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AN EARLY EVALUATION OF THE IMPACT OF SECTION 404 OF THE SARBANES-OXLEY ACT ON THE REPORTS ISSUED BY PUBLIC ACCOUNTING FIRMS

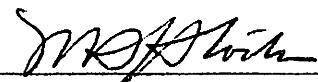
by
Austin Jones

A thesis submitted to the faculty of The University of Mississippi in partial fulfillment of the requirements of the Sally McDonnell Barksdale Honors College.

University of Mississippi
May 2005

Approved by:

Advisor: Dr. Rick Elam



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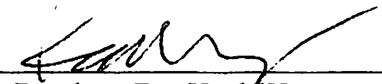

Reader: Dr. Karl Wang

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ABSTRACT

AUSTIN THOMAS JONES: An Early Evaluation of the Impact of Section 404 of the Sarbanes-Oxley Act on the Reports Issued by Public Accounting Firms
(Under the direction of Dr. Rick Elam)

The reports issued by public accounting firms on ninety companies' internal control over financial reporting were analyzed. The internal control reports were gathered from the EDGAR database on the website of the Securities and Exchange Commission. The resulting data demonstrated different proportions of adverse opinions expressed by different accounting firms, different proportions of adverse opinions issued for different size companies, and inconsistencies in the reports issued by separate accounting firms. An unexpectedly small number of adverse opinions were issued for the companies in the sample. Significant inconsistencies exist in the reports issued by various accounting firms. These inconsistencies point to the ambiguity of Auditing Standard 2 issued by the Public Company Accounting Oversight Board.

TABLE OF CONTENTS

INTRODUCTION 1

THE SARBANES-OXLEY ACT 5

THE AUDITOR'S OPINION 13

RESEARCH QUESTIONS 15

METHOD 16

RESULTS 22

FORMAT OF AUDIT REPORT 28

OTHER FINDINGS 46

CONCLUSIONS 49

LIST OF REFERENCES 54

APPENDICES 56

1. Introduction

"Investor disillusionment is perilously high, and the bearish stock market is becoming more and more volatile."[1]

A *Business Week* article used these words to articulate the condition of the American economy after the corporate debacles of Enron and Worldcom in 2002. In response to these scandals and driven "to protect investors by improving the accuracy and reliability of corporate disclosures," Congress passed the Sarbanes-Oxley Act of 2002.[2] *The Economist*, a well respected business publication, describes the Sarbanes-Oxley Act as "one of the most influential—and controversial—pieces of corporate legislation ever to have hit a statute book."[3] The Sarbanes-Oxley Act has reverberating effects on businesses across America and abroad. Section by section and title by title, Sarbanes-Oxley enacted new requirements that force directors and executives of publicly traded companies and accounting firms to reinvent their methods in order to comply with the Act.

One of the most significant elements of the Sarbanes-Oxley Act is its Section 404 which requires management and auditors to assess and report on the internal controls of the company. The impact of Section 404 began to be visible with corporate financial statements published in early 2005. The purpose of the research reported here is to do an early evaluation of the impact of Section 404 of the Sarbanes-Oxley Act on the reports issued by public accounting firms.

Specifically, this research examines the number of adverse opinions issued by auditors for a sample of large and moderate sized corporations and asks the questions,

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[1] "Getting the Message, Finally." *Business Week.*
[2] The Sarbanes-Oxley Act of 2002.
[3] "A price worth paying? – Auditing Sarbanes-Oxley." *The Economist.*

are there any differences in the percentage of adverse opinions issued by auditing firms and/or are there any differences in number of adverse opinions when very large corporations are compared to moderate size corporations. The research also addresses the important question of consistency of format and wording within the various reports issued by the audit firms and the framework used by these firms in their audits.

Congress and the public became aware of the need for sweeping legislation after the Enron scandal, but it was the downfall of WorldCom that "dramatically underscored the need for legislative and regulatory reform," according to co-author of the Act and House Financial Committee Chairman, Congressman Michael Oxley, a Republican from Ohio. In a press release on June 27, 2002 Oxley went on to state, "Problems with accounting in telecommunications are, unfortunately, damaging a key growth sector of the economy that is already facing other, steep challenges." Oxley's statements clearly express the urgency of passing such legislation and the importance of the reforms. At the end of his press conference Oxley urged "the full Senate to act so that we [Congress] may conference corporate responsibility legislation as soon as possible."[4] In a July 16, 2002 *Dallas Morning News* article, President Bush is reported to have "urged Senate and House leaders to resolve their differing corporate reform bills as quickly as possible so he could sign a bill into law." Senator Paul Sarbanes, a Democrat from Maryland and co-author of the bill, said in the same article, "It is no exaggeration to say the crisis in our markets is putting the plans and hopes and dreams of millions of Americans at risk."[5]

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[4] House Committee on Financial Services.
[5] Jim Landers.

The cost of meeting the requirements set forth by the Sarbanes-Oxley Act is staggering. On May 21, 2005, *The Economist* reported, "According to one study... the net private cost amounts to $1.4 trillion." The article goes on to clarify, "In principle, this [figure] ought to reflect all the anticipated costs and benefits, direct and indirect, that impinge on company values."[6] In the same article, *The Economist* reported, "companies paid an average of $2.4 million more for their audits last year than they had anticipated. Deloitte [and Touche], a big accounting firm, has said that large firms have on average spent nearly 70,000 additional man-hours complying with the new law." An April 2005 article in *Chief Executive* states, "It's turning out that the more obvious demands imposed by Sarbanes-Oxley in financial accounting—the expense, the time investment, the extra audits—are just the tip of the iceberg."[7] In a May 2005 article entitled "Lights out", *Entrepreneur* magazine reports, "The number of companies deregistering from major stock exchanges tripled from 2002 to 2003," and "in early 2004, numbers continued to be high."[8] In its explanation of the reason for the growing amount of deregistrations, *Entrepreneur* states, "companies cite the costs of conforming to more stringent reporting requirements mandated by the SEC and detailed in the Sarbanes-Oxley Act of 2002."

The effects of the Sarbanes-Oxley Act are widely felt by the management and executives of publicly traded companies, private enterprises and accounting firms. The most sweeping of the requirements of the Act are those contained in Section 404. This section mandates that all publicly traded companies engage an independent auditor to conduct an audit and issue an opinion on an assessment made by the

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[6] "A price worth paying? – Auditing Sarbanes-Oxley." *The Economist.*
[7] Erik Sherman.
[8] Jennifer Pellet.

company's management of the effectiveness of the company's internal control over financial reporting. In addition, it requires that the firm perform an audit of the companies' internal control over financial reporting and issue an opinion on their effectiveness.

This paper is organized as follows. The paper begins with an overview of the Sarbanes-Oxley Act, followed by a brief description of the Public Company Accounting Oversight Board and Section 404. The following sections discuss the data and findings, and include examples of different types of opinions. The paper is completed with conclusions and suggestions for future research.

A basic understanding of the audit process and the related terms is necessary to grasp the concepts contained in the following sections. An audit is a type of attestation service which entails an exhaustive review of the data and processes related to the subject of the audit. This review is performed by an accounting firm and results in the auditor's opinion. These opinions are expressed in a report issued by the auditor upon completion of the audit and fall into one of the following categories: unqualified, qualified, adverse, or disclaimer. The significance of each type of opinion is discussed in a subsequent section of the paper. The auditing firm is the accounting firm that conducts the audit, and the auditor's report is the report that contains the auditor's opinion. In the past, accounting firms conducted audits solely on a company's financial statements. Because of Section 404 of the Sarbanes-Oxley Act, accounting firms are now required to audit the effectiveness of internal control over financial reporting for publicly traded companies and management's assessment of the company's internal control over financial reporting.

2. The Sarbanes-Oxley Act

In response to the corporate downfalls of the first months of 2002 and the ensuing investor mistrust of corporate America, Congress passed the Sarbanes-Oxley Act. This Act was signed into law in the summer of 2002 and was enacted to protect investors from misleading corporate disclosures filed by public companies. To achieve this end, the Act places many new demands and responsibilities on the management and executives of publicly traded companies and accounting firms.

The Sarbanes-Oxley Act contains eleven separate sections that significantly increase the accountability of publicly traded companies to the investors. One regulatory measure enacted by Sarbanes-Oxley mandates public company CEOs and CFOs to certify the effectiveness of their corporations' internal controls. In addition, the Act bans accounting firms from performing many non-audit services for their audit clients. Sarbanes-Oxley also increases the required financial information disclosures of publicly traded companies. One section of the Act exponentially increases the possible punishments for those who knowingly falsify financial information. The Act also extends the rights of whistleblowers to ensure that they are not intimidated. Sarbanes-Oxley enacts many other regulatory measures used to protect investors from misleading corporate disclosures.

While every section of the Sarbanes–Oxley Act greatly affects corporate America, only two items of the Act are relevant to this study. Title 1 of the Act creates the Public Company Accounting Oversight Board. This body is charged with implementing new standards and regulating the audit of public companies. Section 404 of the Sarbanes-Oxley Act legislates the most significant requirement included in

the Act. This section requires all publicly traded companies to engage an accounting firm to perform an audit of the company's internal control over financial reporting. The nature and implications of the Public Company Accounting Oversight Board and Section 404 are discussed below.

Public Company Accounting Oversight Board

Title 1 of Sarbanes-Oxley creates the Public Company Accounting Oversight Board (PCAOB). The Board was established as a private entity charged with the responsibility of overseeing and regulating the audit of public companies. The Board's duties include registering public accounting firms, establishing standards for these firms to follow, inspecting these firms, and disciplining them when necessary. To ensure that the firms are complying with its standards, the Public Company Accounting Oversight Board will inspect these firms no less than once every three years. The Board, although it was established as a private entity, can almost be considered a subsidiary of the SEC. The Commission has the authority to "relieve the Board of its responsibility to enforce the Act," limit the activities of the Board if it is not properly performing its duties, and even remove a member who fails to properly do his or her duty. The Public Company Accounting Oversight Board is funded by fees collected from public companies, standard setting bodies, and registered public accounting firms. All fines collected will be used to establish a scholarship program for undergraduate and graduate accounting students.

Section 404

While all of the requirements established by the Sarbanes-Oxley Act combine to make it the most sweeping financial legislation in over seventy years, the regulations contained in Section 404 of the Act command the most attention from all parties affected by the Act. In order to implement Section 404, the Public Company Accounting Oversight Board adopted Auditing Standard 2, which was made effective when it was approved by the SEC in June of 2004. This standard thoroughly outlines the responsibilities and requirements of management and auditors in evaluating internal control over financial reporting. Standard 2 also states that in addition to accepting responsibility for its company's internal controls, management must support its evaluation of these controls with documented evidence relating to the companies major accounts, and report its findings in a written assessment at the end of the company's fiscal year. Another facet of the standard mandates that the company's independent auditor evaluate management's assessment of the internal controls over financial reporting and the company's financial statements, and express an opinion on both before the date specified in management's assessment.

Evaluation of Internal Control

In order to provide the auditors with guidance in the conduct of an audit of internal controls over financial reporting, the Public Company Accounting Oversight Board recommended the use of a well-known criteria for an assessment of a corporation's internal control over financial reporting. The criteria chosen by the Public Company Accounting Oversight Board is the *Internal Control-Integrated*

Framework established by the Committee of Sponsoring Organizations of the Treadway Commission, also known as "COSO". The COSO criteria is the most widely known, established criteria and was an obvious choice for the Public Company Accounting Oversight Board. Standard 2 prescribes COSO's *Internal Control-Integrated Framework* as a basis for both management's assessment and the auditor's audit of internal control over financial reporting, but it states that a similar criteria may be used. COSO published its report in 1992 to define internal control and establish its main components. COSO broadly defines internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations."[9]

The COSO report lists five main areas that should be evaluated in the performance of an assessment and an audit—control environment, risk assessment, control activities, information and communication, and monitoring. All of these components are interrelated and each plays a vital role in the company's achievement of each objective listed above. The most important of the five main components of internal control is the control environment as it determines the mood of the organization toward internal control. The control environment consists of the examples set by the executives of the company, passed down through management, to the workers who may implement various aspects of the company's internal control systems. The risk assessment component involves analyzing risks that could affect the achievement of the objectives and determining how they should be handled.

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[9] Committee of Sponsoring Organizations of the Treadway Commission.

Control activities are the methods management uses to enforce their directives on internal control. Information and communication entails identifying relevant information to be evaluated and ensuring that the organization has established communication systems to augment the transfer of important information throughout the organization and to external parties. Monitoring refers to the regular and timely checks of the internal control systems performed to evaluate the effectiveness of the system over time. These five connected components are intertwined with the company's everyday operations and function best when they are integral parts of the company's environment.

In order to reach an opinion on management's assessment of the effectiveness of its company's internal control over financial reporting, the auditor must conduct a thorough and exhaustive evaluation of the company's internal controls. The Public Company Accounting Oversight Board's Standard 2 prescribes a procedure to properly carry out such an evaluation that can be divided into phases. The first phase of the process is planning. The planning phase is extremely important as it sets the tone for the remainder of the audit. In this phase the auditor must take many issues into consideration including what locations to audit if the company has multiple locations, what are the company's transactions, and what is deemed material for different accounts and financial statements. In the second step of the evaluation, evaluating management's assessment process, the auditor reviews management's assessment of the company's internal controls to ensure that management thoroughly examined the company's internal controls and addressed the necessary topics. This phase includes ensuring that management assessed controls over all relevant accounts

and transactions and that management employed sound testing processes while conducting its assessment. In the third phase of the evaluation, the auditor must obtain an understanding of internal control over financial reporting. To obtain this understanding of internal controls, the auditor must first identify all significant controls to be tested. In addition, the auditor must assess the effectiveness of the company's audit committee, determine the relevance of certain accounts, transactions and financial statement disclosures and identify those to be tested. Then the auditor must perform walkthroughs of the controls of the major transactions identified. The next phase of the process consists of actually testing all identified controls. The tests conducted in this phase are aimed at evaluating the design and operating effectiveness of internal control over financial reporting. Using these tests the auditor must obtain direct evidence that the controls in question are effective. The auditor may also use the results of tests performed by others in his assessment if it is determined that those tests were performed flawlessly and objectively. Finally, the auditor forms an opinion on the effectiveness of the internal control over financial reporting for the company in question, and that opinion is published as part of the corporation's annual report and SEC Form 10-K.

In forming an opinion, the auditor must determine the severity of any deficiencies or combination of deficiencies. The deficiencies are ultimately placed into one of three categories: control deficiency, significant deficiency, and material weakness.

Auditing Standard 2 states that "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."[10] Control deficiencies are further categorized as deficiencies of design or deficiencies of operation. A deficiency of design indicates a flaw in the design of the control. A deficiency of operation occurs if an error committed by the operating system or the user causes the control not to operate as designed.

A significant deficiency is a control deficiency, or a combination thereof, that may prevent the detection or correction of a material misstatement of the company's interim or annual financial statements, therefore possibly preventing the company from reporting its financial data reliably and in accordance with generally accepted accounting principles.

A material weakness consists of one or more significant deficiencies that leave "more than a remote likelihood" that a material misstatement will occur on the company's interim or annual financial statements.[11]

In order to determine the significance of any deficiency, the auditor must evaluate its effect on the internal control over financial reporting. In evaluating the deficiency, the auditor must consider the likelihood that the deficiency, alone or combined with other deficiencies, could result in a misstatement of certain account balance disclosures. In addition, the auditor must determine the magnitude of the potential misstatement resulting from the deficiency or deficiencies. Any misstatements that have already occurred are not relevant to the auditor's consideration. The auditor must take several factors into account in the evaluation of deficiencies in internal control. Some of these factors include the nature of the

[10] Public Company Accounting Oversight Board.
[11] Public Company Accounting Oversight Board.

of performing their assigned functions, to prevent or detect misstatements on a timely basis."[10] Control deficiencies are further categorized as deficiencies of design or deficiencies of operation. A deficiency of design indicates a flaw in the design of the control. A deficiency of operation occurs if an error committed by the operating system or the user causes the control not to operate as designed.

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[10] Public Company Accounting Oversight Board.
[11] Public Company Accounting Oversight Board.

financial statements and disclosures potentially affected by the deficiency, the susceptibility of the related assets or liability to fraud, the relationship of the control in question to other controls, and the relationship of the deficiency to other deficiencies. When the auditor evaluates the magnitude of the potential misstatement, he or she should assess the financial statement amounts or the total transactions affected by the deficiency and the current and expected volume of activity in the accounts or transactions exposed to the deficiency. Considering both the qualitative and quantitative factors that affect internal control over financial reporting reveals some areas where almost any deficiency should be deemed a significant deficiency. The controls in these high-risk areas include controls pertaining to the selection and application of Generally Accepted Accounting Principles, antifraud programs, non-routine transactions, and the period-end reporting process. The evaluation of the significance of deficiencies requires a substantial amount of judgment on the part of the auditor and is integral in determining the nature of the opinion.

3. The Auditor's Opinion

After evaluating the significance of all deficiencies, the auditor forms and publishes an opinion on the effectiveness of internal control over financial reporting. The auditor may issue an unqualified opinion in the instance that no material weakness exists and the scope of the auditor's work has not been limited in any fashion. The existence of a material weakness warrants an adverse opinion by the auditor. An adverse opinion indicates that the auditor believes that the financial statements may be distorted by the lack of internal control. In the case that the scope of the auditor's work was limited in some fashion, he or she may express a qualified opinion or a disclaimer of opinion. A qualified opinion states that the scope of the auditor's work was limited while the auditor was conducting the audit. The opinion would continue to state that internal over financial reporting is effective except for the area that warranted a qualification. A disclaimer of opinion implies that the scope of the auditor's work was limited to the extent that he or she could not properly conduct the audit. In addition to the published opinion, the auditor must communicate all discrepancies discovered during the audit to the company's management and audit committee, and possibly to the board of directors.

Initially, Standard 2 stipulated that both the audit of a company's financial statements and management's assessment of the company's internal controls share the same date. In addition, the auditing firm was required to enclose a paragraph that refers to a separate report on management's assessment of the effectiveness of internal control over financial reporting in its report on the company's financial statements. In November of 2004, the Public Company Accounting Oversight Board

proposed a temporary rule that would alleviate auditors from meeting the requirements set forth in Section 404 for non-accelerated filers with fiscal years ending before July 15, 2005. The proposed rule was a response to rising concerns among auditors and issuers who contended that the required work would not be accomplished in the allotted time. This Temporary Transitional Provision granted the auditors additional time to complete their audit of the issuer's assessment of the effectiveness of its internal controls over financial reporting. The extension comes in addition to the standard seventy-five day period auditors have to file their reports with the SEC. Under this temporary rule auditors are not required to date both reports on the same day, and they are allowed to exclude the additional referral paragraph from their report on the company's financial statements. This temporary rule expires on July 15, 2005. In future years auditors will be required to meet the original timing requirements of PCAOB Auditing Standard 2.

4. Research Questions

The broad wake of the Sarbanes-Oxley Act leaves corporations and accounting firms with many questions. These questions will be answered as Sarbanes-Oxley is implemented and the results are revealed. Naturally, there will be many issues that arise as the Section 404 opinions are published for the first time in the year 2005. From the analysis of the legislation and standards that implement Section 404, a subject of significance is the consistency across the accounting profession with which internal controls over financial reporting are audited and the consistency with which opinions are issued on those internal controls.

This study was conducted to determine (1) the format used by various accounting firms in their reports on internal control over financial reporting, (2) the frequency of different types of audit reports used by all audit firms for large and medium sized corporations, and (3) the framework employed by the audit firm (COSO or other) as a guide to evaluate the effectiveness of internal controls.

5. Method

This study was conducted by gathering and analyzing auditors' reports from two samples of public companies that represent a cross-section of large and medium companies filing such reports. For each company in the sample the following data was gathered: the firm that audited the company at hand, the type of opinion expressed, the actual wording of the report, and the assessment criteria (COSO or other) used by the auditing firm. The resulting data were evaluated to show the number of each type of opinion issued by each firm, the number of audits performed by each firm, and the actual wording of each opinion compared. Any noteworthy items contained in the auditor's report were noted and recorded. In addition, management's assessment of the company's internal control over financial reporting was recorded when anything other than an unqualified opinion was expressed. Also, any unique aspects of the form or data were recorded.

The first set of companies in the sample was the thirty companies of the Dow Jones Industrial Average. The second set of companies was the smallest sixty companies of the Fortune 500. Companies rated by Fortune between the 441st and 500th largest companies were used. The thirty companies identified in the Dow represent the largest public companies in America. The sixty companies taken from the Fortune 500 are small compared to those listed in the Dow, but are still considered in the top ten percent of American corporations and include companies form a broad range of industries.

The Dow Jones Industrial Average represents leaders in various industries in the U.S. market. The components of this list "are selected at the discretion of the

editors of The Wall Street Journal," and "companies considered for inclusion in the averages are subjected to a rigorous analysis before a decision is made."[12] According to Dow Jones, the only set criteria for selection of the components of the Industrial Average are that "components must be established U.S. companies that are leaders in their industries." Changes to the list are made with little frequency and "generally occur only after corporate acquisitions or other dramatic shifts in a component's core business."[12] The thirty components of the Dow Jones Industrial Average are ranked among the first 116 companies listed in the Fortune 500, with the majority ranked in the first fifty. The components of the Dow Jones Industrial Average are listed in Table 1.

Table 1: Companies listed in the Dow Jones Industrial Average[13]

Company Name		Company Name
3M Co.		Honeywell International Inc.
Alcoa Inc.		Intel Corp.
Altria Group Inc.		International Business Machines Corp.
American Express Co.		Johnson & Johnson
American International Group Inc.		JPMorgan Chase & Co.
Boeing Co.		McDonald's Corp.
Caterpillar Inc.		Merck & Co. Inc.
Citigroup Inc.		Microsoft Corp.
Coca-Cola Co.		Pfizer Inc.
E.I. DuPont de Nemours & Co.		Procter & Gamble Co.
Exxon Mobil Corp.		SBC Communications Inc.
General Electric Co.		United Technologies Corp.
General Motors Corp.		Verizon Communications Inc.
Hewlett-Packard Co.		Wal-Mart Stores Inc.
Home Depot Inc.		Walt Disney Co.

Every year Fortune magazine compiles a list of the five hundred largest companies in America. According to Fortune, companies "must publish financial

[12] Dow Jones and Company.

[13] Dow Jones and Company.

data and must report part or all of their figures to a government agency" to be eligible for the list. [14] The qualified companies are ranked from one through 500 according to their reported revenues in the previous fiscal year. In addition to revenues, Fortune lists other information pertinent to the financial position of the companies including profits, assets, stockholders' equity, market value, profits as a percentage of revenues, assets and stockholders' equity, earnings per share, and total return to investors. The Fortune 500 is widely circulated and is recognized as the authoritative list of the country's largest corporations.

The bottom sixty companies of the Fortune 500 were included in the sample to complement the companies included in the Dow Jones Industrial Average. Although the revenues recorded by bottom sixty companies listed in the Fortune 500 are small compared to those of the corporate giants of the Dow Jones Industrial Average, these sixty corporations stand in the top ten percent of all publicly traded companies. The following page contains a list of the sixty companies taken form the Fortune 500.

[14] *Fortune Magazine.*

Table 2: Companies ranked from 441-500 in the Fortune 500[15]

Rank	Company	Rank	Company
441.	Big Lots	471.	Wisconsin Energy
442.	C.H. Robinson Worldwide	472.	American Financial Grp.
443.	Conseco	473.	Beazer Homes USA
444.	NVR	474.	Collins & Aikman
445.	Clorox	475.	Borders Group
446.	NTL	476.	Nash Finch
447.	Molson Coors Brewing	477.	Toll Brothers
448.	Enbridge Energy Partners	478.	SCANA
449.	MGM Mirage	479.	Whole Foods Market
450.	Stryker	480.	Corning
451.	Avaya	481.	Sealed Air
452.	Ross Stores	482.	Maxtor
453.	Tenneco Automotive	483.	Reebok International
454.	H&R Block	484.	UGI
455.	Ecolab	485.	Guidant
456.	Engelhard	486.	Host Marriott
457.	Hovnanian Enterprises	487.	Advance Auto Parts
458.	Universal Health Svcs.	488.	ServiceMaster
459.	Omnicare	489.	Wesco International
460.	Affiliated Computer Svcs.	490.	Telephone & Data Sys.
461.	Jefferson-Pilot	491.	Level 3 Communications
462.	Graybar Electric	492.	Brinker International
463.	Mutual of Omaha Ins.	493.	Stater Bros. Holdings
464.	Levi Strauss	494.	Western & Southern Financial
465.	Henry Schein	495.	Gateway
466.	MDC Holdings	496.	Wm. Wrigley Jr.
467.	Pathmark Stores	497.	Peabody Energy
468.	United Stationers	498.	Wendy's International
469.	Ryland Group	499.	Kindred Healthcare
470.	Cooper Tire & Rubber	500.	Cincinnati Financial

[15] *Fortune Magazine.*

The accounting firm's report on a company's internal controls over financial reporting was accessed in the company's Form 10-K. A Form 10-K is an annual report that the SEC requires all public companies to file. This form contains a summary of the company's operations during the previous fiscal year and presents the financial position of the filing corporation at the end of that fiscal year. Included in this form, either directly or by reference, are the auditor's reports on the company's financial statements and internal control over financial reporting. Under some circumstances, companies may file a Form 10-KA to augment the data contained in the Form 10-K. In certain instances, these forms contained the independent auditor's report on internal control over financial reporting. In addition, some companies filed Forms NT 10-K to inform the SEC that their Forms 10-K would be filed later than the required date. In these cases, the Forms NT 10-K were recorded. All forms filed with the SEC, including Forms 10-K, can be found on the SEC's website through a database called EDGAR.

The source used to gather the relevant data of each corporation is the EDGAR database that is accessible through the website of the Securities and Exchange Commission. To access this database, one must simply travel to the SEC's website and click on the link titled "Search for Company Filings" under the "Filings and Forms (EDGAR)" heading. This link will bring the user to a page with two separate columns of additional links. In the column under the heading "General-Purpose Searches", one must follow the link labeled "Companies & Other Filers". This link opens a page entitled "EDGAR Company Search", which contains a form with various fields used in modifying the search. Generally, the corporation's stock

symbol provides sufficient information for EDGAR to complete the search. The other fields included in the search information form are Company Name, File number, State, or Standard Industrial Classification Code. After entering the search information and initiating the search, a page containing the search results opens. The Form 10-K can be accessed easily by simply entering "10-K" in the "Form type" field of the search limiting form in the upper right corner of the page. The ensuing page contains a list of the Forms 10-K filed with the SEC for previous years. The Forms 10-K are listed in descending order starting with the most recent. In some cases, a company referred to the auditor's report in the Form 10-K. In these instances, the company's Annual Report, generally found in the investor section of the company's website, provided the auditor's report on internal control over financial reporting.

5. Results

The review of the data discussed above revealed an overwhelming majority of unqualified opinions issued for the ninety selected companies, as shown in Table 3. Among the unqualified and other opinions issued, certain patterns in each firm's report format were noted, and the differences were analyzed. In addition, other noteworthy items were discovered that merit comment.

Table 3: Types of opinions issued per sample

	Dow 30	#441-500 of Fortune 500
Unqualified	26	42
Adverse	1	3
Disclaimer/Unqualified	0	0
No opinion issued	3	15
Total	30	60

The research revealed that opinions were issued for only 72 of the 90 companies included in the sample. Opinions were not issued for eighteen companies in the sample. Some corporations included in this number, were not required to file by Section 404 because their 2004 fiscal years ended before the required date. Also included in this category is the number of corporations not required to include a report on internal controls dated the same as the auditing firm's report on the financial statements. One corporation filed a form NT 10-K, which notifies the SEC that the company did not file its Form 10-K by the due date and explains the reasons for the delay. Two companies' Forms 10-K were not accessible through the available sources. Sixty-eight of the opinions were unqualified and four were adverse. No disclaimer or qualified opinions were issued for the companies found in the sample. Table 3 portrays the number of unqualified, adverse, and disclaimer/ qualified opinions issued for each data set.

A large majority, almost ninety-five percent, of the opinions expressed for companies in both samples were unqualified. Slightly more than five percent of the opinions expressed were adverse. Interestingly, a slightly higher percentage (6.7% opposed to 3.7%) of the opinions expressed for corporations listed in the lower sixty of the Fortune 500 were adverse. The four corporations whose weaknesses in internal controls warranted adverse opinions are American International Group Inc., Border's Group Inc, Maxtor Corporation, and Pathmark Stores Inc. Also noteworthy is that no disclaimer or qualified opinions were issued.

Only one adverse opinion was filed for all of the corporations included in the Dow Jones Industrial Average. The accounting firm of PricewaterhouseCoopers expressed an adverse opinion on the internal controls over financial reporting for American International Group Inc., (AIG). This opinion was expressed due to a number of material weaknesses and related accounting issues encountered during the audit. AIG filed a Form NT 10-K on March 17, 2005 to explain its reasons for not filing the Form 10-K by the required date. Interestingly, the Form 10-K filed by AIG is considerably briefer than that filed by Collins and Aikman discussed below. AIG hardly dedicates a sentence to its discussion of Section 404, whereas Collins and Aikman includes two lengthy paragraphs to address its material weaknesses in internal controls.[16] After two months of additional audit work, PricewaterhouseCoopers expressed its opinions on AIG's financial statements and internal controls over financial reporting on May 27, 2005. AIG filed its Form 10-K on May 31, 2005. PricewaterhouseCoopers lists five areas of AIG's internal controls

[16] Appendix A.1

in which material weaknesses were identified.[17] Perhaps the most significant of these breaches of the corporation's internal controls, according to the company's auditor and reported by the Wall Street Journal, was the " 'ability which in certain instances was utilized' " by the company's two former top executives " 'to override certain controls,' in some cases 'largely motivated to achieve desired accounting results' outside of generally accepted accounting principles."[18]

The "no report issued" category, in Table 3, includes the number of companies that have not filed required Forms 10-K with the SEC. Only one company falls into this category. Collins and Aikman, a leading supplier of cosmetic automotive parts and producer of acoustic systems, filed a Form NT 10-K with the SEC on March 17, 2005. This form announces that Collins and Aikman "did not file its Annual Report on Form 10-K containing fiscal year 2004 audited financial statements by its due date" because it needed additional time to review certain accounting issues.[19] In its description of these issues, Collins and Aikman discusses its efforts to comply with Section 404 requirements. This discussion contains the following statement:

> "The Company is working towards completion of its assessment of internal controls over financial reporting required under Section 404 of the Sarbanes-Oxley Act and has concluded that certain material weaknesses, in addition to the matters leading to the restatement described above, existed at December 31, 2004, but its assessment of the effectiveness of the Company's control over financial reporting is ongoing and the extent of those material weaknesses remains under review. The Company's outside auditor is in the process of completing its audit of internal controls over financial reporting and has communicated the existence of material weaknesses."[8]

[17] Appendix D.3
[18] Theo Francis.
[19] Appendix A.2
[8] Appendix A.2

The Form NT 10-K goes on to list and expound on the potential material weaknesses identified by the independent auditor, KPMG. In addition, the form states that the company is taking certain steps to remediate the potential weaknesses and that these efforts will continue as new findings are released by the auditor.

A large number of the companies included in the "no report issued" category of Table 3, approximately fifteen percent of the entire sample, were not bound by Section 404 to file reports on internal controls over financial reporting because their fiscal years ended before the effective date of November 15, 2004. Although it was not required to file, with a fiscal year end of September 30, 2004, Walt Disney Company included a report on internal controls over financial reporting in its 2004 Form 10-K. The Form 10-K was filed on December 9, 2004 and PricewaterhouseCoopers performed the audit and issued unqualified opinions on management's assessment and on the internal controls over financial reporting.

While the early filers were not required to engage auditors for an audit of their internal controls over financial reporting, compliance with Section 404 remains a top priority. In its discussion of a material weakness that was discovered by management and defined in the Controls and Procedures section of the company's Form 10-KA filed on March 7, 2005, Whole Foods Market includes the following reference to Standard 2:

> "Restatement of previously issued financial statements to reflect the correction of misstatement is a strong indicator of the existence of a material weakness in internal control over financial reporting as defined in the Public Company Accounting Oversight Board's Auditing Standard No. 2."[20]

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[20] Whole Foods Market.

The Form 10-KA includes supplemental information for the company's Form 10-K that was filed on December 10, 2004 for the fiscal year ended on September 30, 2004.

The "no report issued" category includes the two corporations whose reports issued by their independent auditors were not accessible through the sources used to conduct this research. These corporations are Mutual of Omaha Insurance and Western and Southern Financial Group. When the names of these corporations were entered into the EDGAR database, no results were returned and no opinions were found in the companies' annual reports.

Table 4: Number of companies audited by each firm

	Dow 30	#441-500 of Fortune 500	Total
Deloitte & Touch	1	12	13
Ernst and Young	9	16	25
KPMG	4	6	10
PricewaterhouseCoopers	13	11	24
BDO Seidman	0	1	1
No opinion issued	3	15	18
Total	30	60	90

One objective of the study was to compare the types of opinions issued across audit firms to determine if any firms were more likely to issue qualified or adverse opinions. Table 4 shows the number of companies within the sample audited by each firm. The numbers remain relatively consistent between lists. Deloitte & Touche has a larger percentage of clients in the list taken from the Fortune 500 than from the Dow Jones Industrial Average. Also, the majority of Ernst & Young's clients are in the Fortune 500 sample. BDO Seidman, a large accounting firm with over thirty

offices nationwide and operations that span the globe, is the only accounting firm outside of the "Big Four"[21] whose client's data was included in the sample.

Table 5: Type of opinion issued per firm.

	Unqualified	Adverse	Disclaimer/ Qualified	Firm not relevant
Deloitte & Touch	12	1	0	-
Ernst and Young	24	1	0	-
KPMG	9	0	0	-
PricewaterhouseCoopers	22	2	0	-
BDO Seidman	1	0	0	-
No opinion issued	-	-	-	18
Total	68	4	0	18

The percentage of adverse opinions issued is split between the four major firms. Table 5 captures the amount of each type of opinion each firm has issued. Approximately eight percent of the opinions expressed by Deloitte and Touche and PricewaterhouseCoopers are adverse, whereas less than five percent of the opinions expressed by Ernst and Young are adverse. KPMG and BDO Seidman expressed no adverse opinions on any of their clients included in the sample. The disparity between the number of opinions issued by KPMG and the number of companies it has audited, listed in Table 4, arises because of the firm's ongoing audit of Collins and Aikman discussed above.

[21] A collective term used to denote the four largest accounting firms in the nation: Deloitte & Touche, Ernst &Young, KPMG, and PricewaterhouseCoopers.

6. Format of Audit Report

An objective of this research was to compare the format and language of auditor's reports on internal control to determine the level of consistency maintained by the accounting profession in reports on internal control. Historically, auditor's opinions on consolidated financial statements follow a reasonably standard format. The consistencies in financial statement reports and the PCAOB's enclosure of example opinions in Auditing Standard 2 generated the expectation that Section 404 reports would employ a fairly standard format.

The research included an analysis of unqualified, adverse and disclaimer opinions issued by the various accounting firms. As previously stated, an auditor's unqualified opinion indicates that no material weakness exists and the scope of the auditor's work has not been limited in any fashion. In the case that a material weakness is discovered, the auditor is required to issue an adverse opinion on the corporation's internal control over financial reporting. In the instance that management did not identify the material weakness in its assessment, an adverse opinion is issued on management's assessment of the company's internal controls over financial reporting. In addition, a disclaimer of opinion implies that the scope of the auditor's work was limited to the extent that he could not properly conduct the audit. These terms—unqualified, adverse, and disclaimer—are used to classify the separate types of auditors' reports that contain the specified opinion.

Unqualified opinions

The unqualified reports taken from the sample are similar in most respects, but certain variances do exist between reports issued by different firms. Auditing Standard 2 of the Public Company Accounting Oversight Board requires the report to include certain items, but the Standard does not require firms to follow a set format. Standard 2 also includes example reports that are the basis of comparison in the following paragraphs.[22] These example reports contain six paragraphs, each with a unique purpose. The formats of the reports issued by each firm differ slightly from firm to firm and closer examination finds inconsistencies in the phrasing and design of the unqualified reports issued for different clients by the same firm.

General Format

The Public Company Accounting Oversight Board requires that all unqualified reports contain specific information and employ comparable wording. Each report must contain sixteen items that include the following: an identification of the conclusion of management's assessment, statements that list the responsibilities of management and the auditor, a specified definition of internal control, statements regarding the standards applied, a paragraph addressing the inherent limitations of internal control and an opinion paragraph. Standard 2 permits auditors to issue a single report or a combined report to express an opinion on internal control over financial reporting. Examples of each type of report are included in Auditing Standard 2. The example single report uses six paragraphs to convey the required information, and the example combined report uses five. The paragraphs are labeled:

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[22] Appendix B.1

the introductory paragraph, the scope paragraph, the definition paragraph, the inherent controls paragraph, the opinion paragraph and the explanatory paragraph. The example combined report does not include an explanatory paragraph. Figure 1, on the following page, provides an outline of the example format and items included in each paragraph for the single report.

Figure 1. Outline of example unqualified report presented PCAOB in Auditing Standard 2.

Report of Independent Registered Public Accounting Firm

I. Introductory Paragraph
   a. Title of management's report
   b. Identification of control criteria
   c. Statement of responsibilities

II. Scope Paragraph
   a. Statement of standards followed
   b. Statement of planning and performance requirements
   c. Description of audit process
   d. Reasonable basis statement

III. Definition Paragraph
   a. Definition of internal controls as stated in Standard 2

IV. Inherent Limitations Paragraph
   a. Implications of inherent limitations

V. Opinion Paragraph
   a. Auditor's opinion on management's assessment
   b. Auditor's opinion on company's internal control over financial reporting
   c. Identification of control criteria
   d. Specified date

VI. Explanatory paragraph
   a. Identification of financial statements
   b. Date of report
   c. Nature of opinion on financial statements

VII. City and state or county

VIII. Date of report

IX. Signature of auditor

The example report begins with the introductory paragraph. The first sentence of the introductory paragraph states the title of management's report and identifies the control criteria used in the audit. The subsequent two sentences of this paragraph state the separate responsibilities of the auditor and management regarding the audit. This paragraph closely parallels the introductory paragraph used in an auditor's report on its client's financial statements.

The second paragraph of the example report outlines the scope of the audit. This paragraph lists the standards that governed the audit and explains the requirements contained in those standards. This paragraph states that the audit was conducted in accordance with the standards established by the Public Company Accounting Oversight Board. In addition, this paragraph contains a brief description of the procedures used in the audit. Finally, this paragraph is concluded with the statement, "We believe that our audit provides a reasonable basis for our opinion."[23] The purpose and format of this paragraph mirrors those of the second paragraph, also known as the "scope" paragraph, of auditors' reports issued on financial statements.

The third paragraph, or definition paragraph, defines the purpose and lists the components of a company's internal control over financial reporting. In this paragraph the limits of a company's internal controls are implicitly stated by the exhaustive use of the phrase "reasonable assurance." Auditing firms employ such wording to rid the minds of the users of the financial statements of the thought that effective internal controls ensure sound financial reporting.

The inherent limitations paragraph of the example report states the consequential risks of the inherent limitations of the company's internal controls over

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[23] Appendix B.1

financial reporting. This paragraph explicitly states that internal controls provide no absolute assurance against misstatements and that the effectiveness of these controls cannot be projected to future periods because possible changes of conditions or levels of compliance within the company.

The fifth and most important paragraph of the report is the opinion paragraph. This paragraph provides the auditor's opinions both on management's assessment of the company's internal controls over financial reporting and on the internal controls themselves. The auditor clearly states the determinations made on the effectiveness of the internal controls and management's assessment thereon is solely an opinion. The auditor emphasizes "opinion" to prevent users of the report from believing the evaluations are factual. In addition, the auditor asserts that management's assessment is fairly stated and the company's internal controls are effective "in all material respects." This wording is important to convey that the auditor was primarily concerned with detecting material weaknesses in the company's internal controls over financial reporting. In addition, this paragraph lists the date for which these opinions are effective and the control criteria followed.

The explanatory paragraph of the report contains the auditor's opinion on the client's financial statements. The inclusion of the auditor's opinion on the financial statements is required by Standard 2. Those firms that do not include a sixth paragraph incorporate the opinion on the company's financial statements into the paragraph that expresses the opinions on management's assessment of the internal controls over financial reporting and on the actual internal controls.

The Public Company Accounting Oversight Board also allows auditors to issue a combined report expressing unqualified opinions on both the company's financial statements and internal control over financial reporting. Enclosed in Auditing Standard 2 is an example of the possible format and language of this report. This report closely parallels the format outlined above and basically combines the information normally contained in the separate reports.[24]

The example combined report consists of five paragraphs: an introductory paragraph, a scope paragraph, a definition paragraph, an inherent limitations paragraph, and an opinion paragraph. The introductory paragraph simply combines the essential information of the introductory paragraphs of the separate reports. The scope paragraph integrates the information contained in the scope paragraph of the separate reports. The definition and inherent limitations paragraphs are identical to those described above. In addition, the opinion paragraph combines the information normally contained in the opinion paragraphs of the separate reports. The combination of the opinion paragraphs eliminates the need for an explanatory paragraph.

Inconsistencies

While a great number of commonalities exist among the unqualified reports issued by the audit firms, each firm's unqualified report is different from the others in some fashion. In addition, some inconsistencies were discovered among different unqualified reports issued by the same firm but from different offices or at different times.

[24] Appendix B.2

Deloitte and Touche

Deloitte and Touche follows the example format in its unqualified report, but its wording differs in some instances from that of the example. In the definition and inherent limitations paragraphs, Deloitte and Touche provides more detail regarding the designers and supervisors of a company's internal control and lists examples of the inherent limitations of internal controls. Unlike the other firms, Deloitte and Touche specifies the parties in the corporation responsible for the design, supervision and oversight of the internal controls over financial reporting. These details are expressed by an additional phrase in the opening sentence of the definition paragraph. This sentence states:

> "A company's internal control over financial reporting is a process designed **by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel** to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles."[25]

Deloitte and Touche also provides more detail than the PCAOB example in the inherent limitations paragraph of its unqualified report. The additional wording in the first sentence of this paragraph offers two examples of the inherent limitations of internal controls. In addition to the two examples, Deloitte and Touche also includes language different than that used in the example. This additional wording is included in the first sentence of the risk paragraph which states the following:

> "Because of the inherent limitations of internal control over financial reporting, **including the possibility of collusion or improper management**

[25] Appendix C.1

> **override of controls, material** misstatements due to error or fraud may not be prevented or detected **on a timely basis.**"[26]

The additional words are emboldened for emphasis. The first phrase in bold simply lists two possible ways that an effective internal control system can be breached. Deloitte and Touche includes the word "material" to modify "misstatements" where the example does not. The example simply states, "internal control over financial reporting may not prevent or detect misstatements." [27] From Deloitte and Touche's use of this modifier, two almost opposite implications can be made. First, one could imply that nonmaterial misstatements "due to errors or fraud" will be detected. Secondly, one could believe that the company's internal controls over financial reporting will only prevent or detect material misstatements when "errors or fraud" are involved. The final phrase that is emphasized, "on a timely basis," implies that any existing material misstatements will eventually be detected by the company's internal controls over financial reporting. The explanations and examples added by Deloitte and Touche to its unqualified report make it the most lengthy of all unqualified reports following a similar format.[28]

Ernst and Young and BDO Seidman

The format of unqualified reports issued by Ernst and Young and BDO Seidman closely parallels the format defined by the Public Company Accounting Oversight Board. The unqualified report issued by Ernst and Young is the most concise of the five unqualified reports examined in the research project. Ernst and

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[26] Appendix C.1
[27] Appendix B.1
[28] Appendix C.1

Young employs certain measures, not utilized by other firms, to condense its report. Whereas all of the other firms list the full name of the criteria followed in the audit each time it is referred to in the report, Ernst and Young gives the full name of the criteria, Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, in the introductory paragraph and simply refers to criteria as the "COSO criteria" for the remainder of the report.[29] BDO Seidman uses almost the exact wording employed by the example, and it does not use the abbreviation "COSO criteria" in its unqualified report, making its report lengthier than that of Ernst and Young.[30]

KPMG

Two unqualified reports, issued by KPMG, provide interesting examples of inconsistencies between reports issued by separate offices of the same firm. The two reports analyzed were prepared for General Electric Company in Stamford, Connecticut and Citigroup, Inc. in New York, New York.[31] In general, these reports follow the formats outlined above. The language and format of KPMG's report on the internal control over financial reporting for Citigroup, Inc. greatly resemble the language and format of the example single unqualified report. KPMG makes a small addition in the introductory paragraph as it lists the page number in the Form 10-K on which management's assessment of internal control can be found. Considering this small difference, the unqualified report issued by KPMG's New York office and the PCAOB example unqualified report are almost identical.

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[29] Appendix C.2
[30] Appendix C.3
[31] Appendix C.4,5

Interestingly, the unqualified report prepared by KPMG's Stamford, Connecticut office on General Electric Company's internal control over financial reporting incorporates its report on the company's financial statements with its report on General Electric's internal controls over financial reporting. The resulting report mirrors the format outline by the Public Company Accounting Oversight Board in its example combined report. As stated above, the introductory paragraph in the Stamford office's report combines the information contained in a typical introductory paragraph of both types of reports. In order to make the transition from information regarding the financial statements to that regarding internal control over financial reporting, the auditor simply states, "We have also audited management's assessment." In addition, the Stamford office's report contains scope and opinion paragraphs that integrate information regarding the audit of the company's financial statements and the audit of the company's internal controls. The sections of the introductory, scope, and opinion paragraphs pertaining to the report on internal control over financial reporting employ language that is very similar to that used by the New York office in its report on Citigroup, Inc. The language used by the Stamford office in relation to the audit of the company's financial statements reflects the standard wording used in a single report on a company's financial statements. A lack of subheadings or breaks in the paragraphs of this integrated report require the reader to peruse the aforementioned paragraphs in order to recognize the transitions from the information regarding the financial statements to the information regarding the audit of internal control over financial reporting. Essentially, the Stamford office

eliminated the need for two separate reports by integrating the separate reports into one report on both audits.

PricewaterhouseCoopers

The unqualified reports issued by PricewaterhouseCoopers employ a unique format, but contain wording similar to that of the example reports discussed above. In addition, analysis of separate unqualified reports issued by PricewaterhouseCoopers reveals that changes were made to the format of the report overtime. The current format used by PricewaterhouseCoopers, as evidenced by the firm's report on the internal controls over financial reporting and financial statements of Caterpillar, Inc, issued February 25, 2005, will be discussed first.[32] In this report, PricewaterhouseCoopers employs an integrated format to express its opinions on the company's financial statements and internal control over financial reporting. This format differs greatly from the format for a combined unqualified report outlined by the example of the Public Company Accounting Oversight Board. PricewaterhouseCoopers achieves this format by dividing a single report into two separate sections, each with a heading that expresses what is to follow. These sections are preceded by an introductory paragraph that states the following:

> "We have completed an integrated audit of Caterpillar Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below."[33]

[32] Appendix C.6
[33] Appendix C.6

The above paragraph contains all of the information provided by a typical introductory paragraph except for statements enumerating the responsibilities of the auditor and the company's management. In the section entitled "Consolidated financial statements," the firm integrates the three paragraphs of an unqualified report on consolidated financial statements into one large paragraph. This paragraph contains the essentially the same information listed in a typical unqualified report on financial statements. PricewaterhouseCoopers expresses its opinion on the consolidated financial statements in the first sentence of the paragraph. In the subsequent sentences of the paragraph, it lists the information regarding the scope, methods and standards used in the audit. The section in the report referring to the audit of the company's internal control over financial reporting contains three paragraphs that use language similar to that employed by the example of a single unqualified report. In contrast to the PCAOB example, PricewaterhouseCoopers uses one paragraph to list the information normally included in the opinion paragraph, the introductory paragraph and the scope paragraph. The firm begins this paragraph by expressing its opinion on the corporation's internal control over financial reporting. The paragraph goes on to list the responsibilities of the auditor and of management, and PricewaterhouseCoopers concludes the paragraph by specifying the methods and standards employed in the conduct of the audit. The following and last two paragraphs of the report parallel the definition and inherent limitations paragraphs described above.

The unqualified report issued by PricewaterhouseCoopers on the financial statements and internal control over financial reporting of The Walt Disney Company

provides evidence of the changes made to the format of the firm's unqualified report over time.[34] The Walt Disney report was issued on December 9, 2005. Similar to the February report, the December report is combined report. Unlike the February report, the December report is not divided into two sections. In addition, this report does not parallel the example combined unqualified report enclosed in Auditing Standard 2. Rather, it contains four paragraphs comparable to those of PricewaterhouseCooper's February report and one which discusses a change in accounting principle.[35] The first paragraph of the December report expresses the firm's opinions on the company's consolidated financial statements, management's assessment of the company's internal control over financial reporting and the actual internal control over financial reporting. In addition, this paragraph lists the responsibilities of management and the auditor as they relate to the audits. The second paragraph of the integrated report serves as the scope paragraph and is identical to the PCAOB example. The following two paragraphs of the December report are the definition and inherent limitations paragraphs and are extremely similar in wording and format to those contained in the examples. The differences between the December and February reports demonstrate the changes made by PricewaterhouseCoopers to its integrated unqualified report. The changes greatly enhance the readability of the firm's unqualified report.

The above differences may seem relatively insignificant, but, in comparison to auditors' reports issued on consolidated financial statements, they are glaring. Historically, unqualified reports issued by various accounting firms on a company's

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[34] Appendix C.7

[35] Changes in accounting principles made during the fiscal year of the audit must be disclosed in the notes to the financial statements and good practice recommends that the auditor refer to these notes in the report.

consolidated financial statements follow a fairly standard format. Some reports may contain additional explanation paragraphs and these are included at the end of the firm's report. Furthermore, the basic three paragraphs of an auditor's unqualified report on consolidated financial statements employ relatively standard wording. In some instances, these paragraphs are abbreviated and combined to produce a more concise report. The differences in auditors' reports on companies' internal controls over financial reporting illustrate a lack of uniformity across the profession in reporting on internal control.

Adverse opinions

The Public Company Accounting Oversight Board requires that adverse reports on the effectiveness of a company's internal control over financial reporting contain certain items in addition to the items required in an unqualified report. These additional required items are a definition of a material weakness as specified by Standard 2, a statement that management has identified and included the material weakness in its report, and a description of the identified material weakness. The PCAOB example adverse report contains five paragraphs: an introductory paragraph, a scope paragraph, a definition paragraph, an inherent limitations paragraph, an explanatory paragraph, and an opinion paragraph. The example adverse report does not contain a paragraph expressing the firm's opinion on the financial statements of the client. Four of the five paragraphs have the same purpose as the corresponding paragraphs of the example unqualified report. The explanatory paragraph in the adverse report contains the definition of material weakness, a description of the

identified material weakness or weaknesses, and a statement conveying that the material weakness was considered in the planning of the audit of the company's financial statements and does not affect the resulting report. Other than the differences in opinion and the explanatory paragraph, the PCAOB example adverse and unqualified reports are very similar.

The format of the four adverse opinions found by this research parallel the format of the issuing firm's unqualified report. The adverse reports from Deloitte and Touche, Ernst and Young, and PricewaterhouseCoopers were the only adverse opinions analyzed as none of the reports issued by BDO Seidman and KPMG contained in the sample were adverse. Analysis of the reports issued by PricewaterhouseCoopers and Deloitte and Touch reveals separate inconsistencies in the format or wording of each firm's adverse report.

In its adverse report, issued on the internal controls over financial reporting of American International Group, PricewaterhouseCoopers includes an additional paragraph after its description of the material weaknesses identified in the audit. This additional paragraph conveys the consequences of the identified control deficiencies and lists the firm's reasons for concluding that such deficiencies "constitute material weaknesses."[36] The adverse report issued by PricewaterhouseCoopers is the only adverse report from the sample that contains this additional paragraph. Also, PricewaterhouseCoopers is the only firm of the three that issued a combined report when expressing an adverse opinion on the company's internal control over financial reporting.

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[36] Appendix D.3

The second inconsistency exists in the adverse report issued by Deloitte and Touche on the internal control over financial reporting of Pathmark Stores, Inc. Unlike the other firms, Deloitte and Touche describes a material weakness as a "significant deficiency, or combination of significant deficiencies."[37] The other firms use the term "control deficiency" in their definition of a material weakness. A control deficiency is defined by the Public Company Accounting Oversight Board as a flaw in "the design or operation of a control [that] does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis."[38] A significant deficiency is simply a control deficiency or combination of control deficiencies that may prevent the detection or correction of a material misstatement of the company's financial statements, thus possibly preventing the company from reliably reporting its financial data in accordance with generally accepted accounting principles. The Public Company Accounting Oversight Board includes the term "significant deficiency" in its definition of a material weakness, meaning that Deloitte and Touche's report appears to contain the most accurate definition of the three reports.

Disclaimer/Qualified opinions

Disclaimer and qualified opinions are required to be issued when the auditor's scope of available information was restricted or the management of the client had not prepared an assessment of internal control over financial reporting. Although no

[37] Appendix D.1

[38] Public Company Accounting Oversight Board. Auditing Standard 2. (June 2004) Paragraph 7, items 8-9.

disclaimer or qualified opinions were found in the sample data, discussion of such a report is relevant to this research project and is included below.

The company whose lack of an assessment of it internal controls warranted a disclaimer opinion is MDC Partners Incorporated located in Toronto, Canada. MDC Partners Inc. is registered as an accelerated filer with the SEC. The company's auditor, PricewaterhouseCoopers, did not issue a report on MDC's internal control over financial reporting. Instead, PricewaterhouseCoopers included a disclaimer paragraph in the report on the company's financial position. The paragraph simply stated:

> "The Company has not reported on, and we have not audited the effectiveness of the Company's internal control over financial reporting as of December 31, 2004. Accordingly, we do not express an opinion or any other form of assurance on the effectiveness of the Company's internal control over financial reporting as of December 31, 2004."[39]

[39] PricewaterhouseCoopers.

7. Other Findings

In the process of gathering and analyzing the sample data certain items were discovered that do not fall under any of the previous topics, but merit mention in the research project. These items are not only generally pertinent to the topics discussed in the project; they also provide additional evidence of a lack of uniformity in reporting on internal controls over financial reporting. These items concern the following two topics: managements' references in Forms 10-K to Section 404 preparations of early filers and the enclosure of a unique report issued by Ernst and Young on management's assertion on certain controls of International Business Machines Corporation.

Although not required to comply with Section 404 of the Sarbanes-Oxley Act, certain corporations whose fiscal years ended before November 15, 2004 mentioned the Act and efforts to gain compliance with Section 404 in the Management's Discussion and Analysis section of their Forms 10-K. The management of Hewlett Packard Company simply states its future requirements under Section 404 of the Act in Management's Discussion and Analysis included in its Form 10-K filed on January 14, 2005. In the Controls and Procedures section of its Form 10-K, H & R Block, Inc. includes a discussion of its existing internal control weaknesses and the company's efforts to remediate these weaknesses. Although the company's management does not directly refer to the Sarbanes-Oxley Act, it does state that their efforts to "strengthen financial and internal controls will continue" and should "be completed by the end of fiscal year 2005."[40]

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[40] Appendix E.1

Another item uncovered during the research project that warrants special attention is the report issued by Ernst and Young on certain controls of the Business Consulting Services Reporting Unit ("the Reporting Unit") of IBM.[41] In the report dated February 22, 2005, Ernst and Young employed a format similar to that of its unqualified report issued on Intel Corporation, but the language used in "the Reporting Unit" report differs greatly from that used in the Intel Report. The introductory paragraph contains no mention of the COSO criteria and uses the word "examined" rather than "audited" to describe the procedures performed for "the Reporting Unit," indicating that an assessment of the assertion, rather than an audit, was actually performed. In addition, the second paragraph lists the controls "that formed the basis for management's assertion" rather than the scope of the audit. The third paragraph of "the Reporting Unit" report parallels the scope paragraph of a typical unqualified report on internal controls over financial reporting. In the paragraph that normally defines a company's internal control over financial reporting, Ernst and Young specifies the controls examined and not examined during the firm's assessment of "the Reporting Unit". The fifth paragraph of the report contains the statements pertaining to the inherent limitations of internal controls over financial reporting. The final paragraph of the report expresses the firm's opinion on management's assertion regarding the effectiveness of the stated controls. The report does not comment on an audit of the company's consolidated financial statements.

Interestingly, PricewaterhouseCoopers performed the actual audit of IBM's financial statements and internal control over financial reporting. International

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[41] Appendix E.2

Business Machine acquired the consulting unit of PricewaterhouseCoopers in July, 2002. Consequently, a PricewaterhouseCoopers audit of "the Reporting Unit" may breach the firm's independence with its client, thus requiring a separate auditor for "the Reporting Unit". PricewaterhouseCoopers includes a paragraph in IBM's Form 10-K stating that it has completed an audit of IBM's financial statements and internal controls over financial reporting. This paragraph refers the reader to IBM's annual report which contains the combined opinion of PricewaterhouseCoopers. On February 22, 2005, the same date of the Ernst and Young report, PricewaterhouseCoopers issued unqualified reports on both the company's financial statements and the company's internal control over financial reporting.

8. Conclusions

The Sarbanes-Oxley Act of 2002 has reverberating effects on directors and executives of publicly traded companies and the firms that audit those companies. The Act requires corporations and auditors to reinvent the way they look at and report on corporate internal controls. The first evidence of the response to the requirements of Section 404 became available in early 2005. The purpose of the research reported here was to do an early evaluation of the impact of Section 404 of the Sarbanes-Oxley Act on the reports issued by public accounting firms.

This research examined the number of adverse opinions issued by auditors for a sample of large and moderate sized corporations and asked the questions, are there any differences in the percentage of adverse opinions issued by auditing firms and/or are there any differences in number of adverse opinions when very large corporations are compared to moderate size corporations. The research also addressed the issue of consistency of wording within the various opinions issued by the audit firms.

In order to make this assessment, the audit opinions issued for ninety publicly traded corporations were gathered. The research included all thirty companies contained in the Dow Jones Industrial Average and companies ranking from 441 to 500 in the Fortune 500. The EDGAR database, accessible on the website of the Securities and Exchange Commission, provided most of the data.

Seventy-two of the ninety companies in the sample had published opinions. The remaining eighteen companies did not publish opinions for various reasons. Fourteen of the non-filing corporations' fiscal years ended before the effective date of November 15, 2004. One of the corporations was not registered with the SEC as an

accelerated filer. One corporation had not yet filed its Form 10-K with the SEC and its audit is ongoing. The opinions of two companies could not be accessed through the available sources.

Ninety-five percent (68 of 72) of the published opinions were unqualified. Four adverse opinions were published. Only one adverse opinion was expressed on a company in the Dow Jones Industrial Average and three were expressed on the companies in the sample from Fortune 500.

Three of the five firms issued adverse reports. The percentage of adverse opinions issued varies by firm. Approximately eight percent of the opinions issued by PricewaterhouseCoopers and Deloitte and Touche are adverse, whereas less than five percent of the opinions issued by Ernst and Young are adverse. KPMG and BDO Seidman expressed no adverse reports on any of their clients included in the sample.

Analysis of the unqualified reports revealed inconsistencies and developments within the reporting procedures across the profession. Each firm's unqualified reports contained unique language or followed a unique format that differentiated those reports from the unqualified reports issued by other firms. Some differences were relatively minor, such as a variation in wording or the use of an abbreviation. Other inconsistencies were more significant, such as the order and contents of paragraphs or additional descriptive phrases. Two separate offices of KPMG issued unqualified reports with different formats. Another case demonstrated an evolution in the wording of PricewaterhouseCoopers' current unqualified report by comparing that report to one issued by PricewaterhouseCoopers more than two months earlier.

The small number of adverse opinions in the sample (4 of 72) may indicate that Section 404 was effective in strengthening corporate internal control. On the other hand, the small number of adverse opinions may imply that many companies already maintained effective internal control over financial reporting and Section 404 is just a costly cosmetic piece of legislation.

The unqualified reports present the most convincing evidence of a lack of uniformity in the reporting procedures. Each firm's unqualified report was unique in some fashion. Deloitte and Touche uses more specific language in its report than the other firms use in their reports. Ernst and Young uses the example format and abbreviations to make its report the most concise. Similar to Ernst and Young, BDO Seidman uses the example format, but it spells out the criteria used rather than employing abbreviations. PricewaterhouseCoopers and KPMG issue integrated reports, but each firm's report follows a unique format.

The variances encountered in the analysis of the separate auditors' reports demonstrate the ambiguity of Standard 2. The standardization of the format and wording employed by various firms in their reports on companies' consolidated financial statements suggests a need for the profession to issue reports consistent in format and language. Inconsistencies identified in the firms' reports on internal control over financial reporting suggest ambiguities of Standard 2 pertaining to the required reporting procedures. Although Standard 2 lists the items that must be included in the auditor's report and offers an example of an unqualified report, some firms have opted to implement different formats or language in their reports. These differences will need to be addressed by the PCAOB and the profession in the future.

Limitations

This study was limited by the size of the sample. The number of companies included in the sample was not sufficient to fairly represent all public companies affected by Section 404. Consequently, the percentages of adverse opinions issued by the accounting firms on the sampled companies may not correlate to the percentages of adverse opinions issued on all public companies. In addition, analysis of more unqualified and adverse reports may reveal more inconsistencies in the wording and format employed by the various accounting firms. The nature of these inconsistencies may vary as the reports of more accounting firms are examined.

Future Research

The small number of adverse opinions discovered in the sample was surprising and raises related questions. Was Sarbanes-Oxley so effective that it caused significant improvement in the internal control procedures used by publicly traded companies, making them compliant with Section 404? Or were these companies already compliant in regard to Section 404? The underlying question is: Are Section 404 and the great expense to corporate America achieving a new level of financial integrity or are they simply reiterating a pre-existent level that was not maintained by only a few companies?

A helpful tool in answering this question would be a larger sample. *Compliance Week*, an online and weekly print publication, has compiled such a list of all corporations listed in the Russell 3000 index whose internal controls merited adverse opinions. The list includes related information, such as the auditing firm and

reason for the adverse opinion. Unfortunately, the list was not discovered until after the completion of the data gathering phase of this project.

The Sarbanes-Oxley Act was created and enacted by Congress "to protect investors by improving the accuracy and reliability of corporate disclosures." As the Act was created in order to protect investors, the need for such sweeping legislation and requirements could be accurately measured by answering the question: How does the market respond to adverse opinions? Are investors paying attention to and concerned with auditors' adverse opinions of companies' internal controls over financial reporting?

Answers to the previous questions would certainly help assess the effectiveness of Section 404. In addition, these answers would provide insight into nature of the Act and its importance in the minds of investors.

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APPENDICES

APPENDIX A..Forms NT 10-K
APPENDIX B..Example Unqualified Reports
APPENDIX C..Unqualified Reports
APPENDIX D...Adverse Reports
APPENDIX E..Miscellaneous

APPENDIX A—Forms NT 10-K

1. Relevant paragraph of AIG Form NT 10-K, filed March 17, 2005[42]

The Annual Report on Form 10-K (the "Form 10-K") of American International Group, Inc. (the "Company") for the Company's fiscal year ended December 31, 2004 could not be filed within the prescribed time period because of management changes, including the election on March 14, 2005 of a new Chief Executive Officer and a new Chief Financial Officer, as well as the Company's ongoing internal review of the accounting for certain transactions, which review was commenced in connection with previously announced regulatory inquiries and is continuing.

2. Relevant paragraphs of Collins and Aikman Form NT 10-K, filed March 17, 2005[43]

The Company is working towards completion of its assessment of internal controls over financial reporting required under Section 404 of the Sarbanes-Oxley Act and has concluded that certain material weaknesses, in addition to the matters leading to the restatement described above, existed at December 31, 2004, but its assessment of the effectiveness of the Company's control over financial reporting is ongoing and the extent of those material weaknesses remains under review. The Company's outside auditor is in the process of completing its audit of internal controls over financial reporting and has communicated the existence of material weaknesses. The potential material weaknesses identified include the following: (i) the adequacy of the Company's resources with appropriate accounting expertise to address accounting and reporting matters in certain areas, including revenue recognition, vendor arrangements and post-retirement benefits, and to supervise the Company's decentralized and disparate accounting environment and ensure an appropriate segregation of duties; (ii) the adequacy of the Company's internal audit function's resources and ability to monitor compliance with established policies and procedures; (iii) the effectiveness of certain information technology controls and the sufficiency of documentation to assess the effectiveness of such controls including embedded system application controls; (iv) the adequacy of procedures to consistently identify and reconcile fixed assets and periodically review assets for impairment; and (v) the completeness and consistent adherence to Company policies and procedures. These issues include a range of documentation-related issues and reconciliation issues. Other material weaknesses may be identified as a result of further investigation of the circumstances surrounding the expected restatement arising from vendor rebates. Our review and the audit is ongoing.

While the Company has implemented remediation steps with respect to certain significant deficiencies and material weaknesses, a number of issues still need to be addressed. The Company's remediation plans include the assignment of specific resources with given timelines for each finding. Measurement

[42] American International Group Inc.
[43] Collins and Aikman.

criteria have also been established to monitor the progress of these remediation efforts. To ensure that the Company addresses these issues thoroughly, effectively, and timely, the internal audit department has been supplemented with the services of several outside specialists. Further required remediation will be identified and undertaken as a result of the internal accounting investigation.

APPENDIX B—Example Unqualified Reports[44]

1. Single Unqualified Report

<u>Report of Independent Registered Public Accounting Firm</u>

[Introductory paragraph]

We have audited management's assessment, included in the accompanying *[title of management's report]*, that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]*. W Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

[Scope paragraph]

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

[Definition paragraph]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

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

[Opinion paragraph]

[44] The Public Company Accounting Oversight Board.

In our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]*. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]*.

[Explanatory paragraph]

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

[Signature]

[City and State or Country]

[Date]

2. Example Combined Unqualified Report[45]

Report of Independent Registered Public Accounting Firm

[Introductory paragraph]

We have audited the accompanying balance sheets of W Company as of December 31, 20X3 and 20X2, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X3. We also have audited management's assessment, included in the accompanying *[title of management's report]*, that W Company maintained effective internal control over financial reporting as of December 31, 20X3, based on *[Identify control criteria, for example, "criteria established in Internal Control— Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."]*. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these financial statements, an opinion on management's assessment, and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

[Scope paragraph]

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit

[45] The Public Company Accounting Oversight Board.

of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[Definition paragraph]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[Inherent limitations paragraph]

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

[Opinion paragraph]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X3 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment that W Company maintained effective internal control over financial reporting as of December 31, 20X3, is fairly stated, in all material respects, based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"]. Furthermore, in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X3, based on *[Identify control criteria, for example, "criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).*"].

[Signature]

[City and State or Country]

[Date]

APPENDIX C—Unqualified Reports

1. Deloitte and Touche Unqualified Report on Internal Control Over Financial Reporting[46]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Advance Auto Parts, Inc. and Subsidiaries
Roanoke, Virginia

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Advance Auto Parts, Inc. and subsidiaries (the Company) maintained effective internal control over financial reporting as of January 1, 2005, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

[46] Deloitte and Touche, LLP.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of January 1, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of January 1, 2005, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Advance Auto Parts, Inc. and subsidiaries as of January 1, 2005 and January 3, 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended January 1, 2005 and our report dated March 14, 2005 expressed an unqualified opinion on those financial statements.

DELOITTE & TOUCHE LLP

McLean, Virginia
March 14, 2005

2. Ernst and Young Unqualified Report on Internal Controls Over Financial Reporting[47]

REPORT OF ERNST & YOUNG LLP, INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders, Intel Corporation

We have audited management's assessment, included in the accompanying Management Report on Internal Control Over Financial Reporting, that Intel Corporation maintained effective internal control over financial reporting as of December 25, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Intel Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only

[47] Ernst and Young, LLP.

in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that Intel Corporation maintained effective internal control over financial reporting as of December 25, 2004, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Intel Corporation maintained, in all material respects, effective internal control over financial reporting as of December 25, 2004, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the 2004 consolidated financial statements of Intel Corporation and our report dated February 15, 2005 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

San Jose, California
February 15, 2005

3. BDO Seidman Unqualified Report on Internal Controls Over Financial Reporting[48]

Report of Independent Registered Public Accounting Firm

Board of Directors
Henry Schein, Inc.
Melville, New York

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Henry Schein, Inc. maintained effective internal control over financial reporting as of December 25, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Henry Schein Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for

[48] BDO Seidman, LLP.

external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that Henry Schein, Inc. maintained effective internal control over financial reporting as of December 25, 2004, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also in our opinion, Henry Schein, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 25, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Henry Schein, Inc. as of December 25, 2004 and December 27, 2003 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 25, 2004, and our report dated February 28, 2005 expressed an unqualified opinion.

/s/ BDO Seidman, LLP

New York, New York
February 28, 2005

4. The New York Unqualified Report[49]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM—INTERNAL CONTROL OVER FINANCIAL REPORTING

The Board of Directors and Stockholders
Citigroup Inc.:

We have audited management's assessment, included in the Management's Report on Internal Control over Financial Reporting appearing on page 76, that Citigroup Inc. and subsidiaries (the "Company" or "Citigroup") maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

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[49] KPMG, LLP.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that Citigroup maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Citigroup maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Citigroup as of December 31, 2004 and 2003, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2004, and our report dated February 25, 2005 expressed an unqualified opinion on those consolidated financial statements.

/s/ KPMG LLP

New York, New York
February 25, 2005

5. The Stamford Unqualified Report[50]

Report of Independent Registered Public Accounting Firm

To Shareowners and Board of Directors of General Electric Company

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[50] KPMG, LLP.

We have audited the accompanying statement of financial position of General Electric Company and consolidated affiliates ("GE") as of December 31, 2004 and 2003, and the related statements of earnings, changes in shareowners' equity and cash flows for each of the years in the three-year period ended December 31, 2004. We also have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting, that GE maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). GE management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements, an opinion on management's assessment, and an opinion on the effectiveness of GE's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, the consolidated financial statements appearing on pages 72, 74, 76, 53 and 78–111 present fairly, in all material respects, the financial position of GE as of December 31, 2004 and 2003, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2004, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, management's assessment that GE maintained effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in *Internal Control—Integrated Framework* issued by COSO. Furthermore, in our opinion, GE maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by COSO.

As discussed in note 1 to the consolidated financial statements, GE in 2004 and 2003 changed its method of accounting for variable interest entities, in 2003 changed its method of accounting for asset retirement obligations and in 2002 changed its methods of accounting for goodwill and other intangible assets and for stock-based compensation.

Our audits of GE's consolidated financial statements were made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The accompanying consolidating information appearing on pages 73, 75 and 77 is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations and cash flows of the individual entities. The consolidating information has been subjected to the auditing procedures applied in the audits of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

KPMG LLP
Stamford, Connecticut

February 11, 2005

6. PricewaterhouseCoopers Unqualified Report dated February, 25 2005[51]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

TO THE BOARD OF DIRECTORS AND STOCKHOLDERS OF CATERPILLAR INC.:

We have completed an integrated audit of Caterpillar Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements

In our opinion, the accompanying statements of consolidated financial position and the related statements of consolidated results of operations, changes in stockholders' equity and consolidated cash flow, including pages A-5 through A-34, present fairly, in all material respects, the financial position of Caterpillar Inc. and its subsidiaries at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

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[51] PricewaterhouseCoopers, LLP.

Internal control over financial reporting

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing on page A-3, that the Company maintained effective internal control over financial reporting as of December 31, 2004 based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control—Integrated Framework* issued by COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

PricewaterhouseCoopers LLP

Peoria, Illinois
February 24, 2005

7. PricewaterhouseCoopers Unqualified Report dated December 9, 2005[52]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of The Walt Disney Company

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, shareholders' equity, and cash flows present fairly, in all material respects, the financial position of The Walt Disney Company and its subsidiaries (the Company) at September 30, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2004, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of September 30, 2004 based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2004, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on (i) these financial statements; (ii) management's assessment; and (iii) the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the

[52] PricewaterhouseCoopers, LLP. .

risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

As discussed in Note 2 to the Consolidated Financial Statements, the Company adopted FASB Interpretation 46R, *Consolidation of Variable Interest Entities* and, accordingly, began consolidating Euro Disney and Hong Kong Disneyland as of March 31, 2004. Additionally, the Company adopted EITF No. 00-21, *Revenue Arrangements with Multiple Deliverables* as of October 1, 2002, changing the timing of revenue from certain contracts.

PRICEWATERHOUSECOOPERS LLP

Los Angeles, California

December 9, 2004

APPENDIX D—Adverse Reports

1. Adverse Report of Deloitte and Touch issued on Pathmark Stores, Inc.[53]

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of
Pathmark Stores, Inc.
Carteret, New Jersey

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting, that Pathmark Stores, Inc. and subsidiaries (the "Company") did not maintain effective internal control over financial reporting as of January 29, 2005, because of the effect of the material weakness identified in management's assessment based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

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[53] Deloitte and Touche, LLP.

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. The Company identified material weaknesses in their process of calculating goodwill impairment and in their accounting for book overdrafts. Such material weaknesses were included in management's assessment. The Company's controls surrounding the review of goodwill impairment did not operate effectively. The control ineffectiveness resulted in material adjustments to the Company's goodwill impairment charge and goodwill remaining on the balance sheet at January 29, 2005. These audit adjustments were recorded by the Company. The potential misstatement caused by the control deficiency would be limited to the amount of goodwill recorded in the Company's balance sheet. The material weakness relating to the accounting for book overdrafts resulted from a deficiency in the design of the Company's process of determining whether right of offset exists relating to the Company's overdrafts. The control ineffectiveness resulted in a material adjustment that affected the recorded amounts of cash and accounts payable. The Company corrected these balances at January 29, 2005. The potential misstatement of this error would depend on the Company's cash position and timing of its disbursements. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended January 29, 2005, of the Company and this report does not affect our report on such financial statements.

In our opinion, management's assessment that the Company did not maintain effective internal control over financial reporting as of January 29, 2005, is fairly stated, in all material respects, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of January 29, 2005, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended January 29, 2005 of the Company and our report dated April 29, 2005 expressed an unqualified opinion (and includes an explanatory paragraph related to the change in the method of accounting for cash consideration received from vendors effective as of February 3, 2002), on those financial statements.

/s/ Deloitte & Touche LLP

New York, New York
April 29, 2005

2. Adverse Opinion of Ernst and Young issued on Borders Group, Inc.[54]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

To the Board of Directors and Stockholders of
Borders Group, Inc.

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting, included in Item 9A, that Borders Group, Inc. (the Company) did not maintain effective internal control over financial reporting as of January 23, 2005, because of the effect of the Company's insufficient controls over the selection and monitoring of

[54] Ernst and Young, LLP.

appropriate assumptions and factors affecting lease accounting, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weakness has been identified and included in management's assessment:

In its assessment as of January 23, 2005, management identified as a material weakness the Company's insufficient controls over the selection and monitoring of appropriate assumptions and factors affecting lease accounting practices. As a result of this material weakness in internal control, Borders Group, Inc. concluded the Company's previously issued financial statements should be restated. This material weakness was considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2004 financial statements, and this report does not affect our report dated April 5, 2005 on those financial statements.

In our opinion, management's assessment that Borders Group, Inc. did not maintain effective internal control over financial reporting as of January 23, 2005, is fairly stated, in all material respects, based on the COSO control criteria. Also, in our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, Borders Group, Inc. has not maintained effective internal control over financial reporting as of January 23, 2005, based on the COSO control criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of the Company as of January 23, 2005 and January 25, 2004, and the related consolidated statements of income, stockholders' equity, and cash

flows for each of the three years in the period ended January 23, 2005, and our report dated April 5, 2005 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Detroit, Michigan
April 5, 2005

3. Adverse opinion of PricewaterhouseCoopers issued on American International Group Inc.[55]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of
American International Group, Inc.:

We have completed an integrated audit of American International Group, Inc.'s 2004 consolidated financial statements and of its internal control over financial reporting as of December 31, 2004 and audits of its 2003 and 2002 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

Consolidated financial statements and financial statement schedules

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of American International Group, Inc. and its subsidiaries (AIG) at December 31, 2004 and 2003, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedules are the responsibility of AIG's management. Our responsibility is to express an opinion on these financial statements and financial statement schedules based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 2 to the consolidated financial statements, AIG restated its 2003 and 2002 consolidated financial statements.

As described in Note 21 to the consolidated financial statements, AIG changed the manner in which it accounts for certain non-traditional long duration contracts and for separate accounts as of January 1, 2004.

Internal control over financial reporting

[55] PricewaterhouseCoopers, LLP.

Also, we have audited management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A, that AIG did not maintain effective internal control over financial reporting as of December 31, 2004 because of the effect of the material weaknesses relating to the (1) control environment, (2) controls over the evaluation of risk transfer, (3) controls over certain balance sheet reconciliations, (4) controls over accounting for certain derivative transactions and (5) controls over income tax accounting based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). AIG's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of AIG's internal control over financial reporting based on our audit.

We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. As of December 31, 2004, the following material weaknesses have been identified and included in management's assessment.

Control environment: Certain of AIG's controls within its control environment were not effective to prevent certain members of senior management, including the former Chief Executive Officer and former Chief Financial Officer, from having the ability, which in certain instances was utilized, to override certain controls and effect certain transactions and accounting entries. In certain of these instances, such transactions and accounting entries appear to have been largely motivated to achieve desired accounting results and were not properly accounted for in accordance with GAAP. Further, in certain of these instances, information critical to an effective review of transactions, accounting entries, and certain entities used in these transactions and accounting entries, were not disclosed to the appropriate financial and accounting personnel, regulators and AIG's independent registered public accounting firm. As a result, discussion and thorough legal, accounting, actuarial or other professional

analysis did not occur. This control deficiency is based primarily on these overrides. Specifically, this control deficiency permitted the following:

- Creation of Capco, a special purpose entity used to effect transactions that were recorded to convert, improperly, underwriting losses to investment losses and that were not correctly accounted for in accordance with GAAP, resulting in a misstatement of premiums and other considerations, realized capital gains (losses), incurred policy losses and benefits and related balance sheet accounts.

- Incorrect recording under GAAP of reinsurance transactions that did not involve sufficient risk transfer, such as the Gen Re transaction, and in some cases also related to entities which should have been consolidated, such as Union Excess and Richmond. This incorrect recording under GAAP resulted in a misstatement of premiums and other considerations, incurred policy losses and benefits, net investment income, reinsurance assets, deferred policy acquisition costs, other assets, reserve for losses and loss expenses, reserve for unearned premiums, other liabilities and retained earnings. See below for a related discussion under *Controls over the evaluation of risk transfer.*

- Various transactions, such as Covered Calls and certain "Top Level" Adjustments, converted realized and unrealized gains into investment income, thereby incorrectly applying GAAP, resulting in a misstatement of net investment income, realized capital gains (losses), and accumulated other comprehensive income.

- Incorrect recording under GAAP of changes to loss reserves and changes to loss reserves through "Top Level" Adjustments without adequate support, resulting in a misstatement of incurred policy losses and benefits, reserves for losses and loss expenses, foreign currency translation adjustments and retained earnings.

Controls over the evaluation of risk transfer: AIG did not maintain effective controls over the proper evaluation, documentation and disclosure of whether certain insurance and reinsurance transactions involved sufficient risk transfer to qualify for insurance and reinsurance accounting. These transactions included Gen Re, Union Excess, Richmond and certain transactions involving AIG Re, AIG Risk Finance and AIG Risk Management. As a result, AIG did not properly account for these transactions under GAAP, resulting in a misstatement of premiums and other considerations, incurred policy losses and benefits, net investment income, reinsurance assets, deferred policy acquisition costs, other assets, reserve for losses and loss expenses, reserve for unearned premiums, other liabilities and retained earnings.

Controls over certain balance sheet reconciliations: AIG did not maintain effective controls to ensure the accuracy of certain balance sheet accounts in certain key segments of AIG's operations, principally in the Domestic Brokerage Group. Specifically, accounting personnel did not perform timely reconciliations and did not properly resolve reconciling items for premium receivables, reinsurance recoverables and intercompany accounts. As a result, insurance acquisition and other operating expenses, premiums and insurance balances receivable, reinsurance assets, other assets and retained earnings were misstated under GAAP.

Controls over the accounting for certain derivative transactions: AIG did not maintain effective controls over the evaluation and documentation of whether certain derivative transactions qualified under GAAP for hedge accounting, resulting in a misstatement of net investment income, realized capital gains (losses), other revenues, accumulated other comprehensive income (loss) and related balance sheet accounts.

Controls over income tax accounting: AIG did not maintain effective controls over the determination and reporting of certain components of the provision for income taxes and related

deferred income tax balances. Specifically, AIG did not maintain effective controls to review and monitor the accuracy of the components of the income tax provision calculations and related deferred income taxes and to monitor the differences between the income tax basis and the financial reporting basis of assets and liabilities to effectively reconcile the differences to the deferred income tax balances. As a result, deferred income taxes payable, retained earnings and accumulated other comprehensive income were misstated under GAAP.

The control deficiencies described above resulted in the restatement of AIG's 2003, 2002, 2001 and 2000 annual consolidated financial statements and 2004 and 2003 interim consolidated financial statements, as well as adjustments, including audit adjustments relating to the derivative matter described above, to AIG's 2004 annual consolidated financial statements. Furthermore, these control deficiencies could result in other misstatements in financial statement accounts and disclosures that would result in a material misstatement to the annual or interim AIG consolidated financial statements that would not be prevented or detected. Accordingly, management has concluded that these control deficiencies constitute material weaknesses. These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2004 consolidated financial statements, and our opinion regarding the effectiveness of AIG's internal control over financial reporting does not affect our opinion on those consolidated financial statements.

In our opinion, management's assessment that AIG did not maintain effective internal control over financial reporting as of December 31, 2004, is fairly stated, in all material respects, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO. Also, in our opinion, because of the effects of the material weaknesses described above on the achievement of the objectives of the control criteria, AIG has not maintained effective internal control over financial reporting as of December 31, 2004, based on criteria established in *Internal Control – Integrated Framework* issued by the COSO.

PricewaterhouseCoopers LLP
New York, New York
May 27, 2005

APPENDIX E—Miscellaneous

1. Management's discussion of existing weaknesses and efforts to strengthen internal controls[56]

ITEM 9A. CONTROLS AND PROCEDURES

Disclosures controls are procedures that are designed with the objective of ensuring that information required to be disclosed in reports filed or submitted under the Securities Exchange Act of 1934, such as this Form 10-K, is recorded, processed, summarized and reported in accordance with the SEC's rule. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to management, including the Chief Executive Officer and Chief Financial Officer or persons performing similar functions, as appropriate, to allow timely decisions regarding disclosure.

Our Disclosure Controls were designed to provide reasonable assurance that the controls and procedures would meet their objectives. Our management, including the CEO and Principal Accounting Officer, does not expect that our Disclosure Controls will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable assurance of achieving the designed control objectives and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of simply error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusions of two or more people, or by management override of the control. Because of the inherent limitations in a cost-effective, maturing control system, misstatements due to error or fraud may occur and not be detected.

As of the end of the period covered by this Form 10-K, we evaluated the effectiveness of the design and operation of our Disclosure Controls. The controls evaluation was done under the supervision and with the participation of management, including our CEO and Principal Accounting Officer.

The evaluation of our Disclosure Controls included a review of the controls' objectives and design, our implementation of the controls and the effect of the controls on the information generated for the use in this Form 10-K. In the course of the controls evaluation, we identified a series of control weaknesses related to our corporate tax accounting function. These weaknesses relate specifically to the reconciliation and level of detailed support of both current and deferred income tax accounts. We also determined an acceleration of taxable income was warranted in one of our segments, however, there was no change to our total income tax provision. Upon identification of these control weaknesses, immediate corrective action was undertaken. Our efforts to strengthen financial and internal controls continue. We expect these efforts to be completed by the end of fiscal year 2005.

Based on this evaluation, other than the item described above, our CEO and Principal Accounting Officer have concluded these controls are effective. There have been no significant changes in internal controls, or in other factors, which would significantly affect these controls subsequent to the date of evaluation.

2. Ernst and Young Report on IBM internal controls over financial reporting[57]

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

[56] H & R Block, Inc.
[57] Ernst and Young, LLP.

TO THE BOARD OF DIRECTORS OF
INTERNATIONAL BUSINESS MACHINES CORPORATION

We have examined management's assertion that the controls over the initiation and recording of revenue transactions and the recording of direct costs of the Business Consulting Services Reporting Unit ("the Reporting Unit") (a reporting unit as defined in Statement of Financial Accounting Standards No. 142), of International Business Machines Corporation ("IBM") are effective, as of December 31, 2004. Management is responsible for its controls over the initiation and recording of revenue transactions and the recording of direct costs of the Reporting Unit. Our responsibility is to express an opinion on management's assertion based on our examination.

The control objectives that formed the basis for management's assertion included (1) credit checks, contract pricing, contract terms and conditions, and a valid signed contract are obtained, reviewed and approved, and non-standard contract terms and conditions are identified for review prior to revenue recognition; (2) invoices are generated based on contract terms and conditions and reviewed prior to issuance; (3) revenues and accounts receivable are monitored and appropriate adjustments are made timely; (4) costs are appropriately and timely captured by contract and business unit and reconciled with related revenues; and (5) losses on contracts are identified and appropriate provisions made based on established accounting policies.

Our examination was conducted in accordance with attestation standards adopted by the Public Company Accounting Oversight Board (United States) and, accordingly, included obtaining an understanding of the controls over the initiation and recording of revenue transactions and the recording of direct costs of the Reporting Unit, testing and evaluating the design and operating effectiveness of those controls, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Our examination was limited to those controls that are applied to individual revenue transactions that are initiated within the Reporting Unit, and to those controls that are applied to the direct costs by Reporting Unit personnel. Our examination did not extend to IBM's internal control over financial reporting as it relates to applications and controls that are common to all reporting units within IBM, or to IBM entity-level controls, including those that also affect the recording of the Reporting Unit's revenues and direct costs.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the controls over the initiation and recording of revenue transactions and the recording of direct costs of the Reporting Unit to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the controls may deteriorate.

In our opinion, management's assertion that the controls over the initiation and recording of revenue transactions and the recording of direct costs of the Reporting Unit are effective as of December 31, 2004, is fairly stated in all material respects, based on the control objectives described above.

/s/ Ernst & Young LLP
ERNST & YOUNG LLP

New York, New York
February 22, 2005