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A. Overview of Conforming Amendments to the Standards of the PCAOB

When the Board proposed its auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (PCAOB Release No. 2003-017, dated October 7, 2003) (the "proposed internal control standard"), the Board recognized that some amendments of the professional standards adopted by the Board as its interim standards^{1/} were necessary to make those standards consistent with the principles and requirements in the proposed internal control standard. The Board also intended to make several amendments to the interim standards that would be applicable to situations in which section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") is not applicable and only the financial statements of the company must be audited.

Some commenters on the Board's proposed internal control standard believed that the Board's proposal was not clear about whether the Board intended to amend the interim standards and recommended that the Board specifically identify changes made by the proposed internal control standard to the interim standards. The commenters suggested that identification of such changes is critical in enabling auditors to comply with the Board's standards, as well as in eliminating potential confusion and inconsistencies in interpretation with respect to the affected portions of the interim standards.

^{1/} Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the Securities and Exchange Commission ("SEC" or the "Commission") on April 25, 2003. [See SEC Release No. 33-8222.] On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not superseded or amended by the Board' to each of the interim standards rules." This rule is pending approval from the SEC.

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The Board agrees that its proposed standards should identify how they affect existing standards, to the greatest extent practicable. In future standards-setting proposals, the Board intends to include a specific identification of related proposed amendments to other standards. The Board also agrees that it is important to identify amendments to the interim standards that arise from issuance of PCAOB Auditing Standard No. 2. Accordingly, the Board is issuing, for public comment, this proposed auditing standard that identifies the conforming amendments to the interim standards resulting from the Board's adoption of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

Commenters should recognize that the scope of this proposed auditing standard is relatively narrow and comprises only proposed amendments to the interim standards resulting from the adoption of PCAOB Auditing Standard No. 2. Accordingly, the Board will not consider comments on the principles and requirements in PCAOB Auditing Standard No. 2 itself. Instead, the Board requests comments on the questions identified in this release and seeks other relevant comments on this proposed auditing standard.

B. Nature and Extent of the Conforming Amendments to the Interim Standards of the PCAOB

As a result of the adoption of PCAOB Auditing Standard No. 2, conforming amendments are proposed to the Board's interim standards, in particular the interim auditing, attestation, and independence standards. The nature and extent of those amendments are described below.

1. Auditing Standards

The Board's interim auditing standards include the Statements on Auditing Standards promulgated by the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board ("ASB"), as in existence on April 16, 2003.^{2/} The proposed conforming amendments to the Board's interim auditing standards include –

^{2/} The Statements on Auditing Standards are codified into the AICPA *Professional Standards*, vol. 1, as AU sections 100 through 901.

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a. Addition of References.

References would be added to assist auditors in performing an integrated audit of financial statements and internal control over financial reporting. Auditors are cautioned that the references may not be all inclusive. If there is any conflict between the interim auditing standards and PCAOB Auditing Standard No. 2, auditors should follow the provisions of PCAOB Auditing Standard No. 2.

Question 1 – Are the references useful in assisting auditors when performing an integrated audit of financial statements and internal control over financial reporting? If not, explain.

Question 2 – Have any references been omitted from the proposed auditing standard that commenters believe would be beneficial? If so, explain.

b. Amendments applicable to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements.

While PCAOB Auditing Standard No. 2 is primarily directed to auditors when performing an integrated audit of financial statements and internal control over financial reporting, some requirements in that standard also apply when an auditor is engaged solely to audit a company's financial statements. Such would be the case in limited circumstances, such as in an audit of financial statements in an initial public offering, in which the company is not subject to the requirements of Section 404 of the Act and the SEC's rules implementing that provision.^{3/}

Areas in which changes to the interim auditing standards were intended to apply to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements include the following (for ease of reference, the references below are made to the standards as codified in AICPA *Professional Standards*, rather than to the original pronouncements) –

^{3/} See *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, SEC Release No. 33-8238 (June 5, 2003) [68 FR 36636].

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i. AU sec. 310, "Appointment of the Independent Auditor."

This standard would be amended to include the auditor's understanding with the client when performing an integrated audit of financial statements and internal control over financial reporting. For consistency, certain related amendments also would be made to the auditor's understanding with the client when performing an audit of financial statements.

ii. AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit."

This standard would be amended to add a requirement stating, "Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." As it relates to this requirement, the Board's proposed internal control standard stated, "Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions for all significant accounts and disclosures. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement." A similar conforming amendment would be made to AU sec. 322, "The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements."

iii. AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit."

This standard would be superseded in an integrated audit of financial statements and internal control over financial reporting by paragraphs 207 through 214 of PCAOB Auditing Standard No. 2. This standard also would be superseded in an audit of financial statements by the paragraphs included in the appendix accompanying this Release.

iv. AU sec. 326, "Evidential Matter."

This standard would be amended to add a requirement stating that, "the auditor's substantive procedures must include reconciling the financial statements to the

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accounting records. The auditor's substantive procedures should include examining material adjustments made during the course of preparing the financial statements." PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial reporting. The Board believes that it is logical and appropriate that these procedures also be performed in an audit of the financial statements.

v. AU sec. 329, "Analytical Procedures."

This standard would be amended to add the following directions:

- For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.
- When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.
- Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

PCAOB Auditing Standard No. 2 is clear on the applicability of these procedures in an integrated audit of financial statements and internal control over financial reporting. The Board believes that it is logical and appropriate that these procedures also be performed in an audit of the financial statements.

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Question 3 – Do the proposed amendments clearly describe the new requirements that apply when the auditor is engaged to audit only the financial statements? If not, how can the Board more clearly describe the new requirements?

Question 4 – Are there any additional requirements that are applicable in an integrated audit of financial statements and internal control over financial reporting that also should be applicable when the auditor is engaged to audit only the financial statements? For example:

- Should the auditor be required to report all internal control deficiencies (i.e., including internal control deficiencies that are less severe than significant deficiencies and material weaknesses) to management not previously communicated in writing by the auditor or by others? (Under the proposed amendment, the auditor would be required to report to management and the audit committee significant deficiencies and material weaknesses identified during the audit.)*
- Should the auditor evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting? (Under the proposed amendment, the auditor does not have an explicit requirement to make this evaluation but would be required to report in writing to the board of directors a conclusion that the audit committee's oversight is ineffective, even if the auditor did not perform an evaluation to reach that conclusion.)*

Question 5 – Are there any circumstances in which the proposed amendments in an audit of financial statements are not appropriate or should not be made? If so, what are those circumstances, and why do they indicate that the proposed amendment is not appropriate? Recognizing that the requirements in the proposed amendments are required in an integrated audit, describe the circumstances that are different in an audit of financial statements from those in an integrated audit of financial statements and internal control over financial reporting.

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2. Attestation Standards

The Board's interim attestation standards include the Statements on Standards for Attestation Engagements promulgated by the ASB, as in existence on April 16, 2003.^{4/} Auditors performing an integrated audit of financial statements and internal control over financial reporting to comply with Section 404 of the Act are to follow PCAOB Auditing Standard No. 2 when reporting on an entity's internal control over financial reporting. Accordingly, auditors would not be permitted to use AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting," for this purpose. This standard would supersede AT sec. 501 in its entirety and, therefore, remove it from the Board's interim attestation standards.

While an auditor is not precluded from reporting on the effectiveness of internal control over financial reporting using AT sec. 501 for purposes other than satisfying Section 404 of the Act, auditors should recognize that AT sec. 501 (as it would continue to exist in the professional standards of other bodies) would no longer be considered an interim attestation standard of the Board. Accordingly, it would not be permissible for AT sec. 501 reports to state that the examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States).

Question 6 – Are there any circumstances in which issuers would want or need to file an AT sec. 501 report with the Commission? If so, explain.

Question 7 – Should AT sec. 501 be amended rather than superseded? If amended, what types of changes should be made to AT sec. 501?

Question 8 – Is there a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting? If so, what information should the report include? In which circumstances would the report be issued? Who would use the report?

^{4/} The Statements on Standards for Attestation Engagements are codified into the AICPA *Professional Standards*, vol. 1, as AT sections 101 through 701.

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3. Independence Standards

The Board's interim independence standards include the AICPA Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, promulgated by the AICPA Professional Ethics Executive Committee, as in existence on April 16, 2003.^{5/} As indicated in PCAOB Auditing Standard No. 2, a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer for which the registered public accounting firm also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee. Accordingly, since this requirement is an addition to current independence requirements, it would be added to interpretation 101-3, "Performance of Other Services," to Rule 101, "Independence" (ET sec. 101.05).

Table 1, "Cross-References to Conforming Amendments to PCAOB Interim Standards," identifies all of the proposed amendments, which the appendix to this release describes in more detail. For ease of reference, Table 1 organizes the interim standards according to the codified sections of the AICPA *Professional Standards* (vols. 1 and 2).

^{5/} The AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder, are codified into the AICPA *Professional Standards*, vol. 2, as ET sections 101 and 191.

**TABLE 1 – CROSS-REFERENCES TO CONFORMING AMENDMENTS TO
PCAOB INTERIM STANDARDS**

AU Section	Title	Paragraph ^{6/} Changes
310	Appointment of the Independent Auditor	.06
311	Planning and Supervision	.01
312	Audit Risk and Materiality in Conducting an Audit	.03,.05,.12,.18,.30
313	Substantive Tests Prior to the Balance Sheet Date	.01
316	Consideration of Fraud in a Financial Statement Audit	.01
319	Consideration of Internal Control in a Financial Statement Audit	.02,.09,.65,.83,.97, .107
322	The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements	.01,.16,.20,.22
324	Service Organizations	.01
325	Communication of Internal Control Related Matters Noted in an Audit	In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60 is superseded by paragraphs 207 - 214 of PCAOB Auditing Standard No. 2. In an audit of financial statements only, SAS No. 60 is superseded as described in the appendix.
326	Evidential Matter	.19
329	Analytical Procedures	.09,.10,.16
332	Auditing Derivative Instruments, Hedging Activities, and Investments in Securities	.11
333	Management Representations	.05

^{6/} The word "paragraph" refers to the paragraph number in the corresponding interim standard.

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339	Audit Documentation	Appendix A
342	Auditing Accounting Estimates	.10
508	Reports on Audited Financial Statements	.01,.08
530	Dating of the Independent Auditor's Report	.01
543	Part of Audit Performed by Other Independent Auditors	.01
560	Subsequent Events	.01
561	Subsequent Discovery of Facts Existing at the Date of the Auditor's Report	.01
711	Filings Under Federal Securities Statutes	.02
722	Interim Financial Information	.03

AT Section	Title	Paragraph^{7/} Changes
501	Reporting on an Entity's Internal Control Over Financial Reporting	Superseded

ET Section	Title	Paragraph^{7/} Changes
101	Independence	.05

C. Proposed Effective Date

The Board is proposing November 15, 2004 as the effective date for its standard, *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. Although early implementation of the standard would be permitted, the standard would be effective for audits of financial statements and integrated audits of financial statements and internal control over financial reporting for periods ending on or after November 15, 2004.

Companies considered accelerated filers under Securities Exchange Act Rule 12b-2^{8/} are required to comply with the internal control reporting and disclosure

^{7/} The word "paragraph" refers to the paragraph number in the corresponding interim standard.

^{8/} See 17 C.F.R. 240.12b-2.

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requirements of Section 404 of the Act for fiscal years ending on or after November 15, 2004. Other companies have until fiscal years ending on or after July 15, 2005 to comply with these internal control reporting and disclosure requirements. While non-accelerated filers are not required to comply with the internal control reporting and disclosure requirements until July 15, 2005, the provisions included in this standard relating to audits of financial statements would be effective November 15, 2004.

D. Opportunity for Public Comment

The Board will seek comment on the proposed auditing standard for a 45-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 014 in the subject or reference line and should be received by the Board no later than 5:00 p.m. EST on April 23, 2004.

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

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On the 9th day of March, in the year 2004, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Acting Secretary

March 9, 2004

APPENDIX – Proposed Auditing Standard – *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit of Financial Statements*

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Appendix – Proposed Auditing Standard

March 9, 2004

AUDITING AND RELATED PROFESSIONAL PRACTICE STANDARDS

Proposed Auditing Standard—

**CONFORMING AMENDMENTS TO PCAOB INTERIM
STANDARDS RESULTING FROM THE ADOPTION OF
PCAOB AUDITING STANDARD NO. 2, AN AUDIT OF
INTERNAL CONTROL OVER FINANCIAL REPORTING
PERFORMED IN CONJUNCTION WITH AN AUDIT OF
FINANCIAL STATEMENTS**

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Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements

1. The following conforming amendments to the interim standards of the PCAOB result from the adoption of PCAOB Auditing Standard No. 2, *An Audit Of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*.

Auditing Standards

2. Statement on Auditing Standards (SAS) No. 1, "Codification of Auditing Standards and Procedures," AU sec. 310, "Appointment of the Independent Auditor," as amended by SAS No. 45, "Omnibus Statement on Auditing Standards-1983," SAS No. 83, "Establishing an Understanding With the Client," and SAS No. 89, "Audit Adjustments" (AU sec. 310, "Appointment of the Independent Auditor"), is amended as follows:

- a. The first sentence of paragraph .06 is amended to read as follows:
An understanding with the client generally includes the following matters.
- b. The first bullet point of paragraph .06 is amended to read as follows:
The objective of the audit is:
 - Integrated audit of financial statements and internal control over financial reporting: The expression of an opinion on both management's assessment of internal control over financial reporting and on the financial statements.
 - Audit of financial statements: The expression of an opinion on the financial statements.
- c. The third bullet point of paragraph .06 is amended to read as follows:

Management is responsible for establishing and maintaining effective internal control over financial reporting. In an integrated audit of financial statements and internal control over financial reporting, an auditor is

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required to communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion if management has not fulfilled the following responsibilities:

- Accept responsibility for the effectiveness of the company's internal control over financial reporting.
- Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria,
- Support its evaluation with sufficient evidence, including documentation, and
- Present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

d. The seventh bullet point of paragraph .06 is amended to read as follows:

The auditor is responsible for conducting the audit in accordance with the standards of the Public Company Accounting Oversight Board. Those standards require that the auditor:

- Integrated audit of financial statements and internal control over financial reporting: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether management's assessment of the effectiveness of the company's internal control over financial reporting is fairly stated in all material respects. Accordingly, there is some risk that a material misstatement of the financial statements or a material weakness in internal control over financial reporting would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, an integrated audit is not designed to detect error or fraud that is immaterial to the financial statements or deficiencies in internal control over financial reporting that, individually or in

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combination, are less severe than a material weakness. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- Audit of financial statements: Obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, there is some risk that a material misstatement would remain undetected. Although not absolute assurance, reasonable assurance is, nevertheless, a high level of assurance. Also, a financial statement audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- e. The eighth bullet point of paragraph .06 is amended to read as follows:

An audit includes:

- Integrated audit of financial statements and internal control over financial reporting: Planning and performing the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management's assessment. The auditor is also responsible for obtaining an understanding of internal control sufficient to plan the financial statement audit and to determine the nature, timing, and extent of audit procedures to be performed. The auditor is also responsible for communicating in writing:
 - To the audit committee – all significant deficiencies and material weaknesses identified during the audit.

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- To management – all internal control deficiencies not previously communicated in writing by the auditor or by others, including internal auditors or others inside or outside the company.
- To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.
- Audit of financial statements: Obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify internal control deficiencies. However, the auditor is responsible for communicating in writing:
 - To the audit committee – all significant deficiencies and material weaknesses identified during the audit.
 - To the board of directors – any specific significant deficiency or material weakness identified because the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

3. SAS No. 22, "Planning and Supervision," as amended by SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 77, "Amendments to Statements on Auditing Standards No. 22, 'Planning and Supervision,' No. 59, 'The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,' and No. 62, 'Special Reports'" (AU sec. 311, "Planning and Supervision"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 39 of PCAOB Standard No. 2 regarding planning considerations.

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4. SAS No. 47, "Audit Risk and Materiality in Conducting an Audit," as amended by SAS No. 82, "Consideration of Fraud in a Financial Statement Audit," SAS No. 96, "Audit Documentation," and SAS No. 98, "Omnibus Statement on Auditing Standards--2002" (AU sec. 312, "Audit Risk and Materiality in Conducting an Audit"), is amended as follows:

- a. The following note is added after paragraph 3.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 of PCAOB Auditing Standard No. 2 regarding materiality considerations.

- b. The following note is added after paragraph 5.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

- c. The following note is added after paragraph 12.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 22-23 and 39 of PCAOB Auditing Standard No. 2 regarding materiality and planning considerations, respectively.

- d. The following note is added after paragraph 18.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for discussion of tests to be performed when a company has multiple locations or business units.

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- e. The following note is added after paragraph 30.

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 147-149 of PCAOB Auditing Standard No. 2 regarding tests of controls.

5. SAS No. 45, "Omnibus Statement on Auditing Standards--1983" (AU sec. 313, "Substantive Tests Prior to the Balance-Sheet Date"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 98-103 of PCAOB Auditing Standard No. 2 regarding timing of tests of controls.

6. SAS No. 99, "Consideration of Fraud in a Financial Statement Audit" (AU sec. 316, "Consideration of Fraud in a Financial Statement Audit"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 24-26 of PCAOB Auditing Standard No. 2 regarding fraud considerations.

7. SAS No. 55, "Consideration of Internal Control in a Financial Statement Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment of Statement on Auditing Standards No. 55," and SAS No. 94, "The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit" (AU sec. 319, "Consideration of Internal Control in a Financial Statement Audit"), is amended as follows:

a. In paragraph 2, the term "assertions" is replaced by the term "relevant assertions."

- b. The following sentence is added at the end of paragraph 2:

Regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

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- c. The following note is added after paragraph 2:

Note: Refer to paragraphs 68-70 of PCAOB Auditing Standard No. 2 for discussion of identifying relevant financial statement assertions.

- d. The following note is added after paragraph 9:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," of PCAOB Auditing Standard No. 2 for discussion of tests to be performed when a company has multiple locations or business units.

- e. The following note is added after paragraph 65:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion.

- f. The following note is added after paragraph 83:

Note: In an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, in part, that "If, however, the auditor assesses control risk as other than low for certain assertions or significant accounts, the auditor should document the reasons for that conclusion." Accordingly, if control risk is assessed at the maximum level, the auditor should document the basis for that conclusion. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for additional information regarding documentation requirements.

- g. The following note is added after paragraph 97:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 104-105 of PCAOB Auditing Standard No. 2 for discussion on the extent of tests of controls.

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h. The last sentence of paragraph 107 is replaced with the following sentence:

Consequently, regardless of the assessed level of control risk, the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements.

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

a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 108-126 of PCAOB Auditing Standard No. 2 for discussion on using the work of others to alter the nature, timing, and extent of the work that otherwise would have been performed to test controls.

b. The second sentence of paragraph 16 is replaced with the following sentence:

The auditor assesses control risk for each of the relevant financial statement assertions related to all significant accounts and disclosures in the financial statements and performs tests of controls to support assessments below the maximum.

c. The following note is added after paragraph 20:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 112-116 of PCAOB Auditing Standard No. 2 regarding evaluating the nature of controls subjected to the work of others.

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- d. The following note is added after paragraph 22:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 122 of PCAOB Auditing Standard No. 2 regarding assessing the interrelationship of the nature of the controls and the competence and objectivity of those who performed the work.

9. SAS No. 70, "Service Organizations," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standard No. 55," SAS No. 88, "Service Organizations and Reporting on Consistency," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 324, "Service Organizations"), is amended by adding the following note after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs B18-B29 of Appendix B, "Additional Performance Requirements and Directions; Extent-of-Testing Examples," in PCAOB Auditing Standard No. 2 regarding the use of service organizations.

10. SAS No. 60, "Communication of Internal Control Related Matters Noted in an Audit," as amended by SAS No. 78, "Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55," and SAS No. 87, "Restricting the Use of an Auditor's Report" (AU sec. 325, "Communication of Internal Control Related Matters Noted in an Audit"), is superseded.

- In an integrated audit of financial statements and internal control over financial reporting, SAS No. 60, as amended, is superseded by paragraphs 207-214 of PCAOB Auditing Standard No. 2.
- In an audit of financial statements only, SAS No. 60, as amended, is superseded by the following paragraphs.

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Communications about Control Deficiencies in An Audit of Financial Statements

1. In an audit of financial statements, the auditor may identify deficiencies in the company's internal control over financial reporting. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

- A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met.
- A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or qualifications to perform the control effectively.

2. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Note: The term "remote likelihood" as used in the definitions of significant deficiency and material weakness (paragraph 3) has the same meaning as the term "remote" as used in Financial Accounting Standards Board Statement No. 5, "Accounting for Contingencies" ("FAS No. 5"). Paragraph 3 of FAS No. 5 states:

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When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This Statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:

- a. Probable. The future event or events are likely to occur.
- b. Reasonably possible. The chance of the future event or events occurring is more than remote but less than likely.
- c. Remote. The chance of the future events or events occurring is slight.

Therefore, the likelihood of an event is "more than remote" when it is either reasonably possible or probable.

Note: A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, either individually or when aggregated with other misstatements, would clearly be immaterial to the financial statements. If a reasonable person could not reach such a conclusion regarding a particular misstatement, that misstatement is more than inconsequential.

3. A material weakness is a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Note: In evaluating whether a control deficiency exists and whether control deficiencies, either individually or in combination with other control deficiencies, are significant deficiencies or material weaknesses, the auditor should consider the definitions in

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paragraphs 1, 2 and 3, and the directions in paragraphs 130 through 137 of PCAOB Auditing Standard No. 2. As explained in paragraph 23 of PCAOB Auditing Standard No. 2, the evaluation of the materiality of the control deficiency should include both quantitative and qualitative considerations. Qualitative factors that might be important in this evaluation include the nature of the financial statement accounts and assertions involved and the reasonably possible future consequences of the deficiency. Furthermore, in determining whether a control deficiency, or combination of deficiencies, is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective.

4. The auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. The written communication should be made prior to the issuance of the auditor's report on the financial statements. The auditor's communication should distinguish clearly between those matters considered significant deficiencies and those considered material weaknesses, as defined in paragraphs 2 and 3.

Note: If no such committee exists with respect to the company, all references to the audit committee in this standard apply to the entire board of directors of the company.^{1/} The auditor should be aware that companies whose securities are not listed on a national securities exchange or an automated inter-dealer quotation system of a national securities association (such as the New York Stock Exchange, American Stock Exchange, or NASDAQ) may not be required to have independent directors for their audit committees. In this case, the auditor should not consider the lack of independent directors or an audit committee at these companies indicative, by themselves, of a control deficiency. Likewise, the independence requirements of Securities Exchange Act Rule 10A-3^{2/} are not

^{1/} See 15 U.S.C. 78c(a)58 and 15 U.S.C. 7201(a)(3).

^{2/} See 17 C.F.R. 240.10A-3.

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applicable to the listing of non-equity securities of a consolidated or at least 50 percent beneficially owned subsidiary of a listed issuer that is subject to the requirements of Securities Exchange Act Rule 10A-3(c)(2).^{3/} Therefore, the auditor should interpret references to the audit committee in this standard, as applied to a subsidiary registrant, as being consistent with the provisions of Securities Exchange Act Rule 10A-3(c)(2).^{4/} Furthermore, for subsidiary registrants, communications required by this standard to be directed to the audit committee should be made to the same committee or equivalent body that pre-approves the retention of the auditor by or on behalf of the subsidiary registrant pursuant to Rule 2-01(c)(7) of Regulation S-X^{5/} (which might be, for example, the audit committee of the subsidiary registrant, the full board of the subsidiary registrant, or the audit committee of the subsidiary registrant's parent). In all cases, the auditor should interpret the terms "board of directors" and "audit committee" in this standard as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

5. Although there is not an explicit requirement to evaluate the effectiveness of the audit committee's oversight of the external financial reporting process and the internal control over financial reporting, if a significant deficiency or material weakness exists because the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, the auditor must communicate that specific significant deficiency or material weakness in writing to the board of directors.

^{3/} See 17 C.F.R. 240.10A-3(c)(2).

^{4/} See 17 C.F.R. 240.10A-3(c)(2).

^{5/} See 17 C.F.R. 210.2-01(c)(7).

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6. These written communications should include:
 - a. The definitions of control deficiencies, significant deficiencies, and material weaknesses and should clearly distinguish to which category the deficiencies being communicated relate.
 - b. A statement that the objective of the audit was to report on the financial statements and not to provide assurance on internal control.
 - c. A statement that the communication is intended solely for the information and use of the board of directors, audit committee, management, and others within the organization.
7. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made.
8. The auditor might identify matters in addition to those required to be communicated by this standard. Such matters include control deficiencies identified by the auditor that are neither significant deficiencies nor material weaknesses and matters the company may request the auditor to be alert to that go beyond those contemplated by this standard. The auditor may report such matters to management, the audit committee, or others, as appropriate.
9. The auditor should not report in writing that no significant deficiencies were discovered during an audit of financial statements because of the potential that the limited degree of assurance associated with such a report will be misunderstood.
10. When timely communication is important, the auditor should communicate the preceding matters during the course of the audit rather than at the end of the engagement. The decision about whether to issue an interim communication should be determined based on the relative

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significance of the matters noted and the urgency of corrective follow-up action required.

11. In an audit of financial statements only, auditors may continue to apply auditing interpretation 1 to AU sec. 325, "Reporting on the Existence of Material Weaknesses," except that the term "reportable condition" means "significant deficiency," as defined in paragraph 9 of PCAOB Auditing Standard No. 2.

12. SAS No. 31, "Evidential Matter," as amended by SAS No. 48, "The Effects of Computer Processing on the Audit of Financial Statements," and SAS No. 80, "Amendment to Statement on Auditing Standards No. 31, 'Evidential Matter'" (AU sec. 326, "Evidential Matter"), is amended by adding the following sentences at the end of paragraph 19:

Additionally, the auditor's substantive procedures must include reconciling the financial statements to the accounting records. The auditor's substantive procedures also should include examining material adjustments made during the course of preparing the financial statements.

13. SAS No. 56, "Analytical Procedures," as amended by SAS No. 96, "Audit Documentation" (AU sec. 329, "Analytical Procedures"), is amended as follows:

a. The following sentence is added to the end of paragraph 9:

For significant risks of material misstatement, it is unlikely that audit evidence obtained from substantive analytical procedures alone will be sufficient.

b. The following sentences are added to the end of paragraph 10:

When designing substantive analytical procedures, the auditor also should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial

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statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting fraud.

- c. The following sentence is added to the beginning of paragraph 16:

Before using the results obtained from substantive analytical procedures, the auditor should either test the design and operating effectiveness of controls over financial information used in the substantive analytical procedures or perform other procedures to support the completeness and accuracy of the underlying information.

14. SAS No. 92, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities" (AU sec. 332, "Auditing Derivative Instruments, Hedging Activities, and Investments in Securities"), is amended by adding the following note after paragraph 11:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, PCAOB Auditing Standard No. 2 states, "the auditor must obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements." Therefore, in an integrated audit of financial statements and internal control over financial reporting, if a company's investment in derivatives and securities represents a significant account, the auditor's understanding of controls should include controls over derivatives and securities transactions from their initiation to their inclusion in the financial statements and should encompass controls placed in operation by the entity and the service organization whose services are part of the entity's information system.

15. SAS No. 85, "Management Representations," as amended by SAS No. 89, "Audit Adjustments," and SAS No. 99 "Consideration of Fraud in a Financial Statement Audit" (AU sec. 333, "Management Representations"), is amended by adding the following note after paragraph 5:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 142-144 of PCAOB Auditing

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Standard No. 2 for required written representations to be obtained from management.

16. Appendix A of SAS No. 96, "Audit Documentation" (AU sec. 339, "Audit Documentation"), is amended by adding the following subparagraph:

q. PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, to document the auditor's assessment of internal control over financial reporting when performing an integrated audit of financial statements and internal control over financial reporting. Refer to paragraphs 159-161 of PCAOB Auditing Standard No. 2 for documentation requirements.

17. SAS No. 57, "Auditing Accounting Estimates" (AU sec. 342, "Auditing Accounting Estimates"), is amended by adding the following note after paragraph 10:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may use any of the three approaches. However, the work that the auditor performs as part of the audit of internal control over financial reporting should necessarily inform the auditor's decisions about the approach he or she takes to auditing an estimate because, as part of the audit of internal control over financial reporting, the auditor would have understood the process management used to develop the estimate and tested controls over all relevant assertions related to the estimate.

18. SAS No. 58, "Reports on Audited Financial Statements," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990," SAS No. 79, "Amendment to Statement on Auditing Standards No. 58, 'Reports on Audited Financial Statements,'" SAS No. 85, "Management Representations," SAS No. 93, "Omnibus Statement on Auditing Standards – 2000," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 508, "Reports on Audited Financial Statements"), is amended as follows:

a. The following note is added after paragraph 1:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a

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combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 162-199 of PCAOB Auditing Standard No. 2 for direction on reporting on internal control over financial reporting. In addition, see Appendix A, "Illustrative Reports on Internal Control Over Financial Reporting," of PCAOB Auditing Standard No. 2 which includes an illustrative combined audit report and examples of separate reports.

b. The following subparagraph is added to paragraph 8:

k. When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of W Company's internal control over financial reporting as of December 31, 20X3, based on *[identify control criteria]* and our report dated *[date of report, which should be the same as the date of the report on the financial statements]* expressed *[include nature of opinions]*.

19. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 530, "Dating of the Independent Auditor's Report," as amended by SAS No. 29, "Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 530, "Dating of the Independent Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor's reports on the company's financial statements and on internal control over financial reporting should be dated the same. Refer to paragraphs 171-172 of PCAOB Auditing Standard No. 2, which provide direction with respect to the report date in an audit of internal control over financial reporting.

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20. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 543, "Part of Audit Performed by Other Independent Auditors," as amended by SAS No. 64, "Omnibus Statement on Auditing Standards – 1990" (AU sec. 543, "Part of Audit Performed by Other Independent Auditors"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 182-185 of PCAOB Auditing Standard No. 2, which provide direction with respect to opinions based, in part, on the report of another auditor in an audit of internal control over financial reporting.

21. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 560, "Subsequent Events," as amended by SAS No. 12, "Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments," and SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 560, "Subsequent Events"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 186-189 of PCAOB Auditing Standard No. 2, which provide direction with respect to subsequent events in an audit of internal control over financial reporting.

22. SAS No. 1, "Codification of Auditing Standards and Procedures," AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report," as amended by SAS No. 98, "Omnibus Statement on Auditing Standards – 2002" (AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report"), is amended by adding the following note after paragraph .01:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraph 197 of PCAOB Auditing Standard No. 2, which provides direction with respect to the subsequent discovery of information existing at the date of the auditor's report on internal control over financial reporting.

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23. SAS No. 37, "Filings Under Federal Securities Statutes" (AU sec. 711, "Filings Under Federal Securities Statutes"), is amended by adding the following note after paragraph 2:

Note: When performing an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 198-199 of PCAOB Auditing Standard No. 2, which provide direction with respect to filings under federal securities statutes in an audit of internal control over financial reporting.

24. SAS No. 100, "Interim Financial Information" (AU sec. 722, "Interim Financial Information"), is amended by adding the following note after paragraph 3:

Note: When an auditor is engaged to perform an integrated audit of financial statements and internal control over financial reporting, refer to paragraphs 202-206 of PCAOB Auditing Standard No. 2, which provide direction regarding the auditor's evaluation responsibilities as they relate to management's quarterly certifications on internal control over financial reporting.

Attestation Standards

25. Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of Statement on Standards for Attestation Engagements No. 10, "Attestation Standards: Revision and Recodification" (AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting"), is superseded by this standard and, accordingly, is no longer an interim standard of the Board.

Independence Standards

26. The following paragraph is added after the second paragraph of interpretation 101-3, "Performance of Other Services," to Rule 101, "Independence" (ET sec. 101.05):

Additionally, a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer (defined in section 2(a)(7) of the Sarbanes-Oxley Act of 2002) for which the registered public accounting firm also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee.

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Effective Date

27. This standard is effective for audits of financial statements and integrated audits of financial statements and internal control over financial reporting for periods ending on or after November 15, 2004. Early compliance with this standard is permitted.