

PCAOB FLASH REPORT

PCAOB Issues Report on First-Year Implementation of Auditing Standard No. 5

September 28, 2009

Late last week, the Public Company Accounting Oversight Board (PCAOB) published a report on the first year of implementation of Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting that Is Integrated with an Audit of Financial Statements* (AS5). This report is based on the PCAOB's inspections covering approximately 250 audits of internal control over financial reporting (ICFR) by the eight largest domestic registered firms in 2007 and 2008. Effective for audits for fiscal years ending on or after November 15, 2007, AS5 replaced the PCAOB's previous standard (AS2) covering audits of the effectiveness of ICFR. The years covered by this report (2007 and 2008) were, for auditors and preparers of financial statements, a period of transition from the old to the new internal control reporting requirements. Auditors responded to the issuance of AS5 and preparers of financial statements received interpretive guidance from the U.S. Securities and Exchange Commission (SEC) on management's assessment of ICFR. Together, the new standard and guidance fostered a top-down, risk-based approach that was intended to be more cost-effective in practice than AS2. The PCAOB report is available on the board's web site at http://www.pcaobus.org/Inspections/Other/2009/09-24_AS5_4010_Report.pdf.

Significance of the Report

It takes time for an accounting firm to maximize the consistency of application of a new auditing standard across its entire organization. Because AS5 has only been implemented for a year, public companies can expect the national office of their chosen accounting firm to emphasize in its firmwide communications the improvement areas identified by the PCAOB inspections, and particularly those areas applicable to audits of the firm reviewed by the PCAOB inspectors. Therefore, companies can expect increased attention to these points by the engagement audit partner and his or her engagement team if they haven't addressed them in the prior year's audit. Because the principles-based approach of AS5 can lead to differences of views in application, it is possible that increased attention to some of the areas identified by the PCAOB inspections could result in a change in the audit approach.

Key Findings

The focus of the PCAOB's 2008 inspections of ICFR audits was on determining whether auditors were effectively transitioning their audits to conform to AS5 and evaluating the quality of the firms' implementation of AS5. The overall conclusion in the board's report is that auditors are generally applying AS5 and are generally focused on the areas that present the greatest audit risk. However, while the inspectors' observations varied both across and within the firms, there were six areas in which inspectors most frequently observed instances of inappropriate application of AS5. These areas in which there is still room for improvement are:

risk assessment; fraud risk; using the work of others; entity-level controls; the nature, timing and extent of controls testing; and evaluating and communicating deficiencies.

The six areas are discussed below. (Note: In articulating the findings, it is presumed that the reader possesses a general understanding of the requirements of AS5.)

Risk Assessment

Generally the inspections did not identify deficiencies in the auditors' assessment of risk. In some instances, it was 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.

Areas requiring improvement included instances observed where the auditors failed to adequately assess risk in certain audit areas. These instances included the failure to:

- Identify certain components of an account that presented different risks of material misstatement of the financial statements than other components of the same account.
- Identify certain locations in a multi-location environment that presented different risks of material misstatement of the financial statements than other locations.
- Evaluate both the qualitative and quantitative factors when determining whether to perform tests of controls at a location.
- Identify all relevant financial reporting assertions.
- 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.

Risk of Fraud

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. The 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. Also, the inspectors noted instances where auditors had involved firm personnel with special skills and knowledge regarding fraud to assist them in their fraud risk assessment and controls evaluation.

Areas requiring improvement included the following:

- There were instances in which the nature, timing and extent of the auditors' tests of controls were not sufficiently responsive to an identified fraud risk because the 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.
- Instances were observed 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.

Use of Work of Others

The inspectors observed that auditors generally used the work of others in a manner that was consistent with their assessments of the degree of risk associated with the controls being tested, particularly in lower-risk areas. Similarly, the auditors' use of the work of others

in the majority of instances reviewed was consistent with the auditors' assessment of the competence and objectivity of those individuals.

Areas requiring improvement included the following:

- There were several instances noted in which there were further opportunities for the auditors to use the work of others when the assessed level of risk was lower, e.g., when testing certain system reports and application controls.
- There were other instances 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 AS5 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 others relative to the task being performed, or they did not adequately assess the objectivity of 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 was applied to retesting of 20 percent of the controls tested).

Entity-Level Controls

The inspectors observed significant variance in the effectiveness of the auditors' efforts to identify and test entity-level controls and to use the results of those tests to scope the testing of controls at the process level. 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 related to one or more relevant financial reporting assertions. In these instances, the auditors determined that the entity-level controls either eliminated or reduced the need to test additional controls at the process level related to those assertions.

Areas requiring improvement included the following:

- Situations were noted in which the auditors did not evaluate entity-level controls beyond those associated with the control environment and the period-end financial reporting process. In certain cases, the auditors did not evaluate other entity-level controls because the issuer had not done so. These omissions ignored the potential positive impact of effective entity-level and process-level monitoring on the scope of testing automated and manual process-level controls.
- 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 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 were situations where auditors inappropriately reduced their testing of process-level controls based on their reliance on entity-level controls. In certain of these instances, the auditors failed to consider the precision with which the entity-level controls addressed relevant financial statement assertions. 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

Generally, the inspectors did not identify deficiencies in the process of selecting controls for testing that are important to an auditor's conclusion regarding the sufficiency of the controls in mitigating the risk of material misstatements to financial reporting assertions. They noted that, in some engagements, the auditors used prior years' knowledge, consistent with AS5, when determining the nature, timing and extent of tests of controls for the current year.

Areas requiring improvement included the following:

- 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 assertions.
- Other situations were observed 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.
 - 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 transactions that were significant to the financial statements, including important manual spreadsheets.
 - 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.
 - 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 input and output controls identified in the service auditors' reports.
- Instances were observed 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 techniques, which are tests that ordinarily produce less audit evidence than other tests, such as inspection of relevant documentation or re-performance of a control procedure.
 - Auditors did not test the completeness of the population from which items were selected for testing.
 - The extent of audit procedures was similar for both lower- and higher-risk controls.

Evaluating and Communicating Deficiencies

The 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 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. Also, 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.

Areas requiring improvement included the following:

- Some auditors inappropriately based their conclusions about the severity of control deficiencies solely on the materiality of the identified errors in the financial statements. These auditors failed to consider relevant risk factors when evaluating the severity of identified control deficiencies.
- 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.
- Situations were noted where certain auditors' required communications of identified control deficiencies to management or the audit committee were incomplete.
- 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.

Concluding Comments

Many of the above deficiencies affected the auditors' application of procedures in the higher-risk areas. As a result, they affected the cost-effectiveness of the integrated audit. In its press release dated September 24, 2009, the PCAOB noted that the deficiencies would not lead to any change to, or any new interpretation of, any existing standards. The board's press release is at http://www.pcaobus.org/News_and_Events/News/2009/09-24.aspx.

In 2009, we can expect the PCAOB to review and assess the effectiveness of the audit firms' implementation of the integrated audit in accordance with AS5.

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