

Requirements for Disclosures about Internal Control over Financial Reporting

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The principal sources cited in these FAQs are:

- 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)

- SEC Office of the Chief Accountant and Division of Corporation Finance: Management's Report on Internal Control over Financial Reporting and Disclosure in Exchange Act Periodic Reports – [Frequently Asked Questions](#) (originally issued on June 22, 2004, revised on October 6, 2004)
- [Auditing Standard No. 2 –An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements](#) (Mar. 9, 2004)
- [PCAOB Staff Questions and Answers: Auditing Internal Control Over Financial Reporting](#) (originally issued June 23, 2004, revised July 27, 2004)
- [PCAOB Staff Questions and Answers: Auditing Internal Control Over Financial Reporting](#) (Oct. 6, 2004)
- [PCAOB Staff Questions and Answers: Auditing Internal Control Over Financial Reporting](#) (Nov. 22, 2004)
- [Exchange Act Rule 13a-15](#), Issuer's Disclosure Controls and Procedures Related to Preparation of Required Reports
- [Exchange Act Rule 15d-15](#), Controls and Procedures
- [Item 308 of Regulation S-K](#), Internal Control over Financial Reporting

Cites to the forms and rules applicable to small businesses, foreign private issuers, investment companies and asset-backed issuers are not included in these FAQs.

A. Nature and Timing of the Reporting Requirement

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

Registrants that are:

- “accelerated filers”;
- with less than a \$700 million public equity float as of the end of the second fiscal quarter of their 2004 fiscal year; and
- that have fiscal years ending between and including November 15, 2004, and February 28, 2005,

have, for this year only, until 45 days after the due date for their annual reports to file their internal control reports provided they file their 10-K on time and identify in that 10-K the omitted management and auditors' reports on internal control and describe any material weaknesses that had been identified as of the filing date of the Form 10-K. See [SEC Release No. 34-50734](#) (Nov. 30, 2004).

Accelerated filers that rely on the exemptive relief will not be current for Form [S-2](#) and [S-3](#) purposes until they amend their 10-Ks, without relying on [Rule 12b-25](#), to include the omitted reports. Although the exemptive order does not address the implications of the order on the internal control-related language to be included in the [Section 302](#) certifications, presumably the SEC intended that the language be added to the 302 certifications only once the annual report includes the [Section 404](#) reports.

After the first year of filing internal control reports, these accelerated filers must include reports on internal control over financial reporting in their annual reports on [Form 10-K](#) on a timely basis.

All accelerated filers not described above must include reports on internal control over financial reporting in their annual reports on Form 10-K. All other registrants must include the internal control reports in their annual reports on Form 10-K for fiscal years ending on or after July 15, 2005. See [SEC Release No. 33-8392](#) (Feb. 24 2004).). The SEC may provide relief for foreign private issuers that are going to comply with the International Financial Reporting Standards in 2005. (As discussed below, reports must also be included in the annual reports to shareholders.) See “[Where must a registrant disclose the management report on internal control over financial reporting?](#)”

The SEC recently adopted amendments to postpone, for one year, the effective date of the 60-day filing requirement for annual reports on Form 10-K. See [SEC Release No. 33-8507](#) (Nov. 17, 2004.) This deferral, as well as the additional 45-day period described above, should enable registrants and their auditors to comply with the 404 reporting requirements.

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

Management's 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. The SEC Staff has urged registrants to include the report also in their annual reports to shareholders. Warning that failure to do so when the report is qualified in any way may render the annual report misleading, the Staff has noted that it intends to recommend that the SEC propose to amend Rules [14a-3\(b\)](#) and [14c-3\(a\)](#) under the Securities Exchange Act of 1934 (the “Exchange Act”) and Item 13 of [Schedule 14A](#) under the Exchange Act to require such presentation. See Question 22 of the [SEC Internal Control FAQs](#).

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

Management's 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?](#)”);
- 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. The SEC Staff expects that management's report will use the term “material weakness” in describing any identified material weaknesses. See Question 20 of the [SEC Internal Control FAQs](#). No statement that internal controls are effective “except for” certain identified problems or any similar qualified language is permitted. See Question 5 of the [SEC Internal Control FAQs](#) (see “[Can a registrant say that its disclosure controls and procedures are effective except to the extent of a described problem?](#)”); and
- State that the registrant's outside auditors have reported on management's assessment of internal control over financial reporting. The outside auditors' report must be included in the Form 10-K. See Section II.B.3. of [SEC Release No. 33-8238](#) (June 5, 2003)

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. Once Item 308(c) of [Regulation S-K](#) is effective because a management's report on internal control over financial reporting is required in a company's Form 10-K, the disclosure in reports on Form 10-Q about changes in

internal control over financial reporting will be based upon the quarterly evaluation of such changes in internal control over financial reporting required by Exchange Act [Rule 13a-15\(d\)](#) and [15d-15\(d\)](#). See Item 9A of [Form 10-K](#), Question 5 of the [SEC Internal Control FAQs](#) , and “[Must a registrant describe changes in internal control?](#)” .

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 (“COSO”). In 1992, COSO issued its “ [Internal Control – Integrated Framework](#).”. See Section II.B.3.a. of [SEC Release No. 33-8238](#). COSO is apparently developing a framework for small businesses to use to evaluate internal control, which, once developed, will be available to managements of small businesses required to comply with the internal control reporting requirements.

What must the outside auditors say about internal control over financial reporting?

The outside auditors must state in their report their opinions on whether management's assessment of internal control over financial reporting is fairly stated, in all material respects, and whether the registrant maintained, in all material respects, effective internal control over financial reporting. The report must describe also, among other things, the outside auditors' opinion 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 Paragraphs 167l and m and 170 of [PCAOB Auditing Standard No. 2](#).

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

[PCAOB Auditing Standard No. 2](#) 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. The SEC Staff's response to Question 15 of the [SEC Internal Control FAQs](#) notes that the “auditor should take into account any issues that may arise if its audit report on the financial statements is expected to be reissued or incorporated by reference into a filing under the Securities Act.” Registrants should probably 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.

What must registrants say about their internal control over financial reporting before they must include reports on internal control in their annual reports on Form 10-K?

Registrants must report most, if not all, material weaknesses in internal control over financial reporting and any change in internal control over financial reporting that occurred during the period reflected in a Form 10-Q or the fourth quarter of a fiscal year if that change materially affected or is reasonably likely to materially affect the registrant's internal control over financial reporting. (See “[What is a material weakness in internal control over financial reporting?](#)”) The disclosure about a material weakness is required because registrants must state the conclusion of their CEO and CFO as to the effectiveness of disclosure controls and procedures. Since disclosure controls and procedures include the controls in internal control over financial reporting (unless the controls relate only to the safeguarding, and not the reporting, of assets), 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 [Form 10-K](#) and Item 4 of [Form 10-Q](#).

Can a registrant say that its disclosure controls and procedures are effective except to the extent of a described problem?

No. The CEO and CFO 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. See Question 5 of the [SEC Internal Control FAQs](#). They 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, in most cases, a material weakness in internal control over financial reporting, that the registrant's disclosure controls and procedures are not effective.

What should a registrant say about its ineffective disclosure controls and procedures?

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 why they are not effective, including the nature of the deficiency, so that the disclosure is not misleading. See Question 11 of the [SEC Internal Control FAQs](#). 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 in internal control, adequate financial statements. Any material weakness in internal control over financial reporting must be described in management's report on internal control over financial reporting included in an annual report.

Must a registrant describe changes in internal control?

Disclosure about changes in internal control is required before reports on internal control over financial reporting because the CEO and the CFO must represent in their certification required by [Section 302 of the Sarbanes-Oxley Act of 2002](#), 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 9 of the [SEC Internal Control FAQs](#) states that changes in internal control that are made in preparation for the registrant's first management report on internal control over financial reporting do not need to be disclosed, this relief does not affect the language in Paragraph 4(d) of the [Section 302 certification](#) and, therefore, in my view, the disclosure required by that paragraph. Since the CEO and the CFO must make the representation in Paragraph 4(d) of the Section 302 certification, they need to make sure that the applicable report includes the disclosure about material changes that they represent is set forth in the report. 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 would not likely have a material effect on such internal control over financial reporting.

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?

A registrant should expand its risk factors to disclose any reasonable possibility that its management or its outside auditors will not be able to report on internal control over financial reporting on a timely basis. Therefore, if management reasonably believes that the registrant will not be able to file reports on internal control over financial reporting when they are required, it should disclose that possibility in its risk factors.

The registrant should consider whether the circumstances that may make it impossible for the registrant's management or its outside auditors to report on internal control over financial reporting suggest that the registrant's disclosure controls and procedures are not effective. Registrants have begun to receive notifications from their outside auditors that the registrant has experienced slippage in its 404 implementation schedule and there is no assurance that 404 reporting will be timely if there is further slippage. Receipt of that notification by itself should not require disclosure if the registrant reasonably believes that 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 the [Sarbanes-Oxley Act of 2002](#), 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 unless the internal control reports are omitted in reliance upon the SEC's exemptive relief described above for accelerated filers having less than \$700 million of public equity float. See [When must registrants begin to report on internal control over financial reporting?](#) (The 906 certifications are required by [Exchange Act Rule 13a-14\(b\)](#) or [15\(d\)-14\(b\)](#) to be filed as exhibits to the periodic report containing financial statements. The certifications are filed as Exhibit 32 to the Form 10-K pursuant to Item 601(b)(32) 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 principal executive officer and principal financial officer may be willing to execute the Section 302 certifications as long as they are satisfied that the Form 10-K adequately describes the reasons why 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.

B. Meaning of Internal Control over Financial Reporting

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 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 23 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. An account is significant if there is more than a remote likelihood that the account could contain misstatements that individually, or when aggregated with others, could have a material effect on the financial statements, or the account represents an important performance measure even though it is not quantitatively large.

Generally, internal control over financial reporting includes the following:

- Controls over initiating, authorizing, recording, processing, and reporting significant accounts and disclosures and related assertions embodied in the financial statements.
- Controls over the selection and application of accounting policies that conform to generally accepted accounting principles (“GAAP”).
- Controls over significant nonroutine and nonsystematic transactions, such as accounts involving judgments and estimates.
- Controls, including information technology general controls, on which other controls are dependent.
- Company-level controls (see “[What are company level controls?](#)”).
- Controls designed to prevent, deter, and detect fraud (see “[What controls are necessary to prevent, deter, and detect fraud?](#)”).

See Paragraphs 24, 40, 53 and 114, [PCAOB Auditing Standard No. 2](#).

What are company level controls?

Company level controls are:

- Controls over common processes and systems and the centralized financial system and encompass the tone at the top;
- Human resources policies and programs;
- The assignment of authority and responsibility to persons having the requisite competence, integrity, and ethics;
- Management’s philosophy and operating style;
- Board-approved policies that address significant business control and risk management practices;
- Management’s risk assessment process;
- 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; and
- 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.

See Paragraphs 40 and 50-54, [PCAOB Auditing Standard No. 2](#).

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

Controls to prevent, deter, and detect fraud include:

- Controls restraining misappropriation of the registrant's assets;
- The registrant's risk assessment processes;
- The registrant's code of business conduct and ethics, especially the provisions relating to conflicts of interest, related party transactions, and illegal acts and the monitoring of the code by management and the audit committee or board;
- The internal audit function as well as the audit committee's involvement and interaction with internal audit; and
- The audit committee's procedures for handling complaints and concerns about accounting, auditing, and internal control matters, including those submitted on a confidential basis.

These controls, including the activities undertaken in response to any allegations of fraud are consistent with the [Amendments to the Sentencing Guidelines](#), which became effective on November 1, 2004. See Paragraphs 24-26, [PCAOB Auditing Standard No. 2](#).

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

In his [February 11, 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 anticipates that “management and the internal auditors will be documenting [their company'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.”

Must a registrant's internal control over financial reporting include controls relating to all of the entities reflected in a registrants' 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 Interpretation No. 46](#) (January 2003, revised December 2003), “Consolidation of Variable Interest Entities – an Interpretation of ARB No. 51” (“FIN 46”). 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 will need to 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 [FIN 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:

- (i) 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
- (ii) 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.

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. 2](#) 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?](#)

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 \(SAS 70 or AU §324\)](#). SAS 70 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, the actuary or other specialist is not part of internal control. See the response to Question 24 of [PCAOB's Questions and Answers: Auditing Internal Control over Financial Reporting \(originally issued June 23, 2004, revised July 27, 2004\)](#) ("PCAOB's Q&As). 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?](#)"

Is internal control over financial reporting part of disclosure controls and procedures?

Generally, internal control over financial reporting is part of disclosure controls and procedures. 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 demonstrating that such control is not part of disclosure controls and procedures. [Exchange Act Rules 13a-15\(e\)](#) and [15d-15\(e\)](#) define disclosure controls and procedures as "controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Exchange Act] is recorded, processed, summarized and reported within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the [Exchange Act] is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure."

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 Internal Revenue Code. The SEC Staff's response to Question 10 of the [SEC Internal Control FAQs](#) states that internal control over financial reporting also includes "controls to ensure that the effects of non-compliance with laws, rules and regulations are recorded in the registrant's financial statements, including the recognition of probable losses under Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies."

In addition, "all controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and also have a material effect on the reliability of financial reporting, are a part of internal control over financial reporting." See Paragraph 15 of [PCAOB Auditing](#).

[Standard No. 2](#). This means, according to the response to Question 27 of the [PCAOB's additional set of Staff Questions and Answers](#) that, "internal control over financial reporting encompasses controls over the identification, measurement, and reporting of all material actual loss events which have occurred, including controls over the monitoring and risk assessment of areas in which, given the nature of the company's operations, such actual loss events are reasonably possible."

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. See the SEC Staff's response to Question 10 of the [SEC Internal Control FAQs](#).

C. Registrants' Responsibilities

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

A registrant's documentation of its internal control over financial reporting should be complete enough to:

- Enable accurate and timely implementation of the controls by the persons having the responsibility for those controls;
- Permit the assessment of the adequacy of the design of the controls and whether they appropriately take into account the five components of internal control over financial reporting (that is, the control environment, risk assessment, control activities, information and communication, and monitoring);
- Understand how significant transactions are initiated, authorized, recorded, processed, and reported; and
- Evaluate the point during the flow of transactions at which material misstatements due to error or fraud could occur.

See Paragraphs 42-44 of [PCAOB Auditing Standard No. 2](#).

The controls over all relevant financial statement assertions must provide "the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation of and monitoring of the effective operation of controls." See Paragraph 44 of [PCAOB Auditing Standard No. 2](#). In this regard, a registrant should consider documenting a delegation of authority policy that, among other things, sets a framework for the segregation of duties, encompasses all key decision-making functions, identifies the personnel responsible for those decisions, defines powers reserved for the board, determines how much executives can commit or spend, identifies who can originate and approve policies, and implements a consistent process to monitor compliance and appropriately address any non-compliance through disciplinary actions and modifications of programs.

Who is management?

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 the Sarbanes-Oxley Act of 2002](#) 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 [Item 601\(b\)\(31\) of Regulation S-K](#). Accordingly, registrants may determine that the management who issues the report must be the principal executive and principal financial officers, particularly since the management report should be signed.

What representations must management make to the outside auditors?

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

- (i) management's responsibility for establishing and maintaining effective internal control over financial reporting;
- (ii) management's acknowledgement that its assessment of the effectiveness of internal control over financial reporting was not based at all on the outside auditor's audit of such internal control; and
- (iii) management's disclosure to the outside auditor of:

- (a) all deficiencies in the design or operation of internal control over financial reporting,
- (b) any identification of any fraud that involves senior management or employees who have a significant role in the company's internal control over financial reporting,
- (c) the resolution or other status of any control deficiencies identified and communicated to the audit committee during previous engagements, and
- (d) 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 142 of PCAOB Auditing Standard No 2](#).

The PCAOB Staff's response to Question 34 of the November 22, 2004 “[Staff Questions and Answers: Auditing Internal Control Over Financial Reporting](#)”, states that management must identify all 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\(a\)](#) 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](#)”; “[What internal control framework should management use to assess its internal control over financial reporting?](#)”.

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

- (i) The control environment, that is, the overall tone for the registrant;

(ii) Risk assessment, that is, the assessment of risks from both internal and external sources that affect the registrant's ability to carry out its business;

(iii) Control activities, that is, the policies and procedures that help ensure that management's instructions are implemented;

(iv) Information and communication, that is, the mechanisms intended to ensure that employees understand their responsibilities and that informed business decision-making and external reporting is achieved; and

(v) Monitoring, that is, 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.

How should management assess the five components of internal control?

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

With respect to the control environment:

(i) The degree of specification as to the level of competence necessary for specific assigned responsibilities;

(ii) 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;

(iii) The adequacy of employees' understanding of the code of business conduct and ethics and the procedures for the reporting of concerns or complaints with respect to accounting, internal control, and auditing matters;

(iv) 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;

(v) The adequacy of the example provided and the oversight role played by management and the board of directors, including the audit committee; and

(vi) The adequacy of human resource activities in assuring competence and ethical qualities.

With respect to risk assessment, the adequacy of:

(i) The identification of areas where material misstatements of the significant accounts and disclosures and related assertions in the financial statements might occur; and

(ii) Mechanisms to monitor events that suggest a re-examination of significant estimates and other judgments reflected in the financial statements.

With respect to control activities, the adequacy of:

- (i) Initiatives to check the accuracy and completeness of the control over assets, and the appropriateness of the authorization of transactions;
- (ii) Mechanisms to investigate unexpected results or unusual trends; and
- (iii) The segregation of duties.

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

With respect to monitoring:

- (i) The adequacy of the quarterly evaluation of internal controls, internal audits;
- (ii) The activities of the disclosure committee;
- (iii) The audit committee's oversight of internal control; and
- (iv) 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?

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?](#)" This means that management must obtain an understanding of the controls at the service organization that are relevant to the registrant's internal control 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:

- Performing tests of the registrant's controls over the activities of the service organization;
- Performing tests of controls at the service organization; and
- 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). See Appendix B.18-B.29 of [PCAOB Auditing Standard No. 2](#). 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 14 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 identifying 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 [additional set of Staff Questions and Answers](#), 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 to assess those controls. 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 14 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 requirement in Paragraphs 55-59 of PCAOB [Auditing Standard No. 2](#) that the outside auditors evaluate the effectiveness of the audit committee, management will need to assess the effectiveness of the audit committee as a part of its assessment of internal control over financial reporting. Among the items the outside auditors may consider, and, therefore, management should consider, are the following:

- The independence of the audit committee members from management, including the manner in which the audit committee members were identified for election to the board. See Paragraph 57 of [PCAOB Release No. 2003-017](#) (proposal) (Oct. 7, 2003); Paragraph 58 of [PCAOB Auditing Standard No. 2](#).
- The clarity with which the audit committee's responsibilities are articulated (for example, in the audit committee charter) and how well the audit committee and management understand those responsibilities. See Paragraph 57 of [PCAOB Auditing Standard No. 2](#).
- The quality of the information provided to the audit committee with respect to its oversight activities and the amount of time the audit committee spends on such activities.
- The level of the audit committee's involvement and interaction with the outside auditors (see Paragraph 57 of [PCAOB Auditing Standard No. 2](#)) and the nature of the audit committee's evaluation of the outside auditors' performance and independence, including with respect to non-audit services provided by the outside auditors to the registrant. See Paragraph 34 of [PCAOB Auditing Standard No. 2](#).
- The level of the audit committee's involvement with the internal auditors as well as its interaction with key members of financial management, including the chief financial officer and chief accounting officer. See Paragraph 57 of [PCAOB Auditing Standard No. 2](#).

- Whether the audit committee raises and pursues the right questions with management and the outside auditor. See Paragraph 58 of [PCAOB Auditing Standard No. 2](#).
- Whether the audit committee asks questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates, including the critical accounting estimates related to income taxes. See [Paragraph 58 of PCAOB Auditing Standard No. 2](#); see also, SEC Chief Accountant Donald T. Nicolaisen's February 2004 Remarks at the Tax Council Institute Conference on [The Corporate Tax Practice](#).
- Whether the audit committee is responsive to issues raised by the outside auditor, including information about control deficiencies. See [Paragraphs 39 and 205 of PCAOB Auditing Standard No. 2](#).
- The adequacy of the compliance by the members of the audit committee with, and oversight of, the code of business conduct, if the audit committee has that oversight responsibility. See [Paragraph 24 of PCAOB Auditing Standard No 2](#).
- 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.
- The adequacy of the audit committee's participation in the oversight of the period-end reporting process (see [Paragraph 77 of PCAOB Auditing Standard No. 2](#)), and whether that participation includes the review of earnings releases before they are issued. 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.
- Whether the audit committee members assist management in setting the proper tone at the registrant and creating and maintaining a culture of honesty and high ethical standards. See [Paragraph 25 of PCAOB Auditing Standard No. 2](#).
- The results of the annual audit committee self-assessment. See [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 will 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."

D. Responsibilities of Outside Auditors

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 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:

- (i) Management's assessment of the effectiveness of internal control over financial reporting;
- (ii) Evidence the outside auditors obtain from the work performed by others; and
- (iii) 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?](#)" The outside auditors must perform enough of their own tasks so that their work provides the principal evidence for their opinion. See Paragraphs 4, 5, and 111 of [PCAOB Auditing Standard No. 2](#).

What must the outside auditors do in conducting the audit?

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

- Plan the audit;
- Evaluate management's assessment process;
- Obtain an understanding of the registrant's internal control over financial reporting by:
 1. evaluating the design of controls relating to the five components of internal control, that is, the control environment, risk assessment, control activities, information and communication, and monitoring, which should include all controls specifically intended to address the risks of fraud that have at least a reasonably possible likelihood of having a material effect on the registrant's financial statements;
 2. identifying entity-level controls, which include the tone at the top;
 3. evaluating the effectiveness of the audit committee's oversight;
 4. identifying significant accounts and disclosures;
 5. identifying relevant financial statement assertions;
 6. identifying significant processes and major classes of transactions;
 7. identifying the period-end reporting process;
 8. performing walkthroughs; and
 9. identifying controls to test;
- Test and evaluate the design effectiveness of the registrant's internal control over financial reporting;
- Test and evaluate the operating effectiveness of the registrant's internal control over financial reporting; and
- Form an opinion on the effectiveness of the registrant's internal control over financial reporting.

See Paragraphs 28 through 141 of [PCAOB Auditing Standard No. 2](#).

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:

- If the outside auditors disagree with management's conclusion as to the effectiveness of the registrant's internal control over financial reporting;
- If management fails to provide to the outside auditors written representations relating to, among other things:

(i) management's responsibility for establishing and maintaining effective internal control over financial reporting;

(ii) management's acknowledgement that its assessment of the effectiveness of internal control over financial reporting was not based at all on the outside auditor's audit of such internal control; and

(iii) management's disclosure to the outside auditor of

(a) all deficiencies in the design or operation of internal control over financial reporting,

(b) any identification of any fraud that involves senior management or employees who have a significant role in the company's internal control over financial reporting,

(c) the resolution or other status of any control deficiencies identified and communicated to the audit committee during previous engagements, and

(d) 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;

- If management has not accepted responsibility for the effectiveness of the registrant's internal control over financial reporting;
- If management has evaluated the effectiveness of internal control over financial reporting using unsuitable control criteria;
- If management's documentation of internal control over financial reporting or its documentation of its assessment of the effectiveness of internal control over financial reporting is inadequate;
- If management does not articulate clearly its conclusion as to the effectiveness of internal control over financial reporting;
- If the scope of the outside auditors' audit was restricted;
- If a significant subsequent event occurs after the end of the fiscal year; and
- If management's inability to assess certain controls reflects a failure to fulfill its responsibilities. See Question 28 of PCAOB's [additional set of Staff Questions and Answers](#), which states that such a failure may trigger auditor responsibilities under [Section 10A of the Exchange Act](#).

See [Paragraphs 143, 173-192 of PCAOB Auditing Standard No. 2](#).

Where the circumstances suggest that management is not taking appropriate responsibility, the outside auditors may need to consider withdrawing from the engagement. See [Paragraph 143 of PCAOB Auditing Standard No. 2](#).

E. Meaning of Material Weakness

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

A “material weakness” is a significant deficiency in one or more controls that results in more than a remote likelihood that a material misstatement (based upon both quantitative and qualitative considerations) of the annual or interim financial statements will not be prevented or detected, taking into account the effect of compensating controls and whether such compensating controls are effective.

A “significant deficiency” is a control deficiency, or a combination of control deficiencies, that adversely affects the ability of a registrant to initiate, authorize, record, process, or report external financial data reliably in accordance with GAAP such that there is at least a reasonably possible likelihood that a misstatement of the registrant’s financial statements that is more than inconsequential (that is, a misstatement that a reasonable person could not conclude would clearly be immaterial after taking into account the possibility of further undetected misstatements) will not be prevented or detected.

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. Compensating controls are not relevant in determining whether a control deficiency exists.

See [Paragraphs 8-10 of PCAOB Auditing Standard No. 2](#), and the response to Question 12 of [PCAOB's Q&As](#).

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](#). The response states that compensating controls 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, and 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 that 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 “at least significant deficiencies” in internal control over financial reporting?

The following control deficiencies are considered to be at least significant deficiencies in internal control over financial reporting:

- Deficiencies in controls over the selection and application of accounting policies that are in conformity with GAAP;
- Deficiencies in antifraud programs and controls;
- Deficiencies in controls over non-routine and non-systematic transactions; and
- Deficiencies in controls over the period-end financial reporting process.

See [Paragraph 139 of PCAOB Auditing Standard No. 2](#).

What deficiencies in controls are considered to be “at least significant deficiencies” and strong indicators of material weaknesses?

The following control deficiencies are considered to be at least significant deficiencies and strong indicators of material weaknesses:

- A restatement of previously issued financial statements to correct a misstatement;
- The identification by the outside auditors of a material misstatement in financial statements in the current period;
- The ineffective oversight by the audit committee of the registrant's external financial reporting and internal control over financial reporting;
- The ineffectiveness of the internal audit function or the risk assessment function at a registrant where the effectiveness of such a function is necessary;
- The ineffectiveness of the regulatory compliance function in a registrant in a highly regulated industry;
- The identification of fraud of any magnitude on the part of senior management;
- The failure to correct significant deficiencies that have been communicated to management and the audit committee after a reasonable period of time; and
- An ineffective control environment.

See [Paragraph 140 of PCAOB Auditing Standard No. 2](#).

How should registrants interact with the outside auditors to avoid a significant deficiency or a material weakness resulting from the review by the outside auditors of draft financial statements?

The PCAOB has included in its list of significant deficiencies and strong indicators of a material weakness the identification by the outside auditors of a material misstatement in financial statements in the current period under circumstances in which the material misstatement was not initially identified by the company's internal control over financial reporting. As a result of this item, registrants will have to be careful how they request comments from their outside auditors on preliminary draft financial statements.

The traditional audit process may have to be revised to be sure that the outside auditors are not playing a role in the registrant's internal control over financial reporting. The response to Question 7 in the [PCAOB Q&As](#) 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.

The results of the audit cannot be considered by management or the outside auditors when evaluating whether the registrant's internal control 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 PCAOB's Staff 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 complete. The registrant should identify the numbers and notes that have not been completed, so the outside auditors know that they should not complete 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.

How should registrants interact with the outside auditors to avoid a significant deficiency or a material weakness resulting from a registrant's consultation with the outside auditors as to the appropriate accounting treatment for a particular transaction?

Since internal control over financial reporting must effectively determine the selection and application of accounting policies, the traditional consultation process between a registrant and its outside auditors may need to be structured a little differently.

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 6 of the

[PCAOB's Q&As](#) states that a registrant should make clear to the outside auditors the reason for the communication. Presumably, this means the consultation can be only to confirm the registrant's position and not for the purpose of seeking the outside auditors' conclusion as to the appropriate accounting.

This constraint suggests that management that lacks expertise as to the accounting implications of a transaction may be unable to satisfy the outside auditors as to the effectiveness of the registrant's internal control over financial reporting. Perhaps registrants will need to consult other accounting experts on the appropriate accounting for emerging accounting issues or the application of complex and highly technical accounting pronouncements in the registrant's particular circumstances when management does not have sufficient expertise.

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 have developed a framework that may be useful to registrants. The framework is set forth in "[A Framework for Evaluating Process/Transaction-Level and Information Technology General Control Exceptions and Deficiencies](#)." Originally released on October 28, 2004, and expanded on November 29, 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.

F. Implications of a Material Weakness

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-2 or 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-2](#) or [S-3](#) (both of which require timely and current reporting under the Exchange Act), or the availability to third parties of [Rule 144](#) (which requires current reporting).

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' Teleconferences 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, so it is possible that many registrants will identify material weaknesses in their internal control over financial reporting if they are not satisfied with the adequacy of compensating controls. In the view of SEC Chief Accountant Donald Nicolaisen, however, "not all material weaknesses are likely to be viewed as equally significant." According to Mr. Nicolaisen, Moody's is considering categorizing material weaknesses based upon their assessment of whether the registrant's outside auditors may be able to address the weakness by expanding audit procedures. See [Keynote Speech](#) at 11th Annual Midwestern Financial Reporting Symposium, by Donald T. Nicolaisen (Oct. 7, 2004).

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 has stated that he expects “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.” See [Keynote Speech](#) at 11th Annual Midwestern Financial Reporting Symposium, by Donald T. Nicolaisen (Oct. 7, 2004).

It is unclear whether registrants that report one or more material weaknesses in internal control will be able to sell securities publicly, however. 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.

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](#) and any registration statement filed thereafter (other than on [Form S-8](#)). Among the types of information that the registrant should consider including about the material weakness are:

- a description of the material weakness and how it was identified;
- a discussion about the nature of the improvements and enhancements that were or are being implemented to address the material weakness; and
- the timeline for implementation, and any efforts to mitigate the weakness while the improvements are being implemented to ensure materially accurate financial statements.

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.