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STAFF QUESTIONS AND ANSWERS

AUDITING INTERNAL CONTROL OVER FINANCIAL REPORTING

May 16, 2005

Summary: Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2"), were prepared by the Office of the Chief Auditor. The staff questions and answers related to Auditing Standard No. 2 are numbered sequentially upon issuance. Staff questions and answers numbered 1-37 are available on the Board's Web site at http://www.pcaobus.org. Additional questions should be directed to Laura Phillips, Associate Chief Auditor (202/207-9111; phillipsl@pcaobus.org) or Sharon Virag, Assistant Chief Auditor (202/207-9164; virags@pcaobus.org).

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General

Q38. What is a "top-down approach" to the audit of internal control over financial reporting, and what are its benefits?

A38. In a top-down approach to auditing internal control over financial reporting, the auditor performs procedures to obtain the necessary understanding of

internal control over financial reporting and to identify the controls to test in a sequential manner, starting with company-level controls and then driving down to significant accounts, significant processes, and, finally, individual controls at the process, transaction, or application levels. Auditing Standard No. 2 was designed to encourage the auditor to take this type of top-down approach to his or her audit. A top-down approach prevents the auditor from spending unnecessary time and effort understanding a process or control that does not affect the likelihood that the company's financial statements could be materially misstated.

By following the top-down sequence summarized below, the auditor focuses early in the process on matters, such as company-level controls, that can have an effect on the auditor's later decisions about scope and testing strategy. This approach also helps the auditor to identify and eliminate from further consideration accounts, disclosures, and assertions that have only a remote likelihood of containing misstatements that could cause the financial statements to be materially misstated.

Top-down Approach Sequence	Auditing Standard No. 2 Direction
Identify, understand, and evaluate the design effectiveness of company-level controls	Paragraphs 52 through 59
Identify significant accounts, beginning at the financial-statement or disclosure level	Paragraphs 60 through 67
Identify the assertions relevant to each significant account	Paragraphs 68 through 70
Identify significant processes and major classes of transactions	Paragraphs 71 through 78

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Top-down Approach Sequence	Auditing Standard No. 2 Direction
Identify the points at which errors or fraud could occur in the process	This identification occurs during the identification of significant accounts, relevant assertions, and significant processes, and is confirmed by performing walkthroughs as described in paragraphs 79-82
Identify controls to test that prevent or detect errors or fraud on a timely basis	Paragraphs 83 through 87
Clearly link individual controls with the significant accounts and assertions to which they relate	Paragraph 84

In this top-down approach, the auditor begins by identifying, understanding, and evaluating the design of company-level controls. Company-level controls include:

- controls within the control environment, such as tone at the top, organizational structure, commitment to competence, human resource policies and procedures;
- management's risk assessment process;
- centralized processing and controls, such as shared service environments;
- controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; and
- the period-end financial reporting process.

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Company-level controls function within all five COSO[1/] internal control components and often have a pervasive effect on controls at the process, transaction, or application level. Because of the pervasive effect of company-level controls, in this top-down approach, the auditor tests and evaluates the effectiveness of company-level controls first, because the results of this work will affect the auditor's testing strategy for controls at the process, transaction, and application levels. Staff Question No. 43 further discusses the role of company-level controls in the auditor's decisions about the nature, timing, and extent of tests of controls at the process, transaction, or application levels.

This top-down approach is both effective and efficient. In terms of effectiveness, the identification of significant accounts at the financial statement level (the "top") is driving the audit process "down" to the individual control level. In this manner, the auditor is assured of identifying controls to test that address relevant assertions for significant accounts. In terms of efficiency, this process prevents the auditor from spending unnecessary time and effort understanding a process or control that ultimately is not relevant to whether the financial statements could be materially misstated.

Q39. Auditors generally employ a "risk-based" approach to auditing financial statements. The auditor's assessment of the risk that a financial statement amount or disclosure is misstated affects the nature, timing, and extent of the auditor's work on that financial statement amount or disclosure. How is an audit of internal control over financial reporting risk-based?

A39. Risk assessment underlies the entire audit process described by Auditing Standard No. 2. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's controls and the amount of audit attention the auditor should devote to that area. Accordingly, the lower the risk that a material weakness could exist in a particular area, the less audit attention the auditor would need to devote to the area. On the other hand, the higher the risk that a material weakness could exist in a particular area,

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[1/] COSO refers to The Committee of Sponsoring Organizations ("COSO") of the Treadway Commission's publication, *Internal Control – Integrated Framework* (the "COSO Report"). Paragraph 49 of Auditing Standard No. 2 and the COSO report describe these components.

the greater the amount of audit attention the auditor should devote to the area. This relationship between risk and amount of audit attention is consistent with the auditor's responsibility to plan and perform the audit of internal control over financial reporting so that the risk that he or she fails to find a material weakness that does exist is appropriately low.

Q40. How does the auditor's assessment of the risk of financial statement misstatement affect the work that must be performed in an audit of internal control over financial reporting?

A40. The auditor's assessment of the risk that the financial statements could be materially misstated is an integral part of an audit of internal control over financial reporting conducted pursuant to Auditing Standard No. 2. The auditor's risk assessment, therefore, has a pervasive effect on the amount of work the auditor must perform.

The effects of the auditor's risk assessment are particularly significant in four provisions of Auditing Standard No. 2 that are at the center of an audit of internal control: (1) the identification of significant accounts, (2) the identification of relevant assertions, (3) the nature, timing, and extent of the auditor's tests of controls, and (4) the auditor's use of the work of others.

Significant accounts.
Paragraph 65 of Auditing Standard No. 2 describes quantitative and qualitative risk factors that the auditor should evaluate in deciding whether an account is significant. Using these risk factors, the auditor may eliminate from further consideration (unless the auditor later identifies indications of a higher level of risk) those accounts and disclosures that have only a remote likelihood of containing misstatements that could cause the financial statements to be materially misstated.

Staff Question No. 41 further discusses the identification of significant accounts.

Relevant assertions.
The auditor identifies relevant assertions related to significant accounts by evaluating the risk that the assertions could be misstated. An assertion that does not present a meaningful risk of potential material misstatement should not be

identified as a relevant assertion and does not need to be subject to the auditor's testing.

Nature, timing, and extent of tests of controls.
Auditing Standard No. 2 provides the auditor with the ability to test a control less extensively and farther from the "as-of" date when less risk is associated with the control. Likewise, these provisions direct the auditor to test a control more extensively and closer to the as-of date of management's assessment when more risk is associated with the control.

Staff Question No. 43 further discusses the role of an assessment of risk on the nature, timing, and extent of tests of controls.

Using the work of others.
An important component of the framework for using the work of others in an audit of internal control over financial reporting relates to the nature of the controls subjected to the work of others. Paragraph 112 of Auditing Standard No. 2 describes several risk factors that the auditor should evaluate when evaluating the nature of the controls subjected to the work of others. As these factors decrease in significance, the need for the auditor to perform his or her own work on those controls decreases. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. In this manner, the auditor's degree of reliance on the work of others should be naturally responsive to the degree of risk associated with the testing of those controls.

Staff Question No. 54 further discusses the role of risk assessment on the auditor's use of the work of others.

Scope and Extent of Testing

Q41. The identification of significant accounts plays a central role in the scoping of an audit of internal control over financial reporting. What role do qualitative factors and an assessment of risk have in the identification of significant accounts?

A41. As discussed in Staff Question No. 40, the auditor should determine that an account is significant based on an assessment of the risk that the account could contain misstatements that individually, or when aggregated with others,

could have a material effect on the financial statements. Paragraph 65 of Auditing Standard No. 2 describes quantitative and qualitative factors that the auditor should evaluate together to determine whether an account is significant. It is important for the auditor to take into account the total mix of information that is available in determining whether an account is significant. Accordingly, quantitative measures alone are not determinative of whether an account should be identified as significant.

For example, paragraph 66 of Auditing Standard No. 2 should not be understood to require that the fixed asset account be identified as a significant account for the audit of internal control over financial reporting simply because it is quantitatively large and without regard to the risk that the account could be materially misstated. The example in paragraph 66 in which the fixed asset account is determined to be significant is based on considering both quantitative and qualitative factors.

If the auditor determines that an account is a significant account for the audit of internal control over financial reporting, the auditor should design his or her control testing strategy to be responsive to his or her assessment of the risk related to the account. Staff Question No. 43 further discusses how the auditor may reduce the extent of his or her control testing for accounts that are assessed as having lower risk.

The auditor also should consider that components of an account balance may be subject to differing risks or different controls. Accordingly, the auditor may be able to reduce or eliminate testing of controls for some components. To take an obvious example, the petty cash component of the financial statement line item "cash and cash equivalents" rarely presents a more than remote risk that the financial statements could be materially misstated.

Q42. At many companies, management identifies and tests what it describes as "key" or "significant" controls as a part of its assessment of internal control over financial reporting. Is the auditor required to test all the controls that management tested because management described them as key or significant?

A42. No. Auditing Standard No. 2 does not define key or significant controls. Depending on the way in which key or significant controls are identified, testing

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all of those controls might result in the auditor testing either more or fewer controls than necessary. Rather, paragraph 83 of Auditing Standard No. 2 states that the auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others) for all relevant assertions related to all significant accounts and disclosures in the financial statements. This direction encourages the auditor to focus on assertions that are relevant to the accounts and disclosures that the auditor has determined are significant before deciding which controls to test. This process is consistent with the top-down approach described in Staff Question No. 38.

There may be circumstances in which management identifies and tests more controls than necessary for the purpose of its assessment of internal control over financial reporting. Such a decision on the part of management should not affect the scope of the auditor's work. The auditor need test only those controls that the auditor identifies as controls over relevant assertions related to significant accounts. This direction applies to the auditor's tests of design effectiveness as well as operating effectiveness of controls.

Staff Question No. 49 further discusses the independent nature of management's decisions regarding controls to test compared with the auditor's decisions related to the testing of controls.

Q43. How does the auditor's assessment of risk affect the auditor's decisions about the nature, timing, and extent of testing of controls?

A43. As discussed further in Staff Question No. 40, a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of a company's controls and the amount of audit attention the auditor should devote to that area. Accordingly, the provisions of Auditing Standard No. 2 discussed below provide the auditor with the ability to reduce his or her testing for lower-risk areas.

Nature.
As the risk associated with the control being tested decreases, the persuasiveness of the evidence that the auditor needs to obtain also decreases. On the other hand, as the risk associated with the control being tested increases,

the persuasiveness of the evidence that the auditor needs to obtain also increases.

Paragraphs 89 and 93 of Auditing Standard No. 2 describe the nature of the procedures the auditor might choose to perform to test the effectiveness of a control. These procedures include inquiry, observation, inspection of relevant documentation, and reperformance of the application of the control. The auditor also may perform walkthroughs, which ordinarily consist of some combination of these types of procedures, as tests of design and operating effectiveness. These procedures are listed in the order of the general level of persuasiveness of the evidence that they ordinarily would produce, from lowest to highest. Although inquiry alone is not sufficient, the auditor has significant latitude to determine what work should be done.

Timing.
Generally, as the risk associated with the control being tested decreases, the testing may be performed farther from the as-of date; on the other hand, as the risk associated with the control increases, the testing should be performed closer to the as-of date. Paragraphs 100 and 101 of Auditing Standard No. 2 describe factors that the auditor should evaluate when determining the timing of his or her testing.

In determining that the testing of a control should be performed closer to the as-of date because of increased risk associated with the control, the auditor still may test those controls as of an interim date and correspondingly adjust the nature and extent of his or her roll-forward procedures to be more extensive.

Staff Question No. 51 further discusses determining adequate roll-forward procedures.

Also, as described in paragraph 101 of Auditing Standard No. 2, the auditor should balance performing tests of controls closer to the as-of date with the need to obtain sufficient evidence of operating effectiveness. For example, if the auditor determined that he or she should test 25 operations of a control that operated multiple times per day, the auditor should not test that control 25 times on the last day of the company's fiscal year.

Extent.
As the risk associated with a control decreases, the extensiveness of the auditor's testing should decrease; as the risk associated with a control increases, the extensiveness of the auditor's testing also should increase. Paragraph 105 of Auditing Standard No. 2 describes three primary factors that the auditor should evaluate when determining the extent of testing the auditor should perform on a given control: (1) the nature of the control, (2) the frequency of operation, and (3) the importance of the control. Evaluating the nature of the control, and especially the importance of the control, is related directly to the auditor's assessment of risk associated with the control.

Company-level controls.
As described in Staff Question No. 38 regarding the top-down approach, the auditor's evaluation of company-level controls also will affect the auditor's decisions regarding the nature, timing, and extent of testing a control. Because company-level controls have a bearing on the auditor's evaluation of risk associated with the controls operating at more detailed levels than the company-level controls, the auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels. Although testing company-level controls alone is not sufficient, pervasive company-level controls can have a significant effect on the auditor's testing of other controls, particularly when strong company-level controls that have a direct relationship with lower-level controls result in the auditor decreasing the testing he or she otherwise would have performed.

Q44. The Background and Basis for Conclusions of Auditing Standard No. 2 indicates that the requirements in Auditing Standard No. 2 reflect the Board's decision that "each year's audit must stand on its own." Does this mean that the auditor must ignore the results of the previous year's audit of internal control over financial reporting and conduct subsequent audits as though they were an initial audit?

A44. No. The statement that each year's audit must stand on its own does not mean that audit knowledge obtained in prior years should be ignored in subsequent years' audits. Importantly, the auditor should use previous knowledge about the company's internal control over financial reporting to inform his or her assessments of risk in the current-year's audit. For example, during

the first audit of internal control over financial reporting, the auditor might have determined his or her sample size for testing a control by planning for several exceptions — a sampling strategy that would have resulted in a larger sample size than if no exceptions were expected. Based on favorable audit results, the auditor might reduce his or her sample size to reflect the expectation of no exceptions in the next year.

Staff Question Nos. 39, 40, and 43 further discuss how the auditor's assessment of risk could affect his or her audit approach.

Also, as described in paragraph E120 of Auditing Standard No. 2, some natural efficiency will emerge as the auditor repeats the audit process. For example, the auditor likely will spend less time obtaining the requisite understanding of the company's internal control over financial reporting in subsequent years compared with the time that was necessary in the first year. This use of previous knowledge also means that the auditor's evaluation of the design effectiveness of controls in subsequent years should be substantially more efficient.

Additionally, the statement that each year's audit must stand on its own accommodates both benchmarking automated application controls (See Staff Question No. 45) and alternating tests of controls (See Staff Question No. 46).

Q45. Since each year's audit must stand on its own, can a benchmarking strategy for testing automated application controls be employed? How would the auditor properly execute such a testing strategy?

A45. Yes, a benchmarking strategy for testing automated application controls can be used and presents an area of potential audit efficiency for those companies that have made investments in effective Information Technology ("IT") general controls. As such, paragraph E122 of Auditing Standard No. 2 specifically acknowledges benchmarking as a testing strategy that is permitted by the standard.

In general, to render an opinion as of the date of management's assessment, the auditor needs to test controls every year. This type of evidence is needed regardless of whether controls were found to be effective at the time of the prior annual assessments or whether those controls have changed since that time

because even if nothing significant changed about the company — the business model, employees, organizational structure, etc. — controls that were effective last year may not be effective this year due to error, complacency, distraction, and other human conditions that result in the inherent limitations in internal control over financial reporting. Automated application controls, however, will continue to perform a given control (for example, aging of accounts receivable, extending prices on invoices, performing edit checks) in exactly the same manner until the program is changed. Entirely automated application controls, therefore, are generally not subject to breakdowns due to human failure and this feature allows the auditor to "benchmark," or "baseline," these controls.

If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor last tested the application control, the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

When using a benchmarking strategy for a particular control, the auditor also should consider the importance of the effect of related files, tables, data, and parameters on the consistent and effective functioning of the automated application control. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

To determine whether to use a benchmarking strategy, the auditor should evaluate the following factors. As these factors increase in significance, the control being evaluated should be viewed as well suited for benchmarking. As these factors decrease in significance, the control being evaluated should be viewed as less suited for benchmarking. These factors are:

- the extent to which the application control can be matched to a defined program within an application;

- the extent to which the application is stable (i.e., there are few changes from period to period); and

- whether a report of the compilation dates of all programs placed in production is available and is reliable. (This information may be used as evidence that controls within the program have not changed.)

Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote — for example, when the vendor does not allow access or modification to the source code.

At some point, the benchmark of an automated application control should be reestablished. To determine whether to reestablish a benchmark, the auditor should evaluate the following factors:

- the effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations;

- the auditor's understanding of the effects of changes, if any, on the specific programs that contain the controls;

- the nature and timing of other related tests; and

- the consequences of errors associated with the application control that was benchmarked.

Q46. In the context of an audit of internal control over financial reporting, what does "alternating tests of controls" mean?

A46. Alternating tests of controls relates to using the work of others and other variations in testing from year to year. The statement that each year's audit must stand on its own is a guiding principle, and one that permits significant flexibility in varying the nature, timing, and extent of work in particular areas from year to year.

The auditor may use the work of others in a particular area to a large extent, perhaps entirely, in one or more years and to a lesser extent in other years. This decision to use the work of others as the entirety of the audit evidence for a given area would be made using the principles described in paragraphs 108 through 125 of Auditing Standard No. 2, including evaluating the nature of the controls being tested and the competence and objectivity of the individuals who performed the work.

Variation in the auditor's testing, as paragraph 104 of Auditing Standard No. 2 explains, includes the concept that the auditor "should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances." In a particular area, from year to year, the auditor may vary the time period over which controls are tested, the number and types of procedures performed, or the combination of procedures used. Each year's audit must stand on its own, but each year's audit does not have to include the same scope of testing.

Q47. As companies refine their approach to complying with the reporting requirements of Section 404 in subsequent years, many companies are expected both to improve their processes and procedures for monitoring the operation of controls and to make further use of control self-assessments. Management also plays a role as part of internal control itself. How should these factors affect the auditor's evaluation of management's assessment?

A47. Management's daily interaction with the system of internal control provides it with a broader array of procedures to achieve reasonable assurance for its assessment of internal control over financial reporting than the auditor has available. The auditor should recognize this difference when evaluating the adequacy of management's assessment.

Paragraph 40 of Auditing Standard No. 2, which addresses the auditor's evaluation of management's assessment process, recognizes the important difference between management's assessment and the auditor's testing. The fifth bullet of that paragraph cites as examples of procedures that management could use to obtain sufficient evidence of the operating effectiveness of controls "inspection of evidence of the application of controls, or testing by means of a self-assessment process, some of which might occur as part of management's

ongoing monitoring activities." For example, management might be able to determine that controls operate effectively through its direct and ongoing monitoring of the operation of controls. This determination might be accomplished through performing regular management and supervisory activities, monitoring adherence to policies and procedures, and performing other routine actions. For instance, a supervisor's review of a monthly account reconciliation prepared by one of his or her subordinates could be a monitoring control that also provides management with evidence supporting its assessment of internal control over financial reporting, if the results of the supervisor's review were evaluated and documented as part of management's assessment. To appropriately evaluate the adequacy of management's assessment as directed by the standard, the auditor needs to recognize these other types of procedures that are available to management as part of the basis for its assessment.

Q48. Paragraph 126 of Auditing Standard No. 2 states that the auditor should not use management "self-assessment" of controls as part of the auditor's evidence supporting his or her opinion. Does this mean that the auditor cannot use any procedures that are labeled or characterized as a self-assessment?

A48. No. Simply labeling management tests as self-assessment does not preclude the auditor from using that work. Self-assessment, as the term is currently used by issuers and auditors, has become a broad term that refers to different types of procedures performed by various parties. Accordingly, the auditor should evaluate the nature of the self-assessment process used by management when considering whether to use this work.

Although it does not provide an explicit definition of the term self-assessment, paragraph 126 of Auditing Standard No. 2 uses the term in a specific and narrow way to mean an assessment made by the same personnel who are responsible for performing the control. The auditor should not use this type of self-assessment as a basis for the auditor's opinion because this type of work lacks sufficient objectivity for the auditor's purposes. On the other hand, the broader set of procedures that some issuers and auditors currently label as self-assessment includes assessments and tests of controls performed by persons who are members of management but are not the same personnel who are responsible for performing the control. In this manner, an assessment may be

carried out with varying degrees of objectivity, depending on how far the person performing the assessment is removed from the person performing the control.

When the self-assessment is being performed by persons who are members of management but are not the same personnel who are responsible for performing the control, the auditor should evaluate this work using the provisions in Auditing Standard No. 2 for using the work of others — evaluating the nature of the controls subjected to the work of others and the competence and objectivity of the individuals who performed the work. In this circumstance, the decision about whether the auditor may use the work labeled as a self-assessment, and the extent to which the auditor uses that work, involve judgment in the circumstances beyond simply whether the work is labeled self-assessment.

Q49. Should the auditor evaluate the adequacy of management's assessment of internal control over financial reporting by determining whether, on a control-by-control level, management's testing was at least as extensive as the auditor's?

A49. No. The auditor should not evaluate the adequacy of management's assessment by simply comparing, on a control-by-control level, whether management's testing was at least as extensive as the auditor's. The nature and extent of the procedures that management uses to support its assessment should be determined by management, independent of the auditor's decisions about the nature, timing, and extent of the auditor's procedures. The procedures that management performs to support its assessment might be different from the auditor's procedures, yet still provide management with an adequate basis for its assessment, for several reasons.

First, as discussed in Staff Question No. 47, management has a broader array of procedures available to support its assessment than the auditor. As discussed further in Staff Question No. 48, management also may use self-assessment in particular areas to support its overall assessment of internal control over financial reporting. In this circumstance, the auditor should evaluate whether management's overall assessment process includes periodic, objective validation of the effectiveness of self-assessments in individual areas, such as testing by internal auditors, to verify the effectiveness of self-assessments. This type of validation of self-assessments need not occur every period for every area in which a self-assessment is performed. Management's overall assessment

process, however, should include a rational approach for determining how frequently and extensively to verify the effectiveness of self-assessments.

The work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work of the auditor. The more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

Q50. The auditor's opinion on the effectiveness of internal control over financial reporting is rendered as of a point in time (i.e., at year-end), whereas the auditor's opinion on the financial statements covers the financial results over a period of time (i.e., for the entire year). In an integrated audit of internal control over financial reporting and the financial statements, how should the auditor generally structure his or her testing of controls — throughout the entire period under audit or compressed toward year-end?

A50. In most circumstances, testing controls throughout the year will provide several benefits, perhaps the most important of which will be to fully integrate the audit of internal control over financial reporting with the audit of the financial statements.

In an integrated audit of internal control over financial reporting and the financial statements, the auditor ordinarily would design his or her testing of controls to accomplish the objectives of both audits simultaneously: (1) to obtain sufficient evidence to support his or her opinion on internal control over financial reporting as of year-end, and (2) to obtain sufficient evidence to support a control risk assessment of low for purposes of the audit of financial statements. By obtaining sufficient evidence to support a control risk assessment of low for purposes of the financial statement audit, the auditor will be able to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

To further promote an integrated approach to the audit of internal control over financial reporting and the audit of the financial statements (and, therefore, testing controls over a period of time), paragraph 160 of Auditing Standard No. 2 directs the auditor to document the reasons for assessing control risk as other

than low for any relevant assertions related to significant accounts. This documentation requirement reflects the expectation that the benefits associated with an integrated audit ordinarily will best be achieved by the auditor testing controls over a period of time. There may be circumstances in which it is appropriate and efficient, however, for the auditor not to test controls throughout the period and, therefore, not to assess control risk in the audit of the financial statements as low, such as when a material weakness is eliminated late in the year.

Q51. If the auditor performs procedures to test the effectiveness of controls as of an interim date, how should the auditor determine the nature and extent of roll-forward procedures that are necessary to support the auditor's opinion as of year-end?

A51. The auditor should evaluate the factors described in paragraph 100 of Auditing Standard No. 2 when evaluating the nature and extent of procedures to perform to update the results of his or her testing from an interim date to the company's year-end. As these factors decrease in significance, the evidence that needs to be obtained can be less persuasive, and the necessary updating procedures, accordingly, become less extensive. As these factors increase in significance, the necessary updating procedures become more extensive. These factors include:

- *The specific controls tested prior to the as-of date and the results of those tests*. This factor takes into consideration the nature of the control and the risks associated with the control. The lower the overall risk associated with a given control, the less extensive the auditor's updating procedures should be. Controls tested as of an interim date and for which testing exceptions were identified are an example of controls considered to be of higher risk if the auditor expects to conclude that those controls were effective as of year-end. This factor also includes the direction in paragraph 101 of Auditing Standard No. 2 that, for controls over significant non-routine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments (all areas of higher risk), the auditor should perform tests of controls closer to or at the as-of date rather than at an interim date.

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- *The degree to which evidence about the operating effectiveness of those controls was obtained*. The more persuasive the evidence obtained as of an interim date, the less extensive should be the updating procedures. On the other hand, the less persuasive the evidence obtained as of an interim date is, the more extensive the updating procedures need to be.

- *The length of the remaining period*. The updating procedures should be less extensive if the updating period of time is shorter. In other words, the updating procedures for a control tested through October would need to be less extensive than the updating procedures for a control tested through May for a calendar year-end company.

- *The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date*. The more indicators the auditor has that signal that a control has not changed since the interim testing date, the less extensive the updating procedures should be. For example, if the auditor understands that there have been no changes in the design of the control, the business operations surrounding the control, the personnel performing the control, or other factors, the less extensive the updating procedures need to be. On the other hand, if management has implemented a restructuring of significant processes that affect several significant accounts after the auditor's interim testing, such as when personnel are replaced or positions are lost, the auditor's updating procedures would need to be more extensive.

In selecting the nature of the tests to perform, the auditor might choose to perform the following procedures: inquiry, observation, inspection of relevant documentation, and reperformance of a control. The auditor also may perform walkthroughs, which ordinarily consist of some combination of these types of procedures. These procedures are listed in the order of the general level of persuasiveness of the evidence that they ordinarily would produce, from lowest to highest. For example, "inspection" might include scanning monthly account

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reconciliations to determine that the control was performed on a timely basis during the period between the interim testing and year-end.

Specific examples of roll-forward procedures.
Appendix B of Auditing Standard No. 2 contains four examples of how to apply the requirements in paragraphs 88 through 107 of the standard regarding the nature, timing, and extent of testing of internal control over financial reporting. Those examples should be read in their entirety; however, the table below summarizes the timing of the interim testing and the roll-forward procedures illustrated in the examples.

Examples of Extent-of-Testing Decisions	**Timing of Interim Testing**	**Nature and Extent of Roll-forward Procedures**
Example B-1 Daily programmed application control and daily information technology-dependent control	Through September	Inquiry and observation
Example B-2 Monthly manual reconciliation	May and July	Inquiry and inspection
Example B-3 Daily manual preventive control	Through September	Walkthrough of one December transaction
Example B-4 Programmed prevent control and weekly information technology-dependent manual detective control	Through July	Inquiry, observation, and inspection

Q52. How should the auditor evaluate a company's internal control over financial reporting when a company has implemented a significant change to IT that affects the company's preparation of its financial statements?

A52. To evaluate the effect that a change to the company's IT has on the company's internal control over financial reporting, the auditor should evaluate the company's controls over program development and program changes over the specific planned change to IT, as well as any controls that the company might put in place temporarily during the conversion period. The temporary controls referred to here would include the various procedures, many of which would be manual or IT-dependent manual procedures, that management puts in place to detect and correct errors during the time immediately after the conversion (often referred to as the "shake-down" period).

To evaluate whether the company's controls provide management with reasonable assurance that the company can produce complete and accurate financial statements before, during, and after the change to IT, the auditor should evaluate the combination of all these various types of controls.

As further discussed in Staff Question No. 43, the auditor's evaluation of company-level controls (and their relative strength or weakness), such as IT general controls, will affect the auditor's assessment of risk and, therefore, the nature, timing, and extent of the auditor's testing of more detailed controls.

It would be inappropriate for the auditor to conclude, as a rule, that management should not implement changes to IT for some arbitrary period of time before year-end.

Q53. Does Auditing Standard No. 2 encourage a mindset that in the absence of documentation evidencing the performance of a control, the control should be presumed to be ineffective in its operation?

A53. No. Auditing Standard No. 2 does not contain a presumption that a control is ineffective solely because there is no documentation evidencing the operation of the control. Such a presumption might suggest an emphasis on a "sign-and-file" mentality for management's approach to maintaining effective internal control — that a signature or other evidence of the performance of a control might become more important than the performance of the control itself. Rather, Auditing Standard No. 2 emphasizes the importance of obtaining evidence that is sufficiently persuasive to support a conclusion about whether a

control is operating effectively. Accordingly, the absence of documentation evidencing the operation of an individual control is not determinative that the control is not operating effectively. The auditor must be satisfied, however, that the control actually operated.

Using the Work of Others

Q54. How does the auditor's assessment of risk associated with particular controls and the decision to use the work of others relate to the auditor's determination of whether he or she has obtained the principal evidence supporting his or her opinion?

A54. As discussed in Staff Question No. 40, the auditor's degree of reliance on the work of others should be naturally responsive to the degree of risk associated with the testing of those controls. The requirements in paragraph 116 of Auditing Standard No. 2 that the auditor perform the walkthroughs himself or herself, and the requirements in paragraph 113 that the auditor not use the work of others to reduce the amount of work that he or she performs on controls in the control environment, directly relate to the degree of risk associated with these areas. In other words, because these areas of testing are at the very high end of the scale of audit risk, the auditor should perform this work himself or herself. These specific directions ensure that what should have been a natural result from the auditor's assessment of risk would, in fact, occur in all circumstances.

Having followed the principles in the standard regarding evaluating the nature of the controls subjected to the work of others and evaluating the competence and objectivity of the individuals who performed the work, the auditor should have (1) naturally allocated his or her own work to the areas of highest risk, and (2) generally, already obtained the principal evidence supporting his or her opinion. The note to paragraph 108 of Auditing Standard No. 2 states the following:

> Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work he or she performed on pervasive controls and in areas such as the control environment

than on other controls, such as controls over low-risk, routine transactions.

This note means that the auditor's evaluation of whether he or she has obtained the principal evidence supporting his or her opinion is primarily qualitative. As described above, the auditor should perform more work himself or herself in areas that represent higher risk. Likewise, the auditor should ascribe more weight to work he or she performs in higher-risk areas. In this manner, in most circumstances, following the other risk-based principles regarding using the work of others will result in the auditor having obtained the principal evidence supporting his or her opinion.

Auditor's Responsibilities With Respect to Management's Certification Disclosures

Q55. Paragraphs 202 through 206 of Auditing Standard No. 2 describe the auditor's responsibilities as they relate to management's quarterly certifications on internal control over financial reporting. Is the auditor required to perform the same types of tests of controls that support his or her opinion on internal control over financial reporting as of year-end on a quarterly basis to determine whether any change in internal control over financial reporting has materially affected the company's internal control over financial reporting?

A55. No. The procedures that the auditor is required to perform on a quarterly basis by paragraph 203 of Auditing Standard No. 2 ordinarily are limited to inquiry and observation and an evaluation of the implications of any misstatements identified by the auditor during the auditor's required review of interim financial information. Paragraphs 202 though 206 of Auditing Standard No. 2 do not require — and should not be read to encourage — what might amount to a quarterly audit of internal control over financial reporting. Rather, the auditor's responsibilities related to management's quarterly certifications on internal control over financial reporting are analogous to the auditor's responsibilities related to the company's financial statements in an interim review of financial statements in accordance with AU sec. 722, *Interim Financial Information*.

STAFF QUESTIONS & ANSWERS

For example, in conducting the inquiries and observations, the auditor ordinarily would limit these procedures to members of management within the company who would be expected to have knowledge about significant changes in the design or operation of internal control over financial reporting. These inquiries and observations should not result in the auditor interviewing every one of the company's employees with whom the auditor would interact during a complete audit of internal control over financial reporting.

As another example, if management plans, in connection with a quarterly certification, to disclose that it has eliminated a previously reported material weakness, the auditor's procedures would be limited to inquiry and observation. In connection with management's quarterly certification, the auditor is not required to test the design or operating effectiveness of controls that management believes eliminate a material weakness beyond inquiry and observation.