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REPORT ON THE FIRST-YEAR IMPLEMENTATION OF AUDITING STANDARD NO. 5, *AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS*

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This report describes the most common or noteworthy observations that were derived from inspections conducted during 2008 regarding registered audit firms' first-year implementation of the Board's standard governing integrated audits, Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("AS No. 5").[1/]

Background

On June 12, 2007, the Public Company Accounting Oversight Board ("PCAOB" or "the Board") adopted AS No. 5 as part of the Board's plan to improve implementation of the provisions of the Sarbanes-Oxley Act of 2002 ("the Act") relating to audits of internal control over financial reporting ("ICFR"). The Board had four basic objectives in issuing AS No. 5:

- Focusing auditors on the most important matters in the audit of ICFR,
- Eliminating unnecessary audit procedures,

[1/] Information received or prepared by the Board in connection with any inspection of a registered public accounting firm is subject to certain confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Sarbanes-Oxley Act of 2002 ("the Act"). Under the Board's Rule 4010, however, the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such report may identify the firm or firms to which any quality control criticisms in the report relate.

- Making the audit scalable to the size and complexity of the business, and
- Simplifying the text of the predecessor standard on audits of ICFR.

AS No. 5 became effective for audits for fiscal years ended on or after November 15, 2007.

The PCAOB's 2008 inspections of the eight largest domestic annually inspected registered public accounting firms[2/] included the review of over 250 audits of ICFR that the firms had conducted during 2007 and 2008. Those years were, for auditors and preparers of financial statements, a period of learning and transition, as auditors responded to the issuance of AS No. 5 and preparers of financial statements received guidance from the Securities and Exchange Commission to facilitate their assessment of ICFR.[3/]

The 2008 inspections of ICFR audits were focused on whether auditors were effectively transitioning to AS No. 5. Accordingly, the 2008 inspections process included several procedures designed to monitor and improve the quality of the firms' implementation of AS No. 5. During inspection fieldwork, the inspections staff reviewed aspects of the firms' application of AS No. 5 to selected integrated audits. As described below, the inspectors selected several significant aspects of AS No. 5, and considered whether, in the engagements reviewed, the auditors had applied those aspects appropriately in the process they used to reach their conclusions. The inspections were not designed to evaluate the design or effectiveness of the issuers' controls or to draw conclusions regarding the quality of managements' assessments of those controls. Engagements were selected without regard to whether the ICFR audits resulted in adverse or unqualified opinions and without regard to the number or extent of internal

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[2/] Specifically, the Board's observations in this report are based on information obtained in the course of the 2008 inspections of the following eight registered firms: BDO Seidman, LLP; Crowe Horwath LLP; Deloitte & Touche LLP; Ernst & Young LLP; Grant Thornton LLP; KPMG LLP; McGladrey & Pullen, LLP; and PricewaterhouseCoopers LLP.

[3/] See Interpretive Release: *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* (Release Nos. 33-8810, 34-55992, June 20, 2007)

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control deficiencies identified by the engagement team during the audit. During the fieldwork, the inspection teams communicated to the specific engagement teams whether the inspectors had observed that the teams had implemented effectively the aspects of AS No. 5 that had been reviewed, or whether, and in what respects, their implementation needed improvement. Inspections leadership summarized the observations for each firm and discussed them with the firm's leadership periodically.

Observations on the First-Year Implementation of AS No. 5

In order to comply with the provisions of AS No. 5, the auditor should use a "top-down" approach to the audit of ICFR to select the controls to test. This approach begins with understanding the overall risks to internal control over financial reporting, including the risk of fraud. The auditor then focuses on identifying entity-level controls, and then moves to identifying significant accounts and disclosures and their relevant assertions, understanding likely sources of misstatement, and selecting controls to test.[4/]

Risk assessment underlies the entire AS No. 5 audit process, including the identification of significant accounts and disclosures and relevant assertions, the selection of controls to test, and the determination of the audit evidence necessary for a given control.[5/] The auditor should focus more of his or her attention on the areas of highest risk. Also, in planning and performing the audit of ICFR, the auditor should evaluate the extent to which he or she will use the work of others.[6/]

In light of these concepts, the inspectors' review of the firms' implementation of AS No. 5 focused on the following areas:

- Risk Assessment,
- Risk of Fraud,
- Using the Work of Others,
- Entity-Level Controls,
- Nature, Timing, and Extent of Controls Testing, and
- Evaluating and Communicating Deficiencies.

[4/] See AS No. 5, paragraph 21

[5/] See AS No. 5, paragraph 10

[6/] AS No. 5, paragraph 16

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The inspectors' most common or noteworthy observations, including descriptions of certain of the instances in which the inspectors observed that the auditors' transition to AS No. 5 was particularly effective or where it was less than effective, are described below. The inspectors' observations varied both across and within the firms. In each of the areas that inspectors reviewed, inspectors observed instances of inappropriate application of the standard. In general, the areas where inappropriate application was most frequently observed were risk assessment, the evaluation of entity-level controls, and the nature, timing, and extent of the controls testing. Although the observations described in this report were derived from the performance of various engagement teams at certain firms – who constitute a subset of the auditors who performed integrated audits in 2007 and early 2008 – the Board believes that the observations described in this report can benefit auditors generally, whether they are experienced in performing integrated audits or are performing their first such audits

Risk Assessment

In the selected areas of the engagements reviewed, the inspectors evaluated whether auditors adequately assessed risk, including when determining significant accounts and disclosures and relevant assertions, selecting controls to test, and determining the extent of audit evidence necessary for a given control. In the majority of engagements reviewed, the inspectors did not identify deficiencies in the auditors' assessment of risk. In some instances, the inspectors observed that the auditors appropriately modified the nature, timing, and extent of their tests of controls where they had assessed the related risk as lower.

The inspectors, however, observed other instances where the auditors failed to adequately assess risk in certain relevant aspects of the audit. These instances included the failure to (i) identify certain components of an account or certain locations in a multi-location environment that presented different risks of material misstatement of the financial statements than other components of the same account or other locations, respectively, (ii) evaluate both the qualitative and quantitative factors when determining whether to perform tests of controls at a location, (iii) identify all relevant assertions, and (iv) consider the effects of control deficiencies identified during the audit (including deficiencies in pervasive controls such as information technology general controls) on the risk assessment.

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Risk of Fraud

In the selected areas of the engagements reviewed, inspectors evaluated whether the auditors applied their considerations of the risk of fraud throughout the audit, identified controls that addressed the assessed risk of fraud, and adequately evaluated the control environment and the period-end financial reporting process. In the majority of engagements reviewed, the inspectors did not identify noteworthy deficiencies in the auditors' assessments of fraud risks and their consideration of the results of those assessments when performing the audit of ICFR. Inspectors observed certain instances in which auditors were particularly effective in identifying and testing companies' controls that address fraud risk, including the risk of management override. For example, inspectors observed instances where auditors focused more of their attention on audit areas or locations that they had assessed as more susceptible to material misstatement due to fraud, or where auditors had involved firm personnel with special skills and knowledge regarding fraud to assist them in their fraud risk assessment and controls evaluation.

There were instances, however, where the nature, timing, and extent of auditors' tests of controls were not sufficiently responsive to an identified fraud risk because auditors either failed to alter the extent of testing in areas of greater risk, or they failed to identify and test compensating controls when the controls identified and tested did not completely address the identified risk. The inspectors also observed instances where auditors either did not evaluate all the relevant processes of the company's period-end financial reporting process or did not appropriately test the design or operating effectiveness of controls to address the risk of management override.

Using the Work of Others

AS No. 5 provides that the auditor may use the work of others to reduce his or her own work, but the extent to which the auditor does so should depend on the risk associated with the controls being tested, as well as on the competence and objectivity of the individuals performing the work.[7/] In the selected areas of the engagements reviewed, the inspectors observed that auditors generally used the work of others in a manner that was related to their assessments of the degree of risk associated with the controls being tested, particularly in lower-risk areas. Similarly, the auditors' use of the

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[7/] See AS No. 5, paragraphs 18 and 19

work of others in the majority of instances reviewed was consistent with the auditors' assessment of the competence and objectivity of those individuals. The inspectors observed certain instances where, consistent with AS No. 5,[8/] the auditors used the work of company personnel other than internal auditors, when they determined that those performing the work on behalf of management were sufficiently competent and objective.

The inspectors also identified several instances that presented further opportunities for the auditors to use the work of others when the assessed level of risk was lower, including when testing certain system reports and application controls. The inspectors observed other instances, though, where the extent of the auditor's use of the work of others to reduce the auditor's own work was greater than was appropriate under AS No. 5 considering the level of risk associated with the control being tested (*e.g.*, in the area of controls over journal entries, which generally would be considered higher risk because of the risk of management override or other risk of fraud).

In certain instances, the auditors performed few or no procedures to assess the competence of the others relative to the task being performed, or they did not adequately assess the objectivity of the others, particularly where the work was performed by company personnel other than internal auditors. In addition, the inspectors observed numerous instances where the extent of the auditors' retesting of the work of others was seemingly unrelated to the risks involved (*e.g.*, a uniform approach to retesting of 20 percent of the controls tested).

Entity-Level Controls

The auditor's evaluation of entity-level controls is important to the auditor's ability to appropriately tailor the audit by identifying and testing the most important controls and, when appropriate, reducing the testing of controls at the process level. The standard requires the auditor to test those entity-level controls that are important to the auditor's conclusion about whether the company has effective ICFR.[9/] In the selected areas of the engagements reviewed, the inspectors observed significant variance in the effectiveness of the auditors' efforts to identify and test entity-level controls and to use

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8/ AS No. 5, paragraph 17

9/ AS No. 5, paragraph 22

the results of those tests to tailor the audit. In certain of the engagements reviewed, the auditors were effective in identifying and testing entity-level controls that appeared to be designed and operating at a level of precision sufficient to prevent or detect on a timely basis misstatements to one or more relevant assertions, which the auditors determined either eliminated or reduced the need to test additional controls related to those assertions.

In certain other situations, however, the inspectors observed that the auditors' work in the area could have been more effective. For example, in some instances, auditors did not evaluate entity-level controls beyond those associated with the control environment and the period-end financial reporting process.[10/] (Inspectors were told in certain cases that the auditors did not evaluate other entity-level controls because the issuer had not done so.) Some auditors identified entity-level controls that appeared to be designed to operate with a high degree of precision, but failed to obtain sufficient audit evidence of their operating effectiveness. There also were instances where the auditors identified and tested entity-level controls and found them to be designed and operating with a high degree of precision, but did not alter their tests of process-level controls in response to that assessment.

There also were situations where auditors inappropriately reduced their testing of process-level controls based on reliance on entity-level controls. In certain of these instances, the auditors failed to consider the precision with which the entity-level control addressed a relevant financial statement assertion. In other instances, the auditors determined that the entity-level control was not operating at a level of precision sufficient to address the risk related to a relevant financial statement assertion, yet they nonetheless reduced the testing of the process-level controls for the relevant assertion.

Nature, Timing, and Extent of Controls Testing

The auditor should select controls for testing that are important to the auditor's conclusion about whether the issuer's controls sufficiently address the assessed risk of

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10/ Other entity-level controls include controls over management override, the company's risk assessment process, centralized processing and controls, controls to monitor results of operations, controls to monitor other controls, and policies that address significant business control and risk management practices. AS No. 5, paragraph 24.

misstatement to each relevant assertion.[11] The amount of audit evidence necessary to persuade the auditor that a control is operating effectively depends upon the risk associated with the control.[12] In the selected areas of the engagements reviewed, the inspectors evaluated whether the auditors focused their testing on important controls, determined the amount and type of evidence necessary based on the risk associated with those controls, and designed and executed appropriate control tests to obtain assurance that the controls operated effectively. In the majority of engagements reviewed, the inspectors did not identify deficiencies in these areas. The inspectors noted that, in some engagements, the auditors used prior years' knowledge, consistent with AS No. 5,[13] when determining the nature, timing, and extent of tests of controls for the current year.

Opportunities for improvement also were observed. For example, in certain cases, the auditors did not consider the assessed level of risk when selecting controls to be tested, or the controls selected were not designed to address the risk of misstatement to the relevant assertion(s). The inspectors also observed situations where auditors failed to test a relevant control appropriately or, in some cases, at all. For example, inspectors observed instances where the auditors' testing of controls over financially significant applications was dependent on appropriate segregation of duties, but the auditors did not test to determine whether appropriate segregation of duties existed. Similarly, in some instances, the auditors tested certain controls without testing the system-generated data on which the tested controls depended; the auditors did not test controls over applications that processed financially significant transactions, including important manual spreadsheets; or the auditors observed evidence of review and approval controls (*e.g.* management sign-off evidencing review and approval) without testing the design or operating effectiveness of management's controls. In some instances, the auditors did not obtain service auditors' reports related to controls at outside service organizations, or the auditors failed to perform procedures related to the necessary user controls identified in the service auditors' reports.

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[11] AS No. 5, paragraphs 39 and 41

[12] AS No. 5, paragraph 46

[13] See AS No. 5, paragraphs 57 to 61, for the considerations to be applied in performing subsequent years' audits.

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Inspectors also observed instances where the evidence gathered by the auditor was insufficient to support a conclusion that the controls were operating effectively, yet the audit team relied on the supposed effectiveness of those controls to reduce the scope of other audit procedures. For example, inspectors noted instances where the operating effectiveness of higher-risk controls was tested solely through inquiry and observation, which are tests that ordinarily produce less audit evidence than other tests, such as inspection of relevant documentation or re-performance of a control. In other instances, auditors did not test the completeness of the population from which items were selected for testing. Inspectors also observed instances where the extent of audit procedures was similar for both lower- and higher-risk controls.

Evaluation of Deficiencies

The auditor must evaluate the severity of each control deficiency that comes to his or her attention to determine whether the deficiencies individually, or in combination, are material weaknesses as of the date of management's assessment.[14/] The severity of a control deficiency depends on whether there is a reasonable possibility that a company's controls will fail to prevent or detect a misstatement and the magnitude of the potential misstatement. AS No. 5 includes examples of risk factors that could affect the possibility that a company's controls would fail to prevent or detect a misstatement. Also, in evaluating whether control deficiencies are a material weakness, the auditor should evaluate the effect of compensating controls, including whether they operate at a level of precision that would prevent or detect a misstatement that could be material.[15/] In the selected areas of the engagements reviewed, inspectors found that auditors generally considered both applicable quantitative and qualitative factors when assessing the severity of control deficiencies. Similarly, in those areas of the engagements reviewed, inspectors observed that when the auditors considered compensating controls to have a mitigating effect, the auditors had generally identified compensating controls that appeared to operate at a level of precision to prevent or detect a misstatement that could be material, and had tested the controls sufficiently. Inspectors observed instances where auditors appropriately modified the nature, timing, and extent of their audit procedures in response to having determined that certain controls were ineffective.

14/ AS No. 5, paragraph 62

15/ See AS No. 5, paragraphs 63-68

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Inspectors observed other instances, however, where auditors inappropriately based their conclusions about the severity of control deficiencies solely on the materiality of the identified errors in the financial statements. Also, some auditors failed to consider relevant risk factors when evaluating the severity of identified control deficiencies. In addition, there were instances where the auditors did not consider whether certain control deficiencies identified through using the work of others, in combination with other identified control deficiencies, constituted a material weakness in controls. In certain instances, the compensating controls that the auditors identified and tested were not sufficiently precise or did not operate effectively to mitigate the risks associated with the identified deficiencies. In addition, the inspectors observed that certain auditors' required communications of identified control deficiencies to management or the audit committee were incomplete.

In addition, in an integrated audit, the auditor is required to evaluate the effect of the findings of the substantive procedures on the auditors' conclusions about the effectiveness of ICFR.[16/] In some instances, the inspectors observed that auditors did not consider the possible effects of detected errors in the financial statements on the effectiveness of controls.

Summary and Conclusion

In 2008, the PCAOB's inspectors reviewed auditors' integrated-audit procedures and their efforts to transition to the new standard governing such audits, AS No. 5. The inspections indicated that the auditors whose work was inspected generally had applied the new standard so as to focus their procedures on the areas that they had assessed as presenting more significant audit risk. The inspectors observed, though, deficiencies in some engagement teams' implementation of certain aspects of the standard. These deficiencies included instances where the engagement teams could have improved the audit by shifting more of their focus to the procedures that addressed audit areas of higher risk, as well as instances in which the auditors' procedures in the ICFR audit should have been more effective. In 2009, the Board is continuing to assess the effectiveness of firms' integrated-audit procedures.

[16/] AS No. 5, paragraph B8