

# FREQUENTLY ASKED QUESTIONS ABOUT INTERNAL CONTROL OVER FINANCIAL REPORTING

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## Nature and Timing of the Reporting Requirement

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### *When must registrants begin to report on internal control over financial reporting?*

A registrant must comply with all of the requirements to report on internal control over financial reporting if it satisfies the definition of a “large accelerated filer” or an “accelerated filer,” as defined in Exchange Act Rule 12b-2. Domestic and foreign registrants that are non-accelerated filers or are “emerging growth companies” are required to comply with the management report on internal control over financial reporting, but do not have to provide the auditor attestation report. (See SEC Release Nos. 33-9142, which amended the SEC’s rules applicable to non-accelerated filers in accordance with Section 939G of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and Section 103 of the Jumpstart Our Business Startups Act, which amended Section 404(b) of the Sarbanes-Oxley Act to exclude registrants that meet the definition of “emerging growth companies” specified in Section 3 of the Securities Exchange Act of 1934.) In addition, a newly public company (e.g., a company that conducts an initial public offering) is not required to comply with the internal control reporting requirements until its second annual report filed with the SEC after becoming a public company.

### *Where must a registrant disclose the management report on internal control over financial reporting?*

The management report on internal control over financial reporting must be included in an annual report on Form 10-K or in whatever form is applicable to the registrant. Noting that failure to do so when the report is qualified in any way may render the annual report misleading, the Staff encourages registrants to include the report also in their annual reports to shareholders (see Question 10 of the SEC September 24, 2007 Internal Control FAQs).

Although the SEC’s rules do not specify where the reports on internal control over financial reporting should be included, the SEC’s adopting release for the internal control rules encouraged companies to put the management report “in close proximity to the corresponding attestation report issued by the registrant’s registered public accounting firm.” (See SEC Release No. 33-8238, Section B.3.e.) Nevertheless, many registrants have included the management report within Item 9A of the Form 10-K.

### *What must management say in its report on internal control over financial reporting?*

Item 308 of Regulation S-K provides that the management report on internal control over financial reporting must:

- State that management is responsible for establishing and maintaining adequate internal control over financial reporting for the registrant.
- Identify the framework that management has used to evaluate the effectiveness of the registrant's internal control over financial reporting (see *"What internal control framework should management use to assess its internal control over financial reporting?"* below).
- State management's conclusion as to whether the registrant's internal control over financial reporting is effective (that is, the report must state either that the registrant's internal control over financial reporting is effective or, if management has identified any material weakness in the registrant's internal control over financial reporting, that the registrant's internal control over financial reporting is not effective) and describe any such material weakness in internal control over financial reporting. No statement that internal controls are effective "except for" certain identified problems or any similar qualified language is permitted (see *"What disclosure is required about the effectiveness of disclosure controls and procedures?"* below).
- If applicable, state that the registrant's outside auditors have reported on the registrant's internal control over financial reporting. The outside auditors' report must be included in the Form 10-K.

*What additional disclosures are included in reports on internal control over financial reporting?*

The management reports on internal control over financial reporting that registrants included in their annual reports on Form 10-K often include an explanation about the inherent weaknesses of internal control similar to that included in the report of the outside auditors. The SEC Staff discourages any additional language in the management report on internal controls because it seeks to avoid language that would qualify or detract from the other mandated statements in the management report. Although the SEC Staff has issued comments that have led registrants to exclude any such explanation from the disclosure about the effectiveness of disclosure controls and procedures required by Item 307 of Regulation S-K, the SEC may accept an explanatory paragraph in the report on internal control over financial reporting because the requirements for outside auditors' reports on internal control over financial reporting set forth in PCAOB Auditing Standard No. 5 include the following "Inherent limitations" paragraph:

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

If management describes any material weakness in internal control over financial reporting, it should provide extensive disclosure to fully describe the weakness and the registrant's remediation plan. The disclosure provided in recent years has included details

that appeared to be designed to enable readers to understand the severity of the weakness. Such transparent disclosure is appropriate and probably necessary to avoid inappropriate investor concern about the impact of the weakness on the registrant's ability to prepare accurate financial statements.

Information about how the registrant is addressing the deficiency, including the nature of any improvements and enhancements that were made or are being implemented, the timing of such remediation efforts and any additional steps that the registrant is taking to ensure that its financial statements are accurate in the interim should also be provided. These disclosures should not be included in the management report on internal control over financial reporting. Rather, that disclosure should be set forth in Item 9A of the Form 10-K.

***What other disclosure about internal control over financial reporting must a registrant make?***

The annual report on Form 10-K and interim reports on Form 10-Q must include disclosure about any change in internal control over financial reporting that occurred during the fourth quarter of the fiscal year, in the case of the Form 10-K, or in the period covered by a Form 10-Q, that materially affected or is reasonably likely to materially affect internal control over financial reporting. This disclosure results from the representation in paragraph 4(d) of the certification required to be set forth as an exhibit to the Form 10-K and the Form 10-Q by Exchange Act Rules 13a-14(a) and 15d-14(a) and set forth in Item 601(b)(31)(i) of Regulation S-K. Paragraph 4(d) provides that the principal executive and financial officers "[d]isclosed in this report any change in the registrant's internal control

over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting." In addition, Exchange Act Rules 13a-15(d) and 15d-15(d) require management to evaluate, with the CEO and CFO's participation, "any change in the registrant's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters. . . that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting."

***What internal control framework should management use to assess its internal control over financial reporting?***

In the United States, the only framework for evaluating internal control is the framework established by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). In 1992, COSO issued its "Internal Control - Integrated Framework." (See Section II.B.3.a. of SEC Release No. 33-8238.) In 2006, COSO issued a supplemental framework for small businesses to use to evaluate internal control, which is designed to provide guidance to managements of small businesses required to comply with the internal control reporting requirements. In June 2008, COSO published a draft version of formal guidance on monitoring internal control systems. After receiving and responding to public comment on the draft, COSO published the final version in early 2009.

In November 2010, COSO announced a project to review and update the 1992 "Internal Control - Integrated Framework." COSO's goal in updating the framework is to increase its relevance in the

increasingly complex and global business environment so that organizations worldwide can better design, implement, and assess internal control. In May 2013, COSO published the updated “Internal Control—Integrated Framework.”

***What must the independent registered public accounting firm (the “outside auditors”) say about internal control over financial reporting?***

The SEC now requires, in the case of accelerated filers and large accelerated filers, that outside auditors express an opinion directly on the effectiveness of the registrant’s internal control over financial reporting (rather than also opining on the validity of management’s assessment of internal control, as was previously required). In a release dated August 2007, the SEC explained that it was adopting this requirement in order to communicate the outside auditors’ responsibility with respect to management’s processes. In addition, the direct opinion on internal control necessarily encompasses the outside auditors’ opinion as to whether management’s assessment of internal control is fairly stated. (See Release No. 33-8809.)

The outside auditors must also provide a report on the registrant’s financial statements, unless the outside auditors issue a combined report on both the financial statements and internal control over financial reporting. (See Paragraph 88 of PCAOB Auditing Standard No. 5.)

***Should registrants ask their outside auditors for separate or combined reports?***

PCAOB Auditing Standard No. 5 and Rule 2-02(f) of Regulation S-X permit outside auditors to issue their opinions on internal control over financial reporting in either a separate report or together with their opinion on the financial statements. Registrants may want to

consider whether to request separate reports so that any need for the outside auditors to reissue or double date their report on the financial statements does not raise a question as to the need for an update to the opinion on internal control over financial reporting. Some accounting firms, however, may take the position that their reports on internal control over financial reporting must be combined with the report on the financial statements.

***How do disclosure controls and procedures and internal control over financial reporting differ?***

Disclosure controls and procedures include all controls relating to the preparation of Exchange Act reports and other documents in a timely manner and many of the controls included in internal control over financial reporting, so this category is broader than internal control over financial reporting. Item 307 of Regulation S-K requires disclosure of the conclusions of the CEO and the CFO regarding the effectiveness of disclosure controls and procedures. Exchange Act Rules 13a-15(e) and 15d-15(e) define disclosure controls and procedures as those controls and other procedures that are designed to ensure that information required to be disclosed by a registrant in the reports that it submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms and include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a registrant is accumulated and communicated to the registrant’s management, including its CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Among the controls that would not necessarily be encompassed by disclosure controls and procedures are those that relate only to the safeguarding, and not the reporting, of assets. Any registrant that concludes that an aspect of its internal control over financial reporting is not part of disclosure controls and procedures will have the burden of proving its position. Therefore, the CEO and CFO are not likely to be able to conclude that their disclosure controls and procedures are effective if they, or their outside auditors, have identified any material weakness in internal control over financial reporting. (See Item 307 of Regulation S-K referred to in Item 9A of Part II of Form 10-K and Item 4 of Part I of Form 10-Q.) Disclosure controls and procedures also may be ineffective for reasons unrelated to internal control over financial reporting, such as when a company has failed to file reports on a timely basis in accordance with the SEC's rules.

***What disclosure is required about the effectiveness of disclosure controls and procedures?***

A registrant's CEO and CFO must state either that the registrant's disclosure controls and procedures are effective or, if they have identified any material deficiency within the disclosure controls and procedures, such as a material weakness in internal control over financial reporting, that the registrant's disclosure controls and procedures are not effective. They cannot state that the registrant's disclosure controls and procedures are effective except to the extent of specifically described problems or express similar qualified conclusions.

If the CEO and CFO conclude that the registrant's disclosure controls and procedures are not effective, the annual or quarterly report should state the reasons for

that conclusion, including the nature of the deficiency, so that the disclosure is not misleading. In addition, the registrant should describe how it is addressing the deficiency, including the nature of any improvements and enhancements that were made or are being implemented, the timeline for any further improvements and enhancements, and any efforts to mitigate the weakness in the interim to ensure appropriate public disclosures, including, if the deficiency is with respect to internal control over financial reporting, adequate financial statements.

The SEC has issued comments on registrants' disclosure explaining that a controls system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the controls system are met, and that no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a registrant have been detected. These comments focus on whether the registrants have adequately described the concept of "reasonable assurance" and whether the conclusion as to effectiveness is at the "reasonable assurance" level. (See Release No. 33-8238 at Section II.F.4.) In view of the difficulty of addressing these comments, some registrants have deleted the explanatory language, while others have expanded the disclosure to include all of the information requested by the Staff.

The SEC Staff has issued comments requiring a registrant to include the entire definition of disclosure controls and procedures in its disclosure responsive to Item 307 of Regulation S-K if it includes any part of the definition. For example, the SEC Staff has required a registrant that defined disclosure controls and procedures as "those controls and other procedures that are designed to ensure that information required to be

disclosed by a registrant in the reports that it submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC's rules and forms" to state also that "such controls include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a registrant is accumulated and communicated to the registrant's management, including its CEO and CFO, as appropriate to allow timely decisions regarding required disclosure."

***Must a registrant describe changes in internal control over financial reporting?***

Disclosure about changes in internal control over financial reporting is required regardless of whether a registrant is required to report on internal control over financial reporting. The CEO and the CFO must represent in their certification required by Section 302 of Sarbanes-Oxley, implemented by Exchange Act Rules 13a-14(a) and 15d-14(a), that they have disclosed in the related report "any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting." (See Paragraph 4(d) of Item 601(b)(31) of Regulation S-K.)

Although the SEC Staff's response to Question 7 of the SEC Internal Control FAQs states that changes in internal control that are made in preparation for a registrant's first management report on internal control over financial reporting need not be disclosed, this relief does not affect the language in paragraph 4(d) of the Section 302 certification, and, therefore, registrants

should consider whether the certification requirement would negate the SEC Staff guidance. Furthermore, the disclosure is likely to be required as a result of Rule 12b-20 under the Exchange Act, which requires material disclosures necessary so that the required disclosures are not misleading.

Accordingly, changes in internal control over financial reporting that are made as a part of a registrant's project to fully document its internal control over financial reporting in preparation for management reports on internal control should be disclosed if they have had or are reasonably likely to have a material effect on the registrant's internal control over financial reporting. Changes to simply document a registrant's internal control in anticipation of reporting on internal control over financial reporting likely would not have a material effect on such internal control over financial reporting.

Once a registrant is required to report on internal control over financial reporting, it must also comply with Item 308(c) of Regulation S-K. (See "Should a registrant review its internal control over financial reporting on a quarterly basis?" below.)

***Should a registrant disclose in advance any possibility that it will not be able to file the required reports on internal control over financial reporting on a timely basis?***

If management reasonably believes the registrant will not be able to file management's or the outside auditors' reports on internal control over financial reporting when they are required, the registrant should disclose that possibility in its risk factors.

A registrant should consider whether the circumstances that may make it impossible for its

management or outside auditors to report on internal control over financial reporting suggest that the registrant's disclosure controls and procedures are not effective. Registrants that receive notifications from their outside auditors that they have experienced slippage in their Section 404 implementation schedule and there is no assurance that Section 404 reporting will be timely if there is further slippage should consider warning investors of that possibility. Receipt of that notification by itself should not require disclosure if the registrant reasonably believes it will be able to file the required reports on internal control over financial reporting on a timely basis.

***Will a registrant be able to file its Form 10-K without the required reports on internal control over financial reporting?***

Given the language of the certification required by Section 906 of Sarbanes-Oxley, and Exchange Act Rules 13a-14(b) and 15d-14(b), a registrant's CEO and CFO may not feel comfortable signing the 906 certification required in an annual report on Form 10-K that does not include the required reports on internal control over financial reporting. The 906 certifications are required by Exchange Act Rules 13a-14(b) and 15(d)-14(b) to be "furnished" as exhibits to the periodic report containing financial statements. (The 906 certifications are furnished as Exhibit 32 to the Form 10-K and Form 10-Q pursuant to Item 601(b)(32)(i) of Regulation S-K.) Section 906 requires the CEO and CFO to certify that the periodic report containing financial statements "fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934. . . and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of

operations of the issuer." Since an annual report on Form 10-K that does not include the required reports on internal control over financial reporting would not "fully comply" with the applicable reporting requirements, the CEO and CFO may consider whether to file the Form 10-K without the required 906 certifications, file 906 certifications that have been modified to report the absence of the internal control reports, or file the annual report on a Form 8-K.

The CEO and CFO may be able to execute the Section 302 certifications, however, as long as they are satisfied with the disclosures in the Form 10-K. These certifications state, among other things, that, based on the signing officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements made, in light of the circumstances in which they were made, not misleading. Accordingly, the CEO and CFO may be willing to execute the Section 302 certifications as long as they are satisfied that the Form 10-K adequately describes the reasons management cannot include the required reports in the Form 10-K, the status of the efforts to provide the required reports, any preliminary views as to the registrant's internal control over financial reporting, and the steps the registrant is taking to ensure that the reports will be filed as soon as possible.

A registrant would need to consider the applicable provisions of Rule 12b-25 with regard to notice of and disclosure concerning a late-filed periodic report. In addition, if the registrant files a Form 10-K without including the required reports on internal control over financial reporting, the Form 10-K would be deemed by the SEC Staff to be so deficient that it would not be considered "filed" for the purposes of the SEC's rules,

including eligibility to use short-form registration statements such as Form S-3 (which requires timely and current reporting under the Exchange Act), as well as for the purpose of satisfying the “current public information” requirement in Rule 144.

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### Meaning of Internal Control over Financial Reporting

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#### *How is internal control over financial reporting defined?*

Exchange Act Rules 13a-15(f) and 15d-15(f) define internal control over financial reporting as a “process designed by, or under the supervision of, the issuer’s principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and

- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer’s assets that could have a material effect on the financial statements.”

#### *Does internal control over financial reporting encompass supplementary financial information?*

Internal control over financial reporting does not encompass supplementary information that registrants must disclose in accordance with Regulation S-X, such as financial statement schedules. The SEC Staff has stated that it is considering, however, whether to recommend that the Commission propose to expand the definition of internal control over financial reporting to encompass such supplementary information. (See Question 11 of the SEC Internal Control FAQs.)

#### *What controls are included within internal control over financial reporting?*

Internal control over financial reporting requires controls over all relevant assertions related to all “significant” accounts and disclosures in the financial statements. A registrant’s significant accounts and disclosures are identified by the auditor upon consideration of qualitative and quantitative risk factors related to financial statement line items and disclosures. “Relevant assertions” are those financial statement assertions pertaining to significant accounts and disclosures that have a reasonable possibility of containing misstatements that would cause the financial statements themselves to be materially misstated. (See Paragraphs 28-29 of PCAOB Auditing Standard No. 5.)

Generally, effective internal control over financial reporting means that there is reasonable assurance that the registrant’s financial reporting and preparation of



financial statements are reliable. In order to be considered effective, there cannot be any material weaknesses in the registrant's internal control over financial reporting. (See Paragraph 2 of PCAOB Auditing Standard No. 5.)

In performing an audit of internal control over financial reporting, the auditor must:

- Assess the risk of fraud, and consider controls intended to address the risk of management override of other controls;
- Evaluate the extent to which the auditor will rely on the work of others, including internal auditors, company personnel, and third parties working under the direction of management, and consider the competence and objectivity of such persons;
- Identify and evaluate registrant-level controls; and
- Identify significant accounts and disclosures and their relevant assertions.

(See Paragraphs 10, 14, 16, 18, and 23 of PCAOB Auditing Standard No. 5.)

***What are registrant-level controls?***

Registrant-level controls include:

- Controls related to the control environment (*i.e.*, management's philosophy and operating style, ethical values, and proper oversight by the Board or audit committee);
- Controls over management override;
- Management's risk assessment process;
- Centralized processing and controls;

- Controls to monitor the results of operations;
- Controls to monitor other controls—including activities of the internal audit function, the board, and particularly the audit committee—and self-assessment programs;
- The period-end financial reporting process, including controls over procedures used to initiate, authorize, record, and process journal entries in the general ledger and to record recurring and non-recurring adjustments to the financial statements; and
- Board-approved policies that address significant business control and risk management practices.

(See Paragraphs 22-24 of PCAOB Auditing Standard No. 5.)

***What controls are necessary to prevent, deter, and detect fraud?***

Controls to prevent, deter, and detect fraud include:

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

*How much judgment is involved in identifying the controls necessary in internal control over financial reporting?*

On May 16, 2005, the SEC issued a statement that addresses issues that arose during the first year experience with the implementation of the internal control reporting requirements of Section 404 of Sarbanes-Oxley, including feedback the SEC received at its April 13, 2005, Roundtable on Implementation of Internal Control Reporting Provisions. In its "Commission Statement on Implementation of Internal Control Reporting Requirements," the SEC noted that it "is the responsibility of management to determine the form and level of controls appropriate for each registrant and to scope their assessment and the testing accordingly."

In the first instance, it is management that should identify the appropriate controls based upon the specific characteristics of the registrant. The SEC observed that the costs incurred by accelerated filers to comply with the internal control reporting requirements may have been the result of "a mechanical, and even overly cautious, way" in which registrants and outside auditors complied with the rules. The SEC urged both management and outside auditors to use "reasoned judgment and a top-down, risk-based approach to the Section 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgment focused on reasonable, as opposed to absolute, assurance."

Hence, the identification of controls requires considerable judgment from management in the first instance. Management should focus on the controls

necessary for the areas of greatest risk and not treat all significant accounts and related controls equally. In addition, the controls that are necessary are those required to provide "reasonable assurance" that financial statements will be reliable, not absolute assurance of such reliability.

In the "Staff Statement on Management's Report on Internal Control over Financial Reporting," also issued on May 16, 2005, the SEC Staff explains that "[t]he assessment of internal control over financial reporting will be more effective if it focuses on controls related to those processes and classes of transactions for financial statement accounts and disclosures that are most likely to have a material impact on the registrant's financial statements." Referring to this approach as a "top-down" approach, the Staff suggested that management first "identify the areas of the financial statements that present significant risk that the financial statements could be materially misstated," and then "identify relevant controls and design appropriate procedures for documentation and testing of those controls." Finally, PCAOB Accounting Standard No. 5, adopted on June 12, 2007, codified the "top-down" approach as part of the audit process. (See Paragraph 21.)

*How does reporting on internal control over financial reporting affect the documentation of the tax accrual?*

In a February 2004 speech to the Tax Council Institute Conference, SEC Chief Accountant Donald T. Nicolaisen noted that, in connection with the documentation of internal control over financial reporting, he anticipated that "management and the internal auditors will be documenting [their registrant's] procedures for the preparation of tax accounts, evaluating [their] compliance functions, considering how key estimates

are developed and recorded, and reviewing how tax planning strategies are developed, evaluated, and approved, and how well [the tax] department documents key conclusions and decisions.” Accordingly, management and outside auditors may need to include in their documentation of internal control over financial reporting and audits, respectively, more detailed information, including legal opinions, to support the tax accruals.

*Must a registrant’s internal control over financial reporting include controls relating to all of the entities reflected in a registrant’s financial statements, i.e., subsidiaries, equity investees, and variable interest entities (“VIEs”)?*

A registrant’s internal control over financial reporting must include controls at all of the entities that are included within a registrant’s consolidated financial statements, including majority owned subsidiaries and VIEs that are consolidated as a result of Financial Accounting Standards Board Accounting Standards Codification Topic 810, *Consolidation*. (See Question 1 of the SEC Internal Control FAQs.)

Although a registrant need not have controls at any entities that it accounts for using the equity method of accounting, management must consider equity investments in assessing the registrant’s internal control over financial reporting. The SEC Staff’s response to Question 2 of the SEC Internal Control FAQs states that the registrant must have controls over the recording of amounts related to its investments, and, accordingly, must consider, among other things, its controls over the accounting methods for its investments, the recognition of equity method earnings and losses, and its investment account balance. Moreover, the response

notes that there may be circumstances where the evaluation by a registrant of the control over financial reporting of an equity method investment is not only appropriate but also may be the most effective form of evaluation of that investment.

*Are there any exceptions to the requirement that all consolidated subsidiaries and VIEs be included within a registrant’s internal control over financial reporting?*

The SEC Staff has provided two exceptions to the requirement that a registrant’s internal control over financial reporting include controls at all of the entities reflected in the registrant’s consolidated financial statements. The response to Question 1 of the SEC Internal Control FAQs provides an exception for consolidated entities that were in existence prior to December 15, 2003, are considered to be VIEs, and are consolidated as a result of Financial Accounting Standards Board Interpretation No. 46 if the registrant does not have the right or authority (that is, the ability) to assess the internal controls of the entity or the ability, in practice, to make that assessment. A registrant that relies on that exception must disclose in its annual report on Form 10-K:

- its inability to evaluate the internal controls of the specifically identified VIE due to the fact that it does not have the ability to dictate or modify the controls of the entity and does not have the ability, in practice, to assess those controls; and
- any key amounts in the financial statements that result from consolidation of the entity whose internal controls have not been assessed.

Management's report on internal control over financial reporting should include a reference to that disclosure.

The other exception to the need for internal control over financial reporting to include controls at all subsidiaries is explained in the Staff's response to Question 3 of the SEC Internal Control FAQs. There, the Staff provides an exception for a subsidiary that was acquired in a material purchase business combination that occurred during a registrant's most recent fiscal year, provided that management's report on internal control over financial reporting refers to a discussion in the Form 10-K describing the limitation on the scope of the assessment of internal control over financial reporting and the excluded identified business and its significance to the registrant. This exception may not be helpful to a registrant that plans to sell securities if the underwriting agreement relating to the offering requires the registrant to make representations with respect to its internal control over financial reporting. Presumably, a registrant that made an acquisition that was not "material" would not need to rely on the exception because the controls at the acquired entity would not be sufficiently significant to the registrant's internal control over financial reporting.

***Must a registrant's internal control over financial reporting include the controls relating to outsourced activities, processes, or functions?***

Yes, if the outsourced activities, processes, or functions are significant to the registrant's internal control over financial reporting. PCAOB Auditing Standard No. 5 states that internal control over financial reporting must include controls that address the relevant financial statement assertions for each significant account and

disclosure in a registrant's financial statements. Therefore, the outsourced activity must be encompassed by the registrant's internal control over financial reporting if it relates to a significant account. (See "What controls are included within internal control over financial reporting?" above.)

Historically, outsourced activities have been considered by the outside auditors in determining the scope of their audits in accordance with Auditing Standard Section 234, Service Organizations (Statement on Auditing Standards No. 70 or AU §324). AU §324 indicates that activities are considered part of a registrant's internal control if they affect any of the following:

- The classes of transactions that are significant to the registrant's financial statements;
- The procedures, both automated and manual, by which the registrant's transactions are initiated, recorded, processed, and reported from their occurrence to their inclusion in the financial statements;
- The related accounting record, whether electronic or manual, supporting information, and specific accounts in the registrant's financial statements involved in initiating, recording, processing, and reporting the registrant's transactions;
- How the registrant's information system captures other events and conditions that are significant to the financial statements; and
- The financial reporting process used to prepare the registrant's financial statements, including significant accounting estimates and disclosures.

Service organizations that provide such services include, for example, bank trust departments that invest and service assets for employee benefit plans or for others; mortgage bankers that service mortgages for others; application service providers that provide packaged software applications and a technology environment that enables customers to process financial and operations transactions; entities that develop, provide, and maintain the software used by client organizations; and payroll service providers.

Not all outsourced activities are part of internal control. For example, where the service organization executes transactions that the registrant specifically authorizes, such as processing checking account transactions or wire transfer instructions, or where the registrant outsources actuarial services or other specialist services, such activity is not part of internal control. (See Question 24 of PCAOB's Questions and Answers: Auditing Internal Control over Financial Reporting, originally issued June 23, 2004, and revised July 27, 2004.) Financial interests in partnerships, corporations, and joint ventures, including working interests in oil and gas ventures, should not be considered to cause the controls at such entities to be part of a registrant's internal control over financial reporting, however. (See AU §324.03.) (See "How should management assess the controls at service organizations providing outsourced activities that are part of internal control over financial reporting?" below.)

***Does internal control over financial reporting include compliance with laws and regulations?***

Internal control over financial reporting includes controls relating to laws and regulations that pertain directly to the preparation of financial statements, such

as the SEC's financial reporting requirements and the requirements under the Internal Revenue Code.

Internal control over financial reporting does not encompass compliance with other laws. However, the evaluation of disclosure controls and procedures requires consideration of the registrant's compliance with laws, rules, and regulations, including whether the registrant adequately monitors such compliance and has procedures to ensure appropriate disclosure of legal or regulatory matters.

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**Registrants' Responsibilities**

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***How extensively must registrants document their internal control over financial reporting?***

Generally, a registrant's documentation of its internal control over financial reporting should be as complete as possible, to provide competent evidence of the effectiveness of internal controls. However, the PCAOB has acknowledged that the extent of a registrant's documentation will depend on the size and complexity of the company or unit being audited. Furthermore, documentary evidence may not exist for some controls (such as management's philosophy and operating style). In the event that complete formal documentation of a control is not available, auditors will rely on other procedures, such as observation of activities, inspection of informal documentation, or re-performance of internal controls, to assess the effectiveness of that control. (See Paragraph 51 of PCAOB Auditing Standard No. 5.)

*Who is “management” as contemplated in the internal control reporting requirements?*

Presumably, the management that must issue the report on internal control over financial reporting required by the SEC’s rules that implement Section 404 of Sarbanes-Oxley may include more than just a registrant’s principal executive and principal financial officers. Exchange Act Rules 13a-15(c) and 15d-15(c) provide that “management... must evaluate, with the participation of the issuer’s principal executives and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer’s internal control over financial reporting.”

With respect to management’s report on internal control over financial reporting, Item 308(a) of Regulation S-K states that management’s report must contain, among other things, a “statement of management’s responsibility establishing and maintaining adequate internal control over financial reporting.” In contrast, the principal executive and principal financial officers must certify in their certificates required by Exchange Act Rules 13a-14(a) and 15d-14(a) that they, and not “management,” “are responsible for establishing and maintaining... internal control over financial reporting.” (See language in paragraph 4 of the Certification in Item 601(b)(31) of Regulation S-K, effective, together with paragraph 4(b), once internal control over financial reporting is effective.) Accordingly, at a minimum, the management report and the certification requirements indicate that the CEO and CFO should have significant involvement in the internal control reporting process.

*What representations must management make to the outside auditors?*

Management must provide to the outside auditors written representations relating to, among other things:

- Management’s responsibility for establishing and maintaining effective internal control over financial reporting;
- Management’s acknowledgment that its assessment of the effectiveness of internal control over financial reporting was not based at all on the outside auditors’ audit of such internal control; and
- Management’s disclosure to the outside auditors of:
  - all deficiencies in the design or operation of internal control over financial reporting;
  - any identification of any fraud that involves senior management or employees who have a significant role in the registrant’s internal control over financial reporting;
  - the resolution or other status of any control deficiencies identified and communicated to the audit committee during previous engagements; and
  - any changes in internal control over financial reporting or other factors subsequent to the end of the fiscal year that might significantly affect internal control over financial reporting, including any corrective actions with regard to significant deficiencies and material weaknesses.

(See Paragraph 75 of PCAOB Auditing Standard No 5.)

The response to Question 34 of the PCAOB's Q&As dated November 22, 2004, states that management must disclose to the outside auditors deficiencies that it identifies, regardless of whether the deficiencies had been corrected as of the date of management's assessment of internal control over financial reporting.

*How should management assess the registrant's internal control over financial reporting?*

Exchange Act Rules 13a-15(c) and 15d-15(c) provide that "[t]he framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment." In SEC Release No. 33-8238, the SEC stated that the COSO framework satisfies that criteria. As noted above, COSO is the only framework currently available in the United States. (See COSO "Internal Control - Integrated Framework" and "What internal control framework should management use to assess its internal control over financial reporting?" above.)

COSO requires an evaluation of the five components of internal control:

- The control environment: the overall tone for the registrant;
- Risk assessment: the assessment of risks from both internal and external sources that affect the registrant's ability to carry out its business;
- Control activities: the policies and procedures that help ensure that management's instructions are implemented;

- Information and communication: the mechanisms intended to ensure that employees understand their responsibilities and that informed business decision-making and external reporting are achieved; and
- Monitoring: the assessment of the quality of the internal control system over time.

In Section II.B.3.d of SEC Release No. 33-8238, the SEC also stated that the assessment of internal control over financial reporting must be based on procedures sufficient both to evaluate the design of internal control over financial reporting as well as to test its operating effectiveness. Inquiry is not enough, but management may rely on activities conducted by non-management personnel acting under their supervision.

The statements issued by the SEC and its Staff on May 16, 2005, relating to reporting on internal control over financial reporting, emphasized the need for management to use reasonable judgment in determining the scope of its assessment and testing of internal control. The SEC Staff noted that some of the feedback it had received relating to the experiences of registrants and outside auditors with implementation of the internal control over financial reporting rules noted that too many controls were identified, documented, and tested. The SEC Staff provided additional guidance for reducing the amount of testing conducted by management in connection with its assessment of internal controls, such as a top-down approach, alternating the testing of different controls from year-to-year, and testing controls at different points during the year. Both qualitative and quantitative factors are relevant in assessing the significant accounts to be included within the assessment. The SEC Staff noted that qualitative factors include the risk associated with

the various accounts and their related processes. The Staff noted that quantitative thresholds may provide a reasonable starting point for evaluating the significance of an account or process but that judgment, including a review of qualitative factors, must be exercised to determine the need for exceptions to those thresholds. Whereas, in most cases, the identification of significant accounts will focus on annual and registrant measures rather than interim or segment measures, the SEC Staff noted that, in some cases, interim or segment measures may be appropriate.

In addition, the SEC Staff noted that the assessment process should focus on the objective of controls and combine controls for testing purposes to determine that they meet the broad objective. Accordingly, the assessment process may not need to test every individual step comprising a control. In addition, the SEC Staff noted that the assessment process should not require the assessment of general information technology internal controls that relate to the efficiency or effectiveness of the operations of the registrant since they are not relevant to financial reporting. This statement suggests that the assessment process also may become more efficient in the future as management can avoid further detailed testing as of the fiscal year-end date based upon greater reliance on its evaluation of controls through its daily interaction with the internal control system and ongoing monitoring of the operation of controls.

In June 2007, the SEC issued Interpretive Guidance to expand upon its May 2005 Staff Statement, discussed above. The Commission Interpretive Guidance was centered around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the

risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner. The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. Under the guidance, management can align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas.

*How should management assess the five components of internal control over financial reporting?*

In evaluating the components of internal control over financial reporting, management may want to consider the following matters, among other things.

With respect to the control environment:

- The degree of specification as to the level of competence necessary for specific assigned responsibilities;
- The adequacy of the example provided with respect to, and the adequacy of communication of, integrity and ethical values, including the nature of the training provided to employees;
- The adequacy of employees' understanding of the code of business conduct and ethics and the procedures for reporting concerns or complaints with respect to accounting, internal control, and auditing matters;



- The adequacy of the responses of the board, audit committee, and management to information about violations of the code of business conduct and ethics and concerns about accounting, internal control, and auditing matters;
- The adequacy of the example provided and the oversight role played by management and the board of directors, including the audit committee; and
- The adequacy of human resource activities in assuring competence and ethical qualities.

With respect to risk assessment, the adequacy of:

- The identification of areas where material misstatements of the significant accounts and disclosures and related assertions in the financial statements might occur; and
- Mechanisms to monitor events that suggest that significant estimates and other judgments reflected in the financial statements must be re-examined.

With respect to control activities, the adequacy of:

- Initiatives to check whether the control over assets is accurate and complete, and whether the authorization of transactions is appropriate;
- Mechanisms to investigate unexpected results or unusual trends; and
- The segregation of duties.

With respect to information and communication, the adequacy of the methods that a registrant uses to generate its financial data.

With respect to monitoring, the adequacy of:

- The quarterly evaluation of internal controls and the results of internal audits;
- The activities of the disclosure committee;
- The audit committee's oversight of internal control over financial reporting; and
- The responses to reports of deficiencies in quarterly certifications and any other self-assessment processes.

(See COSO "Internal Control - Integrated Framework.")

*How should management assess the controls at service organizations providing outsourced activities that are part of internal control over financial reporting?*

When a service organization provides outsourced activities, processes, or functions that are part of the registrant's internal control over financial reporting, management must consider the activities of the service organization in making its assessment of internal control over financial reporting. (See "Must a registrant's internal control over financial reporting include the controls relating to outsourced activities, processes, or functions?" above.) This means that management must obtain an understanding of the controls at the service organization that are relevant to the registrant's internal control over financial reporting and the controls at the registrant over the activities of the service organization, and must obtain evidence that the controls that are relevant to management's assessment are operating effectively.

Management's procedures may include obtaining a report from the service organization's outside auditors on controls in operation and tests of operating effectiveness, or a report on the application of agreed-

upon procedures that describes relevant tests of controls (a Type 2 SAS 70 Report). The SEC Staff explained in footnote 3 to the SEC Internal Control FAQs that, in a Type 2 SAS 70 Report, the outside auditors “report on a service organization’s description of the controls that may be relevant to a user organization’s internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.”

In all cases, however, management must maintain and evaluate, as appropriate, controls over the flow of information to and from the service organization. (See Question 8 of the SEC Internal Control FAQs.)

The easiest way for management to assess the effectiveness of the service organization’s controls may be for management to obtain a Type 2 SAS 70 report from the service organization’s outside auditors. If the Type 2 SAS 70 report adequately addresses the procedures and controls relevant to management’s assessment process, management may not need to test the service organization’s controls at all.

Not all service organizations have Type 2 SAS 70 reports, however, and it may take a long time to obtain one if the service organization never has had one before. Therefore, registrants should have already focused on identifying organizations that provide outsourced services that are part of the registrant’s internal control over financial reporting so they can either begin the process of obtaining Type 2 SAS 70 reports or identify other procedures that will enable them to assess the

effectiveness of the relevant controls at the service organization.

In the response to Question 28 of the PCAOB’s Q&A’s dated October 6, 2004, the PCAOB Staff noted that management’s inability to assess controls at a service organization could lead to a disclaimed opinion by the outside auditors if the outside auditors conclude that management did not fulfill its responsibilities. Management’s failure to try to renegotiate a contract in order to obtain a Type 2 SAS 70 report might be viewed as a failure by management to fulfill its responsibilities.

How management obtains a Type 2 SAS 70 report is critical, however. Although the SEC Staff’s response to Question 8 in the SEC Internal Control FAQs states that management would be able to rely on a Type 2 SAS 70 report even if the outside auditors for both the registrant and the service organization were the same, it also states that management may not rely on a Type 2 SAS 70 report if management were to engage the registrant’s audit firm to prepare the report on the service organization.

***Should management assess the effectiveness of the audit committee?***

Given the position in Paragraph 69 of PCAOB Auditing Standard No. 5 that ineffective performance by the audit committee is an indicator of material weakness in internal control over financial reporting, management should assess the effectiveness of the audit committee as a part of its assessment of internal control over financial reporting. In particular, management should be aware that the independent auditor will be evaluating the audit committee’s effectiveness in overseeing both the external and internal financial reporting of the registrant.

Management should also assess whether the audit committee appropriately evaluates the risk environment and the registrant's establishment of controls to prevent, deter, and detect risk and fraud, and monitors the registrant's efforts to address any weaknesses in the controls. (See Section 303A.07(c)(iii)(D) of the NYSE Listed Company Manual, which is applicable to registrants that have securities listed on the New York Stock Exchange and arguably establishes best practices applicable to audit committees.) Management's assessment should also include an evaluation of whether the audit committee's participation in the oversight of the period-end reporting process includes the review of earnings releases before they are issued, as well as the results of the annual audit committee self-assessment. (See Section 303A.07(c)(iii)(C) of the NYSE Listed Company Manual, which requires a discussion by the audit committee of earnings releases generally, among other things, although best practices suggest the advance review of draft earnings releases, and Section 303A.07(c)(ii) of the NYSE Listed Company Manual.)

***How extensively must a registrant document its assessment of internal control over financial reporting?***

Instruction 1 to Item 308 of Regulation S-K provides guidance as to the nature of management's documentation of its assessment of the effectiveness of internal control. It states that: "The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting."

In addition, Section II.B.3 of SEC Release No. 33-8238 (June 5, 2003) explains that the "evidential matter" that supports management's assessment "should provide

reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered."

Perhaps outside auditors evaluate the quality of management's documentation of its assessment of the effectiveness of internal control over financial reporting using the standard applicable to their audits in the PCAOB's Auditing Standard No. 3, "Audit Documentation." This standard requires that the documentation of an audit "contain sufficient information to enable an experienced auditor, having no previous connection with the engagement: to understand the nature, timing, extent, and results of the procedures performed, evidence obtained and conclusions reached."

Given the May 16, 2005 guidance of the SEC and the PCAOB, however, the documentation of management's assessment of internal control over financial reporting may not need to be as extensive as registrants have thought. The SEC stated in its guidance that management's assessment and the documentation of that assessment should be consistent with the focus on areas of the financial statements that present significant risk that the financial statements could be materially misstated. That is, management should not need to assess the adequacy of controls that do not relate to areas of the financial statements that present significant risk that the financial statements could be materially misstated. In addition, the extent of documentation may be affected by the nature of management's assessment process. To the extent that management relies on its direct and ongoing monitoring of the

operation of controls rather than specific testing, which the response to Question 47 of the PCAOB's Q&As dated May 16, 2005 describes as appropriate, the level of documentation would likely be very different.

Moreover, the 2007 SEC Interpretive Guidance provides management with flexibility in making judgments about what constitutes adequate evidential matter. The guidance recognizes that the form and extent of documentation will vary with the size, nature and complexity of the company, and with the assessed level of risk. According to the guidance, management should also consider the complexity of the control, the level of judgment required to operate the control, and the risk of material misstatements in the financial statements. As these factors increase, separate evidential matter should be produced and maintained. Under certain circumstances, management may determine that the company's books and records provide sufficient evidence to satisfy the requirements of management's internal controls assessment.

*Should a registrant review its internal control over financial reporting on a quarterly basis?*

To assess the effectiveness of disclosure controls and procedures on a quarterly basis in accordance with Exchange Act Rules 13a-15(b) and 15d-15(b), a registrant's management must also evaluate its internal control over financial reporting because disclosure controls and procedures include most, if not all, of a registrant's internal control over financial reporting. That evaluation is not required to be as extensive as the evaluation and testing of internal control over financial reporting required by Section 404 of Sarbanes-Oxley and Exchange Act Rules 13a-15(c) and 15d-15(c), which must be based upon a suitable, recognized framework

for such an assessment. (See SEC Release No. 33-8238, at 19 (stating that, while the quarterly evaluation of disclosure controls and procedures is of "effectiveness overall, a registrant's management has the ability to make judgments. . . that evaluations, particularly quarterly evaluations, should focus on developments since the most recent evaluation, areas of weakness or continuing concern or other aspects of disclosure controls and procedures that merit attention".))

Once a registrant is subject to the requirement to report on internal control over financial reporting, paragraph (d) of Exchange Act Rules 13a-15 and 15d-15 becomes effective. As noted above, this provision requires management to evaluate, with the CEO and CFO's participation, "any change in the registrant's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters. . . that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting." Although the evaluation of the effectiveness of disclosure controls and procedures and the disclosure of material changes in internal control over financial reporting pursuant to paragraph 4(d) of the certification required by Exchange Act Rules 13a-14(a) and 15d-14(a) have required registrants to evaluate internal control over financial reporting, the effectiveness of paragraph (d) of Exchange Rules 13a-15 and 15d-15 and Item 308(c) of Regulation S-K suggests that registrants' managements should consider additional procedures. The SEC does not expect these procedures to be as extensive as the annual evaluation (see SEC Release No.33-8238, at 17) but expects the nature of the quarterly evaluation to "be informed by the purposes of disclosure controls and procedures." (See SEC Release No. 33-8238, at 19.)

Possible additional procedures are an evaluation of whether any control deficiencies identified by management, any of its employees, or its outside auditors at any time, including during the most recent quarter, have been appropriately remediated; consideration of whether any additional controls are necessary as a result of changes in the business or management structure in the entity or changes in the industry or other developments; and consideration of whether recommendations for enhancements or changes to internal control over financial reporting should be solicited from persons involved in the control system.

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### Responsibilities of Outside Auditors

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#### *What is the objective of the outside auditors' audit of internal control over financial reporting?*

The objective of such an audit is for the outside auditors to express an opinion on the effectiveness of the company's internal control over financial reporting. To issue this opinion, the auditor must obtain reasonable assurance that no material weaknesses exist in the registrant's internal control over financial reporting as of the end of the registrant's fiscal year. This goal requires the outside auditors to evaluate:

- Management's assessment of the effectiveness of internal control over financial reporting;
- Evidence the outside auditors obtain from the work performed by others; and
- Evidence obtained by the outside auditors by performing auditing procedures themselves about whether the internal control over

financial reporting was designed and operated effectively.

The outside auditors' job will be considerably assisted if a registrant's management thoroughly documents its assessment of internal control over financial reporting. (See "*How extensively must registrants document their internal control over financial reporting?*" above.) The outside auditors must perform enough of their own tasks so that their work provides the principal evidence for their opinion. (See Paragraphs 16-19 of PCAOB Auditing Standard No. 5.)

In its statement issued on May 16, 2005, the PCAOB emphasized its view that the outside auditors must exercise "the judgment necessary to conduct an internal control audit in a manner that is both effective and cost-efficient." In this regard, the PCAOB noted its view that the outside auditors should:

- Integrate their audits of internal control over financial reporting with their audits of financial statements;
- Exercise judgment to tailor their audit plans to focus on areas that pose higher risks of misstatement of the individual audit client's financial statements;
- Use a "top-down" approach that focuses on company-level controls to identify for further testing only those accounts and processes that are relevant to internal control over financial reporting and that uses a risk assessment process to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;

- Use the work of others to the maximum extent possible by performing more work in high-risk areas and using the work of others in areas of lesser risk; and
- Respond on a timely basis to audit clients' requests for the outside auditors' views on accounting or internal control issues.

#### ***What is an integrated audit?***

While explaining that the objectives of the two audits are not identical, PCAOB Auditing Standard No. 5 requires that the audit of internal control over financial reporting be integrated with the audit of the registrant's financial statements. This means that the auditor must design his or her testing of controls to simultaneously accomplish the separate objectives of each audit. Furthermore, if the auditor obtains sufficient evidence that a registrant's control risks are low, the auditor's workload may decrease in connection with the financial statement audit. (See Paragraphs 6-8 of PCAOB Auditing Standard No. 5.) As explained in the PCAOB's May 16, 2005 statement relating to internal control over financial reporting, the benefits of the integration are that the processes required to reach opinions on the financial statements and on internal control are "mutually reinforcing." The findings and conclusions reached by the outside auditors during the audit of internal control "help the auditor better plan and conduct the auditing procedures designed to determine whether the financial statements are fairly presented." In the opinion of the PCAOB, the failure to integrate the audit of the financial statements with the audit of internal control over financial reporting "not only wastes resources, but it also jeopardizes the quality of the overall audit and, potentially, misses key insights

that could identify and uproot a budding accounting or reporting problem."

#### ***What must the outside auditors do in conducting the audit?***

To perform an audit of a registrant's internal control over financial reporting, the outside auditors must:

- Plan the audit;
- Use a top-down approach to select the controls to test;
- Identify entity-level controls, as well as significant accounts and disclosures and their relevant assertions;
- Identify and understand likely sources of misstatements in the registrant's financial statements;
- Test the selected controls for design effectiveness and operating effectiveness;
- Evaluate the level of risk associated with the tested controls, taking into account various factors such as the nature and materiality of the misstatements that a control is intended to prevent or detect, the inherent risks associated with the related accounts and assertions, the volume and nature of transactions that might affect the effectiveness of a control, the history of errors associated with the account in question, the competence of personnel performing the control, and the general complexity of the control;
- Evaluate the severity of each identified control deficiency to determine whether it (individually or in combination with others)

constitutes material weaknesses, taking into account whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure, and the magnitude of the potential misstatement resulting from the deficiency;

- Form an opinion on the effectiveness of internal control over financial reporting by evaluating evidence obtained from all sources, including a review of the registrant's internal audit, which opinion must be adverse if any material weaknesses have been identified;
- Obtain written representations from management that, among other things, acknowledge management's responsibility for establishing and maintaining effective internal control over financial reporting and state that management has disclosed to the auditor all deficiencies reported as part of its own evaluation of internal control over financial reporting;
- Communicate in writing to management and the audit committee all material weaknesses identified during the audit, and consider whether there are any significant deficiencies that should also be so communicated; and
- The auditor must also inquire of management whether there have been any subsequent changes in internal control over financial reporting since the date of the report.

(See Paragraphs 9 through 98 of PCAOB Auditing Standard No. 5.)

#### ***How much judgment can the outside auditors exercise?***

PCAOB Auditing Standard No. 5 explains that outside auditors must exercise "objective and impartial judgment on all issues encompassed within the accountant's engagement." The PCAOB Staff believes that the judgments exercised through the top-down approach should help the auditor "eliminate from further consideration accounts, disclosures, and assertions that have only a remote likelihood of containing misstatements that could cause the financial statements to be materially misstated." (See Question 38 of the PCAOB's Q&As dated May 16, 2005.) The degree of risk that a material weakness might exist is relevant to the attention that the outside auditors will give to an area.

The response to Question 40 of the PCAOB's Q&As dated May 16, 2005 notes that the outside auditors' risk assessment will affect the identification of significant accounts that must be evaluated; the identification of relevant assertions related to such significant accounts; the nature, timing, and extent of the auditors' tests of controls; and the auditors' use of the work of others. Whether, as a result of this guidance, outside auditors will reduce their efforts in any way, and, therefore, reduce the costs of internal control audits, remains to be seen.

#### ***When must the outside auditors modify their opinion?***

The outside auditors cannot issue a clean opinion on internal control over financial reporting under certain circumstances, including:

- Where elements of management's annual report on internal control are incomplete or improperly presented;

- Where there is a restriction on the scope of the auditors' engagement;
- If the auditor decides to refer to the report of other auditors as the partial basis for his or her report;
- If there is other information contained in management's annual report on internal control over financial reporting; or
- If management's certification pursuant to Section 302 of the Sarbanes-Oxley Act is misstated.

(See Paragraph C1 of PCAOB Auditing Standard No. 5.)

Where the circumstances suggest that management is not taking appropriate responsibility, the outside auditors may need to consider withdrawing from the engagement. (See Paragraph 76 of PCAOB Auditing Standard No. 5.)

***Must the outside auditors evaluate internal control over financial reporting in connection with their review of quarterly financial statements?***

Registrants subject to Exchange Act Rules 13a-15(d) and 15d-15(d), which require a quarterly evaluation of any change in internal control over financial reporting that has materially affected or is reasonably likely to materially affect internal control over financial reporting, are probably conducting additional procedures to evaluate their internal control over financial reporting. (See "Should a registrant review its internal control over financial reporting on a quarterly basis?" above.) Although no longer prescribed by the PCAOB, the outside auditors also should conduct certain procedures to evaluate internal control over financial reporting in connection with Section 302

compliance. Paragraph C15 of PCAOB Auditing Standard No. 5 provides that, if matters come to the attention of the outside auditor that "lead him or her to believe that modifications to the disclosures about changes in internal control over financial reporting (addressing changes in internal control over financial reporting occurring during the fourth quarter) are necessary for the annual certifications to be accurate and to comply with the requirements of Section 302 of Sarbanes-Oxley and Securities Exchange Act Rule 13a-14(a) or 15d-14(a)," the auditor has a duty to communicate his or her findings to management and the audit committee as described in The American Institute of Certified Public Accountants Code of Professional Conduct, *AU Section. 722 Interim Financial Information*, for any interim period. If management and the audit committee fail to respond appropriately, the auditor must then modify the audit report accordingly.

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**Meaning of Material Weakness**

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***What is a material weakness in internal control over financial reporting?***

As a result of public comment requesting that the SEC and PCAOB align their definitions of the term "material weakness," SEC Release Nos. 33-8809 and 34-55928 (August 27, 2007), as well as Paragraph A7 of PCAOB Auditing Standard No. 5, now define "material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." PCAOB Auditing Standard No. 5 also provides that a "reasonable possibility" is present



when the likelihood of an event is either “reasonably possible” or “probable,” as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies.

According to Paragraph A11 of PCAOB Auditing Standard No. 5, a “significant deficiency” is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.

A “deficiency” in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively. (See Paragraph A3 of PCAOB Auditing Standard No. 5.)

To determine whether a deficiency is a significant deficiency or a material weakness, management must consider both qualitative and quantitative analyses. The SEC Staff suggests that the qualitative analysis consider the nature of the deficiency, its cause, the relevant financial statement assertion the control was designed to support, its effect on the broader control environment, and whether other compensating controls

are effective. In addition, the significance of a deficiency must be assessed “by using both quarterly and annual measures and considering segment measures where applicable.” (See the response to Question 12 of PCAOB’s Q&As dated June 23, 2004.)

***How should compensating controls be evaluated in determining whether there is a significant deficiency or a material weakness in internal control over financial reporting?***

The PCAOB’s Staff addressed this issue in its response to Question 14 in the PCAOB’s Q&As dated June 23, 2004. The response states that a compensating control can support a conclusion that a control deficiency is not a significant deficiency if the compensating control operates at a level of precision that would prevent or detect a misstatement that was more than inconsequential. A compensating control can support a conclusion that a control deficiency is not a material weakness if the compensating control operates at a level of precision that would prevent or detect a misstatement that was material. Therefore, if a registrant’s compensating controls result in a manual calculation of amounts that cannot be determined through its accounting system, the control deficiency will not be a significant deficiency, provided the manual calculation is at a level of precision that prevents a misstatement that is more than inconsequential.

***What deficiencies in controls are considered to be indicators of material weaknesses?***

The following control deficiencies are considered to be indicators of material weaknesses:

- Identification of fraud, whether or not material, on the part of senior management;

- Restatement of previously issued financial statements to reflect the correction of a material misstatement;
- Identification by the auditor of a material misstatement of financial statements in the current period in circumstances that indicate that the misstatement would not have been detected by the company's internal control over financial reporting; and
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

(See Paragraph 69 of PCAOB Auditing Standard No. 5.)

In its May 16, 2005, statement, the SEC Staff noted that “[n]either Section 404 nor the Commission’s implementing rules require that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error.” The assessment of whether a restatement means that a material weakness exists in the registrant’s internal control over financial reporting requires an evaluation of the reasons for the restatement and all of the other “facts and circumstances, including the probability of occurrence in light of the assessed effectiveness of the registrant’s internal control, keeping in mind that internal control over financial reporting is defined as operating at the level of ‘reasonable assurance.’”

*What types of interactions can registrants have with the outside auditors without triggering a significant deficiency or a material weakness?*

Both the SEC and the PCAOB emphasized in their May 16, 2005, statements that “frequent and frank” communication between registrants and the outside auditors regarding accounting and internal control matters is appropriate. These statements were in response to observations made at the SEC’s April 13, 2005, Roundtable on Implementation of Internal Control Reporting Provisions that, as a result of Auditing Standard No. 2, registrants might not be looking to their auditors for advice on difficult accounting and internal control issues.

Characterizing this registrant reaction as a misconception of Auditing Standard No. 2, the PCAOB stated that outside auditors should “engage in direct and timely communication with audit clients when those clients seek auditors’ views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.” The SEC stated that “[b]oth common sense and sound policy dictate that communications must be ongoing and open in order to create the best environment for producing high quality financial reporting and auditing; communications must not be so restricted or formalized that their value is lost.”

The registrant reaction stemmed from Auditing Standard No. 2 (now superseded by Auditing Standard No. 5), as well as the PCAOB Staff response to Question 7 of the PCAOB’s Q&As dated June 23, 2004. The PCAOB Staff response to Question 7 explains that the registrant must demonstrate that it is responsible for the financial statements and has effective controls

surrounding the preparation of the financial statements. Accordingly, the results of the audit cannot be considered by management or the outside auditors when evaluating whether the registrant's internal control over financial reporting provides reasonable assurance that the registrant's financial statements will be presented fairly in accordance with GAAP.

To avoid the risk of a significant deficiency or material weakness arising from the outside auditors' review of draft preliminary financial statements, the response to Question 7 recommends that a registrant make clear to the outside auditors the extent to which the financial statements have been completed so the auditors know what tasks the registrant still intends to perform. The registrant should identify the numbers and notes that have not been completed, so the outside auditors know that they should not finalize those items. In addition, while the outside auditors may give a registrant accounting disclosure checklists to assist in the evaluation of the financial statements, the registrant should complete each checklist itself and not rely on the outside auditors to do so.

To avoid the risk of a significant deficiency or material weakness arising from the routine and timely consultation process between a registrant and its outside auditors, the response to Question 7 states that a registrant should make clear to the outside auditors the reason for the communication. This response suggested to some that consultation could only be used to confirm the registrant's position and not to seek the outside auditors' views as to the appropriate accounting.

Both the SEC Staff and the PCAOB's May 16, 2005 statements make clear that they want the outside auditors to review draft financial statements and provide advice to their audit clients on a timely basis.

The SEC Staff noted that such discussions would not adversely affect the outside auditors' independence. The PCAOB emphasized that audit clients are not required to engage outside experts to provide accounting or internal control advice; rather, outside auditors simply cannot make decisions for their clients. As long as management makes its own informed decisions regarding applicable accounting and disclosures, it may obtain from the outside auditors advice on applicable accounting principles, suggestions on improvements to disclosures and financial statement quality, and updates on recent accounting matters. The PCAOB noted that those situations are very different from where the outside "auditor identifies a potential misapplication of applicable accounting principles in connection with a transaction that the auditor learns of outside of the consultation process, such as during a quarterly review, or after management has completed its financial statements and disclosures, in which case the auditor would have to consider whether management's failure to recognize the potential misapplication of applicable accounting principles constitutes a significant deficiency or material weakness."

*How should registrants analyze the significance of deficiencies?*

There is no required framework for the analysis by registrants of the significance of deficiencies in internal control over financial reporting. Representatives of ten accounting firms developed a framework that may be useful to registrants. The framework is set forth in "A Framework for Evaluating Control Exceptions and Deficiencies." Originally released on October 28, 2004, and expanded on November 29, 2004 and December 20, 2004, the framework is intended to provide guidance to

registrants and their outside auditors in evaluating whether any process/transaction-level exception or deficiency or any information technology general control deficiency that the registrant identifies represents a control deficiency and, if so, whether the control deficiency is a significant deficiency or a material weakness.

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### Implications of a Material Weakness

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*If a registrant's management or outside auditors report a material weakness in internal control over financial reporting and that report is included in the registrant's annual report on Form 10-K, will the registrant be able to file a registration statement on Form S-3, will the SEC declare the registration statement effective, and will affiliates and others be able to use Rule 144?*

The SEC Staff's response to Question 4 of the SEC Internal Control FAQs states that a material weakness, by itself, will not affect a registrant's ability to file a registration statement on Form S-3 (which requires timely and current reporting under the Exchange Act), or the availability to third parties of Rule 144 (which requires current reporting), even though a material weakness will require management and the outside auditors to issue adverse opinions.

In addition, the SEC Staff has stated that an adverse opinion by management or the outside auditors on internal control over financial reporting would not, by itself, impair the ability of the SEC Staff to declare a registration statement effective. Of course, the registration statement will need to include appropriate disclosures, including disclosures about the material weakness, the registrant's remediation efforts,

resolution efforts, and the steps the registrant is taking to be sure that unaudited financial information is accurate. (See "SEC 'Hot Topics' Teleconference, SEC, PCAOB Internal Controls over Financial Reporting: New Regulations" [July 20, 2004].)

*Are all material weaknesses serious problems for a registrant?*

The definition of material weakness is very broad, and, as stated by SEC Chief Accountant Donald Nicolaisen, "not all material weaknesses are likely to be viewed as equally significant."

In October 2004, Moody's issued a Special Comment in which it described the way it would categorize and evaluate material weaknesses based upon its assessment of whether the registrant's outside auditors may be able to address the weakness by expanding audit procedures. Among other things, the Special Comment notes that a material weakness that relates to company-level controls may impact a registrant's rating because the outside auditors might not be able to "audit around problems that have a pervasive effect on a registrant's financial reporting" and the material weakness may suggest an inability of the registrant to prepare accurate financial statements or control the business.

In addition, a weakness in the oversight role played by the audit committee or in the tone at the top might make it impossible for the outside auditors to audit the registrant's financial statements; a material weakness limited to an account balance might not be as serious.

*How will regulators and investors react to reports of material weaknesses in internal control over financial reporting?*

SEC Chief Accountant Donald Nicolaisen stated before any reports on internal control over financial reporting were filed with the SEC that he expected that “a number of companies will announce that they have material weaknesses in their controls” but that those reports should not “necessarily be motivation for immediate or severe regulatory or investor reactions.” Of course, the SEC can be expected to bring enforcement actions against registrants that do not maintain effective internal controls as defined in Section 13(b)(2)(B) of the Exchange Act or internal control over financial reporting in appropriate circumstances, even when the deficiencies in internal control did not have a material impact on the financial statements. (*See, e.g.,* SEC Release No. 51995 (July 8, 2005), Order Instituting Cease-and-Desist Proceedings, Making Findings, and Imposing a Cease-and-Desist Order Pursuant to Section 21C of the Securities Exchange Act of 1934.)

It is likely that some registrants that report one or more material weaknesses in internal control may have difficulties selling securities publicly, depending upon the nature of the material weakness. Underwriting agreements have included representations as to a registrant’s internal control since at least the time the Sarbanes-Oxley Act was enacted. Underwriters may not be willing to accept a qualified representation in an underwriting agreement from a registrant that has a material weakness in its internal control over financial reporting if the underwriter is concerned that the weakness suggests that the registrant may not be able to prepare accurate financial statements.

*What kind of disclosure should a registrant that reports a material weakness include in the annual report on Form 10-K, or any registration statement, filed after the material weakness is reported?*

A registrant that reports a material weakness should include appropriate disclosure about the material weakness in the annual report on Form 10-K, as well as updates on the remediation process in subsequent reports. Among the types of information that the registrant should consider including about the material weakness are:

- A description of the material weakness, including the nature of the material weakness and its impact on prior financial statements and the control environment, and how and by whom it was identified;
- A discussion about the specific steps the registrant is taking to remediate the material weakness; and
- The timeline for implementation of the remediation steps, and any efforts to mitigate the weakness while the improvements are being implemented to ensure materially accurate financial statements.

The SEC Staff’s May 16, 2005 statement strongly encourages management to “provide disclosure that allows investors to assess the potential impact of each particular material weakness.” The SEC Staff states also that the “disclosure will likely be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have

a pervasive impact on internal control over financial reporting from those material weaknesses that do not.”

The SEC Staff may ask for an explanation as to why, notwithstanding the material weakness, the registrant believes its interim financial statements are accurate and may ask the registrant’s outside auditors to explain what procedures they undertook to satisfy themselves as to the accuracy of any interim financial statements included in a registration statement.

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**Implications of the Failure to File Reports on Internal Control over Financial Reporting or the Filing of a Qualified or Disclaimed Auditors’ Opinion**

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***Will the SEC accept a Form 10-K without the required reports on internal control over financial reporting?***

The SEC will not reject an annual report on Form 10-K that does not include the required reports on internal control over financial reporting. However, the report will be considered deficient. Therefore, the registrant will not be considered to have timely filed all required reports, and thus will not be eligible to file on a Form S-3 for twelve full calendar months after the untimely filing. In addition, the registrant will not be considered to be current for purposes of Rule 144 until the required reports are filed. (See discussion of similar situation in Question 6 of “Exemptive Order on Management’s Report on Internal Control over Financial Reporting and Related Auditor Report: Frequently Asked Questions” (January 21, 2005); see also Division of Corporation Finance Securities Act Forms Compliance and Disclosure Interpretations Question 115.02.) A registrant must consider the impact of such an incomplete Form 10-K on the CEO and CFO

certifications required by paragraphs (a) and (b) of Exchange Act Rules 13a-14 and 15d-14.

***Will the SEC accept a qualified or adverse auditors’ opinion?***

The outside auditors should issue a qualified opinion for various reasons, including if they are unable to complete the audit for a specific reason or if they determine that internal control over financial reporting was inadequate or that management’s report was inadequate.

When outside auditors are unable to apply all of the audit procedures, they should either withdraw from the engagement, disclaim an opinion, or express a qualified opinion, depending upon their assessment of the importance of the omitted procedures to their ability to form an opinion on the effectiveness of the registrant’s internal control over financial reporting. If the outside auditors are unable to complete the audit because of restrictions imposed by management, the auditors should withdraw from the engagement or issue a disclaimed opinion on the effectiveness of internal control over financial reporting.

The SEC likely will take the position that a registrant that has included a qualified opinion on internal control over financial reporting in its Form 10-K is current in its filing obligations because the qualified opinion constitutes an attestation report for purposes of Rule 2-02(f) of Regulation S-X and, therefore, the filing of the qualified opinion is consistent with the requirement in Item 308(b) of Regulation S-K that the registrant file an attestation report on internal control over financial reporting. Rule 2-02(f) of Regulation S-X provides that the outside auditors’ report must “clearly state the opinion of the accountant, either unqualified or

adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting, except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion.” Since a qualified opinion explains why an overall opinion cannot be expressed, its inclusion in an annual report should mean that the registrant is current in its filing obligations.

If the outside auditors believe that the registrant’s internal control over financial reporting has significant deficiencies that individually or in combination result in one or more material weaknesses, management must express an adverse opinion on internal control over financial reporting. Even if management has identified all of the material weaknesses that the outside auditors have identified in an appropriate process, the outside auditors can still issue an adverse opinion on the registrant’s internal control over financial reporting. The SEC Staff will consider a registrant that has included an adverse opinion on internal control over

financial reporting in its annual report to be current in its reporting obligations.

*Will the SEC accept a disclaimed auditors’ opinion?*

As noted above, outside auditors may issue a disclaimed opinion, such as when the auditors are unable to complete the audit. The SEC Staff takes the position that reports on audits of internal control over financial reporting that disclaim an opinion due to a scope limitation do not satisfy the requirements of Item 308 of Regulation S-K. In such a situation, however, it is possible that the outside auditors will withdraw from the engagement or refuse to express an opinion at all.

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