
)
)
)
)
REPORT ON THE SECOND-YEAR)
IMPLEMENTATION OF AUDITING STANDARD)
NO. 2, *AN AUDIT OF INTERNAL CONTROL*)
OVER FINANCIAL REPORTING PERFORMED IN)
CONJUNCTION WITH AN AUDIT OF FINANCIAL)
STATEMENTS)
)
)
)
)

PCAOB Release No. 2007-004
April 18, 2007

Overview

This report discusses issues identified in the course of the Board's review, as part of inspections conducted during 2006, of the implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS No. 2"). That standard implements Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act").

In 2006, Board inspectors reviewed portions of approximately 275 audits of internal control over financial reporting ("internal control") conducted in the second year of implementation of AS No. 2. These inspections revealed that progress was made in improving the efficiency of internal control audits.^{1/} Many of these improvements resulted from the easing of time constraints that auditors and issuers faced in the first year, issuers' and auditors' additional experience, and changes that auditors made in their methodologies and staff training. In addition, on May 16, 2005, the Board issued a policy statement regarding the implementation of AS No. 2, accompanied by additional staff questions and answers.^{2/} Both documents provided guidance on, among other

^{1/} The Board has defined "efficiency" as "the auditor achieving the objectives described in the Board's standards with the least expenditure of effort and resources." See PCAOB Release No. 2005-023, Report on the Initial Implementation of [AS No. 2] (November 30, 2005) ("the November 30, 2005 Release").

^{2/} See PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial*

RELEASE

topics, integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk. In the 2006 inspections, the inspectors focused their efforts on assessing the firms' implementation of AS No. 2 in these four areas.^{3/}

In the 2006 inspections, the inspectors found evidence that most firms had made progress in integrating their audits (for example, by using the same engagement team to perform both the financial statement audit and the audit of internal control over financial reporting). The inspectors also observed more instances in which auditors approached the audit of internal control from the top down and thus did a better job of focusing their testing and evaluation on the relevant company-level controls. As a result, they spent less time testing a larger number of controls that existed at the process, transaction, and application levels. Several of the firms achieved greater efficiencies by varying the extent of their testing commensurate with the level of risk and, generally, auditors used the work of others more in the second year of implementing AS No. 2 than in the first year.

Notwithstanding the improvements noted in the second year of implementation, the Board has identified, in its inspections and other monitoring, ways in which auditors

Reporting Performed in Conjunction with an Audit of Financial Statements (May 16, 2005) ("the May 16, 2005 Statement"); Staff Questions and Answers, Auditing Internal Control Over Financial Reporting (May 16, 2005). PCAOB Releases and related staff guidance cited in this report are available on the Board's web site at www.pcaobus.org.

^{3/} See PCAOB Release 104-2006-105, Statement Regarding the Public Company Accounting Oversight Board's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle (May 1, 2006) ("the May 1, 2006 Statement"). The Board's observations in this report are based primarily on information obtained in the Board's inspection process, which in the 2006 cycle included review of portions of a selection of audits of internal control. 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 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 published report may identify the firm or firms to which any quality control criticisms in the report relate.

RELEASE

can further improve their implementation of AS No. 2. The Board considered the results of its monitoring, including these findings, when it proposed a new auditing standard, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* that would supersede Auditing Standard No. 2.^{4/} The Board expects that the improvements observed in 2006, as well as further improvements in the areas described below, will enable firms to achieve more efficient and effective audits as they transition to a new standard.

Summary of the Board's Observations

In each of the four areas on which the inspection teams focused, the reviews identified ways in which auditors could have been more efficient. While these observations varied in form and degree among the firms and engagement teams, the lessons learned can benefit auditors generally. The most common observations were --

- Some auditors did not fully integrate their audits.
- Some auditors failed to apply a top-down approach to testing controls.
- Some auditors assessed the level of risk only at the account level and not at the assertion level. As a result, those auditors likely expended more effort than necessary when testing controls for assertions that were lower risk. In a few cases, auditors tested the same controls that the issuer had tested, without assessing whether this was necessary to sufficiently address the risk that a relevant assertion might be misstated.
- Some auditors could have increased their use of the work of others.

In addition to their observations related to the four areas of specific focus, the inspectors identified certain other matters that may present additional opportunities for improvement. These observations, which, like the observations summarized above, varied among firms and engagement teams, include --

^{4/} See PCAOB Release 2006-007, Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (December 19, 2006).

RELEASE

- Some auditors spent a significant amount of time testing management's process, although they did not need to do so in order to support their opinion on management's assessment, and yet did not use that work to reduce their control testing.
- In performing tests of controls, some auditors did not test automated, rather than manual, controls, where possible, or did not consider benchmarking strategies for automated application controls they were testing for the second or subsequent year.
- Some firms did not have a monitoring system in place to address whether engagement teams incorporated the May 16, 2005 Policy Statement into their audits or planned and performed their audits to be more efficient.
- Engagement teams often stated that the issuer's circumstances contributed to the need to do more work to complete the audit of internal control. While the issuer's circumstances can increase the amount of work that the auditor needs to perform, the Board encourages auditors to engage in discussions with issuer clients and their audit committees as early as possible in order to identify and address issuer-specific obstacles to efficiency.

Background

Section 404 of the Act, along with the Securities and Exchange Commission's (the "Commission" or "SEC") implementing rules, requires a public company to report annually on its assessment of internal control and to include an auditor's attestation to, and report on, that assessment and on the effectiveness of internal control. As required by Sections 404(b) and 103 of the Act, the Board adopted AS No. 2 to apply to these audits.

As described in the November 30, 2005 Release, both corporate managements and auditors expended significant efforts complying with Section 404's requirements in the first year of implementation, especially given the short deadline for compliance that they confronted. Firms have indicated that the effort expended in the second year of implementation was, generally, less than in the first year. Nonetheless, given the importance of audits of internal control and the ongoing challenges of implementing AS

RELEASE

No. 2, the Board continued to make the monitoring of firms' implementation of the standard one of its top priorities. As a result, the Board took the following steps (among others) during the past year. The Board issued the May 1, 2006 Statement describing the Board's 2006 approach to inspecting internal control audits. On May 10, 2006, the PCAOB and SEC jointly sponsored a "Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions." On May 17, 2006, the Board announced a "Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements" encompassing the following, all of which the Board continues to work on:

1. Amend AS No. 2;^{5/}
2. Reinforce auditor efficiency through PCAOB inspections;
3. Guidance and education for auditors of small companies; and
4. Continue PCAOB Forums on Auditing in the Small Business Environment.

In 2006, the Board focused its inspections of internal control audits on whether the firms achieved the objectives of an internal control audit in an efficient manner. The Board's objectives in conducting these inspections included providing auditors with timely feedback regarding the implementation of the standard, in light of the related Board statements and Board staff guidance.^{6/} Specifically, inspectors evaluated the firms' approaches to (1) integrating the audit of internal control with the audit of the financial statements, (2) using a top-down approach to the internal control audit, (3) using a risk-based approach, and (4) using the work of others.

^{5/} On December 19, 2006, the Board proposed for public comment a new standard on audits of internal control. See PCAOB Release 2006-007, Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit Of Financial Statements and Related Other Proposals (December 19, 2006).

^{6/} See the May 16, 2005 Statement; the November 30, 2005 Release; see also Staff Questions and Answers, Auditing Internal Control Over Financial Reporting (May 16, 2005).

RELEASE

Board Observations Regarding the Performance of Audits of Internal Control

The Board's inspections and other monitoring revealed that, on the whole, the firms' audits of internal control were more efficient than in the first year of implementation of AS No. 2. Nonetheless, the Board believes that firms can be more efficient in auditing internal control through additional changes to firm methodology, additional firm training and guidance, increased internal monitoring of efficiencies, and more rigorous discussions with issuer clients about ways in which the issuer's actions can affect the performance of the audit. The inspectors' most frequent observations are described below.

The Integrated Audit

Overall, the inspectors observed that firms made progress over the past year in integrating the audit of internal control with the financial statement audit. Nonetheless, in certain engagements, auditors failed to integrate their audits; instead they planned and performed essentially separate audits of internal control and of the financial statements. When an auditor has effectively integrated the two audits, the results of the procedures performed in connection with either audit contribute to the completion of both audits. In several of the audit engagements reviewed, there appeared to have been additional opportunities for the auditors to adjust the nature, timing, and extent of their substantive procedures in light of the results of their control testing. In some of these instances, auditors may have planned their financial statement audit based on the assumption that they could place a certain level of reliance on controls and then failed to reassess their planned approach when their test results indicated they could place a different level of reliance on controls.

In some cases where the inspectors observed that engagement teams did not integrate their audits, the inspectors also observed that engagement teams performed their control testing late in the year, sometimes concurrently with their substantive work on the financial statements. In some of these instances, the auditors stated that they delayed their control testing because the issuer had not completed its management assessment. In a few other cases, there appeared to be a predisposition to perform a purely substantive financial statement audit, as the auditor had performed prior to the issuance of AS No. 2, without considering whether an integrated audit could have achieved the audit objectives as effectively and more efficiently.

RELEASE

Top-down Approach

When properly executed, a "top-down" approach directs auditors to focus on controls over accounts, disclosures, and assertions that present a reasonable possibility of material misstatement. The auditor selects for testing only those controls necessary to obtain reasonable assurance about whether material weaknesses in internal control exist. When using a top-down approach, the auditor begins by evaluating company-level controls (such as the control environment, the period-end financial reporting process, shared-service processes, controls to monitor other controls, and the company's risk assessment process) and then "works down" to significant accounts and relevant individual controls at the process, transaction, and application levels. By following this top-down sequence, the auditor focuses early in the process on matters, such as company-level controls, that can have an effect on the auditor's later decisions about the scope and testing of controls at the process, transaction, and application levels. The results of the auditor's tests at each level help the auditor tailor the remainder of the work so that it can result in an efficient audit. Effective company-level controls can result in the auditor modifying the nature, timing, and extent of tests of controls conducted at the process, transaction, and application levels.

Successful implementation of a top-down approach requires the auditor to evaluate company-level controls early in the audit. In certain audit engagements that the inspectors reviewed, the auditors had not done this. Rather, to varying degrees, the auditors had tested the company-level controls, in whole or in part, concurrently with, or after, testing the process, transaction, and application controls.

The inspectors observed that, even in some cases where the auditors had tested and evaluated the company-level controls early in the audit, the auditors had not altered their tests of controls at the process, transaction, or application levels to the extent supported by the results of their tests of the company-level controls. Moreover, some auditors did not link company-level controls to related controls at the process, transaction, and application levels in order to evaluate whether they could reduce their tests of those latter controls.

Risk-Based Approach

In several of the engagements reviewed, auditors failed to vary the nature, timing, or extent of testing commensurate with the level of risk at the assertion level.

RELEASE

For example, some auditors assessed all assertions for a given significant account as relevant without considering the related level of risk. This may have resulted in the auditor spending time identifying and testing controls that were related to assertions that did not present a meaningful risk of a potential material misstatement of the financial statements. Similarly, a few auditors simply tested all the controls that the issuer had identified and tested, without considering their associated risk. Although auditors' judgments might vary as to the extent and number of controls that may need to be tested, some auditors expended more effort than necessary by testing multiple controls that addressed the same assertion.

The inspectors also observed that, for many engagements, the auditor's identification of significant accounts was based solely on quantitative measures. In other words, the auditor identified all accounts over a certain materiality threshold as significant without applying qualitative measures. Frequently, this was attributable to the firms' tools and methodologies that stipulate that accounts over a certain threshold are significant and should automatically be included in control testing. Such methodologies failed to consider that there may be accounts that meet a quantitative threshold for materiality but are not significant for purposes of control testing, and that there may be accounts that are significant even though they are not material quantitatively.^{7/}

Using the Work of Others

AS No. 2 permits auditors to use the work of others in a way that corresponds directly with the auditor's assessment of the risk associated with particular controls and the competence and objectivity of the persons performing the work. An auditor who appropriately uses the work of others can achieve the objectives of the audit while not duplicating effort in lower-risk areas, and also is better able to focus his or her own

^{7/} For example, property, plant, and equipment may meet a quantitative threshold for materiality, but for certain issuers, this account may not be significant from a risk perspective. On the other hand, accounts that may not be large quantitatively, but may be particularly complex or subjective, or may present the potential for substantial adjustments, may be significant from a risk standpoint for certain issuers so that testing of controls relating to the account would be appropriate.

RELEASE

efforts on higher-risk controls. Inspection teams observed instances in which auditors did not use the work of others to the extent permitted by AS No. 2.

Although the Board staff's guidance issued on May 16, 2005 clarified that the principal evidence requirement is primarily qualitative,^{8/} inspectors observed that many engagement teams used quantitative approaches to determine the extent to which the testing had to be done by the engagement team itself. Most firms' methodologies prescribe ranges (generally expressed as percentages) that are specific to the various categories of financial statement account types, transactions, or processes, to guide auditors on the extent to which they may use the work of others and the extent to which they should perform their own testing. The inspectors noted that auditors used the work of others and performed their own testing within the quantitative ranges set by the firms. They also observed that auditors frequently chose to use the most conservative approach (*i.e.*, the lower end of the ranges for using the work of others and the upper end of the ranges for their own testing) that was permitted by their firm's methodologies.

The inspectors also found that some auditors used a quantitative approach (typically a range of percentages) to determine the extent of the re-performance of the work of others that was considered necessary to assess the quality and effectiveness of the others' work. Many auditors re-performed a percentage of the tests of controls over all significant accounts for which the auditor used the work of others. The use of a purely quantitative approach to determining the extent of re-performance of the work of others to assess quality and effectiveness may result in less flexibility than if the firms were to rely on the auditor's judgment, given the specific facts and circumstances.

Some auditors told the inspectors that they had not used the work of others (whom the auditors had assessed as sufficiently competent and objective) because the work performed by others was not completed in a timely manner, or covered only a portion of the year. In other instances, inspectors observed that auditors failed to use the work of others to the extent they could have, because it was performed by management (or outside parties hired by management), rather than by internal auditors, even when the auditor's assessment was that those performing the testing were

^{8/} PCAOB Staff Question and Answer No. 54 (May 16, 2005).

RELEASE

sufficiently competent and objective.^{9/} In those circumstances, AS No. 2 does not prevent the use of such work.

In addition to inefficiencies noted in the four areas that were the specific focus of the inspection procedures, the inspection teams identified other issues. These observations are discussed below.

Evaluation of Management's Assessment

The inspectors observed that some auditors spent a significant amount of time performing detailed testing, such as re-testing items that management had tested, although they did not need to do so in order to support their opinion on management's assessment, and yet did not use this work to reduce their control testing.

Controls Performed by Computer Systems

Auditors often can be more efficient by identifying and testing automated controls. AS No. 2 requires that auditors subject manual controls to more extensive testing than automated controls performed by computer systems. In some circumstances, testing a single operation of an automated control (a "test of one") may be sufficient to obtain enough evidence that the control is operating effectively. Although some auditors evaluated the use of relevant automated controls, in other cases the inspection teams observed a greater reliance on manual detective controls or other manual controls than on automated controls. This may be attributable to the auditor using the issuer's process for testing controls to identify controls for the auditor's own testing.

Using benchmarking strategies also may increase efficiency when auditing computerized accounting systems. A benchmarking strategy enables the auditor to conclude, without repeating the tests performed in the first year of benchmarking, that automated controls may continue to be relied upon since the last time they were tested,

^{9/} For example, some issuers used company employees whose core responsibilities involved permanently serving in a testing or compliance function, such as a loan review officer in a financial institution, while other issuers used outside parties (such as another accounting firm or information technology consultants) that management had hired to perform tests.

RELEASE

provided those controls have not changed and the information technology general controls ("ITGCs") are designed appropriately and operating effectively. Certain firms' methodologies identify benchmarking as a strategy for testing automated controls. Nonetheless, even in these firms, inspectors generally did not observe auditors using benchmarking strategies to reduce their testing of automated controls in years after the initial year of testing. In addition, there was little or no evidence that the auditors had considered doing so.

Auditor Self-Monitoring

The inspection teams frequently observed that firms had no formal process for monitoring whether, at the engagement level, auditors were implementing AS No. 2 as the Board intended, including in light of the Board's May 16, 2005 Statement, the Board's November 30, 2005 Release, and relevant Board staff guidance. Such monitoring could measure the effect of firm guidance and training on implementing AS No. 2 consistent with Board statements and Board staff guidance and could provide the firms with a way to benchmark their progress. Several firms relied primarily on networks of partners or managers or collecting such information without having any policies or procedures to ensure that this process would be uniform across all practice areas and would facilitate an evaluation of the efficiency aspects of AS No. 2 implementation.

The Effects of Issuer's Processes

In some instances, auditors told the inspectors that certain factors regarding the issuer's processes affected the auditor's performance of the audit of internal control. Although the Board's inspections did not include any procedures to verify the extent of those factors, some of the factors that the auditors cited more frequently are described below.

- Completion of an issuer's own testing and assessment of internal control late in the year reduced the auditor's opportunity to use that work to reduce the auditor's own tests.
- Requests by the issuer that the auditor delay internal control testing, either so that the issuer could remediate identified control deficiencies or for other reasons, reduced the auditor's opportunity both to integrate the audits and to use the work of others.

RELEASE

- Significant changes in the issuer's business or personnel during the year reduced the likelihood that the auditor could adjust the nature, timing, and extent of the substantive financial-statement audit procedures.
- Significant revisions to the issuer's control processes and systems in the second year of implementation delayed the start of the auditor's testing, affected the auditor's ability to test or to adjust the nature, timing, and extent of the substantive financial-statement audit procedures, or required the auditor to test the controls in both the old and the new control systems.
- Failures by the issuer to remediate identified deficiencies in ITGCs prevented the auditors from shifting the emphasis of their testing from manual, detective controls to automated application controls.

In addition, for certain firms some of the engagements inspected were new clients of that firm and those issuers had material weaknesses or significant deficiencies in the year the firm audited, or had had such weaknesses or deficiencies at the end of the prior year. In these situations, the firms stated that, because they had to test controls to support an opinion on the issuer's internal control but were unable to rely on those controls to the fullest extent for the financial statement audit, they needed to spend more time performing substantive audit procedures to support their financial statement audit opinion than they would have if controls had been designed appropriately and operating effectively throughout the period under audit.

Although the inspectors did not attempt to make any determination about the extent to which such factors affected the reviewed audits, as a general matter, such factors can affect the nature, timing, and extent of the work that an auditor must perform in order to complete the audit. In those circumstances, even an optimally efficient auditor may need to perform procedures that could have been eliminated or reduced had the audit client's own process proceeded differently. For that reason, the Board encourages auditors to engage in timely discussions with their issuer audit clients and audit committees about how the issuer's own processes can affect the amount of the auditor's work necessary to perform the audit of internal control.

RELEASE

Conclusion

The Board's review of the second year of implementation of AS No. 2 revealed evidence that firms have made progress in implementing AS No. 2. Nonetheless, the review identified several areas in which the Board believes that auditors have opportunities for further improvement. These observations have been discussed with the appropriate firms, and the Board believes and expects that those discussions are contributing to changes in methodology, additional firm training and guidance, increased internal monitoring of efficiency, and better communications with issuers about the role that they play in achieving efficiencies in the audit of internal control. The Board remains confident that as firms and issuers become more experienced in the implementation of the internal control reporting requirements, the process will continue to improve.