
STAFF QUESTIONS AND ANSWERS

AUDITING INTERNAL CONTROL OVER FINANCIAL REPORTING

October 6, 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. Refer to the staff questions and answers dated June 23, 2004 for questions numbered 1-26. Additional questions should be directed to Laura Phillips, Associate Chief Auditor (202/207-9111; phillips1@pcaobus.org) or Greg Fletcher, Assistant Chief Auditor (202/207-9203; fletchergr@pcaobus.org).

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Scope and Extent of Testing

Q27. Paragraph .05 of AU sec. 317, *Illegal Acts by Clients*^{1/}, states the following:

^{1/} The Board adopted the generally accepted auditing standards, as described in the American Institute of Certified Public Accountants' ("AICPA") Auditing Standards Board's ("ASB") Statement on Auditing Standards No. 95, *Generally*

STAFF QUESTIONS & ANSWERS

The auditor considers laws and regulations that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts. For example, tax laws affect accruals and the amount recognized as expense in the accounting period; applicable laws and regulations may affect the amount of revenue accrued under government contracts.

Paragraph 15 of Auditing Standard No. 2 states:

Also, operations and compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements are encompassed in internal control over financial reporting.... Accordingly, all controls that could materially affect financial reporting, including controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations and also have a material effect on the reliability of financial reporting, are a part of internal control over financial reporting.

Paragraph 15 of Auditing Standard No. 2 does not use the phrase, "direct and material effect on the determination of financial statement amounts," used in AU sec. 317. Does the scope of internal control over financial reporting as it relates to compliance with laws and regulations under Auditing Standard No. 2 encompass controls over a broader array of circumstance than those circumstances described in AU sec. 317?

A27. Yes. Paragraph 15 of Auditing Standard No. 2 does not include the phrase, "direct and material effect on the determination of financial statement amounts," because this paragraph in Auditing Standard No. 2 encompasses controls over a broader array of circumstances than those described in AU sec. 317. Paragraph 15 of Auditing Standard No. 2 also is consistent with the Securities and Exchange Commission ("SEC") staff's views about management's responsibilities for assessing internal control over financial reporting.

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

The statement in Auditing Standard No. 2 that "compliance with laws and regulations directly related to the presentation of and required disclosures in financial statements are encompassed in internal control over financial reporting" includes the "direct and material" effects described in AU sec. 317, such as compliance with tax laws that affect accruals and the amount recognized as expense in the accounting period, as well as some circumstances that would be classified under AU sec. 317 as having only indirect effects on the financial statements.

Regarding the possible accrual or disclosure of a contingency under Financial Accounting Standards Board ("FASB") Statement No. 5, *Accounting for Contingencies*, related to the violation of laws or regulations, a circumstance might have a material effect on the reliability of financial reporting and, therefore, be encompassed by internal control over financial reporting under Auditing Standard No. 2 and, at the same time, have a material, but indirect, effect on the financial statements under AU sec. 317. AU sec. 317.07 states that if specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect on the financial statements, the auditor should apply auditing procedures specifically directed to ascertaining whether an illegal act has occurred. In the absence of such information, the auditor does not need to perform any procedures other than those procedures required by AU sec. 317.08. On the other hand, Auditing Standard No. 2 encompasses controls over compliance with laws and regulations that have a material effect on the reliability of financial reporting. Therefore, internal control over financial reporting encompasses controls over the identification, measurement, and reporting of all material actual loss events which have occurred, including controls over the monitoring and risk assessment of areas in which, given the nature of the company's operations, such actual loss events are reasonably possible. For example, internal control over financial reporting at a waste disposal company ordinarily would encompass controls for identifying and measuring environmental liabilities for existing and newly acquired landfills, even if there is no governmental investigation or enforcement proceeding underway.

As previously mentioned, this interpretation is consistent with the SEC staff's views regarding management's responsibilities for assessing internal control over

STAFF QUESTIONS & ANSWERS

financial reporting. Question 10 of 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 Certification of Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions*, dated June 23, 2004 (as amended October 6, 2004), discusses these views.

Evaluating Deficiencies

Q28. Paragraph 20 of Auditing Standard No. 2 states that for the auditor to satisfactorily complete an audit of internal control over financial reporting, management must fulfill several responsibilities, including evaluating the effectiveness of the company's internal control over financial reporting and supporting its evaluation with sufficient evidence.

Paragraphs 178 and 179 of Auditing Standard No. 2 describe situations in which there are restrictions on the scope of the auditor's engagement. Paragraphs B14-B17 of Appendix B of Auditing Standard No. 2 describe special situations and address whether the scope of the evaluation of internal control over financial reporting extends to controls in these special situations. Appendix B also describes the situation in which a service organization's controls are part of the company's internal control over financial reporting.

There may be circumstances in which management's assessment and the auditor's audit procedures do not encompass certain controls that should have been encompassed because neither management nor the auditor has the ability to evaluate those controls. For example, both management and the auditor may determine that it is necessary in the circumstances to obtain evidence of operating effectiveness of controls at a service organization used by the issuer but are unable to obtain such evidence because a Type 2 Statement on Auditing Standards ("SAS") 70 report is not available, and neither management nor the auditor is able to perform tests of controls at the service organization because management does not have a contractual right to do so.

What effects do these circumstances have on the auditor's evaluation of management's assessment and the auditor's report?

A28. Question 19 of 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 Certification of Disclosure in Exchange Act*

STAFF QUESTIONS & ANSWERS

Periodic Reports, Frequently Asked Questions, dated June 23, 2004 (as amended October 6, 2004), states that management cannot issue a report on internal control over financial reporting with a scope limitation, subject to the exceptions in Questions 1, 2, and 3 of that document. Management must determine whether the inability to assess controls over a particular process is significant enough to conclude in their report that internal control over financial reporting is ineffective. Consistent with the answer to the aforementioned Question 19, management's assessment of the effectiveness of the company's internal control over financial reporting required by Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") is part of the control environment and monitoring components of internal control over financial reporting. Accordingly, management's inability to assess certain controls over financial reporting that should have been included in management's assessment, represents a control deficiency in the control environment and monitoring components of internal control over financial reporting. As described in paragraph 130 of Auditing Standard No. 2, the auditor must evaluate the significance of all identified control deficiencies. If the transaction or events subject to controls that management is unable to assess are material to the company's financial statements, the auditor ordinarily would determine that this control deficiency represents a material weakness. In this case, the auditor would not follow the directions in paragraphs 178-179 of Auditing Standard No. 2 on scope limitations; rather, he or she would follow the directions in paragraphs 175-177 on material weaknesses.

The auditor also would need to determine whether management's inability to assess certain controls was such that management had not fulfilled its responsibilities to evaluate the effectiveness of the company's internal control over financial reporting and support its evaluation with sufficient evidence, as described in paragraph 20 of Auditing Standard No. 2. If the auditor determines that management has not fulfilled its responsibilities, paragraph 21 of Auditing Standard No. 2 requires the auditor to disclaim an opinion. In making this determination, the auditor could evaluate factors such as:

- The date of the contract or other transaction documents that could have provided management with the ability to assess controls or otherwise to obtain evidence of the operating effectiveness of relevant controls (i.e., whether the contract was executed prior to the time management became aware that the company would be

STAFF QUESTIONS & ANSWERS

required to make an assessment of the effectiveness of internal control over financial reporting).

- The relative ease or difficulty with which management could renegotiate the contract or transaction documents and the extent to which management has attempted to do so.
- The ability of management to assess the controls or obtain evidence of operating effectiveness of relevant controls in the absence of having access to the controls.

If the auditor determines that management has not fulfilled its responsibilities and that the auditor is required to disclaim an opinion, he or she should follow the directions in paragraph 180 of Auditing Standard No. 2 that require the auditor's report to include disclosure of the material weakness. Further, as discussed in PCAOB Staff Question and Answer No. 8, because management is required to fulfill those 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*, and Section 10A of the Securities Exchange Act of 1934.

The following two examples illustrate how to apply these views in various situations. These examples are for illustrative purposes only. Further, these examples do not represent an exhaustive list of the situations in which these directions might apply.

Example 1. In the service organization example in the question, management and the auditor determined that evidence of the operating effectiveness of controls at the service organization is necessary. If the transactions or events subject to the controls at the service organization are material to the company's financial statements and management is unable to obtain evidence about their operating effectiveness, the auditor ordinarily would determine that this circumstance represents a material weakness in the company's internal control over financial reporting. If the servicing contract was executed in 2001 (a time that is well before the existence of the Sarbanes-Oxley Act), for example, and management already has negotiated with the service organization to provide a

STAFF QUESTIONS & ANSWERS

suitable Type 2 SAS 70 report to provide the necessary evidence to support management's assessment next year, the auditor might determine that management had fulfilled its responsibilities as described in paragraph 20 of Auditing Standard No. 2, and thus be able to complete the audit of internal control over financial reporting. On the other hand, if management recently renewed its contract with the service organization and did not negotiate either an agreement about obtaining a suitable Type 2 SAS 70 report or permission to test controls at the service organization, or if the contract with the service organization is long-dated and management has made no attempt to negotiate the ability to obtain the necessary evidence of operating effectiveness of controls, the auditor ordinarily would determine that management had not fulfilled its responsibilities. Accordingly, the auditor would be required to disclaim an opinion as directed by paragraph 21 of Auditing Standard No. 2. The auditor also would need to evaluate whether he or she had additional responsibilities in this circumstance under AU sec. 317 and Section 10A.

Example 2. Another example relates to entities consolidated by virtue of FASB Interpretation No. 46, *Consolidation of Variable Interest Entities—An Interpretation of ARB No. 51* ("FIN No. 46"). Paragraph 16 of Appendix B of Auditing Standard No. 2 states that in situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner and report without reference to the limitation in scope. Question 1 of 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 Certification of Disclosure in Exchange Act Periodic Reports, Frequently Asked Questions*, dated June 23, 2004 (as amended October 6, 2004), discusses such a situation. In this interpretation, the SEC staff allows management to exclude from the scope of its assessment of internal control over financial reporting the controls of an entity in existence prior to December 15, 2003, that is consolidated by virtue of FIN No. 46, for which the company does not have the right or authority to assess the controls and also lacks the ability, in practice, to make that assessment. Management's inability to assess the controls of an entity consolidated by virtue of FIN No. 46 that came into existence subsequent to December 15, 2003, would represent a deficiency in the control environment and monitoring components of the company's internal control over financial reporting. If the variable interest entity consolidated under FIN No. 46 is material to the

STAFF QUESTIONS & ANSWERS

company's consolidated financial statements, the auditor ordinarily would determine that this circumstance represents a material weakness in internal control over financial reporting.

The auditor also needs to determine whether management has fulfilled its responsibilities as described in paragraph 20 of Auditing Standard No. 2. For an entity that came into existence subsequent to December 15, 2003, consider the following additional details. Assume, for example, that in the regular course of the company's business, the company enters into option contracts that constitute variable interests in variable interest entities. The company is considered the primary beneficiary of the variable interest entities and, therefore, is required to consolidate the entities; however, management is unable to assess controls at these variable interest entities. Additionally, the variable interest entities are, in the aggregate, material to the company's consolidated financial statements. As described above, the auditor ordinarily would determine that this circumstance represents a material weakness in internal control over financial reporting. If the existing option contracts that create the variable interests that require consolidation are short-dated (that is, with remaining terms of less than a year) and cannot be amended to permit management to assess controls, and management has already drafted option contracts that it plans to execute next year for all future such transactions and these revised contracts provide management with the ability to assess controls at the variable interest entity, the auditor might determine that management has fulfilled its responsibilities as described in paragraph 20 of Auditing Standard No. 2 and thus be able to complete the audit of internal control over financial reporting. On the other hand, if the existing option contracts that create the variable interests that require consolidation do not expire for a longer period of time, for example, 10 years, and management has made no attempt to negotiate the ability to assess controls at the variable interest entities, the auditor ordinarily would determine that management had not fulfilled its responsibilities. Accordingly, the auditor would be required to disclaim an opinion as directed in paragraph 21 of Auditing Standard No. 2. The auditor also would need to evaluate whether he or she had additional responsibilities in this circumstance under AU sec. 317, *Illegal Acts by Clients*, and Section 10A.

STAFF QUESTIONS & ANSWERS

Service Organizations

Q29. Paragraph 79 of Auditing Standard No. 2 requires the auditor to perform at least one walkthrough for each major class of transactions. Paragraph 80 states:

The auditor's walkthroughs should encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified, including controls intended to address the risk of fraud.

Paragraph B19 states:

When the service organization's services are part of the company's internal control over financial reporting, 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.

If a service organization's services involve the processing of a major class of transactions, should the company's auditor perform walkthroughs at the service organization?

A29. If the auditor is able to obtain sufficient evidence to achieve the objectives of the walkthrough by other means, such as through a service auditor's report, the auditor would not need to perform a walkthrough at the service organization.

The auditor performs walkthroughs to, among other things, obtain evidence to confirm the auditor's understanding of the process flow of transactions. Paragraph B18 of Auditing Standard No. 2 states that the auditor may apply the relevant concepts described in AU sec. 324, *Service Organizations*, to the audit of internal control over financial reporting. Paragraph B20 of Auditing Standard No. 2 specifically highlights several paragraphs of AU sec. 324 that describe the procedures the auditor should perform to obtain an understanding of the controls at the service organization that are relevant to the entity's internal control and the entity's controls over the activities of the service organization.

These portions of AU sec. 324 state that information about the nature of the services provided by a service organization that are part of the user

STAFF QUESTIONS & ANSWERS

organization's information system and the service organization's controls over those services may be available from a wide variety of sources, such as user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports by service auditors, internal auditors, or regulatory authorities on the service organization's controls. Additionally, AU sec. 324 provides that, after considering the available information, the user auditor may conclude that he or she has the means to obtain a sufficient understanding of internal control. If the user auditor concludes that information is not available to obtain a sufficient understanding, he or she may consider contacting the service organization, through the user organization, to obtain specific information or to request that a service auditor be engaged to perform the procedures that will supply the necessary information, or the user auditor may visit the service organization and perform such procedures.

Therefore, paragraphs 80 and B19 of Auditing Standard No. 2 do not, by themselves, require the auditor to perform a walkthrough at the service organization when the service organization's activities involve the processing of a major class of transactions. The auditor may determine that it is possible to obtain sufficient evidence to understand the process flow of transactions at a service organization from a variety of sources, including a service auditor's report. For example, a service auditor's report includes a description of the service organization's controls and the service auditor's opinion on whether the description presents fairly the relevant aspects of the service organization's controls that have been placed in operation as of a specific date. The service auditor would have performed procedures comparable to those the user auditor would have performed during a walkthrough to support the service auditor's opinion on whether the description presents fairly the relevant aspects of the service organization's controls that have been placed in operation. When the auditor plans to use a service auditor's report, he or she should evaluate whether the report provides evidence sufficient to achieve the objectives of a walkthrough. The auditor should follow the directions in paragraphs B21-B24 in obtaining evidence and evaluating whether the service auditor's report provides sufficient evidence.