

CAQ Alert #2009-91 – October 13, 2009

## DEAR CENTER MEMBERS

### [PCAOB Issues Report on First-Year Implementation of AS 5](#)

On September 24, 2009, the [Public Company Accounting Oversight Board](#) (PCAOB) issued a [report](#) on the first-year of implementation of [Auditing Standard No. 5](#) (AS 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The report describes the most common or noteworthy observations derived from inspections conducted during 2008 which focused on the eight largest registered audit firms' first-year transition to and implementation of AS 5 and involved the review of over 250 ICFR audits. ***The report may assist experienced auditors with the application of AS 5, as well as, auditors of non-accelerated filers who are preparing to comply for the first time.***

The areas below are highlighted within the report.

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

The [Center for Audit Quality](#) (CAQ) has prepared the table below, which summarizes the PCAOB reported observations for improving AS 5 implementation. The CAQ has also provided hyperlinks to resources which it believes are relevant to each area of focus in the PCAOB report. The table is not intended to be definitive in either its interpretation of the PCAOB report or in its suggestions as to relevant resources. Readers are urged to read the entire PCAOB report found at the hyperlink above and to be aware that there may be other relevant resources.

AREAS FOR IMPROVED IMPLEMENTATION	RELEVANT RESOURCES
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OBSERVATIONS ON RISK ASSESSMENT
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<ul style="list-style-type: none"> <li>• Failure to adequately assess risk in certain relevant aspects of the audit including:             <ul style="list-style-type: none"> <li>○ Identification of certain components of an account or certain locations in a multi-location environment that presented different risks of material misstatement of the financial statements than other components of the same account or other locations, respectively.</li> <li>○ Evaluation of both the qualitative and quantitative factors when determining whether to perform tests of controls at a location.</li> <li>○ Identification of all relevant assertions.</li> <li>○ Consideration of the effects of control deficiencies identified during the audit on the risk assessment (including deficiencies in pervasive controls such as information technology general controls).</li> </ul> </li> </ul>	<p>PCAOB – AS 5</p> <ul style="list-style-type: none"> <li>• <a href="#">Paragraph 10</a>, <i>Role of Risk Assessment</i></li> <li>• <a href="#">Appendix B10</a> – <i>Multiple Locations Scoping Decisions</i></li> </ul> <p>PCAOB Staff Views</p> <ul style="list-style-type: none"> <li>• <a href="#">Appendix A</a>, <i>The Integrated Audit Process</i></li> </ul> <p>CAQ Lessons Learned Publication</p> <ul style="list-style-type: none"> <li>• <a href="#">Lesson #4</a></li> <li>• <a href="#">Lesson #13</a></li> <li>• <a href="#">Lesson #14</a></li> <li>• <a href="#">Lesson #15</a></li> <li>• <a href="#">Lesson #16</a></li> </ul>
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OBSERVATIONS ON RISK OF FRAUD
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<ul style="list-style-type: none"> <li>• Insufficient response to an identified fraud risk because auditors either failed to alter the extent of testing in areas of greater risk, or they failed to identify and test compensating controls when the controls identified and tested did not completely address the identified risk.</li> <li>• Lack of evaluation of 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.</li> </ul>	<p>PCAOB AS 5</p> <ul style="list-style-type: none"> <li>• <a href="#">Paragraphs 14-15</a>, <i>Addressing the Risk of Fraud</i></li> </ul> <p>PCAOB Staff Views</p> <ul style="list-style-type: none"> <li>• <a href="#">Chapter 3</a>, <i>Assessing the Risk of Management Override and Evaluating Mitigating Actions</i></li> </ul>
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OBSERVATIONS ON USING THE WORK OF OTHERS
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- Further opportunities for auditors to utilize the work of others when the assessed level of risk was lower, including tests of certain system reports and application controls, were identified.
- Extent of the auditor's use of the work of others was greater than appropriate to reduce the auditor's own work under AS 5 given the level of risk associated with the control being tested (e.g., in the area of controls over journal entries, generally considered higher risk because of the risk of management override or other risk of fraud).
- Performance of too few or no procedures to assess the competence of the others relative to the task being performed, or inadequate assessment of objectivity, particularly where the work was performed by company personnel other than internal auditors.
- Numerous instances where the extent of the auditors' retesting of the work of others was seemingly unrelated to the risks involved. For example, a uniform approach to retesting 20% of the controls tested.

PCAOB AS 5

- [Paragraph 16-19](#), *Using the Work of Others*

CAQ Lessons Learned Publication

- [Lesson #2](#)
- [Lesson #3](#)
- [Lesson #6](#)
- [Lesson #7](#)
- [Lesson #18](#)

OBSERVATIONS ON ENTITY-LEVEL CONTROLS

- No evaluation of entity-level controls beyond those associated with the control environment and the period-end financial reporting process.
- Identification of entity-level controls that appeared to be designed to operate with a high degree of precision, but failure to obtain sufficient audit evidence of their operating effectiveness.
- Identification and testing of entity-level controls that were found to be designed and operating with a high degree of precision, but no alteration of tests of process-level controls in response to such an assessment.
- Inappropriate reduction of process-level controls testing based on a reliance on entity-level controls. In certain of these instances:
  - There was failure to consider the precision with which the entity-level control addressed a relevant financial statement assertion, or
  - It was determined that the entity-level

PCAOB AS 5

- [Paragraphs 22-27](#), *Identifying Entity-Level Controls*

PCAOB Staff Views

- [Chapter 2](#), *Evaluating Entity-Level Controls*

CAQ Lessons Learned Publication

- [Lesson #17](#)

control was not operating at a level of precision sufficient to address the risk related to a relevant financial statement assertion, yet nonetheless reduced the testing of the process-level controls for the relevant assertion.

## OBSERVATIONS ON THE NATURE, TIMING AND EXTENT OF CONTROLS TESTING

- Inappropriate consideration of the assessed level of risk when selecting controls to be tested, or the controls selected were not designed to address the risk of misstatement to the relevant assertion (s).
- Failure to test a relevant control appropriately or, in some cases, at all. Examples include:
  - Tests of controls over financially significant applications dependent on appropriate segregation of duties were not tested.
  - Controls tested without testing the system-generated data on which the respective controls depended.
  - Lack of testing controls over applications that processed financially significant transactions, including important manual spreadsheets.
  - Observation of 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.
  - Failure to obtain service auditors' reports related to controls at outside service organizations.
  - Failure to perform procedures for necessary user controls identified in the service auditors' report.
- Insufficient evidence gathered by the auditor 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:
  - Operating effectiveness of higher-risk controls was tested only through inquiry

### PCAOB AS 5

- [Paragraphs 39 & 41](#), *Selecting Controls to Test*
- [Paragraph 46](#), *Relationship of Risk to the Evidence to be Obtained*
- [Paragraphs 57-61](#), *Special Considerations for Subsequent Years' Audits*
- [Appendix B17](#), *Use of Service Organizations*

### PCAOB Staff Views

- [Chapter 4](#), *Evaluating Segregation of Duties and Alternative Controls*
- [Chapter 5](#), *Auditing Information Technology Controls in a Less Complex Information Technology Environment*

### CAQ Lessons Learned Publication

- [Lesson #1](#)
- [Lesson #5](#)
- [Lesson #6](#)
- [Lesson #7](#)
- [Lesson #8](#)
- [Lesson #9](#)
- [Lesson #10](#)
- [Lesson #11](#)
- [Lesson #12](#)
- [Lesson #15](#)
- [Lesson #19](#)
- [Lesson #20](#)
- [Lesson #21](#)

and observation rather than other tests yielding stronger audit evidence such as inspection of relevant documentation or re-performance of a control.

- Failure to test the completeness of the population from which items were selected for testing.
- Extent of audit procedures was similar for both lower- and higher-risk controls.

## OBSERVATIONS ON EVALUATION OF DEFICIENCIES

- Inappropriately basing conclusions regarding the severity of control deficiencies solely on the materiality of the identified errors in the financial statements.
- Failure to consider relevant risk factors when evaluating the severity of identified control deficiencies.
- Failure to 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.
- 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.
- Required auditor communications of identified control deficiencies to management or the audit committee were incomplete.
- Lack of consideration to the possible effects of detected errors in the financial statements on the effectiveness of controls.

### PCAOB AS 5

- [Paragraphs 62-68](#), *Evaluating Identified Deficiencies*
- [Appendix B8](#), *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls*

### PCAOB Staff Views

- [Chapter 8](#), *Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies*

## Other Related Resources

[CAQ Web Resource](#) Resources for Integrated Audits of Non-Accelerated Filers

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## Stay Informed

As a member of the CAQ, you will receive timely communication of regulatory developments and

technical updates on important matters related to various standard-setters, regulators and others, as well as the activities of the CAQ. To stay abreast of these and other relevant events in public company audit practice, please visit the CAQ Web site at [www.thecaq.org](http://www.thecaq.org). Also, we welcome any suggestions or questions - please send them by email to [center@thecaq.org](mailto:center@thecaq.org).

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