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STAFF AUDIT PRACTICE ALERT NO. 11

CONSIDERATIONS FOR AUDITS OF INTERNAL CONTROL OVER FINANCIAL REPORTING

October 24, 2013

Staff Audit Practice Alerts highlight new, emerging, or otherwise noteworthy circumstances that may affect how auditors conduct audits under the existing requirements of the standards and rules of the PCAOB and relevant laws. Auditors should determine whether and how to respond to these circumstances based on the specific facts presented. The statements contained in Staff Audit Practice Alerts do not establish rules of the Board and do not reflect any Board determination or judgment about the conduct of any particular firm, auditor, or any other person.

Summary

The Office of the Chief Auditor is issuing this practice alert in light of significant auditing practice issues observed by the Public Company Accounting Oversight Board ("PCAOB" or the "Board") staff in the past three years relating to audits of internal control over financial reporting ("audits of internal control"). The practice alert highlights certain requirements of the auditing standards of the PCAOB in aspects of audits of internal control in which significant auditing deficiencies have been cited frequently in PCAOB inspection reports. Specifically, this alert discusses the following topics:

- Risk assessment and the audit of internal control
- Selecting controls to test
- Testing management review controls
- Information technology ("IT") considerations, including system-generated data and reports
- Roll-forward of controls tested at an interim date
- Using the work of others

- Evaluating identified control deficiencies

Auditors should take note of the matters discussed in this alert in planning and performing their audits of internal control. Because of the nature and importance of the matters covered in this alert, it is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews. Auditing firms also should consider whether additional training of their auditing personnel is needed for the topics discussed in this alert.

Audit committees of companies for which audits of internal control are conducted might wish to discuss with their auditors the level of auditing deficiencies in this area identified in their auditors' internal inspections and PCAOB inspections, request information from their auditors about potential root causes of such findings, and ask how they are addressing the matters discussed in this alert. In particular, audit committees may want to inquire about the involvement and focus by senior members of the firm on these matters.

Introduction

Effective internal control over financial reporting ("internal control") helps assure that companies produce reliable published financial statements that investors can use in making investment decisions. Since the 1970s, federal laws have required public companies to maintain sufficient "internal accounting controls."[1/] The Sarbanes-Oxley Act of 2002, as amended, ("Act") requires company management to annually assess and report on the effectiveness of the company's internal control. For larger companies, the Act also requires independent auditors to attest to management's assessment of the effectiveness of the company's internal control.[2/]

Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* establishes requirements for performing and reporting on audits of internal control. The audit of internal control should be integrated with the audit of the financial statements. The objectives of the audits are not identical, and the auditor must plan and perform the work to achieve the objectives of both audits. In reporting on an integrated audit of internal control and financial statements ("integrated audit"), the auditor expresses an opinion on the financial statements and an opinion on the effectiveness of the company's internal control.

[1/] See 15 U.S.C. 78m, which was added to federal securities law by the Foreign Corrupt Practices Act of 1977, which sets forth requirements for devising and maintaining a "system of internal accounting controls" sufficient to provide reasonable assurance that, among other things, transactions are recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or any other applicable criteria.

[2/] See § 404 of the Act. The auditor attestation requirement applies to companies that qualify as "large accelerated filers" or "accelerated filers," other than "emerging growth companies." Pursuant to 17 C.F.R. § 240.12b-2, the designation of accelerated filers and large accelerated filers is based on, among other things, the aggregate worldwide market value of the voting and non-voting common equity held by non-affiliates as of the last business day of the issuer's most recently completed second fiscal quarter. For an accelerated filer, the aggregate market value criterion is $75 million or more, but less than $700 million. For a large accelerated filer, the aggregate market value criterion is $700 million or more.

Auditing Standard No. 5 establishes a top-down,[3/] risk-based approach to the audit of internal control. The auditing standard is designed to focus auditors on the most important matters in the audit of internal control and avoid procedures that are unnecessary to an effective audit.

When Auditing Standard No. 5 was adopted, the Board announced its intention to monitor the implementation of that auditing standard. The PCAOB has continued to monitor Auditing Standard No. 5 execution as part of its ongoing oversight activities. Over the last three years, the PCAOB's inspections staff has observed a significant number of auditing deficiencies in audits of internal control. As reported in *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* ("the general inspection report"),[4/] in 46 of the 309 integrated audit engagements (or 15 percent) covered by the general inspection report, inspections staff found that the firm, at the time it issued its audit report, had failed to obtain sufficient appropriate evidence to support its opinion on the effectiveness of internal control due to one or more auditing deficiencies identified by the inspections staff. The general inspection report also noted that, in an additional 16 percent of the engagements covered by the report, the inspections staff identified other deficiencies in the auditing of internal control that did not involve findings of such significance that they indicated a failure to support the firm's internal control opinion.[5/] Inspections in subsequent years have

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[3/] Under PCAOB standards, a top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to internal control over financial reporting. The auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions. This approach directs the auditor's attention to accounts, disclosures, and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The auditor then verifies his or her understanding of the risks in the company's processes and selects for testing those controls that sufficiently address the assessed risk of misstatement to each relevant assertion. See paragraph 21 of Auditing Standard No. 5.

[4/] See PCAOB Release 2012-006, *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* (December 10, 2012).

continued to identify similarly high levels of deficiencies in audits of internal control.

Deficiencies in audits of internal control also can affect the audit of the financial statements. In integrated audits, auditors often rely on controls to reduce their substantive testing of financial statement accounts and disclosures. Thus, deficiencies in testing and evaluating internal control can lead to inadequate testing of accounts and disclosures in the financial statement audit. The general inspection report notes that, in 39 of the 46 engagements (85 percent) in which the inspection staff found that the firm did not have sufficient appropriate evidence to support the firm's internal control opinion, representing 13 percent of the 309 integrated audit engagements that were inspected, inspection staff found that the firm also failed to obtain sufficient appropriate evidence to support its opinion on the financial statements.

Significant auditing deficiencies in audits of internal control that have been frequently cited in PCAOB inspection reports include failures to:

- Identify and sufficiently test controls that are intended to address the risks of material misstatement;
- Sufficiently test the design and operating effectiveness of management review controls that are used to monitor the results of operations;
- Obtain sufficient evidence to update the results of testing of controls from an interim date to the company's year end (i.e., the roll-forward period);
- Sufficiently test controls over the system-generated data and reports that support important controls;[6]

[5/] Although the general inspection report relates to inspections of eight domestic registered firms that have been inspected annually since the inception of the PCAOB inspections program, as the report states, PCAOB inspections have found similar problems with audits of internal control at other registered firms.

[6/] See paragraph 39 of Auditing Standard No. 5, which provides that the auditor should test those controls that are important to the auditor's

- Sufficiently perform procedures regarding the use of the work of others; and

- Sufficiently evaluate identified control deficiencies.[7/]

This practice alert discusses the application of certain requirements of Auditing Standard No. 5 and other PCAOB standards to specific aspects of the audit of internal control in light of recent observations of auditing deficiencies. Specifically, this alert discusses the following topics:

- *Risk assessment and the audit of internal control.* This alert explains how the risk assessment process set forth in PCAOB standards relates to certain aspects of the audit of internal control. It also discusses coordinating the procedures for obtaining an understanding of internal control with the Auditing Standard No. 5 objectives for understanding likely sources of misstatement, assessing risks for components of significant accounts and disclosures, and considering risk in determining the scope of testing in multi-location engagements.

- *Selecting controls to test.* The alert discusses the requirements for selecting controls to test and considerations for making an appropriate selection of controls to test, including controls that operate infrequently.

- *Testing management review controls.* The alert discusses management review controls and the requirements in PCAOB standards for testing those controls.

- *Information technology ("IT") considerations, including system-generated data and reports.* The alert highlights requirements in PCAOB standards regarding the consideration of IT in audits of internal control, including testing controls that use system-

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conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion.

[7/] See, e.g., PCAOB Release 2012-006, *Observations from 2010 Inspections of Domestic Annually Inspected Firms Regarding Deficiencies in Audits of Internal Control Over Financial Reporting* (December 10, 2012).

generated data and reports and evaluating deficiencies in IT general controls ("ITGCs").

- *Roll-forward of controls tested at an interim date.* The alert discusses the auditor's responsibilities when controls are tested at an interim date in the audit of internal control, including the necessary roll-forward procedures to extend the results of interim testing to year end.

- *Using the work of others.* The alert discusses the requirements in PCAOB standards regarding when it is appropriate to use the work of others, how to determine the extent to which the work can be used, and the importance of testing the work of others.

- *Evaluating identified control deficiencies.* The alert discusses the auditor's responsibilities for evaluating control deficiencies and highlights the importance of testing compensating controls and performing the evaluation with professional skepticism and careful analysis.

Risk Assessment and the Audit of Internal Control

One of the potential root causes for the deficiencies in audits of internal control, as cited in the general inspection report, is improper application of the top-down approach set forth in PCAOB standards.[8/] For example, the general inspection report notes that, in some instances, it appears that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether they adequately addressed the assessed risks of material misstatement of the significant account or disclosure. In some instances, inspections staff observed that firms failed to test controls for all relevant assertions of the significant accounts and disclosures. In other instances, it appeared to the inspections staff that firms did not sufficiently understand the likely sources of

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[8/] See paragraph 21 of Auditing Standard No. 5. Also, the general inspection report notes that the improper application of the top-down approach may be caused, in part, by other root causes discussed in that report and a reduced focus by firms on the requirements of Auditing Standard No. 5. See the general inspection report at 18.

potential misstatements related to significant accounts or disclosures as part of selecting controls to test.

Risk assessment is a key element of the top-down approach, and it underlies the entire audit process in the audit of internal control.[9/] An effective risk assessment process pursuant to PCAOB standards is fundamental to the audit of internal control.[10/] Identifying the risks of material misstatement – including the types of potential misstatements that can occur and the likely sources of those potential misstatements – is necessary for the auditor to select appropriate controls to test and to evaluate whether those controls adequately address the risks. For example, an auditor who identifies revenue overstatement as a risk, without assessing how overstatements might occur or understanding the controls in place to address the risk, lacks the basis to make an informed selection of controls to test or to meaningfully evaluate whether the selected controls are designed and operating to prevent or detect potential misstatements.

Auditing Standard No. 5 requires a risk-based audit approach. Proper application of the auditing standards for assessing and responding to risk ("risk assessment standards")[11/] is important for performing effective audits of internal control and integrating the audit of internal control with the audit of financial statements.

Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* establishes a process for identifying and assessing risks of material misstatement in an audit, which applies to audits of internal control and audits of financial statements. The risk assessment procedures required by Auditing Standard No. 12 include, among other things, obtaining an understanding of the company and its environment and obtaining an understanding of internal control. The auditing standard also sets forth a process for assessing identified risks, which includes determining the likely sources of

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9/ See paragraph 10 of Auditing Standard No. 5. Also, see generally, Auditing Standard No. 8, *Audit Risk,* Auditing Standard No.12, *Identifying and Assessing Risks of Material Misstatement,* and Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

10/ See paragraph 6 of Auditing Standard No. 12 and paragraphs 6 and 10 of Auditing Standard No. 5.

11/ Auditing Standard Nos. 8-15.

potential misstatement and evaluating the types of misstatements that could result from the risks; the accounts, disclosures, and assertions that could be affected; and the likelihood and magnitude of potential misstatements.[12/]

Obtaining an Understanding of Internal Control

In an audit of internal control, a thorough understanding of the company's internal control is important because it enables the auditor to appropriately plan and perform the necessary tests of controls. Auditing Standard No. 12 requires the auditor to obtain a sufficient understanding of each component[13/] of internal control to (1) identify the types of potential misstatements, (2) assess the factors that affect the risks of material misstatement, and (3) design tests of controls and substantive procedures.[14/]

Understanding internal control includes understanding the information system, including the related business processes, relevant to financial reporting, which comprise the following:

a. The classes of transactions in the company's operations that are significant to the financial statements;

b. The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, processed, recorded, and reported;

c. The related accounting records, supporting information, and specific accounts in the financial statements that are used to initiate, authorize, process, and record transactions;

12/ See paragraphs 59 and 61 of Auditing Standard No. 12.

13/ Paragraph 21 of Auditing Standard No. 12 provides that internal control can be described as consisting of the following components: the control environment, company's risk assessment process, information and communication, control activities, and monitoring of controls.

14/ See paragraph 18 of Auditing Standard No. 12 and paragraph 13 of Auditing Standard No. 15, *Audit Evidence*.

d. How the information system captures events and conditions, other than transactions, that are significant to the financial statements; and

e. The period-end financial reporting process.[15/]

In an audit of internal control, Auditing Standard No. 5 requires the auditor to perform procedures to achieve certain objectives for further understanding likely sources of potential misstatements and as part of selecting controls to test.[16/] The procedures performed to achieve those objectives may be performed concurrently with procedures for identifying and assessing risks of material misstatement pursuant to Auditing Standard No. 12. Performing the procedures concurrently could facilitate compliance with PCAOB standards, enhance the auditor's understanding of the company's processes and likely sources of potential misstatements, and avoid potential duplication of audit effort.

The following table illustrates how certain of the procedures required by Auditing Standard No. 12 can be coordinated with the procedures applied to meet certain of the Auditing Standard No. 5 objectives. For example, while obtaining an understanding of the information system pursuant to Auditing Standard No. 12, the auditor also can perform procedures to understand the flow of transactions for relevant assertions. Similarly, while obtaining an understanding of the company's risk assessment process and control activities, the auditor also can identify the controls that management has implemented to address potential misstatements.

15/ See paragraph 28 of Auditing Standard No. 12.

16/ See paragraph 34 of Auditing Standard No. 5.

Procedures Required by Auditing Standard No. 12	Related Objective in Auditing Standard No. 5[17]
Obtain an understanding of the information system, including the related business processes, relevant to financial reporting[18]	Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded
Identify and assess the risks of material misstatement at the assertion level and identify significant accounts and disclosures and their relevant assertions[19]	Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material
Obtain an understanding of the company's risk assessment process and[20] control activities,[21] and consider controls that address fraud risks and other significant risks[22]	Identify the controls that management has implemented to address the potential misstatements Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements

[17] Id.

[18] See paragraph 28 of Auditing Standard No. 12.

[19] See paragraphs 59-64 of Auditing Standard No. 12.

[20] See paragraphs 26-27 of Auditing Standard No. 12.

[21] See paragraph 34 of Auditing Standard No. 12.

[22] See paragraphs 72-73 of Auditing Standard No. 12.

Auditing Standard No. 5 and Auditing Standard No. 12 provide that, although walkthroughs are not required, performing walkthroughs that encompass the procedures set forth in the standard[23/] is an effective way to meet the required Auditing Standard No. 5 objectives in the table above and may be used in testing the design of controls.[24/] Thus, careful planning and execution of walkthroughs, particularly when performed or supervised by experienced personnel, can enhance the effectiveness of those aspects of the integrated audit and avoid duplication of effort. Incomplete or poorly executed walkthroughs, however, can lead to inadequate risk assessments, which can impair the effectiveness of auditors' selection and testing of controls.

The general inspection report notes that, in some situations, firms' walkthrough procedures were not adequate to verify the auditor's understanding of the risks in the company's processes and to identify and select for testing controls sufficient to address the risk of misstatement for the relevant assertions, as they were limited to:

- Performing inquiry and observation to confirm that there have been no significant changes to the processes;
- Obtaining an understanding through controls testing and substantive procedures;
- Reviewing walkthroughs performed by the company's internal auditor who did not provide direct assistance under the firm's supervision; or

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23/ Paragraph 37 of Auditing Standard No. 5 provides that, in performing a walkthrough, the auditor follows a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use. Walkthrough procedures usually include a combination of inquiry, observation, inspection of relevant documentation, and re-performance of controls.

24/ See paragraphs 37-38 and 43 of Auditing Standard No. 5, paragraphs 20 and 37-38 of Auditing Standard No. 12, and paragraph 20 of Auditing Standard No. 13.

- Relying on the auditor's knowledge and experience obtained from prior years' audits.

Assessing Risks of Material Misstatement in Components of Significant Accounts and Disclosures

In assessing risks of material misstatement and selecting controls to test, it is important for auditors to be aware that the components of a potential significant account or disclosure might be subject to significantly different risks.[25/] Also, different risks of material misstatement affecting the same assertion of an account or disclosure might arise at different points within the company's processes. If risks differ among components, the auditor might need to select and test different controls to support a conclusion that the controls adequately address the risks to the account or disclosure.

The following are some examples of accounts and disclosures for which individual components could have different risks:

- Individual revenue categories might have different risks because of varying types of products and services, sales terms, information systems, including revenue processes, or accounting requirements.

- Individual investment securities or categories of securities in a portfolio might have different risks if they vary in nature and complexity, level of market activity, or availability of observable market data.

- The components of an allowance for loan losses might have different risks, for instance, if those components reflect different credit exposures, are determined using different methods, or are subject to different accounting requirements.

- The components of a reserve for sales returns and allowances might have different risks if they relate to different sales terms or repayment terms, use different information systems, including business processes, or are subject to different accounting requirements.

[25/] See paragraph 63 of Auditing Standard No. 12.

Effect of Risk Assessment on the Scope of Testing in Multi-location Engagements

Inspections staff have observed instances, such as the following, in which it appeared that firms did not sufficiently test controls that addressed the risks of material misstatement in multi-location engagements:

- Testing a sample of locations and extrapolating the results of that testing to other locations without performing procedures to evaluate whether the issuers' systems and controls were designed and implemented consistently across all of those locations.

- Excluding certain locations from testing without establishing whether there was a reasonable basis for excluding those locations.

Also, inspections staff have observed instances in which it appeared that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether the controls selected for testing, individually or in combination, adequately addressed the assessed risks of material misstatement of the significant account or disclosure across the significant locations.

In multi-location engagements, PCAOB standards require the auditor to assess the risks of material misstatement to the consolidated financial statements associated with the location or business unit and correlate the amount of auditing attention devoted to the location or business unit with the degree of risk.[26/] Auditing Standard No. 9 lists factors that are relevant to the assessment of the risk of material misstatement associated with a location or business unit and the determination of the necessary audit procedures.[27/] Certain of the factors listed in Auditing Standard No. 9 relate to the inherent risks of material misstatement, while others – such as the control environment, centralized processing, and monitoring activities – relate to entity-level controls. Auditing Standard No. 5 provides that, in lower risk locations, the auditor might first evaluate whether entity-level controls, including controls in place to provide

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[26/] See paragraph 11 of Auditing Standard No. 9, *Audit Planning,* and paragraph B10 of Auditing Standard No. 5.

[27/] See paragraph 12 of Auditing Standard No. 9.

assurance that appropriate controls exist throughout the organization, provide the auditor with sufficient evidence.[28/] Auditing Standard No. 5 also provides that the auditor may take into account the work of others in determining the locations or business units at which to perform tests of controls.[29/] Using the work of others is discussed later in this alert.

To illustrate the application of these principles, assume that an auditor is performing an integrated audit of a company with business units in several locations. After assessing the risks associated with the individual locations, an auditor might design an audit strategy involving:

a. Identifying and testing controls over specific risks that present a reasonable possibility of material misstatement to the company's consolidated financial statements;

b. To the extent not covered in item a above, identifying and testing controls at locations or business units that, individually or in combination, present a reasonable possibility of material misstatement through one or more of the following:

   (1) Testing entity-level controls that operate at a level of precision that would detect material misstatements in the locations or business units, individually or in combination.

   (2) For locations with centralized systems and processes and homogeneous controls, performing tests of the common controls across the locations or business units.

   (3) Using the work of others who tested controls at the locations, to the extent appropriate, as discussed later in this release.

c. No specific testing of controls for locations or business units that individually or in combination do not present a reasonable possibility of material misstatement of the consolidated financial statements.

28/ See paragraph B11 of Auditing Standard No. 5.

29/ See paragraph B12 of Auditing Standard No. 5.

In testing controls at locations or business units other than controls that address specific risks, the auditor should reassess the audit strategy if the auditor obtains information that is contrary to the premises under which the audit strategy was developed.[30/] For example, the strategy should be reassessed if the auditor obtains information indicating certain locations have risks not identified previously; certain locations have higher risk than the initial assessment; certain locations do not have homogeneous processes, systems, controls, or operating environments as previously thought; entity-level controls do not, by themselves, operate with the necessary level of precision; or the work of others cannot be used to the extent planned.

Selecting Controls to Test

As discussed previously, the general inspection report notes that, in some instances, it appears that firms, in implementing a top-down approach, placed undue emphasis on testing management review controls and other detective controls without considering whether they adequately addressed the assessed risks of material misstatement of the significant account or disclosure. In some instances, inspections staff observed that firms failed to test controls for all the relevant assertions of the significant accounts and disclosures.

In the audit of internal control, PCAOB standards require the auditor to test:[31/]

a. Entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting, including evaluating the control environment and period-end financial reporting process;[32/] and

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30/ See paragraph 15 of Auditing Standard No. 9 and paragraph 74 of Auditing Standard No. 12, which discuss the auditor's responsibilities for changing the audit strategy and planned audit procedures when circumstances change or contrary information is identified.

31/ Paragraph 14 of Auditing Standard No. 5 provides that the auditor also should evaluate whether the company's controls sufficiently address identified fraud risks and controls intended to address the risk of management override.

32/ See paragraphs 22 and 26 of Auditing Standard No. 5.

b. Controls that are important to the auditor's conclusion about whether the company's controls sufficiently address the assessed risk of misstatement to each relevant assertion (which may be entity-level controls or other controls).[33/]

Also, Auditing Standard No. 5 cautions that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures.[34/]

In selecting controls over significant accounts and disclosures, an important consideration is determining that the auditor has selected controls that, individually or in combination, are intended to address the identified risks of material misstatement, including risks for the relevant assertions and the components of the account or disclosure with differing risks. The following is a partial list from the general inspection report of assertions or account components for which inspections staff observed that auditors failed to identify and sufficiently test controls that addressed the risks of material misstatement:

- Revenue: Significant business units or significant revenue categories, significant contract provisions affecting revenue recognition, and significant inputs to percentage-of-completion calculations

- Inventory: Pricing of significant inventory components and determination of reserves for excess and obsolete inventory

- Fair value of financial instruments: Inputs used to value hard-to-value financial instruments and determinations of the classification of securities within the fair value hierarchy set forth in Financial Accounting Standards Board Accounting Standards Codification Topic 820, *Fair Value Measurement*

- Valuation of pension plan assets[35/]

33/ See paragraphs 23, 39, and 41 of Auditing Standard No. 5.

34/ See paragraph B9 of Auditing Standard No. 5.

35/ See the general inspection report at 5-6.

To illustrate the process of selecting controls to test, assume that an auditor identifies risks of material misstatement related to reserves for excess and obsolete inventory. When selecting controls that are important to address the risks of material misstatement, it is important to look for controls that encompass each segment of inventory for which there is a reasonable possibility of material misstatement regarding the related reserve for excess and obsolete inventory. Limiting the selection to controls over inventory segments that have no reserves, for example, would not be sufficient to address the risk of material misstatement.

The procedures performed to obtain an understanding of internal control pursuant to Auditing Standard No. 12 and to meet the objectives of paragraph 34 of Auditing Standard No. 5 can provide a basis for the auditor to determine whether the selected controls cover the identified risks. For example, performing those procedures enables the auditor to understand the likely sources of potential misstatement and the controls intended to prevent or detect those misstatements.

Another important consideration in selecting controls to test is whether the controls, individually or in combination, are capable of addressing the risks of material misstatement to the relevant assertion.[36/] Some risks, especially those related to complex processes or subjective estimates, might require a combination of controls to prevent or detect misstatements. For example, if a company has a complex income tax calculation, the controls needed to address the risks of material misstatement might consist of a combination of (1) a review of the overall tax calculation by a person with the necessary authority and competence and (2) certain other types of controls over key aspects of the calculation. As another example, an auditor might select a combination of a manual review control that uses system-generated data and IT controls over the completeness and accuracy of that data, as discussed later in this alert.

Controls over Infrequent Processes and Transactions

Internal control is not limited to frequent processes and normal recurring transactions. It also applies to infrequent processes, such as an analysis of whether long-term assets are impaired, and to nonrecurring transactions outside the normal course of business, such as a material business combination.

[36/] See paragraphs 23, 39, and 41 of Auditing Standard No. 5.

When a company has infrequent processes or enters into nonrecurring transactions that present a reasonable possibility of material misstatement of the financial statements, the auditor should test the controls over those processes or transactions. Performing substantive audit procedures to determine whether the accounts or transactions are accounted for properly is important for the financial statement audit but, by itself, does not provide sufficient appropriate evidence to support a conclusion that the controls over those transactions or analyses are designed and operating effectively. As discussed previously, Auditing Standard No. 5 cautions that a control must be tested directly to obtain evidence about its effectiveness; an auditor cannot merely infer that a control is effective because no misstatements were detected by substantive procedures.[37/]

In some cases, auditors are able to design and perform procedures that test controls over nonrecurring transactions concurrently with substantive tests of those transactions, thereby obtaining sufficient appropriate evidence to fulfill the related objectives for the financial statement audit and the audit of internal control. For example, when auditing the company's accounting for a business combination, the auditor also might obtain an understanding of the company's financial reporting process, and related controls, regarding the business combination. In that situation, the auditor could test important controls over the accounting for business combinations when auditing the accounting for the business combination. In that situation, the auditor's substantive testing and tests of controls should be sufficient to meet the objectives of both tests.

Testing Management Review Controls

Auditors often select and test management review controls in audits of internal control. Such management reviews might be performed to monitor the results of operations, such as (1) monthly comparisons of actual results to forecasted revenues or budgeted expenses; (2) comparisons of other metrics, such as gross profit margins and expenses as a percentage of sales; and (3) quarterly balance sheet reviews. These reviews typically involve comparing recorded financial statement amounts to expected amounts and investigating significant differences from expectations.

As with other types of controls, the auditor should perform procedures to obtain evidence about how a management review control is designed and

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[37/] See paragraph B9 of Auditing Standard No. 5.

operates to prevent or detect misstatements.[38] Verifying that a review was signed off provides little or no evidence by itself about the control's effectiveness.

Evaluating the Precision of Management Review Controls

Many management review controls are entity-level controls, so testing those review controls can be an appropriate part of a top-down approach. Auditing Standard No. 5 provides that entity-level controls vary in nature and precision and that some entity-level controls might operate at a level of precision that would adequately prevent or detect misstatements on a timely basis.[39] Other entity-level controls, by themselves, might not operate with the necessary level of precision, but might be effective in combination with other controls in addressing the assessed risk of material misstatement.

Thus, the main consideration in assessing the level of precision is whether the control is designed and operating to prevent or detect on a timely basis misstatements that could cause the financial statements to be materially misstated. Factors that can affect the level of precision of an entity-level control include the following:

- *Objective of the review.* A procedure that functions to prevent or detect misstatements generally is more precise than a procedure that merely identifies and explains differences.

- *Level of aggregation.* A control that is performed at a more granular level generally is more precise than one performed at a higher level. For example, an analysis of revenue by location or product line normally is more precise than an analysis of total company revenue.

- *Consistency of performance.* A control that is performed routinely and consistently generally is more precise than one performed sporadically.

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[38] See paragraphs 42-45 of Auditing Standard No. 5, which describe the auditor's responsibilities for testing the design and operating effectiveness of controls.

[39] See paragraph 23 of Auditing Standard No. 5.

- *Correlation to relevant assertions.* A control that is indirectly related to an assertion normally is less likely to prevent or detect misstatements in the assertion than a control that is directly related to an assertion. For example, a control designed to detect errors in the recorded amounts of accounts receivable might not operate with a sufficient level of precision to detect errors in the valuation of delinquent receivables.

- *Predictability of expectations.* Some entity-level controls are designed to detect misstatements by using key performance indicators or other information to develop expectations about reported amounts ("detective controls"). The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.

- *Criteria for investigation.* For detective controls, the threshold for investigating deviations or differences from expectations relative to materiality is an indication of a control's precision. For example, a control that investigates items that are near the threshold for financial statement materiality has less precision and a greater risk of failing to prevent or detect misstatements that could be material than a control with a lower threshold for investigation.

Testing Design Effectiveness

Auditing Standard No. 5 provides that the auditor should test the design effectiveness of controls by determining whether the company's controls, if they are operated as prescribed by persons possessing the necessary authority and competence, satisfy the company's control objectives[40/] and can effectively prevent or detect errors or fraud that could result in material misstatement of the financial statements.[41/]

Evaluating whether a management review control is capable of preventing or detecting potential material misstatements generally involves obtaining an understanding of and evaluating the following:

[40/] See paragraph A2 of Auditing Standard No. 5 for the definition of the term "control objective."

[41/] See paragraph 42 of Auditing Standard No. 5.

a. Whether the control satisfies the corresponding control objective, including whether it addresses the risks of material misstatement to the relevant assertion of the significant account or disclosure;

b. The factors affecting the precision of the review, including the objective of the review and the appropriateness of the expectations, level of aggregation, and criteria for investigation for identifying potentially material misstatements;

c. The steps involved in identifying, investigating, and resolving significant differences from expectations;

d. The person(s) who performs the control, including the competence and authority of the person(s);

e. The frequency of performance of the control, that is, whether the review occurs often enough to prevent or detect misstatements before they have a material effect on the financial statements; and

f. The information used in the review, for example, whether the review uses system-generated data or reports, as discussed later in this alert.

The evaluation of design may be performed in conjunction with obtaining an understanding of internal control over financial reporting and performing procedures to achieve the objectives of paragraph 34 of Auditing Standard No. 5, which were presented in the prior table.[42/] For example, to assess whether a control is effectively designed, it is important to identify the risk of material misstatement to the relevant assertion of the significant account or disclosure that the control is intended to address.

[42/] See paragraph 43 of Auditing Standard No. 5, which provides that procedures the auditor performs to test design effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, and inspection of relevant documentation. Walkthroughs that include these procedures ordinarily are sufficient to evaluate design effectiveness.

Testing Operating Effectiveness

Auditing Standard No. 5 provides that the auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control has the necessary authority and competence to perform the control effectively.[43/] The auditing standard also provides that the evidence necessary to persuade the auditor that a control is effective depends upon the risk associated with the control.[44/]

Testing the operating effectiveness of a management review control involves performing procedures to evaluate whether the control is working as designed to prevent or detect potentially material misstatements. Testing typically involves, for selected operations of the control, obtaining and evaluating evidence about:[45/]

a. The steps performed to identify and investigate significant differences; and

b. The conclusions reached in the reviewer's investigation, including whether potential misstatements were appropriately investigated and whether corrective actions were taken as needed.

The nature, timing, and extent of testing should be commensurate with the risk associated with the controls. Higher risk controls warrant more testing.

The auditor also should take into account other relevant evidence obtained in the audit when evaluating the effectiveness of a control, such as identified misstatements that were not prevented or detected by the control.[46/]

[43/] See paragraph 44 of Auditing Standard No. 5.

[44/] See paragraph 46 of Auditing Standard No. 5.

[45/] If the control uses system-generated information or reports, the auditor also should obtain evidence about the completeness and accuracy of those reports, as discussed in the information technology considerations section of this alert. This also applies to other internally-produced information used by the company in an important control.

[46/] See paragraph 71 of Auditing Standard No. 5.

Example: Test of a Management Review Control

To illustrate the process of testing management review controls, assume that, in an audit of a commercial enterprise with four similar branch locations, the auditor selects for testing a monthly control over the existence, completeness, and allocation assertions for certain selling, general, and administrative expenses, such as salaries and wages, utilities, facilities, and depreciation. In the selected control, each branch controller performs an analysis comparing the expense-related accounts in the branch's financial statements to the prior year and forecasted financial statements for the branch and investigates differences over a predetermined threshold set by the company's chief financial officer ("CFO"). Each branch controller discusses the results of the analysis with the CFO to enable the CFO to understand the basis for significant differences and determine whether any financial statement adjustments or other corrective actions are needed.

The auditor assesses a higher risk associated with the management review control because the control applies to multiple assertions for several material accounts with varying levels of risk of material misstatement.[47/]

In this illustration, the auditor's procedures may include the following:[48/]

a. Evaluating whether the control addresses the risks of material misstatement to the relevant assertions of the selling, general, and administrative expense accounts, as intended;

b. Evaluating whether the use of prior year and forecast information at the branch level is an appropriate basis for establishing expectations to identify potential misstatements;

[47/] See, e.g., paragraph 47 of Auditing Standard No. 5, which provides that two factors affecting the risk associated with a control are (1) the nature and materiality of misstatements that the control is intended to prevent or detect and (2) the inherent risk associated with the related account(s) and assertion(s).

[48/] The procedures listed here are illustrative. The actual procedures needed for a particular management review control will depend on, among other things, the nature of the control, the risk associated with the control, the information used in the control, and the evidence of the control's operation.

c. Evaluating whether the criteria used for identifying differences for investigation are set at an appropriate level to enable the branch controller to identify misstatements that could be material to the financial statements, individually or in combination with other misstatements;

d. Evaluating the competencies of the CFO and branch controllers based on, among other things, the auditor's knowledge of the individuals and experience with them in current and prior audits;

e. Evaluating whether the control operates often enough to prevent or detect misstatements before they have a material effect on the financial statements;

f. For selected operations of the control, obtaining the information used by the branch controller in the analysis, understanding the steps performed by the branch controller to investigate significant differences, reperforming the analysis and comparing the auditor's identification of significant differences and evaluation of results – including identified misstatements, if any – to the branch controller's analysis; and

g. Observing or reading summaries of selected meetings in which the results of the analyses by the branch controllers were discussed with the CFO; inspecting the information presented to the CFO; and evaluating the matters discussed, conclusions reached, and corrective actions taken, if any.

The auditor also determined that the control uses financial statement and forecast information that is maintained and reported by the same IT system. The company's IT systems are centrally managed, and the IT controls for that system were tested in conjunction with tests of IT controls for the company's other financial statement related systems.

The preceding example illustrates an approach to testing accounts that tend to be routine and predictable. If testing controls over accounts or assertions that are more complex or less predictable, management review controls consisting primarily of comparisons to budgets or forecasts might not operate at a sufficient level of precision. In those situations, it might be necessary to test a combination of management review controls and other controls to conclude on whether the company's controls sufficiently address the risks of material misstatement for the relevant assertions of significant accounts.

Information Technology Considerations, Including System-generated Data and Reports

The general inspection report notes that inspections staff have observed instances in which firms selected controls for testing but failed to sufficiently test controls over the completeness and accuracy of system-generated data or reports used in the operation of those controls. For example, some firms failed to: (1) test ITGCs that are important to the effective operation of the applications that generated the data or reports, (2) test the logic of the queries (or parameters) used to extract data from the IT applications used in the reports, or (3) address control deficiencies that were identified with respect to the ITGCs over either the applications that process the data used in the reports or the applications that generated the reports.[49/] Similarly, inspections staff have observed instances in which firms have identified that certain ITGCs were ineffective but failed to perform other procedures to test report writers and systems used to produce spreadsheets, queries, or reports. In other instances, the firms planned their tests of controls to include testing of ITGCs for IT-dependent controls, but those IT-dependent controls used customized data or queries that were not subject to the ITGCs the firms tested.

A company's use of IT can significantly affect a company's internal control. The following are examples of IT-related matters that can affect the auditor's evaluation of internal control:

- Risks of material misstatement resulting from the company's IT processes or systems;[50/]
- Important controls that depend on the effectiveness of IT controls ("IT-dependent controls"), for example, because they use system-generated data or reports; and
- Important IT controls, such as, automated controls that address risks of material misstatement to one or more assertions, along with the IT controls that support the effectiveness of the automated controls.

49/ See the general inspection report at 11.

50/ See, e.g., paragraphs 36 and 47 of Auditing Standard No. 5 and paragraphs B1-B6 and 29 of Auditing Standard No. 12.

PCAOB standards require the auditor to obtain an understanding of the company's information system relevant to financial reporting and take into account IT considerations in assessing the risks of material misstatement. This includes obtaining an understanding of the extent of manual controls and automated controls used by the company, including the ITGCs that are important to the effective operation of the automated controls.[51/] The auditor also should obtain an understanding of specific risks to a company's internal control resulting from IT.[52/]

In an audit of internal control, if the auditor selects an IT-dependent control for testing, the auditor should test the IT-dependent controls and the IT controls on which the selected control relies to support a conclusion about whether those controls address the risks of material misstatement.[53/] For example, if a control selected for testing uses system-generated data or reports, the effectiveness of the control depends in part on the controls over the accuracy and completeness of the system-generated data or reports. In those situations, supporting a conclusion on the effectiveness of the selected control involves testing both the selected control and the controls over the system-generated data and reports.

As discussed later in this alert, PCAOB standards require evaluation of the severity of identified control deficiencies. This includes deficiencies in IT controls. However, the nature of IT systems, processes, and controls can affect how deficiencies in IT controls should be evaluated. For example, an IT control might not be intended to prevent or detect misstatements by itself, but it might impair the effectiveness of important IT-dependent controls if it were deficient. In those situations, evaluating the severity of a deficient IT control involves assessing the effect of the deficiency on important IT-dependent controls and, in turn, the likelihood and magnitude of potential misstatements that could result, individually or in combination with other control deficiencies. Also, deficient IT controls might impair the effectiveness of multiple controls across multiple accounts. In those situations, it may be necessary to assess the severity of those impaired controls

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51/ See paragraph B1 of Auditing Standard No. 12.

52/ See paragraph B4 of Auditing Standard No. 12.

53/ See, e.g., paragraphs 39-41 of Auditing Standard No. 5, which discuss selecting controls to test and paragraph 47 of Auditing Standard No. 5, which cite situations in which controls rely on the effectiveness of IT general controls.

in combination across the affected accounts and with other control deficiencies affecting those accounts.

Roll-forward of Controls Tested at an Interim Date

The general inspection report notes that inspections staff have identified instances in which firms tested significant controls at an interim date and either did not perform any testing, or used inquiry alone, to update the results of their testing of higher risk controls that had been performed prior to year end. For example, an engagement team performed tests of highly subjective controls during the interim period, three to six months prior to year end. Yet the engagement team's procedures to update the results of its testing of these controls from the interim date to year end were limited to general inquires as to whether the operation of any of these controls had changed, despite higher degrees of risks associated with these controls, including, in some cases, high inherent risks or heightened fraud risks. In another example, the engagement team's procedures to update the results of its testing of internal control for the six-month period from the interim date to year end were limited to inquiry, including for higher-risk controls and controls affected by a change in management review and approval responsibilities.[54/]

Although the auditor expresses an opinion on internal control as of the end of the year, auditors may decide to test some important controls at an earlier date. When auditors test controls at an interim date, PCAOB standards require auditors to perform "roll-forward" procedures to update the results of interim testing to year end.[55/] The amount of evidence needed from the roll-forward procedures depends on the following factors:

- The specific control tested at an interim date, including the risks associated with the control and the nature of the control, and the results of those tests;

54/ See the general inspection report at 10.

55/ See paragraph 55 of Auditing Standard No. 5. If the auditor plans to rely on controls in the financial statement audit, the auditor must obtain evidence about the controls over the entire period of reliance, as discussed in paragraphs 16 and 29-30 of Auditing Standard No. 13.

- The sufficiency of the evidence of effectiveness obtained at an interim date;

- The length of the roll-forward period; and

- The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.[56/]

Auditing Standard No. 5 provides that inquiry might be a sufficient roll-forward procedure when evaluation of the preceding factors indicates a low risk that the controls are no longer effective during the roll-forward period.[57/] For example, inquiry might be appropriate if the risk associated with the control were low, the auditor obtained substantially all of the evidence necessary to support the conclusion on the control as of the interim date with no observed test exceptions, the roll-forward period was relatively short, and there were no significant changes in internal control during the roll-forward period. Conversely, inquiry is unlikely to be sufficient if the control is more complex, subjective or otherwise higher risk; the control was not tested extensively at the interim date; exceptions were noted in the interim testing; the roll-forward period spans a significant portion of the year; or significant changes occurred in internal control during the roll-forward period. Similarly, when inquiry is not sufficient, the additional evidence to cover the roll-forward period cannot be inferred from the absence of misstatements detected by substantive procedures.[58/]

Using the Work of Others

The general inspection report notes that inspections staff have identified situations in which firms used the work of others, most often internal audit, who performed tests of controls without establishing a sufficient basis for using that work. For example, in some instances, the extent to which firms used the work of internal audit in higher risk areas involving significant judgment, such as aspects of revenue and the valuation of complex, hard-to-value investment securities, was inappropriate. Also, in some instances, firms failed to evaluate the design of

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56/ See paragraph 56 of Auditing Standard No. 5.

57/ Id.

58/ See paragraph B9 of Auditing Standard No. 5.

internal audit's control testing procedures, including the scoping and the identification of important controls. For example, the engagement team used the work of internal audit to test controls over revenue. The engagement team did not re-perform any of the tests of controls performed by the issuer's internal audit group. In addition, there was no documentation of the nature, timing, and extent of the control testing performed by internal audit.[59/]

PCAOB standards allow the auditor to use the work of others as evidence of the effectiveness of selected controls, and Auditing Standard No. 5 requires auditors to determine the extent to which the work of others will be used.[60/]

PCAOB standards provide that the extent to which the work of others can be used depends on the following factors:

- The risk associated with the control being tested;[61/] and
- The competence and objectivity of the persons whose work the auditor plans to use.[62/] For example, persons who test controls are less objective if they report to those responsible for the operation of the controls being tested.

The risk associated with the control is the risk that a control might not be effective and, if not effective, that a material weakness would result.[63/] Auditing Standard No. 5 discusses factors that affect the risk associated with a control, including the complexity of the control and significance of judgments that must be made in connection with its operation and the inherent risks of the related account or assertion.[64/] As the risk associated with the control increases, the

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59/ See the general inspection report at 12.

60/ See paragraphs 16-17 of Auditing Standard No. 5.

61/ See paragraph 19 of Auditing Standard No. 5.

62/ See paragraph 18 of Auditing Standard No. 5 and paragraphs .09-.11 of AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements.*

63/ See paragraph 46 of Auditing Standard No. 5.

64/ See paragraph 47 of Auditing Standard No. 5.

need for the auditor to perform his or her own testing of the control increases.[65/] In higher risk areas, such as testing complex controls, controls that address specific fraud risks, or controls that require significant judgment to operate or evaluate, use of the work of others would be limited, if at all.[66/] Conversely, the work of competent and objective persons could be used more extensively in lower risk areas.

PCAOB standards provide direction on evaluating the competence and objectivity of others.[67/] The higher the degree of competence and objectivity, the greater use the auditor may make of the work. The impact of the work of others on the auditor's work also depends on the relationship between the risk associated with the control and the competence and objectivity of those who performed the work. As the risk decreases, the necessary level of competence and objectivity decreases.[68/]

When the auditor uses the work of others, the auditor also should test and evaluate that work, including evaluating the quality and effectiveness of the others' work.[69/] The necessary extent of testing of that work depends on the risk associated with the control and the competence and objectivity of the others. More extensive testing of the others' work is needed as the risk increases or the others' level of competence or objectivity decreases. When using the work of

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[65/] See paragraph 19 of Auditing Standard No. 5.

[66/] See PCAOB Release 2007-005A, *Auditing Standard No. 5 – An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements and Related Independence Rule and Conforming Amendments* (June 12, 2007), at 14.

[67/] See paragraph 18 of Auditing Standard No. 5 and AU sec. 322.09-.11. For example, the objectivity of the others is lower when they report directly to management or to the person performing the control they are evaluating.

[68/] See PCAOB Release 2007-005A at 14.

[69/] See paragraph 16 of Auditing Standard No. 5 and AU sec. 322.24-.27. See also PCAOB Release 2007-005A at A4-4.

others that provide direct assistance, the auditor should supervise that work, including reviewing the work, as well as testing and evaluating it.[70/]

Evaluating Identified Control Deficiencies

The general inspection report notes that inspections staff observed instances in which firms failed to evaluate sufficiently the severity of the control deficiencies that they had identified. Specifically, in some cases firms did not:

- *Sufficiently evaluate whether audit adjustments and exceptions identified from substantive procedures were indicators of the existence of control deficiencies.* For example, the firm's valuation specialist concluded that the recorded fair values of certain of the issuer's assets were outside a reasonable range due to the use of unsupported assumptions. This resulted in a significant audit adjustment that the issuer recorded. The issuer's controls had failed to identify that the valuation assumptions were not supported; however, the engagement team failed to identify and evaluate this control deficiency.

- *Consider all of the relevant risk factors that should have affected the determination of whether there was a reasonable possibility that a deficiency, or a combination of deficiencies, could result in a material misstatement.* For example, a significant deficiency was identified over the issuer's process for valuing hard-to-value financial instruments. The engagement team failed to appropriately evaluate the severity of the deficiency as it did not evaluate relevant risk factors, such as, the nature of the accounts affected by the deficiency, and the subjectivity, complexity, or extent of judgment required to determine the valuations. In addition, the engagement team did not consider the magnitude of audit adjustments related to this control deficiency in determining whether the control deficiency was a material weakness rather than a significant deficiency.

- *Consider all of the relevant factors that should have affected the determination of the magnitude of potential misstatements.* For example, an engagement team did not sufficiently evaluate the severity of certain control deficiencies identified through tests of

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[70/] Id.

controls over revenue. Specifically, as part of the issuer's evaluation of control deficiencies, management calculated the magnitude of the potential misstatement resulting from the control deficiencies using certain significant assumptions. The engagement team used the issuer's evaluation but did not assess the reasonableness of the issuer's assumptions.

- *Sufficiently evaluate compensating controls, including identifying and testing those controls and determining whether they operated at a level of precision that would prevent or detect a misstatement that could be material.* For example, an engagement team concluded that certain compensating controls partially mitigated the effect of the deficiencies and that the control deficiencies therefore constituted a significant deficiency rather than a material weakness. The engagement team, however, failed to obtain sufficient appropriate audit evidence to support its conclusion that the compensating controls operated at a level of precision that would prevent or detect a misstatement that could be material. Specifically, the engagement team concluded that one of the compensating controls operated effectively even though the control failed to identify an error that was in excess of the engagement team's established materiality.[71/]

Control deficiencies might be identified during the audit of the financial statements as well as the audit of internal control. For example, an error identified in the financial statement audit often results from a deficiency in the design or operation of controls, or a lack of controls, over that account or disclosure. PCAOB standards require auditors to evaluate the effect of the findings of the substantive procedures performed in the financial statement audit on the effectiveness of internal control.[72/] This includes identifying and evaluating any specific control deficiencies related to the identified misstatements.

PCAOB standards require auditors to evaluate the severity of each control deficiency that comes to his or her attention to determine whether the

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[71/] See the general inspection report at 13-14.

[72/] See paragraph B8 of Auditing Standard No. 5.

deficiencies, individually or in combination, are material weaknesses.[73/] Auditing Standard No. 5 provides that the severity of a control deficiency depends on (1) whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure and (2) the magnitude of the potential misstatement resulting from the deficiency or deficiencies.[74/] The severity of a deficiency does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement.[75/]

Auditing Standard No. 5 also provides additional direction on evaluating the severity of control deficiencies, including risk factors that affect the evaluation of the likelihood and potential magnitude of misstatements resulting from control deficiencies and indicators of material weaknesses.[76/] For example, deficiencies in controls over the key assumptions in a significant accounting estimate could result in a reasonable possibility of misstatement because of the subjectivity, complexity, or extent of judgment required to determine the amount of the estimate. Also, multiple control deficiencies affecting the same account can increase the likelihood of misstatement. Similarly, the magnitude of potential misstatements resulting from a deficiency is greater for control deficiencies affecting processes with large transaction volumes or the existence of accounts with large recorded amounts.

In forming a conclusion about whether a control deficiency or combination of deficiencies is a material weakness, the auditor should evaluate the effect of compensating controls, if any. This includes testing the compensating controls to determine whether they operate at a level of precision that would prevent or detect a misstatement that could be material. This includes evaluating whether the control addresses the risk of material misstatement to the relevant assertion

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[73/] See, e.g., paragraph 62 and the second note to paragraph 65 of Auditing Standard No. 5.

[74/] See paragraph 63 of Auditing Standard No. 5.

[75/] See paragraph 64 of Auditing Standard No. 5.

[76/] See paragraphs 64-70 of Auditing Standard No. 5, which set forth additional requirements and direction regarding evaluating the severity of control deficiencies.

intended to be addressed by the deficient control. If the compensating control is a management review control, the previously discussed considerations for testing management review controls apply to the compensating control.

Evaluating whether a control deficiency, or a combination of control deficiencies, results in a material weakness requires professional skepticism and a careful analysis of all the evidence obtained. Auditors who perform a mechanical or cursory evaluation of deficiencies might reach premature conclusions without appropriately considering critical information. For example, a mechanical or cursory evaluation may lead an auditor to

- Assess control deficiencies in isolation, without considering the effects of deficiencies in combination;
- Consider only the amount of identified misstatements, without evaluating the magnitude of potential misstatement that could occur; or
- Focus on a checklist of material weakness indicators without considering other relevant factors.

Conclusion

An integrated audit of financial statements and internal control benefits investors because the auditor's reports address both the audited financial statements and the effectiveness of the controls the company uses to produce its financial statements. Appropriate application of the top-down, risk based approach pursuant to PCAOB standards can result in an effective audit of internal control while avoiding unnecessary work.

The PCAOB has observed through its inspections a significant number of audit deficiencies in audits of internal control over the past three years. This alert discusses certain significant matters relating to the application of PCAOB standards to audits of internal control, in light of these inspections observations.

Auditors should take note of the matters discussed in this alert in planning and performing their audits of internal control. Because of the nature and importance of the matters covered in this alert, it is particularly important for the engagement partner and senior engagement team members to focus on these areas and for engagement quality reviewers to keep these matters in mind when performing their engagement quality reviews. Auditing firms also should consider whether additional training of their auditing personnel is needed for the topics discussed in this alert.

Audit committees of companies for which audits of internal control are conducted might wish to discuss with their auditors the level of auditing deficiencies in this area identified in their auditors' internal inspections and PCAOB inspections, request information from their auditors about potential root causes of such findings and ask how they are addressing the matters discussed in this alert. In particular, audit committees may want to inquire about the involvement and focus by senior members of the firm on these matters.

As noted in the general report, audit committees may consider inquiring of the issuer's auditor how the controls to be tested will address the assessed risks of material misstatement for relevant assertions of significant accounts and disclosures. Also, audit committees may consider discussing with the auditor his or her assessment of risks, evaluation of control deficiencies, and whether the auditor has adjusted as necessary the nature, timing, and extent of his or her control testing and substantive audit procedures in response to risks related to identified control deficiencies.

The PCAOB will continue to monitor the execution of audits of internal control as part of its ongoing oversight activities.

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