and use the work and reports of the other practitioner as a basis, in part, for his or her opinion. If the practitioner decides it is appropriate for him or her to serve as the principal practitioner, he or she should then decide whether to make reference in the report to the examination performed by the other practitioner. In these circumstances, the practitioner's considerations are similar to those of the independent auditor who uses the work and reports of other independent auditors when reporting on an entity's financial statements. SAS No. 1, *Codification of Auditing Standards and Procedures* (AICPA, *Professional Standards*, vol. 1, AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), provides guidance on the auditor's considerations when deciding whether he or she may serve as the principal auditor and, if so, whether to make reference to the examination performed by the other practitioner.

**114.** When the practitioner decides to make reference to the report of the other practitioner as a basis, in part, for the practitioner's opinion, the practitioner should disclose this fact when describing the scope of the examination and should refer to the report of the other practitioner when expressing the opinion.<sup>36</sup> The following form of the report is appropriate in these circumstances.

#### Independent Accountant's Report

*[Introductory paragraph]*

We have examined the effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*. W Company's management is

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<sup>36</sup> Whether the other practitioner's opinion is expressed on the responsible party's assertion or on the effectiveness of internal control does not affect the determination of whether the principal practitioner's opinion is expressed on the assertion or on the subject matter itself.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of W Company's internal control over financial reporting based on our examination. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was examined by other accountants 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 accountants.

*[Scope paragraph]*

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other accountants provide a reasonable basis for our opinion.

*[Standard inherent limitations paragraph]*

*[Opinion paragraph]*

In our opinion, based on our examination and the report of the other accountants, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on *[identify criteria]*.

*[Signature]*

*[Date]*

### Subsequent Events

**115.** Changes in internal control or other factors that might significantly affect internal control may occur subsequent to the date as of which internal control over financial reporting is being examined but before the date of the practitioner's report. As described in paragraph 94, the practitioner should obtain written representations from the responsible party relating to such matters. Additionally, to obtain information about whether changes have occurred that might affect the effectiveness of the entity's internal control and, therefore, the practitioner's report, he or she should inquire about and examine, for this subsequent period, the following:

- a. Relevant internal auditor reports issued during the subsequent period
- b. Independent auditor reports (if other than the practitioner's) of significant deficiencies or material weaknesses
- c. Regulatory agency reports on the entity's internal control

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

- d. Information about the effectiveness of the entity's internal control obtained through other professional engagements

**116.** If the practitioner obtains knowledge about subsequent events that he or she believes significantly affect the effectiveness of the entity's internal control as of the date specified in the assertion, the practitioner should report directly on the effectiveness of the entity's internal control, and issue a qualified or an adverse opinion. If the practitioner is unable to determine the effect of the subsequent event on the effectiveness of the entity's internal control, the practitioner should disclaim an opinion.

**117.** The practitioner may obtain knowledge about subsequent events with respect to conditions that did not exist at the date specified in the assertion but arose subsequent to that date. Occasionally, a subsequent event of this type has such a material impact on the entity that the practitioner may wish to 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.

### Subsequent Discovery of Information Existing at the Date of the Practitioner's Report

**118.** The practitioner has no responsibility to keep informed of events subsequent to the date of his or her report; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of the report on an audit of financial statements described in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"). The guidance in that AU section 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 considers (a) whether the facts would have changed the report if he or she had been aware of them and (b) whether there are persons currently relying on or likely to rely on the practitioner's report on the effectiveness of the entity's internal control. Based on these considerations, detailed guidance is provided for the auditor in SAS No. 1 (AU sec. 561.06).

### Reporting on the Effectiveness of a Portion of the Entity's Internal Control

**119.** When engaged to examine the effectiveness of only a portion of an entity's internal control (for example, internal control over financial reporting of an entity's operating division or its accounts receivable), a practitioner should follow the guidance in this Statement and issue a report using the guidance in paragraphs 96 through 112, modified to refer to the portion of the entity's internal control examined. In this situation, the practitioner may use a report such as the following.

#### Independent Accountant's Report

[Introductory paragraph]

We have examined the effectiveness of W Company's internal control over financial reporting for its retail division as of December 31, 20XX, based on [identify criteria]. W Company's management is responsible for maintaining effective internal control over financial reporting. Our responsibility is to express an opinion on the effectiveness of W Company's internal control over financial reporting based on our examination.

[Standard scope and inherent limitations paragraphs]

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

[*Opinion paragraph*]

In our opinion, W Company's retail division maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

[*Signature*]

[*Date*]

### Reporting on the Suitability of Design of the Entity's Internal Control

**120.** The client may request the practitioner to examine the suitability of the design of the entity's internal control for preventing or detecting material misstatements on a timely basis. For example, prior to granting a new casino a license to operate, a regulatory agency may request a report on whether internal control that the responsible party plans to implement will provide reasonable assurance that the control objectives specified in the regulatory agency's regulations will be achieved. When evaluating the suitability of design of the entity's internal control for the regulatory agency's purpose, the practitioner should obtain an understanding of the components of internal control<sup>37</sup> that the responsible party should implement to meet the control objectives of the regulatory agency and identify the controls that are relevant to those control objectives.

**121.** The following is a suggested form of report a practitioner may issue. The actual form of the report should be modified, as appropriate, to fit the particular circumstances.<sup>38</sup>

#### Independent Accountant's Report

[*Introductory paragraph*]

We have examined the suitability of W Company's design of internal control over financial reporting to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for the suitable design of internal control over financial reporting. Our responsibility is to express an opinion on the design of W Company's internal control over financial reporting based on our examination.

[*Scope paragraph*]

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether internal control over financial reporting is suitably designed, in all material respects, to prevent or detect material misstatements in the financial statements on a timely basis. Our examination included obtaining an understanding of internal control over financial reporting, evaluating the design of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

[*Standard inherent limitations paragraph*]

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<sup>37</sup>

See paragraph 53.

<sup>38</sup>

This report assumes that the control criteria of the regulatory agency are both suitable and available to users as discussed in Chapter 1 of SSAE No. 10 (AT sec. 101.23-.33). Therefore, there is no restriction on the use of this report.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

[*Opinion paragraph*]

In our opinion, W Company's internal control over financial reporting is suitably designed, in all material respects, to prevent or detect material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*].

[*Signature*]

[*Date*]

When reporting on the suitability of design of the entity's internal control that has already been placed in operation, the practitioner should modify his or her report by adding the following to the scope paragraph of the report:

We were not engaged to examine and report on the operating effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, and, accordingly, we express no opinion on operating effectiveness.

### Reporting on Internal Control Based on Criteria Specified by a Regulatory Agency

**122.** A governmental or other agency that exercises regulatory, supervisory, or other public administrative functions may establish its own criteria and require reports on the internal control of entities subject to its jurisdiction. Criteria established by a regulatory agency may be set forth in audit guides, questionnaires, or other publications. The criteria may encompass specified aspects of an entity's internal control and specified aspects of administrative control or compliance with grants, regulations, or statutes. If such criteria have been subjected to due process procedures, including the distribution of proposed criteria for public comment, and the criteria are available to users (see Chapter 1 of SSAE No. 10 [AT sec. 101.23–.33]), a practitioner should use the form of report illustrated in paragraph 98. If, however, the criteria are not available to users as described in Chapter 1 (AT sec. 101.33), or such criteria have not been subjected to due process procedures and the practitioner determines that such criteria are appropriate only for a limited number of users who either participated in their establishment or can be presumed to have an adequate understanding of the criteria, the practitioner should modify the report by adding a separate paragraph that restricts the use of the report to the regulatory agency and to those within the entity.

**123.** For purposes of these reports, a material weakness is:

- a. A significant deficiency in one or more of the internal control components that alone or in the aggregate precludes the entity's internal control from reducing to an appropriately low level the risk that misstatements in amounts that would be material in relation to the applicable grant or program will not be prevented or detected on a timely basis.
- b. A condition in which the lack of conformity with the regulatory agency's criteria is material in accordance with any guidelines for determining materiality that are included in such criteria.

**124.** The following is an illustration of a report that a practitioner might use when he or she has been engaged to examine the adequacy of an entity's internal control over financial reporting based on criteria established by a regulatory agency that are not suitable for general use.

#### Independent Accountant's Report

[*Introductory paragraph*]

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

We have examined the adequacy of W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria, for example, the criteria established by \_\_\_\_\_ agency, as set forth in its audit guide dated \_\_\_\_\_*]. W Company's management is responsible for maintaining adequate internal control over financial reporting. Our responsibility is to express an opinion on whether W Company's internal control over financial reporting is adequate to meet such criteria based on our examination.

[*Standard scope and inherent limitations paragraphs*]

[*Opinion paragraph*]

We understand that the agency considers the controls over financial reporting that meet the criteria referred to in the first paragraph of this report adequate for its purpose. In our opinion, based on this understanding and on our examination, W Company's internal control over financial reporting is adequate, in all material respects, based on the criteria established by [\_\_\_\_\_ agency].

[*Restricted use paragraph*]

This report is intended solely for the information and use of the board of directors and management of W Company and [agency] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

**125.** When the practitioner issues this form of report, he or she does not assume any responsibility for the comprehensiveness of the criteria established by the regulatory agency. However, the practitioner should report any condition that comes to his or her attention during the course of the examination that he or she believes is a material weakness, even though it may not be covered by the criteria.

**126.** If a regulatory agency requires the reporting of all conditions (whether material or not) that are not in conformity with the agency's criteria, the practitioner should describe all conditions of which he or she is aware in the report.

### **OTHER INFORMATION IN A CLIENT-PREPARED DOCUMENT CONTAINING THE PRACTITIONER'S REPORT ON THE EFFECTIVENESS OF THE ENTITY'S INTERNAL CONTROL**

**127.** A client may publish various documents that contain information in addition to the practitioner's attest report on internal control (or an assertion related thereto). Chapter 1 of SSAE No. 10 (AT sec. 101.91–.94) provides guidance to the practitioner when the other information is contained in (a) annual reports to holders of securities or beneficial interest, annual organizations for charitable and philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934, or (b) other documents to which the practitioner, at the client's request devotes attention.

### **RELATIONSHIP TO THE FOREIGN CORRUPT PRACTICES ACT**

**128.** The Foreign Corrupt Practices Act of 1977 (FCPA) includes provisions regarding internal accounting control for entities subject to the Securities Exchange Act of 1934. Whether an entity

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

is in compliance with those provisions of the FCPA is a legal determination. A practitioner's examination report issued under this Statement does not indicate whether an entity is in compliance with those provisions.

### **EFFECTIVE DATE**

**129.** This Statement is effective when the subject matter or assertion is as of or for a period ending on or after September 15, 2003.

## REPORTING ON AN ENTITY'S INTERNAL CONTROL OVER FINANCIAL REPORTING

### APPENDIX

The following documents contain guidance for practitioners engaged to provide other services in connection with an entity's internal control.

- The proposed Statement on Auditing Standards (SAS) *Communication of Internal Control Related Matters Noted in an Audit* establishes standards and provides guidance on identifying and communicating significant deficiencies and material weaknesses that come to the auditor's attention during an audit of financial statements.
- SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), as amended provides guidance to auditors of a service organization on issuing a report on certain aspects of the service organization's internal control that can be used by other auditors, as well as guidance on how other auditors should use such reports.
- The AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* provides auditors of state and local governmental entities with a basic understanding of the work they should do and the reports they should issue for audits under Government Auditing Standards (1994 Revision), as amended, issued by the Comptroller General of the United States and for audits under the Single Audit Act requirements and A-133 (June 1997).
- SOP 98-3, *Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards*, provides auditors with a basic understanding of the work they should do and the reports they should issue for audits under Government Auditing Standards (1994 Revision), as amended, issued by the Comptroller General of the United States and for audits under the Single Audit Act requirements and A-133 (June 1997).