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STAFF QUESTIONS AND ANSWERS

AUDITING INTERNAL CONTROL OVER FINANCIAL REPORTING

JUNE 23, 2004 (Revised July 27, 2004)[1/]

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. Questions should be directed to Laura Phillips, Associate Chief Auditor (202/207-9111; phillipsl@pcaobus.org) or Greg Fletcher, Assistant Chief Auditor (202/207-9203; fletcherg@pcaobus.org).

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General

Q1. What is the authoritative status of the Background and Basis for Conclusions appendix in a Board's standard?

[1/] Paragraph A16 was revised on July 27, 2004 to more closely align the answer with the directions in paragraph B6 of Auditing Standard No. 2 upon which the answer was based.

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A1. All appendices of auditing standards issued by the Board, including the Background and Basis for Conclusions, are an integral part of the standard and carry the same authoritative weight as the body of the standard.

Q2. What is the authoritative status of the Notes included within the body of a Board's standard?

A2. Both the Notes and footnotes to a Board standard are an integral part of the standard and carry the same authoritative weight as any other information in the body of, or appendices to, the standard.

Independence

Q3. Paragraph 33 of Auditing Standard No. 2 states: "The auditor must not accept an engagement to provide internal control-related services to an issuer for which the auditor also audits the financial statements unless that engagement has been specifically pre-approved by the audit committee." Although the word "non-audit" does not appear in that requirement, do only non-audit internal control-related services need to be specifically pre-approved?

A3. The pre-approval requirement in Auditing Standard No. 2 applies to *any* internal control-related services, regardless of whether they are classified as audit or non-audit services for proxy disclosure purposes or otherwise. Every proposed engagement by the issuer's auditor to provide internal control-related services merits specific attention by the audit committee so that the audit committee can determine whether the performance of the services would impair the auditor's independence and whether management's involvement in the services is substantive and extensive.

Q4. Under Auditing Standard No. 2, an auditor cannot accept an engagement to provide internal control-related services unless the audit committee has evaluated the actual, individual control-related service before the auditor was engaged. An auditor might have been engaged by an issuer to perform internal control-related services prior to the effective date of Auditing Standard No. 2, at which time those services were pre-approved in a manner that would not satisfy the requirement in Auditing Standard No. 2. Further, those services might be ongoing such that the auditor continues to provide internal control-related services *after* the effective date of Auditing Standard No. 2 that were pre-approved *prior* to the effective date of Auditing Standard No. 2 in a manner

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that does not satisfy the auditor's requirement in Auditing Standard No. 2. Is there any grandfathering for these types of engagements in which their original pre-approval would be considered sufficient under Auditing Standard No. 2?

> **A4.** No, there is no grandfathering for internal control-related engagements that were pre-approved prior to the effective date of Auditing Standard No. 2 in a manner that would not satisfy the requirement in Auditing Standard No. 2 if the provision of services is ongoing after the effective date of the standard. If the auditor has been engaged to perform internal control-related services that were pre-approved prior to the effective date of Auditing Standard No. 2 in a manner that does not satisfy the requirements of Auditing Standard No. 2 and if those services are ongoing after the effective date of Auditing Standard No. 2, the auditor should request the audit committee to specifically evaluate the independence implications of the continuation of those services as soon as practicable. This type of remedial involvement of the audit committee is consistent with the emphasis and vigilance that is appropriate for the audit committee to have regarding approval of internal control-related services.

Scope and Extent of Testing

Q5. Several passages in Auditing Standard No. 2 refer to "financial statements and related disclosures." Do these references to "related disclosures" extend the auditor's evaluation and testing of controls to controls over the preparation of management's discussion and analysis ("MD&A")?

> **A5.** No. References in Auditing Standard No. 2 to "financial statements and related disclosures" refer to a company's financial statements and notes as presented in accordance with generally accepted accounting principles ("GAAP"). These references do not extend to the preparation of MD&A or other similar financial information presented outside a company's GAAP-basis financial statements and notes.

Q6. If management implements, late in the year, a new accounting system that significantly affects the processing of transactions for significant accounts, and if the majority of the year's transactions were processed on the old system, does the auditor need to test controls over the *new* system? Given the same scenario, does the auditor need to test controls over the *old* system?

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A6. To audit internal control over financial reporting, the auditor will need to test controls over the new system. Paragraphs 147-149 of Auditing Standard No. 2 provide relevant directions to the auditor in this situation. Those paragraphs state that the auditor's opinion on whether management's assessment of the effectiveness of internal control over financial reporting is fairly stated relates to the effectiveness of the company's internal control over financial reporting as of a *point in time*. Furthermore, Section 404(a) of the Act requires that this assessment be as of the end of the issuer's most recent fiscal year. Because controls over the *new* system, which significantly affect the processing of transactions for significant accounts, are the controls that are operating as of the date of management's assessment, the auditor should test controls over the new system.

Although the auditor would not be required to test controls over the *old* system to have sufficient evidence to support his or her opinion on management's assessment of the effectiveness of internal control over financial reporting as of the end of the issuer's fiscal year, the old system is relevant to the audit of the financial statements. In the audit of the financial statements, the auditor should have an understanding of the internal control over financial reporting, which includes the old system. Additionally, to assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. Paragraphs 150 and 151 of Auditing Standard No. 2 provide relevant directions to the auditor in this situation.

Q7. Paragraph 140 of Auditing Standard No. 2 includes the following circumstance as a significant deficiency and a strong indicator of a material weakness:

> Identification by the auditor of a material misstatement in financial statements in the current period that was not initially identified by the company's internal control over financial reporting. (This is a strong indicator of a material weakness even if management subsequently corrects the misstatement.)

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Historically, many auditors have worked with companies closely at year-end, performing auditing procedures on preliminary drafts of the financial statements and providing feedback over a period of time on each successive draft. If the auditor identifies a misstatement in a preliminary draft of financial statements, does this represent a significant deficiency and a strong indicator of a material weakness? Do discussions between management and the auditor regarding the adoption of a new accounting principle or an emerging issue that have, in the past, been seen as a normal part of a high quality audit, need to be postponed until after the company has completed its related accounting?

A7. The inclusion of this circumstance in Auditing Standard No. 2 as a significant deficiency and a strong indicator of a material weakness emphasizes that a company must have effective internal control over financial reporting on its own. More specifically, the results of auditing procedures cannot be considered when evaluating whether the company's internal control provides reasonable assurance that the company's financial statements will be presented fairly in accordance with generally accepted accounting principles. There are a variety of ways that a company can emphasize that it, rather than the auditor, is responsible for the financial statements and that the company has effective controls surrounding the preparation of financial statements.

Modifying the traditional audit process such that the company provides the auditor with only a single draft of the financial statements to audit when the company believes that all its controls over the preparation of the financial statements have fully operated is one way to demonstrate management's responsibility and to be clear that all the company's controls have operated. However, this process is not necessarily what was expected to result from the implementation of Auditing Standard No. 2. Such a process might make it difficult for some companies to meet the accelerated filing deadlines for their annual reports. More importantly, such a process, combined with the accelerated filing deadlines, might put the auditor under significant pressure to complete the audit of the financial statements in too short a time period thereby impairing, rather than improving, audit quality. Therefore, some type of information-sharing on a timely basis between management and the auditor is necessary.

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A company may share interim drafts of the financial statements with the auditor. The company can minimize the risk that the auditor would determine that his or her involvement in this process might represent a significant deficiency or material weakness through clear communications (either written or oral) with the auditor about the following:

- state of completion of the financial statements;
- extent of controls that had operated or not operated at the time; and
- purpose for which the company was giving the draft financial statements to the auditor.

For example, a company might give the auditor draft financial statements to audit that lack two notes required by generally accepted accounting principles. Absent any communication from the company to clearly indicate that the company recognizes that two specific required notes are lacking, the auditor might determine that the lack of those notes constitutes a material misstatement of the financial statements that represents a significant deficiency and is a strong indicator of a material weakness. On the other hand, if the company makes it clear when it provides the draft financial statements to the auditor that two specific required notes are lacking and that those completed notes will be provided at a later time, the auditor would not consider their omission at that time a material misstatement of the financial statements.

As another example, a company might release a partially completed note to the auditor and make clear that the company's process for preparing the numerical information included in a related table is complete and, therefore, that the company considers the numerical information to be fairly stated even though the company has not yet completed the text of the note. At the same time, the company might indicate that the auditor should not yet subject the entire note to audit, but only the table. In this case, the auditor would evaluate only the numerical information in the table and the company's process to complete the table. However, if the auditor identifies a misstatement of the information in the table, he or she should consider that circumstance a misstatement of the financial statements. If the auditor determines that the misstatement is material, a significant deficiency as well as a strong indicator of a material weakness would exist.

This type of analysis, focusing on the company's responsibility for internal control, may be extended to other types of auditor involvement. For example, many audit firms prepare accounting disclosure checklists to assist both companies and auditors in evaluating whether financial statements include all the required disclosures under GAAP. Obtaining a blank accounting disclosure checklist from the company's auditor and independently completing the checklist as part of the procedures to prepare the financial statements is not, by itself, an indication of a weakness in the company's controls over the period-end financial reporting process. As another example, if the company obtains the blank accounting disclosure checklist from its auditor, requests the auditor to complete the checklist, and the auditor determines that a material required disclosure is missing, that situation would represent a significant deficiency and a strong indicator of a material weakness.

These evaluations, focusing on the company's responsibility for internal control over financial reporting, will necessarily involve judgment on the part of the auditor. A discussion with management about an emerging accounting issue that the auditor has recently become aware of, or the application of a complex and highly technical accounting pronouncement in the company's particular circumstances, are all types of timely auditor involvement that should not necessarily be indications of weaknesses in a company's internal control over financial reporting. However, as described above, clear communication between management and the auditor about the purpose for which the auditor is being involved is important. Although the auditor should not determine that the implications of Auditing Standard No. 2 force the auditor to become so far removed from the financial reporting process on a timely basis that audit quality is impaired, some aspects of the traditional audit process may need to be carefully structured as a result of this increased focus on the effectiveness of the company's internal control over financial reporting.

Q8. If an issuer decides to forego the required testing or documentation that would form a sufficient basis for management's assessment of the effectiveness of internal control over financial reporting, may the auditor simply render an adverse opinion on internal control over financial reporting? In this circumstance, could the auditor render an adverse opinion on management's assessment but render an unqualified opinion on the effectiveness of internal control over financial reporting?

A8. No. Paragraph 20 of Auditing Standard No. 2 describes the responsibilities that management is required to fulfill for the auditor to satisfactorily complete an audit of internal control over financial reporting. These responsibilities include management evaluating the effectiveness of the company's internal control over financial reporting and supporting its evaluation with sufficient evidence, including documentation. If the auditor concludes that management has not fulfilled these responsibilities, Auditing Standard No. 2 states that the auditor should communicate, in writing, to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. Therefore, an auditor could not render either an adverse opinion on management's assessment or an unqualified opinion on internal control over financial reporting because, in this situation, the auditor would be precluded from expressing any opinion.

Additionally, management is required to fulfill these responsibilities under Items 308(a) and (c) of Regulation S-B and S-K, 17 C.F.R. 228.308 (a) and (c) and 229.308 (a) and (c), respectively. To the extent that management has willfully decided not to fulfill these responsibilities, the auditor also may have responsibilities under AU sec. 317, *Illegal Acts by Clients,*[2/] and Section 10A of the Securities Exchange Act of 1934.

Q9. Is it necessary for the auditor to test controls directly if management asserts that internal control over financial reporting is ineffective? If the auditor identifies a material weakness, does the auditor need to complete his or her testing of controls?

[2/] The Board adopted the generally accepted auditing standards, as described in the AICPA Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally Accepted Auditing Standards,* as in existence on April 16, 2003, on an initial, transitional basis. The Statements on Auditing Standards promulgated by the ASB have been codified into the AICPA *Professional Standards*, Volume 1, as AU sections 100 through 900. References in Auditing Standard No. 2 and this Staff Questions and Answers document refer to those generally accepted auditing standards, as adopted on an interim basis in PCAOB Rule 3200T.

A9. Yes. Paragraph 27 of Auditing Standard No. 2 requires the auditor to obtain sufficient competent evidence about the design and operating effectiveness of controls over all relevant financial statement assertions related to all significant accounts and disclosures in the financial statements. That paragraph also requires the auditor to plan and perform the audit to obtain reasonable assurance that *all* material weaknesses are identified. Therefore, to complete an audit of internal control over financial reporting and render an opinion, it is necessary for the auditor to test controls directly, regardless of the company's assessment or the auditor's earlier identification of a material weakness.

Q10. Auditing Standard No. 2 describes five financial statement assertions and describes the auditor's responsibilities in terms of relevant assertions. Some professional standards, such as the International Standards on Auditing, include more than five financial statement assertions. Some companies are using fewer than five assertions when making their assessments. For the auditor to perform an audit of internal control over financial reporting in accordance with Auditing Standard No. 2, must management and the auditor use the five assertions described therein?

A10. No. For the auditor to perform an audit of internal control over financial reporting in accordance with Auditing Standard No. 2, management and the auditor may base their evaluations on assertions that are different from those specified in Auditing Standard No. 2. Paragraphs 69 and 70 of Auditing Standard No. 2 describe the identification of relevant assertions. Relevant assertions are those that have a meaningful bearing on whether the account is fairly stated. To identify relevant assertions, the auditor should determine the sources of likely potential misstatements in each significant account. Ultimately, management and the auditor should identify and test controls over all relevant assertions for all significant accounts. To the extent that management or the auditor bases his or her work on assertions different from those in Auditing Standard No. 2, the auditor would be required to determine that he or she had identified and tested controls over all sources of likely potential misstatements in each significant account and over all representations by management that have a meaningful bearing on whether the account is fairly stated.

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Evaluating Deficiencies

Q11. The definition of a significant deficiency is based, in part, on a magnitude of financial statement misstatement that is "more than inconsequential." Paragraphs E87-E91 of Auditing Standard No. 2 describe the development of the Board's definition of the term *inconsequential*. The definition is based on paragraph .41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, which states:

> In aggregating likely misstatements that the entity has not corrected, pursuant to paragraphs .34 and .35 [of AU sec. 312], the auditor may designate an amount below which misstatements need not be accumulated. This amount should be set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements, after the possibility of further undetected misstatements is considered.

In the audit of the financial statements, different auditors designate the amount described in paragraph .41 of AU sec. 312 in various ways. Some auditors quantify, during the planning phase of the audit, a specific dollar amount above which likely misstatements will be accumulated. Others take a more judgmental approach to determining which likely misstatements to accumulate. Of the auditors who quantify a specific dollar amount above which likely misstatements will be accumulated, different auditors use different methodologies to arrive at different thresholds or specific dollar amounts.

Given the relationship of paragraph .41 of AU sec. 312 to the definition of inconsequential, is a known or likely misstatement aggregated by the auditor during the audit of the financial statements in response to the directions in paragraph .41 of AU sec. 312 by definition "more than inconsequential"? Furthermore, by virtue of having been aggregated by the auditor, such a misstatement would have a "more than remote likelihood" of occurring; therefore, by extension, does the aggregation of a difference by the auditor, by definition, mean that there is a significant deficiency in the company's internal control over financial reporting?

> **A11.** No. A known or likely misstatement aggregated by the auditor as part of the audit of the financial statements is not, by definition, either "more than inconsequential" or determinative of there being a significant deficiency. There are several reasons and circumstances why such a likely misstatement

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aggregated by the auditor might or might not indicate the existence of a significant deficiency.

The threshold for "more than inconsequential" when evaluating whether a significant deficiency exists is not necessarily the same as the amount the auditor establishes pursuant to paragraph .41 of AU section 312 for aggregating misstatements. The definition of inconsequential includes a combination of concepts from both Staff Accounting Bulletin ("SAB") No. 99, *Materiality*, and AU sec. 312. The definition of inconsequential is largely based on the discussion of magnitude in SAB No. 99 and on AU sec. 312 for its directions regarding both the consideration of misstatements individually and in the aggregate as well as the possibility of undetected misstatements.

Also, as the Board indicated in paragraph E75 of the Background and Basis for Conclusions of Auditing Standard No. 2, one reason that a significant deficiency is defined differently from the previously used term "reportable condition" is because the definition of reportable condition was solely a matter of the auditor's judgment. A definition dependent *solely* on the auditor's judgment was insufficient for purposes of the Sarbanes-Oxley Act because management also needs a definition to determine whether a deficiency is significant, and that definition should be the same as the definition used by the auditor. Accordingly, Auditing Standard No. 2's definition of significant deficiency is not, by definition, the same as the auditor's threshold for aggregating likely misstatements in the audit of the financial statements.

As indicated in the question, different auditors exercise their professional judgment in different ways in different circumstances when accumulating likely misstatements as part of the audit of the financial statements. Furthermore, some auditors, as a matter of policy, tend to set their posting threshold for accumulating likely misstatements lower than "inconsequential." For example, some auditors set their posting threshold for accumulating likely misstatements at .25 percent of the company's pre-tax income which would, in most cases, be clearly inconsequential on a quantitative basis.

Because a likely misstatement aggregated by the auditor as part of the audit of the financial statements is not, by definition, "more than inconsequential" or determinative of the existence of a significant deficiency, the auditor need not align the amount above which he or she aggregates misstatements with the amount above which he or she believes a misstatement to be "more than inconsequential" or determinative of the existence of a significant deficiency. Furthermore, the auditor should not, for example, change the types of deficiencies that he or she determines to be significant deficiencies simply by raising the auditor's threshold for accumulating likely misstatements. These determinations also need to take into consideration qualitative, as well as quantitative, factors. The auditor might still determine that there is a more than remote likelihood that a misstatement *larger* than the difference on his or her summary of audit differences might occur and not be prevented or detected. For these reasons, it is possible that a control deficiency associated with a likely misstatement accumulated by the auditor on his or her summary of audit differences might indicate the existence of a deficiency, a significant deficiency, *or* a material weakness.

Q12. When determining whether a control deficiency exists, should the auditor consider compensating controls?

A12. No. The Note to paragraph 10 of Auditing Standard No. 2 states that "… in determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness, the auditor should evaluate the effect of compensating controls and whether such compensating controls are effective." An important part of the evaluation of whether a significant deficiency or material weakness exists includes aggregating deficiencies and considering their effect in combination. The logical extension of this aggregation is to also consider compensating controls. However, control deficiencies should be considered individually and in isolation; therefore, the existence of compensating controls does not affect whether a control deficiency exists.

Q13. Are all control testing exceptions, by definition, control deficiencies?

A13. No. Paragraph 107 of Auditing Standard No. 2 states: "A conclusion that an identified exception does not represent a control deficiency is appropriate only if evidence beyond what the auditor had initially planned and beyond inquiry supports that conclusion." Paragraph 133 also includes the example that "a control with an observed non-negligible deviation rate is a deficiency." Both these passages in the standard recognize the inherent limitations in internal control. Effective internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting. Because effective internal control over financial reporting cannot, and does not, provide absolute assurance of achieving financial reporting objectives, any individual control does not necessarily have to operate perfectly, all the time, to be considered effective. Therefore, Auditing Standard No. 2 provides the auditor with directions that allow the use of judgment in the circumstances in which he or she is evaluating whether a control testing exception is a control deficiency.

Q14. When a control deficiency exists, what degree of precision is required for a compensating control to effectively mitigate a significant deficiency or material weakness?

A14. As discussed in A13, Auditing Standard No. 2 provides that auditors should evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a significant deficiency or a material weakness. However, to have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that was more than inconsequential or material, respectively.

Q15. Paragraph 9 of Auditing Standard No. 2 defines a significant deficiency as "a control deficiency, or combination of control deficiencies ..." Paragraph 10 defines a material weakness as "a significant deficiency, or combination of significant deficiencies..." The definition of a material weakness, therefore, relies on the definition of significant deficiency. Does this mean that a control deficiency, once determined to be only a control deficiency and not also a significant deficiency, could be excluded from the evaluation of whether a significant deficiency or combination of significant deficiencies constitutes a material weakness?

A15. No. The definitions of significant deficiency and material weakness delineate increasingly severe types of control deficiencies. All significant deficiencies are also deficiencies; all material weaknesses are also significant deficiencies and deficiencies. If the auditor correctly aggregates control deficiencies when evaluating whether a significant deficiency exists, then all related and salient control deficiencies will also be included in the auditor's evaluation of whether a combination of significant deficiencies represents a material weakness. Therefore, whether the definition of a material weakness is expressed as "a significant deficiency, or combination of significant deficiencies…" or as "a control deficiency, or combination of control deficiencies…" is unimportant. Both the meaning and the evaluation are the same.

Multi-Location Issues

Q16. Paragraph 87 of Auditing Standard No. 2 states:

> Appendix B, paragraphs B1 through B17, provide additional direction to the auditor in determining which controls to test when a company has multiple locations or business units. In these circumstances, the auditor should determine significant accounts and their relevant assertions, significant processes, and major classes of transactions based on those that are relevant and significant to the consolidated financial statements. Having made those determinations in relation to the consolidated financial statements, the auditor should then apply the directions in Appendix B.

Paragraph B4 states:

> Because of the importance of financially significant locations or business units, the auditor should evaluate management's documentation of and perform tests of controls over all relevant assertions related to significant accounts and disclosures at each financially significant location or business unit, as discussed in paragraphs 83 through 105 [of the standard].

Does the combination of these directions mean that, for example, if the auditor determines that accounts receivable is a significant account to the consolidated financial statements, the auditor should test controls over all relevant assertions over accounts receivable at every financially significant location or business unit, even if accounts receivable at a particular financially significant location is immaterial?

A16. No. The combination of these directions means that the auditor should determine significant accounts and their relevant assertions based on the consolidated financial statements and perform tests of controls over all relevant assertions related to those significant accounts at each financially significant location or business unit for which the selected accounts are material at the account level. Therefore, the auditor need not test controls over all relevant assertions for a significant account at a financially significant location where the significant account is immaterial. However, if accounts receivable at a location or business unit that is not otherwise considered financially significant represents a risk of material misstatement to the consolidated financial statements, the auditor should test controls over all relevant assertions for accounts receivable at that location. This direction is consistent with the directions in paragraph B6 addressing locations or business units that involve specific risks.

Q17. The multi-location guidance in Appendix B of Auditing Standard No. 2 states that the auditor should test controls over a "large portion" of the company's operations and financial position. Many auditors are referring to specific percentages that represent coverage over a "large portion" of the company's operations and financial position, such as 60 percent or 75 percent. Are these percentages set in Auditing Standard No. 2?

A17. No. Auditing Standard No. 2 does not establish specific percentages that would achieve this level of testing. During the comment period on the proposed standard for the audit of internal control over financial reporting, several commenters suggested that the standard should provide more specific directions regarding the evaluation of whether controls over a "large portion" of the company's operations and financial position had been tested, including establishing specific percentages. The Board decided that balancing auditor judgment with the consistency that would be enforced by increased specificity would be best served by this direction remaining "principles-based." Therefore, Auditing Standard No. 2 leaves to the auditor's judgment the determination of what exactly constitutes a "large portion."

Additionally, the Note to paragraph B11 states that, "the evaluation of whether controls over a large portion of the company's operations or financial position have been tested should be made at the overall level, not at the individual significant account level." For example, if an auditor believes that he or she should test controls over x percent of some measure, that auditor should evaluate whether he or she had tested controls over x percent of the company's consolidated operations or financial position (e.g., x percent of total assets or x percent of revenues) and not x percent of each individual significant account.

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Q18. Is any type of sampling strategy accommodated by the direction to test controls over "a large portion" of financial position or operations?

A18. Yes. The directions in paragraph B11 of Auditing Standard No. 2 that the auditor should test controls over a large portion of the company's operations or financial position are intended as a fail-safe to ensure that every audit of internal control over financial reporting is supported by sufficient evidence. In no case should the auditor find that, in following the directions in paragraphs B1-B10, the auditor could merely test company-level controls without also testing controls over all relevant assertions related to significant accounts and disclosures.

The direction to test controls over a large portion of financial position or operations is easily satisfied at companies in which the auditor's testing of individual financially significant locations or business units clearly covers a large portion. At these types of entities and others, the type of judgment discussed in Q17 in which an auditor determines that he or she should test controls over 60 percent or 75 percent of the company's financial position or operations are readily satisfied. However, in circumstances in which a company has a very large number of individually insignificant locations or business units, testing controls over 60 percent or 75 percent of the company's financial position or operations may result in an extensive amount of work, in which the auditor would test controls over hundreds and even thousands of individual locations to reach that type of percentage target. In circumstances in which a company has a very large number of individually insignificant locations or business units and management asserts to the auditor that controls have been documented and are effective at all locations or business units, the auditor may satisfy the directions in paragraph B11 by testing a representative sample of the company's locations or business units.

The auditor may select the representative sample either statistically or non-statistically. However, the locations or business units should be selected in such a way that the sample is expected to be representative of the entire population. Also, particularly in the case of a non-statistical sample, the auditor's sampling will be based on the expectation of no, or very few, control testing exceptions. In such circumstances, because of the nature of the sample and the control testing involved, the auditor will not have an accurate basis upon which to extrapolate an error or exception rate that is more than negligible. Furthermore, the existence of testing exceptions would not support management's assertion that controls had been documented and were effective at all locations or business units. Therefore, if the auditor elects to use a representative sample in these circumstances and encounters testing exceptions within the sample that exceed a negligible rate, the auditor might decide that testing controls over a very large number of individual locations or business units is necessary to adequately support his or her opinion.

Q19. Paragraphs B16 and B17 of Auditing Standard No. 2 provide direction to the auditor in situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities. The SEC staff's guidance, *Office of the Chief Accountant and Division of Corporation Finance: Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions*, dated June 23, 2004, discusses such situations in Questions 1 and 3. However, that document also instructs management to refer in its report on internal control over financial reporting to disclosure in its Form 10-K or Form 10-KSB regarding the scope of management's assessment and any entity excluded from the scope. How does this disclosure by management in its report affect the directions in Auditing Standard No. 2 that instruct the auditor, in these situations, to report without reference to the limitation in scope?

A19. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the scope paragraph in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting.

Using the Work of Others

Q20. Auditing Standard No. 2 allows the auditor to use the work of others to alter the nature, timing, or extent of the work the auditor would otherwise have performed. If the auditor plans to use the work of others, he or she should, among other things, test some of the work performed by others to evaluate the quality and effectiveness of the work. In performing this testing, does the auditor need to test the work of others in every significant account in which the auditor plans to use their work?

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A20. No. Auditing Standard No. 2 establishes a framework for using the work of others based on evaluating the nature of the controls, evaluating the competence and objectivity of the individuals who performed the work, and testing some of the work performed by others to evaluate the quality and effectiveness of their work. Within this framework, the amount of testing of the work of others should be sufficient to enable the auditor to evaluate the overall quality and effectiveness of their work. Auditing Standard No. 2 provides flexibility in this regard; testing the work of others in every significant account in which the auditor plans to use their work is not required. Furthermore, if the auditor believes that extensive testing of the work of others is necessary in every area in which the auditor plans to use their work, the auditor should keep in mind the directions in paragraph 124 of Auditing Standard No. 2. Those directions state that the auditor should also assess whether the evaluation of the quality and effectiveness of the work of others has an effect on the auditor's conclusions about the competence and objectivity of the individuals performing the work. If the auditor determines the need to test the work of others to a high degree, the auditor should consider whether his or her original assessment of their competence and objectivity is correct.

Q21. Paragraph 108 of Auditing Standard No. 2 requires the auditor to perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. Does the auditor's testing of the work of others "count" toward the auditor obtaining the principal evidence supporting his or her opinion?

A21. No. As described in paragraph 109 of Auditing Standard No. 2, to determine the extent to which the auditor may use the work of others to alter the nature, timing, or extent of the work the auditor would have otherwise performed, *in addition to obtaining the principal evidence for his or her opinion*, the auditor should, among other things, test some of the work performed by others to evaluate the quality and effectiveness of their work. Therefore, the auditor's testing of the work of others is not considered to be part of the principal evidence obtained by the auditor. As described in A20, if the auditor determines the need to test the work of others to a high degree, the auditor should consider whether his or her original assessment of their competence and objectivity is correct.

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Q22. Paragraph 123 of Auditing Standard No. 2 states that the auditor's tests of the work of others may be accomplished by either (a) testing some of the controls that others tested or (b) testing similar controls not actually tested by others. Based on the response in A21, regardless of whether the auditor tested some of the controls tested by others or tested similar controls not actually tested by others ("independent testing"), if the objective of that testing is to evaluate the quality and effectiveness of the work of others, that testing should not be considered as part of the principal evidence obtained by the auditor. However, does the auditor's independent testing in areas in which the auditor is using the work of others count as principal evidence if the independent tests are not for the purpose of assessing the quality and effectiveness of the work of others?

> **A22.** Yes. The auditor's independent testing in these circumstances may be considered as work performed by the auditor when evaluating whether the auditor obtained the principal evidence supporting his or her opinion, but only if these independent tests are not for the purpose of assessing the quality and effectiveness of the work of others. If the independent tests are for the purpose of assessing the quality and effectiveness of the work of others, then the independent tests should not be considered as work performed by the auditor when evaluating whether the auditor obtained the principal evidence supporting his or her opinion.

Q23. Paragraphs 113 through 115 of Auditing Standard No. 2 describe the auditor's evaluation of the nature of the controls subjected to the work of others when determining how to use the work of others to alter the nature, timing, or extent of the work the auditor would otherwise have performed. Those paragraphs state that the auditor should not use the work of others to reduce the amount of work he or she performs on controls in the control environment. Further, those directions state that controls that are part of the control environment include, but are not limited to, controls specifically established to prevent and detect fraud that is at least reasonably possible to result in a material misstatement of the financial statements. How do these directions regarding the auditor's testing of controls specifically established to prevent and detect fraud relate to the auditor's responsibilities in AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*?

> **A23.** Paragraph 26 of Auditing Standard No. 2 generally describes how the auditor's evaluation of controls in an audit of internal control over financial reporting is interrelated with the auditor's evaluation of fraud risks in a financial

statement audit as required by AU sec. 316. AU sec. 316 requires, among other things, that the auditor identify risks that may result in a material misstatement of the financial statements due to fraud and that the auditor should respond to those identified risks. AU sec. 316 emphasizes that the auditor's response to the risks of material misstatement due to fraud involves the application of professional skepticism when gathering and evaluating evidence. The auditor also is required to respond to the results of the fraud risk assessment in three ways:

a. A response that has an overall effect on how the audit of the financial statements is conducted, that is, a response involving more general considerations apart from the specific procedures otherwise planned.

b. A response to identified risks that involves the nature, timing, and extent of auditing procedures to be performed.

c. A response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls.

The relationship of these requirements with the directions in Auditing Standard No. 2 regarding the auditor's use of the work of others may be illustrated by several examples.

First, AU sec. 316 establishes a presumption that there is a risk of material misstatement due to fraud relating to revenue recognition. If the auditor does not overcome this presumption, as would frequently be the case with, for example, software revenue recognition, the auditor should test the controls specifically established to prevent and detect fraud related to a material misstatement of the company's revenue recognition himself or herself.

Because material misstatement due to fraud often involves manipulation of the financial reporting process by management, AU sec. 316 also requires the auditor to review journal entries and other adjustments for evidence of material misstatement due to fraud. Paragraph 112 of Auditing Standard No. 2 includes as one of the factors that the auditor should evaluate when evaluating the nature of the controls subjected to the work of others "the potential for management

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override of the control." Taken together, these directions mean that obtaining the understanding of the design of controls over journal entries and other adjustments and determining whether they are suitably designed and have been placed in operation, as required by AU sec. 316, and performing any associated testing of those controls that the auditor determines is necessary when auditing internal control over financial reporting under Auditing Standard No. 2, should be performed by the auditor himself or herself. However, Auditing Standard No. 2 emphasizes that, although the auditor should not use the work of others in this situation, the auditor should consider the results of work performed in the area by others because it might indicate the need for the auditor to increase his or her work.

Service Organizations

Q24. What types of outsourcing activities result in a service organization arrangement addressed by Statement on Auditing Standards ("SAS") No. 70, *Service Organizations* (AU sec. 324)? What types of outsourcing activities are part of a company's internal control over financial reporting?

A24. As described in paragraph .03 of AU sec. 324, a service organization's services are part of a company's information system if they affect any of the following:

- The classes of transactions in the company's operations that are significant to the company's financial statements.
- The procedures, both automated and manual, by which the company's transactions are initiated, authorized, recorded, processed, and reported from their incurrence to their inclusion in the financial statements.
- The related accounting records, whether electronic or manual, supporting information and specific accounts in the company's financial statements involved in initiating, authorizing, recording, processing and reporting the company's transactions.

- How the company's information system captures other events and conditions that are significant to the financial statements.

- The financial reporting process used to prepare the company's financial statements, including significant accounting estimates and disclosures.

Paragraph .03 of AU sec. 324 also provides examples of situations in which a service organization's services affect a company's information system. For instance, the trust departments of banks and insurance companies often serve as the custodian of an employee benefit plan's assets, including making investment decisions, maintaining records of each participants account, allocating income amongst participants, and preparing other types of recordkeeping; this type of servicing is a common example of a service organization's services that affect a company's information system. In contrast, AU sec. 324 does not apply to situations in which the services being provided are limited to executing client organization transactions that the client specifically authorizes. For example, the processing of checking account transactions or wire transfer instructions by a bank would not constitute a service organization arrangement. Paragraph .03 of AU sec. 324 also excludes other types of transactions, such as transactions arising from joint ventures, from the scope of a service organization arrangement addressed by AU sec. 324.

All of the examples of outsourcing activities in paragraph .03 of AU sec. 324 (which are not an exhaustive listing of all types of possible outsourcing activities) are part of the company's information system. However, not all outsourcing activities are a part of the company's information system. In addition to the arrangements described in paragraph .03 of AU sec. 324 to which AU sec. 324 does *not* apply, the use of a specialist is not part of a company's information system. For example, a company might outsource actuarial services; however, the nature of the services represents the use of a specialist, and the actuary is not a part of the company's information system.

If the service organization's services are part of a company's information system, then they are part of the information and communication component of the company's internal control over financial reporting. In those circumstances, management should consider the activities of the service organization in making its assessment of internal control over financial reporting, and the auditor should consider the activities of the service organization in determining the evidence required to support his or her opinion. Appendix B of Auditing Standard No. 2 provides additional directions regarding the procedures management and the auditor should perform with respect to activities performed by the service organization.

Q25. Auditing Standard No. 2 indicates that evidence about the operating effectiveness of controls at a service organization can be obtained from a Type 2 SAS No. 70 report. Is a Type 2 SAS No. 70 report issued more than six months prior to the date of management's assessment current enough to provide any such evidence?

A25. Paragraphs B25 through B27 provide directions when a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment. These directions do not establish any "bright lines." In other words, application of the directions does not result in a precise answer as to whether a service auditor's report issued more than six months prior to the date of management's assessment is not current enough to provide *any* evidence. Rather, these directions state that, when a significant period of time has elapsed between the time period covered by the tests of controls in the service auditor's report and the date of management's assessment, additional procedures should be performed.

Paragraph B26 provides directions to the auditor in determining whether to obtain additional evidence about the operating effectiveness of controls at the service organization. The auditor's procedures to obtain additional evidence will typically be more extensive the longer the period of time that has elapsed between the time period covered by the service auditor's report and the date of management's assessment. Also, those auditor's procedures will vary depending on the importance of the controls at the service organization to management's assessment and on the level of interaction between the company's controls and the controls at the service organization.

The auditor's procedures will be focused on, among other things, identifying changes in the service organization's controls subsequent to the period covered by the service auditor's report. The auditor should be alert for situations in which management has not made changes to its procedures and controls to respond to changes in procedures and controls at the service organization. These situations might result in errors not being prevented or detected in a timely manner.

Q26. Can a registered public accounting firm in the integrated audit of an issuer obtain evidence from a service auditor's report issued by a non-registered public accounting firm?

A26. Yes. Paragraph B24 of Auditing Standard No. 2 directs the auditor to make inquiries concerning the service auditor's reputation, competence, and independence in determining whether the service auditor's report provides sufficient evidence to support management's assessment and the auditor's opinion on internal control over financial reporting. Auditing Standard No. 2 does not require that the service auditor be a registered public accounting firm.

The auditor should be aware of how evidence obtained from a service auditor's report issued by a non-registered firm interacts with the Board's registration rules. Any public accounting firm that "plays a substantial role in the preparation or furnishing of an audit report" with respect to any issuer must register with the Board. Because of the nature of the service auditor's report (the user auditor could have performed tests of controls at the service organization himself or herself but, instead, may have chosen to obtain evidence from a service auditor's report), when a registered public accounting firm obtains evidence from a service auditor's report in the audit of an issuer, the service auditor has participated in the audit of the issuer. If the service auditor's work, measured in terms of either services or procedures, meets the "substantial role" threshold (as defined in Rule 1001(p)(ii)) for the audit of the user organization, the service auditor is required to be registered with the Board.