



Public Company Accounting Oversight Board

1666 K Street, NW  
Washington, DC 20006  
Telephone: (202) 207-9100  
Facsimile: (202) 862-8430  
www.pcaobus.org

June 16, 2020

By Electronic Mail

The Honorable Walter J. Clayton  
The Honorable Hester M. Peirce  
The Honorable Elad L. Roisman  
The Honorable Allison Herren Lee  
US Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Dear Chairman Clayton and Commissioners Peirce, Roisman, and Lee:

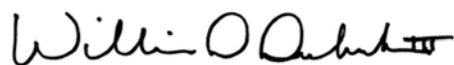
I am pleased to transmit to you a summary of the Public Company Accounting Oversight Board's (PCAOB) Office of Internal Oversight and Performance Assurance (IOPA) performance review, titled Internal Controls over Financial Reporting (ICFR) Program Review. The PCAOB Board formed IOPA to provide the Board, the Securities and Exchange Commission, and others assurance that the PCAOB is achieving the objectives of Title I of the Sarbanes-Oxley Act in an effective manner. IOPA conducted this review in conformance with the Institute of Internal Auditors' *International Standards for the Professional Practice of Internal Auditing*.

IOPA undertook this review to evaluate the Office of Administration's ICFR program and its governance, compliance with relevant policies and procedures, and operational effectiveness and efficiency. As the summary describes, IOPA concluded that the ICFR program is well organized and effectively managed, with thorough internal-control documentation, rigorous testing procedures, and transparent exception reporting. IOPA also recognized a clear trend toward improved internal control execution and diminishing annual control-testing exceptions. IOPA did not identify any areas related to control documentation or testing where ICFR program management either did not plan sufficiently or underperformed the established test plan.

IOPA proposed recommendations related to three audit observations (all rated by IOPA as low risk) that it believes will add value to the ICFR program. We accept those recommendations and PCAOB management is working diligently to implement these improvements.

The Board intends to publish the summary on the PCAOB's public website on or about June 30, 2020. Please feel free to contact the Director of IOPA, Ryan Sack, at (202) 591-4165, or me if you have any questions or would like any additional information about the review.

Sincerely,

A handwritten signature in black ink, appearing to read "William D. Duhnke III". The signature is written in a cursive style with a prominent "W" and "D".

William D. Duhnke III  
Chairman

Enclosure: Internal Controls over Financial Reporting Program Review (IOPA-19-OA-05), dated March 2020

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## **PERFORMANCE REVIEW**

### **INTERNAL CONTROLS OVER FINANCIAL REPORTING PROGRAM** **(19-OA-05)**

#### **INTERNAL OVERSIGHT AND PERFORMANCE ASSURANCE** **MARCH 2020**

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#### **Background**

We conducted a review of the Internal Controls over Financial Reporting (ICFR) program during December 2019 – March 2020. The ICFR program work, conducted by the Financial Operations team (referenced in this report as “FinOps-ICFR” to clearly differentiate from other financial operations), is scheduled throughout the year and includes a materiality calculation, financial risk assessment, process walkthroughs, internal control testing, and reporting of results to senior management and the PCAOB Board. The PCAOB’s financial reporting management (including the Chief Administrative Officer and Chief Financial Officer, under the direction of the Chairman), is responsible for establishing and maintaining adequate internal controls over financial reporting.<sup>1</sup> Ultimately, the results of the FinOps-ICFR control assessment and testing inform financial reporting management regarding the adequacy and operation of internal controls.

FinOps-ICFR is staffed with three full-time employees, who are all highly experienced in the areas of accounting and ICFR, and each maintains credentials as Certified Public Accountant or Certified Fraud Examiner. Additionally, each year, four to five Division of Registration and Inspections (DRI) inspectors with expertise in either financial controls or information technology controls serve as additional temporary resources to assist in performing control testing. FinOps-ICFR directly supervises testing performed by the DRI inspectors and independently concludes on the severity of the test results.

For the 2019 program cycle, management identified key controls over 28 process areas within the organization, including financial controls, application controls, and Information Technology General Controls (ITGCs). FinOps-ICFR conducts testing over these controls.

We reviewed the history of control exceptions over the past six annual test cycles and noted a trend of continuous improvement in control function and testing results, particularly over the last three-year period.

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<sup>1</sup> See Financial Reporting Management’s Report On Internal Control Over Financial Reporting in the 2018 PCAOB Annual Report.

**Objective and Scope**

The purpose of our review was to evaluate the ICFR program and its governance, compliance with relevant OA policies and ICFR desktop procedures, and operational effectiveness and efficiency. The scope of our review covered the 2019 testing cycle. We reviewed the year-end reporting from the 2018 testing cycle, as the 2019 year-end reporting was not yet available when we conducted our fieldwork. To accomplish our objective, we:

1. Assessed the department structure, responsibilities, and reporting lines in the ICFR program, applying the Institute of Internal Auditors’ “three lines of defense” model.
2. Reviewed and evaluated relevant policies, procedures, and framework governing the ICFR function, and assessed the program for compliance.
3. Identified and interviewed Office of Administration, Division of Registration and Inspection, Office of Enterprise Risk Management, and Board stakeholders in an effort to detect gaps or inefficiencies that might exist in the ICFR program.
4. Evaluated the processes surrounding the materiality calculation, risk assessments, key control determination, control testing, deficiency determination, monitoring, and reporting.
5. Assessed the processes involved with ITGCs and their relationship to the overall ICFR program.

We conducted our review in conformance with the Institute of Internal Auditors *International Standards for the Professional Practice of Internal Auditing*.

**Summary Results and Conclusion**

We found the ICFR program to be well organized and effectively managed, with thorough internal-control documentation, rigorous testing procedures, and transparent exception reporting. We also recognized a clear trend toward improved internal control execution and diminishing annual control-testing exceptions. We did not identify any areas related to control documentation or testing where FinOps-ICFR either did not plan sufficiently or underperformed the established test plan.

We conclude that the number of key controls tested and the rigor of the testing program are appropriate for current conditions and a conservative approach. More importantly, we noted that FinOps-ICFR actively evaluates whether the program’s effectiveness and efficiency are appropriately balanced. Should additional annual test cycles pass with outcomes that present an opportunity to achieve equivalent results with less documentation and testing rigor, we understand that FinOps-ICFR intends to adjust their program effort accordingly.

During the course of our review, we identified opportunities to improve the governance and operational effectiveness of the ICFR program. The brief table below summarizes and categorizes the audit observations on a risk scale.<sup>2</sup>

<b>Low Risk (3)</b>	<b>Moderate Risk (0)</b>	<b>Significant Risk (0)</b>	<b>Material Risk (0)</b>
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Our observations, all of which we rated “Low Risk”, are briefly described below.

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<sup>2</sup> See Appendix A for IOPA Risk Rating Legend

- **Evaluate ICFR Program Independence** – In contrast to the ICFR program’s conservative approach to control documentation and testing, certain factors indicate a less conservative posture related to FinOps-ICFR independence from first-line-of-defense functions. In particular, an OA management employee currently supervises both the ICFR program and the first-line Issuer and Broker-Dealer Funding process. However, we determined this dual-management role does not critically impair overall FinOps-ICFR independence, due to 1) the limited impact of the Issuer and Broker-Dealer Funding allocation on the accuracy of the PCAOB financial statements<sup>3</sup> and 2) the OA management employee’s removal from participation in testing and evaluation of the Issuer and Broker-Dealer Funding process.
- **Update the Guide and Instructions for Internal Control Testing** – The current Guide and Instructions for Internal Control Testing has not been updated since 2013 and contains references to offices and processes that are obsolete. The sampling methodology and test exception rules are discussed annually by FinOps-ICFR, however, this review has not resulted in an updated Guide and Instructions document.
- **Implement Continuous Improvement via DRI Feedback** – FinOps-ICFR receives informal “lessons learned” feedback from DRI inspectors who are performing control testing, but there is no formal process for soliciting this information after testing for the year has been completed. Formalizing a post-mortem review had not been prioritized.

### **Recommendations**

With regard to ICFR program independence, we recommend that the Office of Administration senior management –

- Review the current FinOps-ICFR alignment within Finance and determine whether the current level of FinOps-ICFR independence corresponds with the PCAOB’s conservative risk tolerance.
- Monitor the impact of common management of the FinOps ICFR function and the first-line Issuer and Broker-Dealer Funding function and determine whether roles should be separated in the future to increase independence.
- Determine whether FinOps-ICFR independence could increase by reallocating any available FinOps-ICFR bandwidth beyond its core ICFR duties to second-line functions outside of OA Finance.

We recommend that FinOps-ICFR –

- Update its Guide and Instructions for Internal Control Testing to include correct office names and current procedures and utilize it as the primary means of documenting ICFR test procedures, methodologies, workpaper preparation/retention, and communication of test results.
- Make a deliberate request that DRI inspectors engaged in control testing log potential improvements or areas that vary when benchmarked against what DRI normally sees during their firm inspections, and implement a formal post-mortem meeting where

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<sup>3</sup> The Funding team’s role involves allocating the accounting support fee among issuers and Broker/Dealers (and some issuer contact for collection). It does not have duties that influence or adjust the PCAOB financial statements.

FinOps-ICFR and DRI inspectors discuss recommendations noted during the course of testing. Recommendations taken from this process (along with an implementation plan and timeline) should be documented, and appropriate follow-up actions should be taken.

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Finance and FinOps-ICFR management provided responses indicating concurrence with our observations and a commitment to corrective actions that is responsive to our recommendations.

We thank all personnel who supported our review, both at the senior management and staff operating level, for their courtesy and cooperation throughout this assessment.

## Appendix A – Risk Classifications and Definitions

To provide the reader with further perspective of the degree of risk IOPA attributes to each audit observation, we have assigned color-coded risk ratings as explained in the legend below.

Degree of Risk and Priority of Action	
<b>Material</b>	The degree of risk is unacceptable and poses a significant level of financial, compliance or operational risk to the organization. As such, complete remediation is generally required no later than one month from the time of the finalized IOPA report.
<b>Significant</b>	The degree of risk is undesirable and poses a significant financial, compliance or operational risk to the organization. As such, complete remediation is generally required no later than three months from the time of the finalized IOPA report.
<b>Moderate</b>	The degree of risk is undesirable and poses a moderate financial, compliance or operational risk to the organization. As such, complete remediation is generally required no later than six months from the time of the finalized IOPA report.
<b>Low</b>	The degree of risk appears reasonable but there are opportunities to further reduce risk through improvements to existing policies, procedures, and/or operations. As such, management should take actions to reduce the risks to the organization.

IOPA used its professional judgement in determining the overall ratings presented in the Executive Summary of this report. The report is intended to provide management with information about the condition of risks and internal controls at a point in time.