PCAOB
Public Company Accounting Oversight Board

1666 K Street, N.W.
Washington, DC 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org

STAFF QUESTIONS AND ANSWERS

AUDITING INTERNAL CONTROL OVER FINANCIAL REPORTING

November 22, 2004

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 sequentially numbered upon issuance. Staff questions and answers numbered 1-26 were issued June 23, 2004, and staff questions and answers numbered 27-29 were issued October 6, 2004. Additional 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).

* * *

Scope and Extent of Testing

Q30. Paragraphs 182-185 of Auditing Standard No. 2 provide directions regarding opinions based, in part, on the report of another auditor. Paragraph 182 of Auditing Standard No. 2 states that if the auditor decides it is appropriate to serve as the principal auditor of the financial statements, then that auditor also should be the principal auditor of the company's internal control over financial reporting. When

STAFF QUESTIONS & ANSWERS

another auditor has been engaged to audit the financial statements of a subsidiary, division, branch, or component of the company, must the other auditor also audit internal control over financial reporting in accordance with Auditing Standard No. 2? In other words, is the other auditor required to perform an integrated audit of the financial statements and internal control over financial reporting to satisfy the principal auditor's obligation to report on the consolidated financial statements and internal control over financial reporting?

A30. No. There are a number of ways in which the principal auditor can satisfy his or her obligation to report on the consolidated financial statements and internal control over financial reporting, three of which are described below.

- The other auditor may be engaged to perform an integrated audit of the financial statements and internal control over financial reporting. In this instance, the principal auditor must decide whether he or she will assume responsibility for the work of the other auditor. If the principal auditor assumes responsibility for the work of the other auditor, the principal auditor will not refer to the work of the other auditor in his or her report. If the principal auditor decides to divide responsibility with the other auditor, the principal auditor will refer to the other auditor in his or her report. The directions in paragraph 184 of Auditing Standard No. 2 allow the principal auditor to assume responsibility for the audit of the financial statements or the audit of internal control over financial reporting, or both, or neither. If the principal auditor decides to make reference to the other auditor in his or her report on the audit of internal control over financial reporting, then the other auditor must perform an integrated audit of internal control over financial reporting and the financial statements and separately issue a report in accordance with Auditing Standard No. 2.

- The principal auditor may direct the other auditor to perform specified procedures related to internal control over financial reporting at the subsidiary, division, branch, or component of the company based on the significance of the internal control over financial reporting of the subsidiary, division, branch, or component in relation to the internal control over financial reporting of the consolidated entity as a whole. This approach may save costs as compared to performing an integrated audit of the subsidiary while still achieving the same overall reporting objective.

In this case, the principal auditor must assume responsibility for the specified procedures and should follow the directions in Appendix B of Auditing Standard No. 2 regarding tests to be performed when a company has multiple locations or business units.

- The principal auditor may perform procedures at the subsidiary, division, branch, or component of the company that he or she considers necessary to be able to express an opinion on the internal control over financial reporting on a consolidated basis. In this case, the principal auditor should follow the directions in Appendix B of Auditing Standard No. 2 regarding tests to be performed when a company has multiple locations or business units.

Of course, if the subsidiary is itself an issuer subject to Section 404 of the Act and is audited by another auditor, the other auditor must perform an audit of internal control over financial reporting and the financial statements in accordance with Auditing Standard No. 2.

Q31. The Securities and Exchange Commission ("SEC") and the staffs of the Federal Deposit Insurance Corporation ("FDIC"), the Federal Reserve Board, the Office of Thrift Supervision, and the Office of the Comptroller of the Currency have stated that insured depository institutions ("IDIs") that are subject to the internal control reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act ("FDICIA")[1/] as well as the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002 ("the Act") may choose either of the following two options for satisfying both sets of requirements –

1. They can prepare two separate management reports to satisfy the requirements of FDICIA and Section 404 of the Act; or

[1/] See Section 36 of the Federal Deposit Insurance Act and its implementing regulation, 12 CFR Part 363.

STAFF QUESTIONS & ANSWERS

2. They can prepare a single management report that satisfies both the requirements of FDICIA and Section 404 of the Act.[2/]

If an IDI or its holding company elects to prepare a single report to satisfy both sets of requirements, the reports of management and the auditor on the IDI's or the holding company's internal control over financial reporting must address the requirements of both sets of rules.[3/]

In Financial Institution Letter ("FIL") 86-94, *Additional Guidance Concerning Annual Audits, Audit Committees and Reporting Requirements*, the FDIC indicated that financial reporting, at a minimum, includes financial statements prepared under generally accepted accounting principles ("GAAP") and the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report (for example, Schedules RC, RI and RI-A in the Call Report). Accordingly, to comply with FDICIA, management of the IDI (or holding company)[4/] and the auditor should identify and test controls over the preparation of GAAP-basis financial statements as well as the schedules equivalent to the basic financial statements that are included in the IDI's (or holding company's) appropriate regulatory report. Further, either management, or the auditor, or both, should include in their report on the IDI's internal control over financial reporting a specific description indicating that the scope of internal control over financial reporting included controls over the preparation of the IDI's GAAP-basis financial statements as well the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report.

[2/] See Section II.H.4 of Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636], *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports.*

[3/] See Section II.H.4 of Securities and Exchange Commission Release No. 33-8238 (June 5, 2003) [68 FR 36636], *Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports,* for further discussion of how the requirements of FDICIA and Section 404 of the Act differ and what a single report by management would have to cover.

[4/] See FIL 86-94 for further discussion of the holding company exemption for FDICIA reporting purposes and its application as it relates to controls over the preparation of "regulatory reports."

STAFF QUESTIONS & ANSWERS

As discussed in Staff Answer No. 5, 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 GAAP. When performing an audit of internal control over financial reporting in accordance with Auditing Standard No. 2 for the purpose of satisfying an IDI's reporting obligations under both Section 404 of the Act and FDICIA, may an auditor expand his or her testing to include an IDI's controls over the preparation of schedules equivalent to the basic financial statements included in the IDI's appropriate regulatory report? May the auditor modify the wording of his or her report to communicate this expansion?

A31. Yes. When performing an audit of internal control over financial reporting in accordance with Auditing Standard No. 2 for the purpose of satisfying an IDI's reporting obligations under both Section 404 of the Act as well as FDICIA, the auditor may expand his or her audit to include the IDI's controls over the preparation of schedules equivalent to the basic financial statements included in the IDI's appropriate regulatory report.

When expanding the audit of internal control over financial reporting in this manner, the auditor should be aware that he or she should test controls over the preparation of the schedules in the IDI's regulatory report to determine whether they are effective. Auditors of IDIs frequently perform a substantive test of these schedules by reconciling the schedules that are equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report to the IDI's GAAP-basis financial statements. As discussed in paragraph 158 of Auditing Standard No. 2, the absence of misstatements detected by substantive procedures does not provide evidence that controls related to the assertion being tested are effective. The effectiveness of controls should be tested directly. Also, as discussed in paragraph 96 of Auditing Standard No. 2, the nature of the tests of controls should be beyond inquiry alone.

Additionally, paragraph 76 of Auditing Standard No. 2 describes the period-end financial reporting process as including the procedures for drafting annual and quarterly financial statements and related disclosures. Accordingly, when the audit of internal control over financial reporting has been expanded to include the IDI's controls over the preparation of schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report, the auditor

should test controls over the preparation of those schedules in the IDI's annual and interim regulatory reports.

When the auditor expands his or her audit of internal control over financial reporting to include the IDI's controls over the preparation of schedules equivalent to the basic financial statements included in the IDI's appropriate regulatory report, the auditor's report may be modified to indicate this. For example, the auditor could add the following sentence as the second sentence of the definition paragraph of the auditor's report for a bank holding company:

> Because management's assessment and our audit were conducted to also meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), management's assessment and our audit of W Company's internal control over financial reporting included controls over the preparation of financial statements in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9 C).[5/]

The staff believes that this type of change to the auditor's report would communicate appropriately the expanded nature of the audit of internal control over financial reporting to meet the requirements of both Section 404 of the Act and FDICIA and satisfy the reporting elements described in paragraph 167 of Auditing Standard No. 2. The auditor might determine that changes to his or her report other than the one illustrated above also could accomplish the same objectives.

[5/] This sentence would be modified if the reporting entity was an IDI rather than a bank holding company to refer to the Federal Financial Institutions Examination Council instructions for Consolidated Reports of Condition and Income ("call report instructions") or Office of Thrift Supervision Instructions for Thrift Financial Reports ("TFR instructions") instead of to the FR Y-9C. This sentence also would be modified if the IDI employed another approach to reporting on controls over the preparation of regulatory reports as permitted by FIL 86-94.

STAFF QUESTIONS & ANSWERS

Evaluating Deficiencies

Q32. The definitions of significant deficiency and material weakness in paragraphs 9 and 10, respectively, of Auditing Standard No. 2 address the likelihood and magnitude of misstatements of the annual or interim financial statements. Therefore, the auditor should evaluate the possible effects of identified control deficiencies on both the annual and interim financial statements to determine whether the control deficiencies, individually or in combination, represent significant deficiencies or material weaknesses. Does this responsibility have any effect on either the scope or timing of the auditor's procedures in an audit of internal control over financial reporting?

> **A32.** No. As discussed in paragraph 147 of Auditing Standard No. 2, the auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a point in time. Additionally, paragraph E92 of Auditing Standard No. 2 points out that an evaluation of internal control over financial reporting as of year end encompasses controls over the annual financial reporting and quarterly financial reporting as such controls exist at that point in time. Although the auditor should obtain evidence about the internal control over financial reporting over a sufficient period of time, as discussed in paragraph 148 of the standard, the auditor has flexibility in determining the timing of his or her testing. Further, the auditor is required by paragraph 130 of Auditing Standard No. 2 to reach a conclusion regarding the significance of all identified control deficiencies only as of the date of the assessment (i.e., as of year end). This is consistent with the directions in paragraphs 98-103 of Auditing Standard No. 2 regarding the timing of tests of controls. Although the auditor might reach a conclusion regarding the significance of a control deficiency as of an earlier date, an earlier conclusion is not required by Auditing Standard No. 2.

Q33. Paragraph 207 of Auditing Standard No. 2 states that the auditor must communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit. Paragraph 214 states that when timely communication is important, the auditor should communicate significant deficiencies and material weaknesses during the course of the audit rather than at the end of the engagement. In light of these directions, can the auditor strictly limit his or her communication of significant deficiencies and material weaknesses to those that exist of as the date of management's assessment? For example, can the auditor exclude from this communication any significant deficiencies and material weaknesses of which the auditor was aware during the course of his or her audit but

that did not exist as of the date of management's assessment because they were corrected?

A33. No. The directions in paragraph 207 refer to "significant deficiencies and material weaknesses identified during the audit" — not significant deficiencies and material weaknesses existing as of the date of management's assessment. The auditor, therefore, must include in his or her written communication to management all significant deficiencies and material weaknesses that exist as of the date of management's assessment as well as significant deficiencies and material weaknesses that the auditor becomes aware of as of an interim date that have not yet been corrected as of that interim date.

This communication requirement was designed with several objectives in mind. First, it is important for the auditor to communicate all significant deficiencies and material weaknesses that the auditor believes exist as of year end to enable management and the audit committee to understand whether the auditor, in his or her independent judgment, has reached similar conclusions as management regarding the severity of deficiencies that exist as of year end. It is also important for the auditor to communicate any conditions that the auditor believes are significant deficiencies and material weaknesses as of an interim date (as described in paragraph 214) so that management and the audit committee can take corrective action as soon as possible. In this manner, management might be able to correct a significant deficiency or material weakness identified by the auditor in advance of the date of management's annual assessment required by Section 404(a) of the Act.

The need to communicate significant deficiencies and material weaknesses identified as of an interim date, however, is limited by several aspects of Auditing Standard No. 2. As described in Staff Answer No. 32, the auditor is required by paragraph 130 of Auditing Standard No. 2 to reach a conclusion regarding the significance of all identified control deficiencies only as of the date of the assessment (i.e., as of year end). Although the auditor might reach a conclusion regarding the significance of a control deficiency as of an earlier date, an earlier conclusion is not required by Auditing Standard No. 2. The audit of internal control over financial reporting is an annual, not a quarterly, process. Also, because the objective of a timely auditor communication regarding significant deficiencies and material weaknesses is to enable management and the audit committee to take corrective action as soon as possible, there is no need for the

STAFF QUESTIONS & ANSWERS

auditor to communicate significant deficiencies and material weaknesses as of an interim date when the auditor becomes aware of their existence only because management already has identified them as significant deficiencies or material weaknesses and begun corrective action.

Therefore, the auditor's responsibility to communicate in writing to management and the audit committee all significant deficiencies and material weaknesses identified during the audit encompasses (1) all significant deficiencies and material weaknesses that exist as of the date of the assessment and (2) any deficiencies that the auditor concludes, as of an earlier date, are significant deficiencies or material weaknesses and that management has not also identified as significant deficiencies or material weaknesses and begun corrective action upon as of the interim date.

Q34. Paragraph 142 of Auditing Standard No. 2 states that the auditor should obtain a representation from management that, among other matters, management has disclosed to the auditor all deficiencies in the design or operation of internal control over financial reporting identified as part of management's assessment, including separately disclosing to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses. Can the auditor accept this representation from management if management has communicated only deficiencies, including those that are significant deficiencies and material weaknesses, that exist as of the date of management's assessment?

A34. No. This representation contemplates that management has disclosed to the auditor all deficiencies in internal control over financial reporting identified as part of management's assessment, regardless of whether the deficiencies have been corrected as of the date of management's assessment.

Management already is required by other provisions of the Act and the SEC's associated implementing rules to communicate all significant deficiencies and material weaknesses to the auditor and the audit committee. The representation in paragraph 142 was intended to close what some commenters on the Board's proposed internal control standard perceived as a loophole: that management could conceal a deficiency from the auditor by concluding that it was only a deficiency and, therefore, was not captured by other communication requirements for management to communicate significant deficiencies and material weaknesses to the auditor and the audit committee. When the auditor

obtains the representation from management described in paragraph 142 that management has communicated to the auditor all deficiencies in internal control over financial reporting identified as part of management's assessment, the auditor has the ability (and responsibility) to evaluate, in his or her own judgment, (1) whether those deficiencies exist as of the date of management's assessment and, if so (2) the severity of those deficiencies. This is an important part of the auditor obtaining sufficient evidence supporting his or her opinion about the effectiveness of internal control over financial reporting.

Management may, of course, communicate all deficiencies in internal control over financial reporting identified as part of management's assessment throughout the course of management's assessment process and in a number of different forms. The staff expects that management would not ordinarily need to assemble a separate documentation package solely for the purpose of representing that it has disclosed to the auditor all identified deficiencies in internal control. In most circumstances, management's documentation of its assessment would be sufficient for communicating all deficiencies to the auditor. For example, if management uses a database to accumulate and document all identified control deficiencies, management could grant the auditor continuous access to management's database. Further, some issuers might correct identified control deficiencies prior to year end without reaching a conclusion as to their severity. In this case, the significance of the deficiency would be irrelevant in terms of management's year-end conclusion as part of its assessment of internal control over financial reporting because the deficiency would not exist as of year end. Management's representation that it has separately disclosed to the auditor all such deficiencies that it believes to be significant deficiencies or material weaknesses does not, by itself, obligate management to conclude on the severity of a deficiency that it otherwise would not have concluded upon.

Q35. Paragraph 50 of Auditing Standard No. 2 states that some controls might have a pervasive effect on the achievement of many overall objectives of the control criteria. For example, information technology ("IT") general controls over program development, program changes, computer operations, and access to programs and data help ensure that specific controls over the processing of transactions are operating effectively. IT general controls whose design or operation is ineffective would, of course, be deficiencies. The definitions of significant deficiency and material weakness, however, focus on the likelihood and magnitude of financial statement misstatement. IT general

controls, by their nature, do not affect a company's financial statements directly. How should the significance of deficiencies in IT general controls be evaluated?

A35. To evaluate the significance of a deficiency in IT general controls, the effect of the deficiency on application controls should be evaluated. Application controls can be automated control procedures (for example, calculations, posting to accounts, generation of reports, edits, and control routines) performed by IT. When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include automated application controls related to the corresponding assertions for significant accounts or disclosures. Application controls also may be manual controls that are dependent on IT (for example, the review by an inventory manager of an exception report when the exception report is generated by IT). Although IT general control deficiencies do not result in financial statement misstatements directly, an associated ineffective application control may lead to misstatements. Therefore, the significance of an IT general control deficiency should be evaluated in relation to its effect on application controls, that is, whether the associated application controls are ineffective.

An application control might be effective even if deficiencies exist in IT general controls. For example, in the presence of deficient program change controls, management and the auditor might be able to determine that, in the circumstances, the relevant application controls were operating effectively as of the date of management's assessment. In this case, the deficiency in IT general controls could be classified as only a deficiency. On the other hand, deficient program change controls might result in unauthorized changes to application controls, in which case the application controls are ineffective. In this case, the ineffective program change controls, combined with the ineffective application controls, should be evaluated in terms of likelihood and magnitude of potential financial statement misstatement. In this manner, the combined effect of the ineffective IT general control and the ineffective application control(s) could be classified as either a significant deficiency or a material weakness for both the application control and the related IT general control.

The definitions of significant deficiency and material weakness also contain aggregation concepts: a control deficiency, *or combination of control deficiencies*, can represent a significant deficiency or material weakness. After an IT general control deficiency has been evaluated in relation to its effect on application

controls, it also should be evaluated when aggregated with other control deficiencies. For example, all deficiencies affecting the control environment should be evaluated in the aggregate. Management's decision not to correct an IT general control deficiency and its associated reflection on the control environment, when aggregated with other deficiencies affecting the control environment, could lead to the conclusion that a significant deficiency or material weakness in the control environment exists.

An IT general control deficiency in the absence of an application control deficiency could be classified as only a control deficiency. Based on the directions in paragraph 137, the auditor also could determine that a prudent official in the conduct of his or her own affairs would conclude that the IT general control deficiency, by itself, was a significant deficiency. In this manner, an IT general control deficiency, by itself, could be covered by paragraph 140 of Auditing Standard No. 2, which states that significant deficiencies that have been communicated to management and the audit committee that remain uncorrected after some reasonable period of time are strong indicators of a material weakness.

Using the Work of Others

Q36. Auditing Standard No. 2 allows the auditor to use the work of others to alter the nature, timing, and extent of work he or she otherwise would have performed. Paragraph 109 of Auditing Standard No. 2 states that the auditor may apply the relevant concepts of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*,[6/] to using the work of others in the audit of internal control over financial reporting. AU sec. 322 allows the auditor to use internal auditors to provide direct assistance in an audit of the financial statements. Can the auditor use

---

[6/] 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.

STAFF QUESTIONS & ANSWERS

internal auditors to provide direct assistance in the audit of internal control over financial reporting?

A36. Yes. The reference to AU sec. 322 in paragraph 109 of Auditing Standard No. 2 means that the auditor can use internal auditors to provide direct assistance in the audit of internal control over financial reporting. AU sec. 322 further describes using internal auditors as direct assistance.

Paragraph 108 of Auditing Standard No. 2, however, states that the auditor must perform enough of the testing himself or herself so that the auditor's own work provides the principal evidence for the auditor's opinion. Because the auditor is not performing the testing himself or herself when internal auditors provide direct assistance, testing performed by internal auditors as direct assistance does not qualify as part of the principal evidence supporting the auditor's opinion.

Similarly, paragraph 116 of Auditing Standard No. 2 states that the auditor should perform the walkthroughs (described beginning at paragraph 79) himself or herself because of the degree of judgment required in performing this work. Therefore, the auditor may not use internal auditors as direct assistance for the walkthroughs that the auditor determines are necessary. Also, as described in paragraph 113, 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 because of the nature of the controls in the control environment. Accordingly, the auditor cannot use direct assistance provided by internal auditors to reduce the amount of work the auditor performs himself or herself on controls in the control environment.

Therefore, when the auditor uses internal auditors to provide direct assistance in the audit of internal control over financial reporting, the auditor should determine the extent to which this direct assistance alters the nature, timing and extent of the work the auditor would otherwise have performed by following the directions in paragraphs 108-126 of Auditing Standard No. 2 regarding using the work of others. For example, consistent with the example in paragraph 126 regarding management self-assessment of controls, the auditor should not use internal auditors to provide direct assistance to test controls the internal auditor tested as part of management's assessment.