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STAFF VIEWS

AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING THAT IS INTEGRATED WITH AN AUDIT OF FINANCIAL STATEMENTS:

GUIDANCE FOR AUDITORS OF SMALLER PUBLIC COMPANIES

JANUARY 23, 2009

This publication presents the views of the staff of the Public Company Accounting Oversight Board on how auditors can apply certain provisions of Auditing Standard No. 5 to audits of internal control over financial reporting of smaller, less complex public companies.

The statements contained in this publication are not rules of the Board, nor have they been approved by the Board.

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Introduction

The information in this publication is intended to help auditors apply the provisions of the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* ("Auditing Standard No. 5"),[1/] to audits of smaller, less complex public companies ("smaller, less complex companies"). If used appropriately, it can help auditors design and execute audit strategies that will achieve the objectives of Auditing Standard No. 5. This publication is not, however, a rule of the Board and does not establish new requirements. All audits of internal control over financial reporting – regardless of the size of the company – must comply with the requirements of Auditing Standard No. 5. Also, this publication does not address all of the requirements and direction in Auditing Standard No. 5 or all issues that may be encountered in audits of smaller, less complex companies.

In adopting Auditing Standard No. 5, one of the Board's objectives was to make the audit of management's assessment of the effectiveness of internal control over financial reporting ("audit of internal control") more clearly scalable for smaller, less complex companies. Thus, the standard contains direction to auditors on scaling the audit based on a company's size and complexity. This publication discusses how that direction may be applied to audits of smaller, less complex companies, including smaller companies that are not complex, and how auditors may address some of the challenges that might arise in audits of those companies.

Development of This Publication

This publication was developed by the staff of the Board's Office of the Chief Auditor ("OCA"). To develop the information in this publication, OCA organized a working group composed of auditors who have experience with audits of internal control over financial reporting in smaller, less complex companies. These auditors identified issues that pose particular challenges in auditing internal control in smaller, less complex companies. The auditors provided insights and examples based on their experiences in addressing these issues, and they assisted in drafting a preliminary version of the guidance. In developing that preliminary guidance, OCA also consulted with financial executives from smaller public companies, who helped the staff evaluate whether it appropriately reflected the smaller, less complex company environment.

The staff issued the preliminary guidance for public comment on October 17, 2007, and received 23 comments. After considering those comments, the staff made

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[1/] 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)

certain changes in this final version that clarify or enhance the guidance. Appendix B to this publication discusses comments received and related changes.

References

This publication assumes that the user is familiar with the provisions of Auditing Standard No. 5 and the following publications:

- Committee of Sponsoring Organizations of the Treadway Commission ("COSO"), *Internal Control – Integrated Framework*[2/]
- COSO, *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* (June 2006) ("COSO Small Companies Guidance")
- SEC Release No. 33-8810, Commission Guidance Regarding *Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* (June 20, 2007) ("SEC Management Guidance")

The following publications also provide information that might be relevant to the audit of internal control over financial reporting:

- SEC Release No. 33-8809, *Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting* (June 20, 2007)
- SEC Release No. 33-8829, *Definition of the Term Significant Deficiency* (August 3, 2007)
- SEC Release No. 33-8238, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports* (June 5, 2003)
- SEC Office of the Chief Accountant, Division of Corporation Finance, *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions* (September 24, 2007)

[2/] Auditing Standard No. 5 states that the auditor should use the same internal control framework that management uses in its assessment of internal control. Although this publication uses certain terms and concepts from COSO's *Internal Control – Integrated Framework*, the principles in this publication could be applied to other internal control frameworks.

Internal Control Examples in This Publication

This publication discusses certain types of controls and provides examples of those controls to help auditors understand the types of controls that might be encountered in the audit of a smaller, less complex company and to provide a context for the discussion of audit strategies for evaluating the effectiveness of those controls. The discussions and examples of controls do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting.

Chapter 1

Scaling the Audit for Smaller, Less Complex Companies

Auditing Standard No. 5 establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of internal control over financial reporting that is integrated with an audit of the financial statements.

The complexity of a company is an important factor in the auditor's risk assessment and determination of the necessary audit procedures. Auditing Standard No. 5 provides direction on scaling the audit of internal control based on the size and complexity of a company. Scaling is important for audits of internal control of all companies, especially smaller, less complex companies. This chapter highlights principles for scaling the audit of internal control over financial reporting set forth in Auditing Standard No. 5 and discusses considerations for applying the principles in audits of smaller, less complex companies.

The audit of internal control should be integrated with the audit of the financial statements, so the auditor must plan and perform the work to achieve the objectives of both audits.[1/] This direction applies to all aspects of the audit, and it is particularly relevant to tests of controls. This chapter discusses testing of controls in an integrated audit of a smaller, less complex company. Appendix A illustrates an audit approach for the integrated audit.

Scaling the Audit of Internal Control

Scaling the audit of internal control involves tailoring the audit approach to fit the individual facts and circumstances of the company. Many smaller companies have less complex operations, and they typically share many of the following attributes:

- Fewer business lines
- Less complex business processes and financial reporting systems
- More centralized accounting functions
- Extensive involvement by senior management in the day-to-day activities of the business
- Fewer levels of management, each with a wide span of control.[2/]

[1/] See Auditing Standard No. 5, paragraphs 6 and 7.

[2/] See Auditing Standard No. 5, paragraph 9.

The attributes of a smaller, less complex company can affect the particular risks that could result in material misstatement of the company's financial statements and the controls that a company might establish to address those risks. Consequently, these attributes have a pervasive effect on the audit of internal control, including assessing risk, determining significant accounts and disclosures and relevant assertions, selecting controls to test, and testing the design and operating effectiveness of controls. The following are examples of internal control-related matters that might be particularly affected by the attributes of a smaller, less complex company –

- *Use of entity-level controls to achieve control objectives.* In smaller, less complex companies, senior management often is involved in many day-to-day business activities and performs duties that are important to effective internal control over financial reporting. Consequently, the auditor's evaluation of entity-level controls can provide a substantial amount of evidence about the effectiveness of internal control over financial reporting. Chapter 2 discusses methods of evaluating entity-level controls and explains how that evaluation can affect the testing of other controls.

- *Risk of management override.* The extensive involvement of senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls or intentionally misstate the financial statements in smaller, less complex companies. In an integrated audit, the auditor should consider the risk of management override and company actions to address that risk in connection with assessing the risk of material misstatement due to fraud and evaluating entity-level controls.[3/] Chapter 3 discusses these considerations in more detail.

- *Implementation of segregation of duties and alternative controls.* By their nature, smaller, less complex companies have fewer employees, which limits the opportunity to segregate incompatible duties. Smaller, less complex companies might use alternative approaches to achieve the objectives of segregation of duties, and the auditor should evaluate whether those alternative controls achieve the control objectives.[4/] This is discussed in Chapter 4.

- *Use of information technology (IT).* A smaller, less complex company with less complex business processes and centralized accounting operations might have less complex information systems that make greater use of off-the-shelf packaged software without modification. In the areas in which off-the-shelf software is used, the auditor's testing of information

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[3/] See Auditing Standard No. 5, paragraphs 14 and 24.

[4/] See Auditing Standard No. 5, paragraph 42.

technology controls might focus on the application controls built into the pre-packaged software that management relies on to achieve its control objectives and the testing of IT general controls might focus on those controls that are important to the effective operation of the selected application controls. Chapter 5 discusses IT controls in more detail.

- *Maintenance of financial reporting competencies.* Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals. The auditor may take into consideration the use of those third parties when assessing competencies of the company. Chapter 6 discusses the evaluation of financial reporting competencies in more detail.

- *Nature and extent of documentation*. A smaller, less complex company typically needs less formal documentation to run the business, including maintaining effective internal control over financial reporting. The auditor may take that into account when selecting controls to test and planning tests of controls. Chapter 7 discusses this in more detail.

In some audits of internal control, auditors might encounter companies with numerous or pervasive control deficiencies. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls. The auditor's strategy can be influenced by the nature of the control deficiencies and factors such as the availability of audit evidence and the effect of the deficiencies on other controls. Chapter 8 discusses these situations in more detail.

Tests of Controls in an Integrated Audit

Auditing Standard No. 5 provides direction on selecting controls to test and testing controls in an audit of internal control. The standard also provides direction on testing controls for the audit of the financial statements. The following paragraphs discuss how the auditor might apply the directions in Auditing Standard No. 5 to an audit of a smaller, less complex company.

Selection of Controls to Test

Appropriate selection of controls helps focus the auditor's testing on those controls that are important to the auditor's conclusion about whether the company's internal control over financial reporting is effective. The decision about whether to select a control for testing depends on which controls, individually or in combination, sufficiently address the assessed risk of misstatement in a given relevant assertion rather than on how the control is labeled (e.g., entity-level control, transaction-level control, control activity, monitoring control, preventive control, or detective control). A

practical starting point for identifying these controls is to consider the controls that management relies on to achieve its objectives for reliable financial reporting.

Besides the overriding consideration of whether a control addresses the risk of misstatement, as a practical matter, the auditor might also consider the following factors when selecting controls to test:

- Is the control likely to be effective?
- What evidence exists regarding operation of the control?

When selecting controls to test, the auditor could seek to select controls that are more likely to be effective in addressing the risk of misstatement in one or more relevant assertions.[5/] If none of the controls that are intended to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion.[6/] Chapter 8 discusses in more detail how auditors could design their audit strategies in a situation when internal control over financial reporting is likely to be ineffective because of the presence of pervasive control deficiencies that result in one or more material weaknesses.

The auditor needs to be able to obtain enough evidence about a control's operation to conclude on its effectiveness. The auditor could take into account the nature and availability of audit evidence when selecting controls to test and determining the nature, timing, and extent of tests of controls. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor may select the control for which evidence of operating effectiveness can be obtained more readily. Chapter 7 discusses documentation and audit evidence in more detail.

Tests of Operating Effectiveness of Controls

Historically, the approach for financial statement audits of smaller, less complex companies has been to focus primarily on testing accounts and disclosures, with little or no testing of controls. The internal control reporting requirements under Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act") give auditors the opportunity to

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[5/] There might be more than one control that addresses the assessed risk of misstatement for a particular relevant assertion; conversely, one control might address the assessed risk of misstatement to more than one relevant assertion. It is neither necessary to test all controls related to a relevant assertion nor necessary to test redundant controls, unless redundancy is itself a control objective. See Auditing Standard No. 5, paragraph 40.

[6/] Auditing Standard No. 5, paragraph 47, indicates that, generally, less evidence is needed to support a conclusion that controls are not operating effectively.

re-consider their traditional approach to the financial statement audit portion of the integrated audit. The principles in Auditing Standard No. 5 also give auditors latitude to determine an appropriate testing strategy to –

(a) Obtain sufficient evidence to support the auditor's opinion on internal control over financial reporting as of year-end, and

(b) Obtain sufficient evidence to support the auditor's control risk assessments in the audit of the financial statements.[7/]

To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant financial statement assertions. Because the auditor's opinion on internal control over financial reporting is as of a point in time, Auditing Standard No. 5 indicates that he or she should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements.[8/]

In an audit of financial statements, the objective of tests of controls is to assess control risk. To assess control risk at less than the maximum, the auditing standards require the auditor to obtain evidence that the relevant controls operated effectively during the entire period upon which the auditor plans to place reliance on those controls.[9/] However, the auditor is not required to assess control risk at less than the maximum for all relevant assertions, and, for a variety of reasons, the auditor may choose not to do so.[10/]

The auditor's assessment of control risk at the maximum for one or more relevant assertions in an audit of financial statements does not necessarily preclude the auditor from issuing an unqualified opinion in an audit of internal control. The objectives of the two audits are not identical. The auditor could obtain sufficient evidence to support his or her opinion on internal control over financial reporting, even if the auditor decides not to test controls over the entire period of reliance to support a control risk assessment below the maximum. However, if the auditor assesses control risk at the maximum because of identified control deficiencies, the auditor should evaluate the severity of the

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[7/] See Auditing Standard No. 5, paragraph 7.

[8/] See Auditing Standard No. 5, paragraph B2.

[9/] See paragraph B4 of Auditing Standard No. 5 and paragraph .66 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit.*

[10/] See Auditing Standard No. 5, paragraph B4, and AU sec. 319.65.

deficiencies, individually or in combination, to determine whether a material weakness exists.[11/]

The auditor's decision about relying on controls in an audit of financial statements may depend on the particular facts and circumstances. In some areas, the auditor might decide to rely on certain controls to reduce the substantive testing of accounts and disclosures. For other areas, the auditor might perform primarily substantive tests of the assertions without relying on controls. For example, the auditor might test a company's controls over billings and cash receipts processing to cover the entire period of reliance in order to reduce the extent of confirmation of accounts receivable balances but might perform primarily substantive tests of the allowance for doubtful accounts. In this case, the auditor might perform the tests of controls over the allowance for doubtful accounts only as necessary for the audit of internal control over financial reporting.

For some significant accounts, the auditor might decide that a relevant assertion can be tested effectively and efficiently through substantive procedures without relying on controls. For example, the auditor might decide to confirm an outstanding loan payable with the lender rather than rely on controls. In that situation, the auditor may test controls of the relevant assertions only as necessary to support his or her opinion on the company's internal control over financial reporting at year-end.

To obtain evidence about whether a selected control is effective, the control must be tested; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, is one of a number of factors that inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.[12/] See the section entitled Specific Responses – Substantive Procedures and Tests of Controls in Appendix A to this publication for more discussion on this topic.

[11/] See Auditing Standard No. 5, paragraph 62.

[12/] See Auditing Standard No. 5, paragraphs 47, 58, and B9.

Chapter 2

Evaluating Entity-Level Controls

An important aspect of performing an audit of internal control is the process of identifying and evaluating entity-level controls. This chapter discusses entity-level controls and explains how they can affect the nature, timing, and extent of the auditor's procedures in an audit of internal control for a smaller, less complex company.

For the purposes of this discussion, entity-level controls are controls that have a pervasive effect on a company's internal control. These controls include [1/] –

- Controls related to the control environment;
- Controls over management override;
- The company's risk assessment process;
- Centralized processing and controls, including shared service environments;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the audit committee[2/] and self-assessment programs;[3/]
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

In smaller, less complex companies, senior management often is involved in many day-to-day business activities and performs many controls – including entity-level controls – that are important to effective internal control over financial reporting. When this is the case, the auditor's evaluation of entity-level controls can be an important source of evidence about the effectiveness of internal control over financial reporting.

[1/] See Auditing Standard No. 5, paragraph 24.

[2/] If no audit committee exists, all references to the audit committee in this publication apply to the entire Board of Directors of the company. See 15 U.S.C. 78c(a)58 and 7201(a)(3).

[3/] Some smaller, less complex companies might have an internal audit function, especially in regulated industries. If the activities of the internal audit function include controls to monitor other controls, those controls also are entity-level controls.

Effective controls related to the control environment and controls that address the risk of management override are particularly important to the effective functioning of controls performed by senior management. Chapter 3 discusses the auditor's evaluation of the risk of management override and mitigating actions.

Auditors might find that limited formal documentation is available regarding the operation of some entity-level controls. Chapter 7 discusses how the auditor can obtain evidence about controls when less formal documentation is available.

Evaluation of Entity-Level Controls and Testing of Other Controls

Auditing Standard No. 5 requires the auditor to test those entity-level controls that are important to the auditor's conclusion about whether the company has effective internal control over financial reporting. This includes evaluating the company's control environment and period-end financial reporting process.[4/]

Identifying Entity-Level Controls

The process of identifying relevant entity-level controls could begin with discussions between the auditor and appropriate management personnel for the purpose of obtaining a preliminary understanding of each component of internal control over financial reporting (i.e., control environment, risk assessment, control activities, monitoring, and information and communication).

While evaluating entity-level controls, auditors might identify controls that are capable of preventing or detecting misstatements in the financial statements. The period-end financial reporting process and management's monitoring of the results of operations are potential sources of such controls.

Assessing the Precision of Entity-Level Controls

Auditing Standard No. 5 indicates that entity-level controls vary in nature and precision –

- Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be detected or prevented on a timely basis. These controls might affect the other controls the auditor selects for testing and the nature, timing, and extent of procedures the auditor performs on other controls.

- Some entity-level controls monitor the effectiveness of other controls. Such controls might be designed to identify possible breakdowns in lower-level controls, but not at a level of precision that would, by themselves, sufficiently address the assessed risk that misstatements to a relevant

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4/ See Auditing Standard No. 5, paragraphs 22, and 25-27.

assertion will be prevented or detected on a timely basis. These controls, when operating effectively, might allow the auditor to reduce the testing of other controls. [See Example 2-1.]

- Some entity-level controls might be designed to operate at a level of precision that would adequately prevent or detect on a timely basis misstatements to one or more relevant assertions. If an entity-level control sufficiently addresses the assessed risk of misstatement, the auditor need not test additional controls relating to that risk.[5/] [See Example 2-2.]

As noted previously, the key consideration in assessing the level of precision is whether the control is designed in a manner to prevent or detect on a timely basis misstatements in one or more assertions that could cause the financial statements to be materially misstated and whether such control is operating effectively.[6/] Factors that auditors might consider when judging the level of precision of an entity-level control include the following:

- *Purpose of the control*. 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.

- *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.

5/ See Auditing Standard No. 5, paragraph 23.

6/ 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 and can effectively prevent or detect errors or fraud that could result in material misstatement of the financial statements. 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. See Auditing Standard No. 5, paragraphs 42 and 44.

- *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.

- *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. The precision of those controls depends on the ability to develop sufficiently precise expectations to highlight potentially material misstatements.

When forming an opinion on the effectiveness of a company's internal control over financial reporting, the auditor should evaluate evidence obtained from all sources, including misstatements detected during the financial statement audit.[7/] Evidence regarding detected misstatements also might be relevant in assessing the level of precision of entity-level controls.

Effect of Entity-Level Controls on Testing of Other Controls

The auditor's evaluation of entity-level controls can result in increasing or decreasing the testing that the auditor otherwise might have performed on other controls. For example, if the auditor has designed an audit approach with an expectation that certain entity-level controls (e.g., controls in the control environment) will be effective and those controls are not effective, the auditor might re-evaluate the planned audit approach and decide to expand his or her audit procedures.

On the other hand, the auditor's evaluation of some entity-level controls can result in a reduction of his or her testing of other controls, such as controls over corresponding relevant assertions. The degree to which the auditor might be able to reduce testing of controls over relevant assertions in such cases depends on the precision of the entity-level controls.

[7/] See Auditing Standard No. 5, paragraph 71.

Example 2-1 – Monitoring the Effectiveness of Other Controls

Scenario: A small public video game developer conducts business in the United States and other countries, requiring the company to maintain a multitude of bank accounts. A staff accountant is charged with performing bank reconciliations for the accounts according to a predetermined schedule (some of the accounts have a different closing date). Through inquiries of management, the auditor learns that the company's chief financial officer ("CFO"), who is an experienced accountant, reviews on a monthly basis the bank reconciliations prepared by the staff accountant as a means to determine –

- whether reconciliations are being prepared on a timely basis,
- the nature of reconciling items identified through the process, and
- whether reconciling items are investigated and resolved on a timely basis.

Audit Approach: In this example, the purpose of the control is one of the factors that the auditor considers in assessing precision of the CFO's review. The auditor has noted that the purpose of the CFO's review is to check that the staff has performed the reconciliations as described above. Therefore, the auditor does not expect the CFO's review of the reconciliations to be sufficiently precise to detect misstatements by itself. However, the CFO's review could still influence the auditor's assessment of risk because it provides additional information about the nature and consistency of the reconciliation procedures. The auditor obtains evidence about the CFO's review through inquiry and document inspection, evaluates the review's effectiveness, and determines the amount of direct testing of the reconciliation controls that is needed based on the assessed level of risk. If the auditor concludes that the CFO's review is effective, she could reduce the direct testing of the reconciliation controls, absent other indications of risk.

Example 2-2 – Entity-Level Controls Related to Payroll Processing

Scenario: A manufacturer of alternative fuel products and systems for the transportation market has union labor, supervisors, managers, and executives. All plants run two shifts six days a week, with each having approximately the same number of employees.

The chief financial officer ("CFO") has been with the company for 10 years and thoroughly understands its business processes, including the payroll process, and reviews weekly payroll summary reports prepared by the centralized accounting function. With the company's flat organizational design and smaller size, the CFO's background with the company and his understanding of the seasons, cycles, and

workflows, and close familiarity with the budget and reporting processes, the CFO quickly identifies any sign of improprieties with payroll and their underlying cause – whether related to a particular project, overtime, hiring, layoffs, and so forth. The CFO investigates as needed to determine whether misstatements have occurred and whether any internal control has not operated effectively, and takes corrective action.[8/] Based on the results of audit procedures relating to the control environment and controls over management override, the auditor observes that the CFO demonstrates integrity and a commitment to effective internal control over financial reporting.

Audit Approach: The auditor evaluates the effectiveness of the CFO's reviews, including the precision of those reviews. She inquires about the CFO's review process and obtains other evidence of the review. She notes that the CFO's threshold for investigating significant differences from expectations is adequate to detect misstatements that could cause the financial statements to be materially misstated. She selects some significant differences from expectations that were flagged by the CFO and determines that the CFO appropriately investigated the differences to determine whether the differences were caused by misstatements. Also, in considering evidence obtained throughout the audit, the auditor observes that the results of the financial statement audit procedures did not identify likely misstatements in payroll expense.

The auditor decides that the reviews could detect misstatements related to payroll processing because the CFO's threshold for investigating significant differences from expectations is adequate. However, she determines that the control depends on reports produced by the company's IT system, so the CFO's review can be effective only if controls over the completeness and accuracy of those reports are effective.

After performing the tests of the relevant computer controls, the auditor concludes that the review performed by the CFO, when coupled with relevant controls over the reports, meets the control objectives for the relevant aspects of payroll processing described above. (See Chapter 5 for a discussion of tests of controls over such reports.)

[8/] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 90.

Chapter 3

Assessing the Risk of Management Override and Evaluating Mitigating Actions

The risk of management override of controls exists in all organizations, but the extensive involvement of senior management in day-to-day activities and fewer levels of management can provide additional opportunities for management to override controls in smaller, less complex companies. Company actions to mitigate the risk of management override are important to the consideration of the effectiveness of internal control over financial reporting.

In an integrated audit, the auditor should consider the risk of management override in connection with assessing the risk of material misstatement due to fraud, as he or she evaluates mitigating actions in connection with the evaluation of entity-level controls and selecting other controls to test.[1/] This chapter discusses the auditor's consideration of the risk of management override of internal control and evaluation of actions that companies take to mitigate that risk.

Assessing the Risk of Management Override

AU sec. 316, *Consideration of Fraud in a Financial Statement Audit,* requires the auditor to assess the risk of material misstatement due to fraud ("fraud risk"). As part of that assessment, the auditor is directed to perform the following procedures to obtain information to be used in identifying fraud risks, which includes procedures to assess the risk of management override[2/] –

- *Conducting an engagement team discussion regarding fraud risks*. This discussion includes brainstorming about how and where management could override controls to engage in or conceal fraudulent financial reporting.

- *Making inquiries of management, the audit committee, and others in the company to obtain their views about the risks of fraud and how those risks are addressed.* These inquiries can provide information about the possibility of management override of controls.

- *Considering fraud risk factors.* Fraud risk factors include events or conditions that indicate incentives and pressures for management to override controls, opportunities for management override, and attitudes or rationalizations that enable management to justify override of controls.

[1/] See Auditing Standard No. 5, paragraph 14.

[2/] See AU sec. 316.14-.34.

After identifying fraud risks, the auditor should assess those risks, taking into account an evaluation of the company's programs and controls that are intended to address those risks.[3/]

Because of the characteristics of fraud, the auditor's exercise of professional skepticism is particularly important when considering the risk of material misstatement due to fraud, including the risk of management override of controls.

Evaluating Mitigating Controls

Auditing Standard No. 5 directs the auditor to evaluate whether the company's controls sufficiently address identified risks of material misstatement due to fraud and controls intended to address the risk of management override of other controls as part of the evaluation of entity-level controls.[4/]

Smaller, less complex companies can take a number of actions to address the risk of management override. The following are examples of some of the controls that might address the risk of management override –

- Maintaining integrity and ethical values;
- Active oversight by the audit committee;
- Maintaining a whistleblower program; and
- Controls over certain journal entries.

When assessing a company's anti-fraud programs and controls, the auditor should evaluate whether the company has appropriately addressed the risk of management override.[5/] Often, a combination of actions might be implemented to address the risk of management override.

Evaluating Integrity and Ethical Values

An important part of an effective control environment is sound integrity and ethical values, particularly of top management, which are communicated and practiced throughout the company. A code of conduct or ethics policy is one way that a company can communicate its policies with respect to ethical behavior. This type of control can be effective if employees are aware of the company's policies and observe the policies in practice.

3/ See AU sec. 316.43-45.

4/ See Auditing Standard No. 5, paragraph 14.

5/ See Auditing Standard No. 5, paragraphs 14 and 24.

Auditors should evaluate integrity and ethical values as part of the assessment of the control environment component of internal control.[6/] One approach for testing the effectiveness of the company's communications regarding integrity and ethical values is to gain an understanding of what the company believes it is communicating to employees and interview employees to determine if they are aware of the existence of the company's policies for ethical behavior and what they understand those policies to be. A discussion with employees regarding observed behaviors can assist the auditor further in understanding management's past actions and determining whether management's behavior demonstrates and enforces the principles in its code of conduct. The auditor's experience with the company also can be an important source of information about whether management demonstrates integrity and ethical values in its business practices and supports the achievement of effective internal control in its day-to-day activities.

Evaluating Audit Committee Oversight

An active and independent audit committee evaluates the risk of management override, including identifying areas in which management override of internal control could occur, and assesses whether those risks are appropriately addressed within the company. As part of their oversight duties, the audit committee might perform duties such as meeting with management to discuss significant accounting estimates and reviewing the reasonableness of significant assumptions and judgments.[7/]

The consideration of the effectiveness of the audit committee's oversight is part of the evaluation of the control environment. In connection with the auditor's inquiries of the audit committee, required by AU sec. 316.22, the auditor may interview audit committee members to determine their level of involvement and their activities regarding the risk of management override. For example, the auditor might read minutes of audit committee discussions on matters related to the committee's oversight or might observe some of those discussions if the auditor attends the meetings in connection with the audit. In addition, the auditor can examine evidence of the board of directors' or audit committee's activities that address the risk of management override, such as monitoring of certain transactions.

[6/] See Auditing Standard No. 5, paragraph 25.

[7/] When a company does not have an audit committee, the entire board of directors is considered the audit committee under Section 2(b)(3) of the Act. In such circumstances, Principle 2, *Board of Directors* of COSO Small Companies Guidance states, "[w]hen a board chooses not to have an audit committee, the full board performing the activities described should have a sufficient number of independent members."

Evaluating Whistleblower Programs

A whistleblower program provides an outlet for employees or others to report behaviors that might have violated company policies and procedures, including management override of controls. A key aspect of an effective whistleblower program is the appropriateness of responses to concerns expressed by employees through the program. The audit committee may review reports of significant matters and consider the need for corrective actions.[8/]

Audit procedures relating to a whistleblower program are intended to assess whether the program is appropriately designed, implemented, monitored, and maintained. Such procedures might include inquiry of employees, inspection of communications to employees about the program, and, if tips or complaints have been received, follow-up procedures to evaluate whether remedial actions were taken as necessary.

Evaluating Controls over Journal Entries

Controls that prevent or detect unauthorized journal entries can reduce the opportunity for the quarterly and annual financial statements to be intentionally misstated. Such controls might include, among other things, restricting access to the general ledger system, requiring dual authorizations for manual entries, or performing periodic reviews of journal entries to identify unauthorized entries.

As part of obtaining an understanding of the financial reporting process, the auditor should consider how journal entries are recorded in the general ledger and whether the company has controls that would either prevent unauthorized journal entries from being made to the general ledger or directly to the financial statements or detect unauthorized entries.[9/] Tests of controls over journal entries could be performed in connection with the testing of journal entries required by AU sec. 316.

[8/] Section 10A(m)(4) of the Securities Exchange Act of 1934 requires audit committees to "establish procedures for (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters." The SEC has implemented this provision by adopting rules directing the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the audit committee requirements mandated by the Act.

[9/] See Auditing Standard No. 5, paragraphs 26 and 34; AU sec. 316.58-60.

Considering the Effects of Other Evidence

The auditor might identify indications of management override in other phases of the integrated audit. For example, AU sec. 316 requires the auditor to perform procedures in response to the risk of management override, including examining journal entries for evidence of fraud, reviewing accounting estimates for bias, and evaluating the business rationale for significant, unusual transactions.[10/] Also, if the auditor performs walkthroughs during the audit of internal control,[11/] he or she could obtain information about potential management override by asking employees about their knowledge of override. Also, the auditor might identify indications of management override when evaluating the results of tests of controls or other audit procedures.

If the auditor identifies indications of management override of controls, he or she should take such indications into account when evaluating the risk of override and the effectiveness of mitigating actions.[12/]

10/ See AU sec. 316.57-.66.

11/ Auditing Standard No. 5, paragraph 34, sets forth the objectives that should be achieved to further understand likely sources of misstatement and as part of selecting controls to test. The standard states that performing walkthroughs will frequently be the most effective way to achieve the objectives in paragraph 34. Paragraphs 37-38 of Auditing Standard No. 5 provide direction on walkthroughs.

12/ See Auditing Standard No. 5, paragraph 15.

Example 3-1 – Audit Committee Oversight

Scenario: The audit committee of a small utility company discusses in executive session at least annually its assessment of the risks of management override of internal control, including motivations for management override and how those activities could be concealed. The audit committee performs the following procedures to address the risk of management override: (a) reviews the reasonableness of management's assumptions and judgments used to develop significant estimates; and (b) reviews the functioning of the company's whistleblower process and related reports, and from time to time, inquires of managers not directly responsible for financial reporting (including personnel in sales, procurement, and human resources, among others), obtaining information regarding concerns about ethics or indications of management override of internal controls.[13/]

Audit approach: In this situation, the auditor can draw upon several sources of evidence to evaluate the audit committee's oversight. The auditor might attend selected meetings of the audit committee where the risks of override and whistleblower programs are discussed or review minutes of meetings where those matters are discussed. In connection with its inquiries of the audit committee about the risk of fraud, as required by AU sec. 316, the auditor can discuss matters relating to the risk of override, including how the audit committee assesses the risk of management override, what information, if any, the audit committee has obtained about possible management override, and how the audit committee's concerns about the risk of management override have been addressed. This information can inform the auditor's consideration of the risk of management override and the testing of mitigating controls.

[13/] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 26.

Chapter 4

Evaluating Segregation of Duties and Alternative Controls

Segregation of duties refers to dividing incompatible functions among different people to reduce the risk that a potential material misstatement of the financial statements would occur without being prevented or detected. Assigning different people responsibility for authorizing transactions, recording transactions, reconciling information, and maintaining custody of assets reduces the opportunity for any one employee to conceal errors or perpetrate fraud in the normal course of his or her duties.[1/]

When a person performs two or more incompatible duties, the effectiveness of some controls might be impaired. For example, reconciliation procedures may not effectively meet the control objectives if they are performed by someone who also has responsibilities for transaction recording or asset custody.

Smaller, Less Complex Companies' Approach to Segregation of Duties

By their nature, smaller, less complex companies have fewer employees, which limits their opportunities to implement segregation of duties. Due to these personnel restrictions, smaller, less complex companies might approach the control objectives relevant to segregation of duties in a different manner from larger, more complex companies. Despite personnel limitations, some smaller, less complex companies might still divide incompatible functions by using the services of external parties. Other smaller, less complex companies might implement alternative controls intended to achieve the same objectives as segregation of duties for certain processes.

This chapter discusses the auditor's evaluation of the company's approach to achieving the objectives of segregation of duties at a smaller, less complex company.

Audit Strategy Considerations

It is generally beneficial for the auditor and the company to identify concerns related to segregation of duties early in the audit process to allow the auditor to design procedures that effectively respond to those concerns. Also, management might have already identified, as part of its risk assessment, risks relating to inadequate segregation of duties and alternative controls that respond to those risks. Where walkthroughs are performed, those procedures can help identify matters related to segregation of duties.

[1/] See the COSO Small Companies Guidance, Volume II: Guidance, page 5, for discussion of management's actions relevant to segregation of duties issues.

When management implements an alternative control or combination of controls that address the same objectives as segregation of duties, the auditor should evaluate whether the alternative control or controls effectively meet the related control objectives.[2/] The auditor's approach to evaluating those alternative control or controls depends on the control objectives, the nature of the controls, and the associated risks. The following sections of this chapter discuss how the auditor can evaluate common approaches to the objectives of segregation of duties.

Use of External Resources

Some small companies use external parties to assist with some of their financial reporting-related functions. Use of external parties also can help achieve segregation of certain incompatible duties without investing in additional full-time resources.

A company might use one or more types of external-party arrangements in meeting its control objectives. Consultants, other professionals, or temporary employees can assist companies in performing some controls or other duties. For more complex or specialized portions of internal control, such as cash receipts handling, payroll processing, or securities recordkeeping, the company might use an external party to perform an entire function.

When controls over a relevant assertion depend on the use of an external party to perform a particular function, the auditor could evaluate that function in relation to the company's other relevant controls and procedures. The audit approach used with respect to the externally performed function depends on the circumstances. For those controls that are documented or are observable by the auditor (e.g., controls performed by external professionals at the company's premises), the auditor's evaluation may be similar to what he or she could perform for the company's other controls. For some externally performed functions, the direction relating to use of service organizations may be relevant.[3/]

Management Oversight and Review

A smaller, less complex company might address some segregation of duties matters through alternative controls involving management oversight and review activities, e.g., reviewing transactions, checking reconciliations, reviewing transaction

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[2/] See Auditing Standard No. 5, paragraph 42.

[3/] See Auditing Standard No. 5, paragraphs B17 – B27, for discussion of the auditor's consideration of a company's use of a service organization in an audit of internal control.

reports, or taking periodic asset counts.[4/] Many of those types of management activities could be entity-level controls. Chapter 2 discusses the auditor's evaluation of entity-level controls at a smaller, less complex company.[5/] Example 4-1 below, and Example 5-1 in Chapter 5 illustrate the testing of certain types of alternative controls.

When the auditor applies a top-down approach to select the controls to test, starting at the financial statement level and evaluating entity-level controls,[6/] the auditor might identify entity-level controls that are designed to operate at a level of precision to effectively address the risk of misstatement for one or more relevant assertions. In those cases, the auditor could select and test those entity-level controls rather than test the process controls that could be affected by inadequate segregation of duties.

Example 4-1 – Alternative Controls over Inventory

Scenario: A provider of office furnishings and equipment uses a locked storeroom to store certain key components. The person responsible for the components has access to both the storeroom and the related accounting records. To address the risks related to undetected loss of components, the manager responsible for purchasing performs periodic spot-checks of the components and reconciles them to the general ledger in addition to the inventory ledger. The components also are included in the company's year-end inventory count. IT access controls are implemented to prevent the person responsible for the components from entering transactions or modifying related account balances in the general ledger.[7/]

Audit approach: The auditor observes the company's year-end inventory counting process. He inspects documentation for some of the periodic spot-checks and the related reconciliations. For discrepancies in the counts or reconciliations inspected, he performs inquiries and inspects the accounting records to determine whether those items were appropriately resolved. Relevant IT access controls are evaluated in connection with the evaluation of IT general controls. (See Chapter 5.)

[4/] See the COSO Small Companies Guidance, Volume II: Guidance, page 5, for examples of the types of management actions that might be used as alternatives to segregation of duties.

[5/] As discussed in Chapter 2, controls related to the control environment and controls over the risk of management override are particularly important to the effective functioning of the controls performed by senior management. Chapter 3 discusses assessing the risk of management override and evaluating mitigating controls.

[6/] See Auditing Standard No. 5, paragraph 21.

[7/] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 60.

Chapter 5

Auditing Information Technology Controls in a Less Complex Information Technology Environment

A company's use of information technology (IT) can have a significant effect on the audit of internal control. The IT environment is a consideration in the auditor's risk assessments, selection of controls to test, tests of controls, and other audit procedures.

This chapter discusses the auditor's evaluation of IT controls in a smaller company with a less complex IT environment. It explains how the auditor could decide which IT controls to evaluate and how the auditor could evaluate those controls. In addition, it provides an overview of the major categories of IT controls and related testing considerations for a smaller, less complex IT environment.

Characteristics of Less Complex IT Environments

In smaller companies, less complex IT environments tend to have the following characteristics:

- *Transaction processing.* Data inputs can be readily compared or reconciled to system outputs. Management tends to rely primarily on manual controls over transaction processing.

- *Software.* The company typically uses off-the-shelf packaged software without programming modification. The packaged software requires relatively little user configuration to implement.[1/]

- *Systems configurations and security administration.* Computer systems tend to be centralized in a single location, and there are a limited number of interfaces between systems. Access to systems is typically managed by a limited number of personnel.

- *End-user computing.* The company is relatively more dependent on spreadsheets and other user-developed applications, which are used to initiate, authorize, record, process, and report the results of business operations, and, in many instances, perform straightforward calculations using relatively simple formulas.

The complexity of the IT environment has a significant effect on the risks of misstatement and the controls implemented to address those risks. The auditor's

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[1/] Significant user configuration might create additional risks that require additional controls.

approach in an environment with the preceding characteristics may be different from the approach in a more complex IT environment.

Some smaller, less complex companies outsource certain of their IT functions to service organizations. Auditing Standard No. 5, paragraphs B17–B27, provides direction on the auditor's consideration of a company's use of a service organization in an audit of internal control.

Determining the Scope of the Evaluation of IT Controls

The following matters affect the scope of the auditor's evaluation of IT controls in a smaller company with a less complex IT environment –

- The risks, i.e., likely sources of misstatement, in the company's IT processes or systems relevant to financial reporting, and the controls that address those risks.[2/]

- The reports produced by IT systems that are used by the company for performing important controls over financial reporting.

- The automated controls that the company relies on to maintain effective internal control over financial reporting.

The IT controls that are important to effective internal control over financial reporting generally relate to at least one of the preceding matters, which are discussed in more detail in the following paragraphs. IT control categories and testing procedures are discussed later in this chapter.

IT-Related Risks Affecting Financial Reporting

Paragraph .19 of AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* lists the following types of IT-related risks that could affect the reliability of financial reporting –

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;

[2/] Auditing Standard No. 5, note to paragraph 36, indicates that the identification of risks and controls within IT is not a separate evaluation. Instead, it is an integral part of the top-down approach used to identify significant accounts and disclosures and their relevant assertions, and the controls to test, as well as to assess risk and allocate audit effort as described by the standard.

- Unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions;
- Unauthorized changes to data in master files;
- Unauthorized changes to systems or programs;
- Failure to make necessary changes to systems or programs;
- Inappropriate manual intervention;
- Potential loss of data.

The IT-related risks that are reasonably possible to result in material misstatement of the financial statements depend on the nature of the IT environment. In a less complex environment, the auditor could identify many of the risks by understanding the software being used and how it is installed and used by the company.

After understanding the relevant IT-related risks, the auditor should identify the controls that address those risks.[3/] These controls could include automated controls and IT-dependent controls and the IT general controls that are important to the effective operation of the selected controls. For example, even the simplest IT environments generally rely on controls that are designed to make sure that necessary software updates are appropriately installed, access controls that are designed to prevent unauthorized changes to financial data, and other controls that address potential loss of data necessary for financial statement preparation.

As the complexity of the software or environment increases, the type and number of potential IT risks increase, which could lead the auditor to devote more attention to IT controls.

IT-Dependent Controls

Many controls that smaller, less complex companies rely on are manual controls. Some of those controls are designed to use information in reports generated by IT systems, and the effectiveness of those controls depends on the accuracy and completeness of the information in the reports. When those IT-dependent controls are selected for testing, it also may be necessary to select controls over the completeness and accuracy of the information in the reports in order to address the risk of misstatement. Example 5-1 presents an illustration involving IT-dependent controls.

[3/] See Auditing Standard No. 5, paragraph 36.

Other Automated Controls

Although smaller, less complex companies tend to rely primarily on manual controls, they could rely on certain automated controls built into the packaged software to achieve some control objectives. For example, software controls can be used to maintain segregation of duties, prevent certain data input errors, or to help make sure that certain types of transactions are properly recorded. The auditor might focus some of his or her testing on these automated controls and the IT general controls that are important to the effective operation of the automated controls.[4/]

Consideration of Deficiencies in IT General Controls on Tests of Other Controls

IT general controls support operation of the application controls by ensuring the proper access to, and functioning of, the company's IT systems. Deficiencies in the IT general controls may result in deficiencies in the operation of the automated or IT-dependent controls. One of the factors in the auditor's evaluation of the identified deficiencies in the IT general controls, is the interaction of an IT general control and the related automated or IT-dependent controls.[5/]

In some situations, an automated or IT-dependent control might be effective even if deficiencies exist in IT general controls. For example, despite the presence of deficient program change controls, the auditor might directly test the related automated or IT-dependent manual control, giving consideration to the risk associated with the deficient change controls in his or her risk assessment and audit strategy. If the testing results were satisfactory, the auditor could conclude that the automated or IT-dependent manual controls operated effectively at that point in time e.g., as of the issuer's fiscal year end. On the other hand, deficient program change controls might result in unauthorized changes to application controls, in which case the auditor could conclude that the application controls are ineffective.

Example 5-1 – IT-Dependent Controls

Scenario: A company has a small finance department. For the accounting processes that have a higher risk of misstatement, senior management performs a number of business process reviews and analyses to detect misstatements in transaction processing.

The company has a small IT department that supports a packaged financial reporting system whose software code cannot be altered by the user. Since the

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[4/] See Auditing Standard No. 5, paragraph 47.

[5/] According to paragraph 65 of Auditing Standard No. 5, one of the risk factors that affects the severity of a deficiency is "The interaction or relationship of the control with other controls, including whether they are interdependent or redundant."

company uses packaged software, and there have been no changes to the system or processes in the past year, the IT general controls relevant to the audit of the internal control over financial reporting are limited to certain access controls and certain computer operation controls related to identification and correction of processing errors. Management uses several system-generated reports in the business performance reviews, but these reports are embedded in the application and programmed by the vendor and cannot be altered.

Audit Approach: The auditor determines that senior management personnel performing the business process reviews and analyses are not involved with incompatible functions or duties that impair their ability to detect misstatements. Based on the auditor's knowledge of the financial reporting system and understanding of the transaction flows affecting the relevant assertions, the auditor selects for testing certain process reviews and analyses and certain controls over the completeness and accuracy of the information in the reports used in management's reviews. The tests of controls could include, for example –

- Evaluating management's review procedures including assessing whether those controls operate at an appropriate level of precision. (See Chapter 2.)
- Evaluating how the company assures itself regarding the completeness and accuracy of the information in the reports used by management in the reviews. Matters that might be relevant to this evaluation include how the company determines that –
    - The data included in the report are accurate and complete. This evaluation might be accomplished through testing controls over the initiation, authorization, processing, and recording of the respective transactions that feed into the report.
    - The relevant computer settings established by the software user are consistent with the objectives of management's review. For example, if management's review is based on items in an exception report, the reliability of the report depends on whether the settings for reporting exceptions are appropriate.

The auditor verifies that the code in the packaged software cannot be changed by the user. The auditor also evaluates the IT general controls that are important to the effective operation of the IT-dependent controls (such as the access controls and operations controls previously described).

Categories of IT Controls

The remaining sections of this chapter discuss major categories of IT controls and considerations for testing them in a smaller, less complex IT environment.

IT General Controls

IT general controls are broad controls over general IT activities, such as security and access, computer operations, and systems development and system changes.

Security and Access

Security and access controls are controls over operating systems, critical applications, supporting databases, and networks that help ensure that access to applications and data is restricted to authorized personnel.

In a small, less complex IT environment, security administration is likely to be centralized, and policies and procedures might be documented informally. A small number of people or a single individual typically supports security administration and monitoring on a part-time basis. Controls for mitigating the risk caused by a lack of segregation of duties over operating systems, data, and applications tend to be detective controls rather than preventive. Access controls tend to be monitored informally.

Tests of security and access controls could include evaluating the general system security settings and password parameters; evaluating the process for adding, deleting, and changing security access; and evaluating the access capabilities of various types of users.

Computer Operations

Computer operations controls relate to day-to-day operations and help ensure that computer operational activities are performed as intended, processing errors are identified and corrected in a timely manner, and continuity of financial reporting data is maintained through effective data backup and recovery procedures.

A smaller, less complex IT environment might not have a formal operations function. There might not be formal policies regarding problem management or data storage and retention, and backup procedures tend to be initiated manually.

Tests of controls over computer operations could include evaluating the backup and recovery processes, reviewing the process of identifying and handling operational problems, and, if applicable, assessing control over job scheduling.

Systems Development and System Changes

Systems development and system change controls are controls over systems selection, design, implementation, and configuration changes that help ensure that new systems are appropriately developed, configured, approved, and migrated into production, and controls over changes – whether to applications, supporting databases, or operating systems – that help to ensure that those changes are properly authorized and approved, tested, and implemented. Although they might be viewed as separate categories, in less complex environments, systems development and system change procedures often are combined for ease of implementation, training, and ongoing maintenance.

A smaller, less complex IT environment typically includes a single or small number of off-the-shelf packaged applications that do not allow for modification of source code. Modifications to software are prepared by and, in some cases, implemented by, the software vendor in the form of updates or patches or via a network connection between the vendor and the organization. Typically, a small number of individuals or a single individual (employees or consultants) support all development and production activities.

Examples of possible tests of controls over systems development and system changes include examining the processes for selecting, acquiring, and installing new software; evaluating the process for implementing software upgrades or patches; determining whether upgrades and patches are authorized and implemented on a timely basis; and assessing the process for testing new applications and updates.

Application Controls

Application controls are automated or IT-dependent controls intended to help ensure that transactions are properly initiated, authorized, recorded, processed, and reported. For example, in a three-way match process, received vendor invoices are entered into the system, which matches them automatically to the purchase order and goods receipt based on the document reference numbers, price, and quantity. The system's simultaneous matching of the information within the three documents upon their entry to authorize a payment to the vendor is an automated application control. Management's review and reconciliation of an exception report generated by the system is an example of an IT-dependent manual control.[6/]

The general nature of application controls tends to be similar in most IT environments, although in less complex environments, the controls tend to be manual and detective rather than automated and preventive. The testing procedures also could be similar. In most IT environments, the auditor could focus on error correction

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[6/] See Example 5-1 for an illustration of how those types of controls might be tested in a small, less complex IT environment.

procedures over inputting, authorizing, recording, processing, and reporting of transactions when evaluating application controls. However, in less complex IT environments there might be fewer financial applications affecting relevant assertions and fewer application controls within those applications.

Regardless of the complexity of the IT environment, the audit plan for testing application controls could include a combination of inquiry, observation, document inspection, and re-performance of the controls. Efficiencies can be achieved through altering the nature, timing, and extent of testing procedures performed related to automated and IT-dependent application controls if IT general controls are designed and operating effectively. In some situations, benchmarking of certain automated controls might be an appropriate audit strategy.[7/]

End-User Computing Controls

End-user computing refers to a variety of user-based computer applications, including spreadsheets, databases, ad-hoc queries, stand-alone desktop applications, and other user-based applications. These applications might be used as the basis for making journal entries or preparing other financial statement information. End-user computing is especially prevalent in smaller, less complex companies.

End-user computing controls are controls over spreadsheets and other user-developed applications that help ensure that such applications are adequately documented, secured, backed up, and reviewed regularly for process integrity. End-user computing controls include general and application controls over user-developed spreadsheets and applications.

Tests of controls over end-user computing could include assessing access controls to prevent unauthorized access: testing of controls over spreadsheet formulas or logic of queries and scripts; testing of controls over the completeness and accuracy of information reported by the end-user computing applications; and reviewing the procedures for backing up the applications and data.

[7/] Auditing Standard No. 5, paragraphs B28–B33, discuss benchmarking of automated controls.

Chapter 6

Considering Financial Reporting Competencies and Their Effects on Internal Control

To maintain effective internal control over financial reporting, a company needs to retain individuals who are competent in financial reporting and related oversight roles.[1/] Smaller, less complex companies can face challenges in recruiting and retaining individuals with sufficient experience and skill in accounting and financial reporting. Also, resource limitations might prevent a smaller, less complex company from employing personnel who are familiar with the accounting required for unique, complex, or non-routine transactions or relevant changes in rules, regulations, and accounting practices. Smaller, less complex companies might address their needs for financial reporting competencies through means other than internal staffing, such as engaging outside professionals.

This chapter discusses the auditor's consideration of financial reporting competencies at a smaller, less complex company, including situations in which a smaller, less complex company enlists outside assistance in financial reporting matters.

Understanding and Evaluating a Company's Financial Reporting Competencies

The evaluation of competence is one aspect of evaluating the control environment and the operating effectiveness of certain controls. For example, when evaluating entity-level controls, such as risk assessment and the period-end financial reporting process, the auditor could obtain information about whether –

- Management identifies the relevant financial reporting issues on a timely basis (e.g., issues arising from new transactions or lines of business or changes to accounting standards); and

- Management has the competence to ensure that events and transactions are properly accounted for and that financial statements and related disclosures are presented in conformity with generally accepted accounting principles ("GAAP").

For recurring clients, the auditor's experience in prior audit engagements can be a source of information regarding management's financial reporting competencies. The auditor could be aware of specific accounts or disclosures that have caused problems in prior engagements, or of management's response to past changes in accounting pronouncements. These experiences can inform the auditor about management's

[1/] See e.g., Principle 5 of the COSO Small Companies Guidance.

financial reporting competencies, including whether and how management identifies and responds to financial reporting risks. The procedures performed to evaluate the period-end financial reporting process also could be valuable to the evaluation of financial reporting competency.

The auditor's inquiries and observations pertaining to the company's overall commitment to competence, which is part of the evaluation of the control environment, also can inform the auditor's assessment of financial competency. The auditor can consider whether and how the company and management –

- Establish and agree on the knowledge, skills and abilities needed to carry out the required responsibilities prior to hiring individuals for key financial reporting positions,
- Train employees involved in financial reporting processes and provide them with the appropriate tools and resources to perform their responsibilities, and
- Periodically review and evaluate employees relative to their assigned roles, including whether the audit committee (or board of directors) evaluates the competencies of individuals in key financial reporting roles, such as the chief executive and financial reporting officers.

Auditors may keep in mind that company financial reporting personnel do not need to be experts in all areas of accounting and financial reporting but need to be sufficiently competent with respect to the accounting for current and anticipated transactions and changes in accounting standards to identify and address the risks of misstatement.

Supplementing Competencies with Assistance from Outside Professionals

Some smaller, less complex companies might not have personnel on staff with experience in certain complex accounting matters that are encountered. In these circumstances, a company might engage outside professionals to provide the necessary expertise (i.e., an individual or firm possessing special skill or knowledge in the particular accounting and financial reporting matter).[2/] When assessing the

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[2/] This section of the chapter does not pertain to management's use of a service organization that supports routine accounting functions, such as processing payroll transactions or supporting the company's information technology systems. It also does not apply to management's use of specialists in matters outside of accounting and financial reporting, such as actuaries, engineers, environmental consultants, and geologists. See Auditing Standard No. 5, AU sec. 324, *Service Organizations*, and AU sec. 336, *Using the Work of a Specialist*, for direction on these matters.

competence of the personnel responsible for the company's financial reporting and associated controls, the auditor may consider the combined competence of company personnel and other parties that assist with functions related to financial reporting.

When an outside professional provides accounting assistance related to relevant assertions or the period-end financial reporting process, the auditor might begin by considering how the company assures itself that events and transactions are properly accounted for and that financial statements and the related disclosures are free of material misstatement. The company might have differing levels of involvement with outside professionals, depending upon the nature of the services provided. The auditor could evaluate management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks.[3/] In performing this evaluation, the auditor can consider –

- Whether management recognizes situations for which additional expertise is needed to adequately identify and address risks of misstatement.
- How management determines that the outside professionals possess the necessary qualifications. For example, management might obtain information from the professional about his or her skills and competence.
- Whom management designates to oversee the services and whether they possess the suitable skill, knowledge, or experience to sufficiently oversee the outside professionals. (Note: Management is not required to possess the expertise to perform or re-perform the services.)
- Whether management has established controls over the work of the outside accounting professional and over the completeness and accuracy of the information provided to the outside professional. For example, in addition to reviewing the work of the outside professional, management might inquire about the professional's monitoring and review procedures related to the work performed by the professional for the company.
- How management participates in matters involving judgment, for example, whether management understands and makes significant assumptions and judgments underlying accounting calculations prepared by an outside professional.

[3/] If the audit committee has oversight over the use of service providers, the auditor may also consider the nature and extent of that oversight.

- How management evaluates the adequacy and the results of the services performed, including the form and content of the outside accounting professional's findings, and accepts responsibility for the results of the services.

In gathering evidence to support this evaluation, the auditor could hold discussions with both management and the outside professional, perhaps while obtaining an understanding of the period-end financial reporting process. The auditor also could inspect documentation that provides support for management's oversight of the outside professional.[4/]

Example 6-1 – Assistance from Outside Professionals

Scenario: A small developer of analytical software products does not have an individual with strong tax accounting expertise on staff. The company retains a third-party accounting firm (not its auditor) to prepare the income tax provision. Management obtains information from the third-party accounting firm about the training and experience of the staff assigned to do this work. The company's CFO, who has basic knowledge of tax accounting, reviews and discusses the tax provision with the accounting firm that prepared it, and compares the provision to CFO's expectations based on past periods, budgets, and knowledge of business operations.[5/]

Audit Approach: The auditor observes that management identifies risks to financial reporting related to accounting for income taxes and engages an outside professional to provide technical assistance. Further, the auditor evaluates management's oversight to determine whether the company, with the assistance of the professional, is adequately identifying and responding to risks of material misstatement regarding the income tax provision. As part of this evaluation, the auditor inspects the engagement letter, other correspondence between the company and the third-party firm, and the tax schedules and other information produced by the third-party firm. The auditor also evaluates the controls over the completeness and accuracy of the information furnished by the company to the third-party firm. The auditor also assesses whether the third-party accounting firm has the proper skills and staff assigned to do this work.

[4/] Refer to Chapter 7 for discussion of how the auditor can obtain sufficient evidence when less formal documentation is available.

[5/] Adapted from the COSO Small Companies Guidance, Volume II: Guidance, page 34.

Chapter 7

Obtaining Sufficient Competent Evidence When the Company Has Less Formal Documentation

Implementing and assessing effective internal control over financial reporting by a company's management generally involves some level of documentation. A smaller, less complex company often has different needs for documentation, and the nature of that documentation might differ from that of a larger or more complex organization. Differences in the form and extent of control documentation of smaller, less complex companies generally relate to their operating characteristics, particularly to fewer resources and more direct interaction of senior management with controls.[1/]

The nature and extent of a company's documentation of internal control over financial reporting can have a significant effect on the auditor's strategy regarding the audit of internal control. This chapter discusses how the auditor could adapt his or her audit strategy to obtain sufficient competent evidence in an environment with less formal documentation.

Audit Strategy Considerations

The auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.[2/] The auditor can obtain this evidence through direct testing or using the work of others, as appropriate. Procedures the auditor could perform to test operating effectiveness include a mix of inquiry of appropriate personnel, observation of the company's operations, inspection of relevant documentation, and re-performance of the control. The nature, timing, and extent of tests of controls depend on the risk associated with the controls. As the risk associated with the control being tested increases, the evidence that the auditor should obtain also increases.[3/]

PCAOB standards establish the documentation requirements for these audits. Those documentation requirements apply only to the auditor.

[1/] The COSO Small Companies Guidance, Volume II: Guidance, pages 12 - 13, discusses circumstances that affect the need for documentation of internal control.

[2/] See Auditing Standard No. 5, paragraph 3.

[3/] Auditing Standard No. 5, paragraph 46. Paragraph 47 discusses the factors that affect the risk associated with a control.

Documentation of Processes and Controls

Larger companies with complex operations are more likely to have formal documentation of their processes and controls, such as in-depth policy manuals and systems flowcharts of processes. In a smaller, less complex company, documentation of processes and controls might take a variety of forms. For example, information about processes and controls might be found in other documentation, such as memoranda, questionnaires, software manuals, source documents, or job descriptions. This documentation might not cover every process and might not be in a consistent form across all processes.

Where walkthroughs are performed, auditors could use those procedures to obtain an understanding of the flow of transactions affecting relevant assertions and to assess the design effectiveness of certain controls, even when documentation is limited.

Documentation of Operating Effectiveness of Controls

In a smaller, less complex business, the nature and extent of documentation of the operating effectiveness of controls may vary. Also, evidence of a control's operation might exist only for a limited period.

The type and availability of evidence regarding controls to be tested can affect the auditor's testing strategy.[4/] In particular, company documentation can influence the nature and timing of audit procedures performed. For example, the nature of some audit procedures e.g., document inspection, requires documentation. Also, the timing of some tests of controls might be determined, in part, based on when the evidence of the controls' operation is available.

Obtaining sufficient evidence about the operating effectiveness of controls can be challenging when there is limited documentation of their operation. In those situations, inquiry combined with other procedures, such as observation of activities, inspection of documentation produced or used by the controls,[5/] and reperformance of certain controls, might provide sufficient evidence about whether a control is effective.

[4/] As discussed in Chapter 8, a pervasive lack of documentation and other audit evidence could prevent the auditor from being able to obtain sufficient evidence to support an opinion on internal control.

[5/] Examples of documentation that might be produced or used by controls include exception reports, memoranda, or documented communications between management and employees.

As a practical matter, the auditor also needs to obtain documentation of the work of others to use that work to reduce the auditor's own testing.[6/]

Other Considerations

When auditing a smaller, less complex company with limited documentation, it generally is helpful to obtain an understanding of the nature and availability of audit evidence relating to internal control over financial reporting as early in the audit process as practical. This understanding ordinarily includes consideration of existing documentation regarding –

- Company processes and procedures, particularly for transactions affecting relevant assertions and controls that the auditor is likely to select for testing
- Monitoring of other controls performed by management or others

The auditor can then identify gaps in important documentation so alternatives can be explored. For example, if the CFO prepares contemporaneous documentation of certain controls and retains it for a limited period, the auditor might arrange to obtain access to that documentation for testing purposes. Early conversations with management about these matters can help provide auditors with the most flexibility in developing efficient and effective audit strategies.

If the company does not have formal documentation of its processes and controls, the auditor may consider whether other documentation is available before drafting formal descriptions of processes and controls for the audit documentation. A practical way to identify such other documentation is to look at the information that the company uses to run the business.

As discussed in Chapter 1, one of the practical considerations when selecting controls to test and determining the nature, timing, and extent of testing is the nature and availability of evidence of operating effectiveness. For example, if two or more controls adequately address the risk of misstatement for a relevant assertion, the auditor could select the control for which evidence of operating effectiveness can be obtained more readily.

[6/] The auditor's use of the work of others also is dependent on such factors as the nature of the subject matter and the competence and objectivity of the individuals performing the work. See Auditing Standard No. 5, paragraphs 16-19.

Example 7-1 – Obtaining Information about Processes and Controls

Scenario: A small manufacturer in the electronics industry periodically makes large purchases of specialty components. The company has established procedures covering the initiation, authorization, and recording of these purchases, although the company has not developed an in-depth policies and procedures manual. The company's procedures provide for completion of a form that describes the product requirements and payment terms and indicates how to record the purchase. The forms are reviewed and approved by the CEO and CFO before the purchase is executed. When the goods are received, they are matched with the purchase form and accounted for as indicated on the form.

Audit Approach: The auditor inspects a copy of a completed purchase form and related documentation to obtain an initial understanding of the flow of the purchase transactions. She follows up with inquiries of personnel involved in the process of authorizing, sending, and accounting for the purchases and traces the recording of the transactions through the accounting system. She summarizes her understanding of the transaction flow in a memo and includes a copy of a purchase form in the workpapers. The auditor uses her understanding of the purchase process to plan and perform tests of selected controls over the purchases.

Example 7-2 – Obtaining Evidence about Operating Effectiveness of Controls

Scenario: One control that management relies on with respect to the period-end financial reporting process is the CFO's review of the quarterly financial statements prepared by the controller. The CFO does not create separate documentation of her review but does retain copies of the financial statements with her handwritten notes and other markings for reference purposes. She sends her review comments to the controller via email, and the company's email system retains the email messages. If errors are identified, the controller prepares adjusting entries, which are approved by the CFO.

Each quarter, the CFO and controller prepare and present to the audit committee a financial package, explaining significant trends in the company's financial condition, operating results, and cash flows, as well as comparisons to budgeted amounts and comparable prior periods.

Audit Approach: The auditor can draw upon multiple sources of audit evidence to evaluate whether the control is in place and operating effectively to detect errors in the period-end financial reporting process. He can make inquiries of the CFO to obtain an understanding of the frequency, nature, timing, and level of precision [7/] of the CFO's review. He can corroborate this understanding and evaluate the operating effectiveness of the review by, for selected items, inspecting copies of the reviewed drafts of the financial statements, reviewing comments sent to the controller, and reviewing adjusting entries and supporting information. He can also talk to other employees to find out if the CFO contacts them to ask questions, what types of questions are asked, and how those questions are resolved. In addition, he can read the information in the financial package delivered to the audit committee and might observe the CFO's financial review with the audit committee, if the auditor attends the meetings in connection with the audit.

7/ Level of precision is discussed in more detail in Chapter 2.

Chapter 8

Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies

In some audits of internal control, auditors might encounter companies with numerous or pervasive deficiencies in internal control over financial reporting. Smaller, less complex companies can be particularly affected by ineffective entity-level controls, as these companies typically have fewer employees and fewer process-level controls.

Auditing internal control over financial reporting in companies with pervasive deficiencies can be challenging. The auditor's strategy is influenced by the nature of the control deficiencies and factors such as the effect of the deficiencies on other controls and the availability of audit evidence. Although the facts and circumstances can vary significantly, the auditor might not be able to express an unqualified opinion on the effectiveness of internal control over financial reporting in some of these situations.[1/]

This chapter discusses how auditors could design their audit strategies in response to situations involving pervasive deficiencies.

Pervasive Deficiencies That Result in Material Weaknesses

The auditor's objective in an audit of internal control is to express an opinion on the effectiveness of the company's internal control over financial reporting. Because a company's internal control over financial reporting cannot be considered effective if one or more material weaknesses exist, to form a basis for expressing an opinion, the auditor must plan and perform the audit to obtain competent evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment.[2/]

Ordinarily, the auditor's strategy should include tests of controls as necessary to support a conclusion that internal control over financial reporting is effective.[3/] However, the auditor's existing knowledge of the company or information obtained early in the audit process might lead an auditor to a preliminary judgment that internal control over financial reporting is likely to be ineffective because of the presence of pervasive control

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[1/] To enable the auditor to express an unqualified opinion on internal control, the company would need to remediate all of its material weaknesses early enough before year-end to enable the auditor to obtain sufficient competent audit evidence about the remediated controls to support an unqualified opinion on internal control over financial reporting.

[2/] See Auditing Standard No. 5, paragraph 3.

[3/] See Auditing Standard No. 5, paragraph 39.

deficiencies that result in one or more material weaknesses. In those situations, the auditor's strategy for testing selected controls may depend on the effect of the pervasive deficiencies on other controls, as discussed in the following paragraphs.

Considering the Effect of Pervasive Control Deficiencies on Other Controls

When the auditor encounters pervasive control deficiencies, he or she might decide that those deficiencies also impair the effectiveness of other controls by rendering their design ineffective or by keeping them from operating effectively. For example, certain deficient entity-level controls, such as the following, might impair the effectiveness of other controls over relevant assertions:

- *Ineffective control environment (considering the risk profile of the company)*. An ineffective control environment can increase the risk associated with a control by rendering its design ineffective or preventing it from operating effectively. Also, certain controls in the control environment, such as maintaining financial reporting competencies, might be necessary for the effective functioning of other controls.

- *Ineffective IT controls or information systems.* Ineffective information systems could impair the effectiveness of certain IT-dependent controls (e.g., monitoring controls that rely on the reports produced by an ineffective information system).

- *Pervasive lack of segregation of duties without appropriate alternative controls.* When a person performs two or more incompatible duties, the design of some controls might be ineffective without appropriate alternative controls.

- *Frequent management override of controls.* A control that is frequently overridden is less likely to operate effectively. The effectiveness of controls that depend on an overridden control also might be impaired.

The top-down audit approach can help the auditor identify pervasive control deficiencies earlier in the audit process and take them into account in determining the audit approach for testing other controls.

The auditor's preliminary judgments regarding the effect of the pervasive control deficiencies can help determine the approach to gathering audit evidence. When the pervasive control deficiencies adversely affect other controls, the auditor may modify the planned testing of the other controls because less evidence generally is needed to support a conclusion that controls are not effective than a conclusion that controls are effective.[4/] For example, if a control is likely to be impaired because of another control's

[4/] See Auditing Standard No. 5, paragraphs 46 and 47.

deficiency, the inquiries and observations during walkthroughs might provide enough evidence to conclude that the design of a control is deficient and thus could not prevent or detect misstatements. In some cases, limited testing of a control might be necessary (e.g., if a walkthrough has not been performed) to conclude that a control is not operating effectively. Also, detected misstatements from the audit of the financial statements could indicate that a control is not effective.

Some companies might have pervasive control deficiencies and still have effective controls over some relevant assertions. For the selected controls that are likely to be effective, the auditor should test those controls to obtain the evidence necessary to support a conclusion about their operating effectiveness.[5/] The pervasive control deficiencies may affect the risk associated with the controls selected for testing, and, in turn, the amount of audit evidence needed. Example 8-1 discusses the effect of pervasive control deficiencies on tests of controls.

Scope Limitation Due to Lack of Sufficient Audit Evidence

Pervasive deficiencies in a company's internal control over financial reporting do not necessarily prevent an auditor from obtaining sufficient audit evidence to express an opinion on internal control over financial reporting. If the auditor determines that sufficient evidence is available to express an opinion, the auditor should perform tests of those controls that are important to the auditor's conclusion about the effectiveness of the company's internal control over financial reporting and evaluate the severity of the identified control deficiencies.[6/]

In some audits of companies with pervasive control deficiencies, the auditor could become aware that there is minimal available evidence about the design and operation of internal control over financial reporting. Such situations could lead the auditor to conclude that the lack of available evidence constitutes a scope limitation that will prevent him or her from obtaining reasonable assurance necessary to express an opinion on internal control over financial reporting, including identification of existing material weaknesses.

The auditor may issue a report disclaiming an opinion on internal control over financial reporting as soon as the auditor concludes that a scope limitation will prevent the auditor from obtaining the reasonable assurance necessary to express an opinion.[7/] The auditor is not required to perform any additional work before issuing a disclaimer when the auditor concludes that he or she will not be able to obtain sufficient evidence to express an opinion. The auditor's report should disclaim an opinion on internal control

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5/ See Auditing Standard No. 5, paragraph 39.

6/ See Auditing Standard No. 5, paragraphs 22, 39 and 62.

7/ See Auditing Standard No. 5, paragraph C6.

and disclose the substantive reasons for the disclaimer. The report also should disclose the material weaknesses of which the auditor is aware.[8/]

Even if the auditor lacks sufficient evidence to express an opinion on internal control, the auditor might still be able to obtain sufficient evidence to perform an audit of the financial statements. The auditor should, however, take into account the control deficiencies and issues encountered in the audit of internal control in assessing control risk and determining the nature, timing, and extent of tests of accounts and disclosures in the audit of the financial statements.[9/]

Example 8-2 illustrates a situation in which the auditor is unable to obtain sufficient evidence to express an opinion on internal control over financial reporting.

Example 8-1 – Pervasive Deficiencies and Testing of Controls

Scenario: A small company has a two-person staff that handles all of the accounting and financial reporting duties. The staff is competent in routine financial reporting matters but has difficulty with more complex accounting matters, such as valuation of stock-based compensation and income tax calculations and disclosures. The lack of competencies in these areas has resulted in adjustments based on the auditor's identification of material misstatements.[10/]

Audit Approach: Based on the auditor's experience with the company, she expects that controls over the valuation/allocation and disclosures related to stock-based compensation and income taxes will not be effective. For those assertions, the auditor obtains evidence about the respective controls during a walkthrough of the related process. Also, misstatements in those assertions were detected in the financial statement audit, and she observes that the controls failed to prevent or detect those misstatements. Based on this evidence, she concludes that the controls over those assertions are not effective.

With respect to routine financial reporting processes, such as cash receipts and disbursements, the auditor plans to perform tests of the selected controls to obtain enough evidence to support a conclusion that the respective controls are effective.

[8/] See Auditing Standard No. 5, paragraph C5, for the specific requirements regarding the disclosures of the material weaknesses.

[9/] See Auditing Standard No. 5, paragraph B5.

[10/] Chapter 6 discusses financial reporting competencies in more detail, including approaches that smaller, less complex companies might take to enhance their financial reporting competencies.

Example 8-2 –Lack of Sufficient Audit Evidence

Scenario: A development stage company is devoted exclusively to research and development for a new product and currently generates no revenue. The financial staff consists of a CFO and accounting clerk. The company's principal accounting records consist of a checkbook and payroll records, and the company has no documentation of policies and procedures. Most of its controls are undocumented supervisory checks by the CFO.

Late in the fourth quarter, a management dispute results in the resignation of the CFO and termination of the accounting clerk. Management hires an accountant on a temporary contract basis to prepare financial statements from the company's existing records and to help the company establish appropriate controls over its financial reporting functions. However, most of these controls were implemented near or shortly after year-end.

Audit Approach: As the auditor begins trying to obtain an understanding of the company's internal control over financial reporting and evaluate entity-level controls, she notes that there is minimal information available about the controls that existed at year-end. Because of the turnover in financial reporting personnel, the auditor is unable to perform inquiries, observations, or other procedures to understand the flow of transactions and related controls in significant processes. The auditor identifies some material weaknesses, but she determines that the lack of evidence results in a scope limitation because she cannot obtain reasonable assurance that all of the existing material weaknesses are identified.

Accordingly, the auditor ceases further audit procedures in the audit of internal control. The auditor's report on internal control over financial reporting contains a disclaimer of opinion and disclosure of the substantive reasons for the disclaimer and the material weaknesses that she identified.

Appendix A

The Integrated Audit Process

Auditing Standard No. 5 indicates that the audit of internal control should be integrated with the audit of the financial statements. This means that the auditor should plan and perform the work to achieve the objectives of both audits, [1/] which are as follows:

- *Audit of the financial statements*. To express an opinion on the fairness with which the financial statements present, in all material respects, financial position, results of operations, and its cash flows in conformity with GAAP.[2/]

- *Audit of internal control*. To express an opinion on the effectiveness of the company's internal control over financial reporting.[3/]

This appendix illustrates one approach for integrating the audit of internal control with the audit of the financial statements and is not intended to present all of the procedures that are required for a particular audit. Auditors must plan and perform their integrated audits to achieve the objectives of the audits and to comply with standards of the PCAOB.[4/]

Summary of the Illustrative Audit Approach

The integrated audit process can be summarized into the following major components:

a. Preliminary engagement procedures

b. Audit planning

c. Risk assessment procedures

d. Auditor response, including tests of accounts and controls

e. Conclusion and wrap-up

[1/] See Auditing Standard No. 5, paragraphs 6 and 7.

[2/] See paragraph .01 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor.*

[3/] See Auditing Standard No. 5, paragraph 3.

[4/] See Auditing Standard No. 5, paragraph 6.

Preliminary Engagement Procedures

Preliminary engagement procedures include the auditor's engagement acceptance process and reaching an understanding with the audit committee about the terms of the engagement, including pre-approval of audit and non-audit services.

During the engagement acceptance process, the auditor might identify matters that could affect the risk of material misstatement of the financial statements or the risk of material weakness in internal control over financial reporting and, thus, could inform the auditor's risk assessments during the audit.

Audit Planning

During audit planning, the auditor should make a preliminary judgment about materiality. The judgment about materiality is the same for both the audit of the financial statements and the audit of internal control.[5/]

The auditor also can develop a preliminary audit strategy and audit plan based on his or her understanding of the company and its environment. The audit strategy could cover matters such as general scope and timing of the engagement. The audit strategy and plan could be refined further as the audit progresses.

Risk Assessment Procedures

Risk assessment procedures are intended to help the auditor identify risks of misstatement and the controls that are in place to address those risks. When performing risk assessment procedures, the auditor should obtain an understanding of the company and its environment, including its internal control.[6/] These procedures include walkthroughs, or other procedures, to understand the likely sources of misstatement.[7/] It also includes performing preliminary analytical procedures and procedures to assess the risk of material misstatement due to fraud.[8/] The auditor's risk identification and assessment should also take into account his or her knowledge about the company and its environment from other sources, such as prior audits.[9/]

[5/] See AU sec. 311.03, AU sec. 312.12-33, and Auditing Standard No. 5, paragraph 20.

[6/] See AU sec. 319.25-61, and Auditing Standard No. 5, paragraph 9.

[7/] See Auditing Standard No. 5, paragraphs 34-38, for discussion of the objectives of walkthroughs and direction on walkthrough procedures.

[8/] See AU sec. 329.06-08, and AU sec.316.35-.45.

[9/] See AU sec. 311.04 and .08, and AU sec. 319.59.

Based on the auditor's understanding gained through performing the risk assessment procedures and obtaining other evidence, the auditor should assess the identified risks.[10/]

The auditor's risk assessments are the basis for the identification of significant accounts and disclosures and relevant assertions as well as the selection of controls to test. Relevant assertions and significant accounts and disclosures should be determined based on whether there is a reasonable possibility that they could contain misstatements that could cause the financial statements to be materially misstated.[11/] The identification of relevant assertions and significant accounts[12/] is the same for both the audit of internal control and the audit of the financial statements.

Auditing Standard No. 5 states that the auditor should use a top-down approach to the audit of internal control to select the controls to test. 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.[13/] 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.

Overall Response to Risks

Based on the auditor's risk assessment, the auditor should evaluate the need for an overall response to the risks.[14/] This evaluation is particularly important for pervasive risks of misstatement, which can affect many financial statement accounts, but it applies to every audit.

[10/] See AU sec. 312.16 and .26-.33.

[11/] See Auditing Standard No. 5, paragraphs 28-33.

[12/] In the financial statement audit, the auditor may perform substantive auditing procedures on financial statement accounts, disclosures, and assertions that are not determined to be significant accounts and disclosures and relevant assertions. This is because his or her assessment of the risk that undetected misstatement would cause the financial statements to be materially misstated is unacceptably high (see AU sec. 312.39 for further discussion about undetected misstatement) or as a means of introducing unpredictability in the procedures performed (see AU sec. 316.50 for further discussion about predictability of auditing procedures).

[13/] See Auditing Standard No. 5, paragraph 21.

[14/] See AU sec. 312.16.

The overall responses could affect such aspects of the audit as –

- Assignment of staff
- Level of supervision
- Need for specialists
- Appropriateness of planned audit strategy and scope

Specific Responses – Substantive Procedures and Tests of Controls

Specific responses to risk relate to the tests of relevant assertions of significant accounts and disclosures ("substantive procedures") and the controls over those assertions. Auditing Standard No. 5 requires the auditor to obtain evidence about the controls over relevant assertions, and it states that the auditor should perform substantive procedures for all relevant assertions, regardless of the assessed level of control risk.[15/] The auditor should determine an appropriate mix of the nature, timing, and extent of testing based on the associated risks and other factors.[16/] The determination of the nature, timing, and extent of testing includes decisions about using the work of others to test controls in the integrated audit. As the associated risk increases, the evidence that the auditor should obtain also increases.[17/]

The relationship between tests of controls and substantive procedures is important to the integration of the audit of internal control with the audit of financial statements. Obtaining sufficient evidence to support control risk assessments of low for purposes of the financial statement audit ordinarily allows the auditor to reduce the amount of substantive procedures that otherwise would have been necessary to opine on the financial statements. On the other hand, deficiencies in the controls that the auditor planned to rely on could lead the auditor to expand his or her substantive procedures.

As discussed in Chapter 1, the results of substantive tests of accounts and disclosures do not provide sufficient evidence for the auditor to conclude on the operating effectiveness of controls. However, the results of substantive tests could affect the auditor's risk assessments associated with the controls. For example, if the results of substantive procedures indicate misstatements in an assertion, evaluating the

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15/ See Auditing Standard No. 5, paragraph B7.

16/ For example, in the audit of internal control, walkthroughs might provide sufficient evidence of operating effectiveness for some selected controls, depending on the risk associated with the control being tested, the specific procedures performed as part of the walkthrough, and the results of those procedures.

17/ See Auditing Standard No. 5, paragraphs 46 and 49.

nature, cause, and significance of the misstatements could lead the auditor to identify a deficiency in the related controls or to modify his or her risk assessments. When no misstatements are detected from substantive procedures for an assertion, the auditor should take that into account along with the factors discussed in paragraphs 46-49 of Auditing Standard No. 5 in considering the risk associated with the related controls, which affects the nature, timing, and extent of the testing necessary to conclude on the effectiveness of the controls.[18/]

Conclusion and Wrap-up

In the conclusion and wrap-up phase, the auditor should evaluate the results of his or her testing, particularly for identified misstatements and control deficiencies. The auditor should evaluate the misstatements and control deficiencies, individually and in the aggregate. In evaluating the effects of misstatements, the auditor should include both quantitative and qualitative considerations.[19/]

Based on the evaluation of the testing results, the auditor should form conclusions about whether –

- The financial statements are materially misstated,
- A material weakness in internal control exists, and
- He or she has obtained sufficient competent evidence to support those conclusions.[20/]

The results of each portion of the integrated audit inform the auditor's conclusions about the other portion. For example, the auditor's conclusions about the effectiveness of controls should be based on all of the pertinent information about control effectiveness,[21/] including –

- Tests of controls for the audit of internal control,
- Tests of controls for the audit of the financial statements,

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[18/] See Auditing Standard No. 5, paragraph B9. This does not mean that the auditor is required to perform substantive procedures for a relevant assertion before performing tests of controls.

[19/] See AU sec. 312.34, and Auditing Standard No. 5, paragraphs 62 and B8.

[20/] See paragraphs .34-.41 of AU sec. 312, *Audit Risk and Materiality in Conducting an Audit*, paragraph .01 of AU sec. 326, *Evidential Matter*, and Auditing Standard No. 5, paragraph 3.

[21/] See Auditing Standard No. 5, paragraph 71.

- Use of the work of others in either audit, and

- Evidence about control deficiencies resulting from identified misstatements or other sources (e.g., control deficiencies identified by management).

This information could affect the conclusions about control effectiveness as of year-end as well as control risk assessments for the financial statement audit. In some situations, the evaluation of audit results also could lead the auditor to re-evaluate his or her assessments of risk and the sufficiency of the audit procedures performed.

The conclusion and wrap-up phase of the audit also includes completion of the review of the audit and resolution of reviewers' comments.

Appendix B

Discussion of Comments Received on the Preliminary Staff Views

On October 17, 2007, the staff of the Board's Office of the Chief Auditor published for comment Preliminary Staff Views – *An Audit of Internal Control That Is Integrated with An Audit of Financial Statements: Guidance for Auditors of Smaller Public Companies* ("the preliminary guidance"). During the public comment period, 23 comment letters were received from investors, auditors, issuers, and others.

The majority of commenters were supportive of the preliminary guidance. They noted that it appropriately considered the environment of smaller, less complex companies and provided useful examples that will help in designing and executing strategies for the audits of these companies in accordance with the provisions of Auditing Standard No. 5.

The commenters offered suggestions to improve the preliminary guidance. After a careful analysis, certain changes have been made to this publication to further clarify or enhance the guidance. This Appendix describes significant comments received on the preliminary guidance and the related changes that the staff made in this publication.

General Comments

The introduction to the preliminary guidance stated that it did not establish new requirements for auditors. However, some commenters suggested reinforcing this statement by providing references to the Board's standards that establish mandatory or presumptively mandatory responsibilities to which this publication refers. As suggested by commenters, this publication includes additional references to the Board's standards.

Several commenters suggested that some or all of the preliminary guidance could be applicable to audits of internal control of larger public companies. As noted in the introduction, this publication was developed specifically to describe how auditors may apply the provisions of Auditing Standard No. 5 to audits of smaller, less complex companies. If auditors of larger public companies find this guidance useful in applying the scalability principles of Auditing Standard No. 5, they may, of course, refer to it. As noted earlier, this guidance does not establish requirements for the audit of internal control. Rather, all audits of internal control – regardless of the size of the company – must comply with the requirements of Auditing Standard No. 5.

Chapter 1 – Scaling the Audit for Smaller, Less Complex Companies

The preliminary guidance said that "[i]f none of the controls that are designed to address a risk for a relevant assertion is likely to be effective, the auditor can take that into account in determining the testing of that control." According to one commenter, this statement could suggest that, under such circumstances, the auditor still has an

obligation to test a particular control. This sentence has been modified to say that, if none of the controls over an assertion "is likely to be effective, the auditor can take that into account in determining the evidence needed to support a conclusion about the effectiveness of controls for this assertion." Paragraph 47 of Auditing Standard No. 5 indicates that less evidence generally is needed to support a conclusion that controls are not effective. Chapter 8 discusses how this principle may be applied when a company has pervasive control deficiencies.

Several commenters asked the staff to clarify the example in the section entitled Tests of Operating Effectiveness of Controls, in which the auditor was able to use the results of tests of controls to reduce the substantive work on accounts receivable but not revenue. In the commenters' view, it can be difficult to distinguish controls over accounts receivable – specifically, over billing and cash receipt processing – from controls over revenue recognition. In response, the reference to revenue recognition in this example has been replaced with a reference to the allowance for doubtful accounts, the controls over which are more easily distinguishable from controls over billing and cash receipt processing.

Additionally, as suggested by the commenters, the discussion leading to this example has been modified to emphasize that the auditor's decisions about relying on controls, which were illustrated by the example, were related to the audit of the financial statements rather than the audit of internal control. The example is not meant to suggest that the auditor should avoid testing controls in high-risk areas. Rather, the example assumes that the auditor is following the requirements and direction in AU sec. 319, *Consideration of Internal Control in a Financial Statement Audit,* in designing his or her audit strategy.

Another commenter asked for clarification about whether an auditor would be able to issue an unqualified opinion on the effectiveness of internal control over financial reporting when the auditor assessed control risk at the maximum for one or more relevant assertions in the audit of financial statements. A new paragraph that discusses the relationship between assessing control risk at the maximum and expressing an opinion on internal control over financial reporting has been added to the section entitled Tests of Operating Effectiveness of Controls.

In the last paragraph of Chapter 1, one commenter asked to clarify what impact the absence of misstatements detected by substantive procedures has on the testing of controls. In response, this publication explains that the absence of misstatements is only one of a number of factors that informs the auditor's risk assessment in determining the testing necessary to conclude on the effectiveness of a control. Additionally, as recommended by another commenter, the wording in this paragraph has been revised to better reflect paragraph B9 of Auditing Standard No. 5, to which it refers.

One commenter suggested adding guidance to address situations in which controls changed during the period. The purpose of Chapter 1 is to discuss the

principles in Auditing Standard No. 5 for scaling the audit and integrating tests of controls in audits of smaller, less complex public companies. Auditing Standard No. 5 and AU sec. 319, address the auditor's responsibilities for situations in which controls change during the year.

Chapter 2 – Evaluating Entity-Level Controls

Comments on Chapter 2 related primarily to the guidance on the precision of entity-level controls.

Some commenters were concerned that the list of factors that the auditor might consider in judging the level of precision of an entity-level control, in the section entitled Assessing the Precision of Entity-Level Controls, will be used as a checklist by auditors. Other commenters suggested expanding the list. Consistent with the preliminary guidance, this publication uses the phrase "factors include" to indicate that the list of factors is not all-inclusive, and the list of factors is not a list of criteria that the auditor should determine are met for every entity-level control. Not all factors are necessarily applicable to every control (e.g., some are relevant only to detective controls), and some factors might be more important than others for a given control. Examples 2-1 and 2-2 have been modified to better explain which factors the auditor in those examples took into account in evaluating the precision of the company's entity-level controls.

One commenter suggested expanding the guidance in Chapter 2 by discussing auditing considerations related to evaluating design and operating effectiveness of company's entity-level risk assessment component. The risk assessment component of internal control involves identification and analysis of the risks of material misstatement [22/] and thus, by itself, would not necessarily prevent or detect misstatements. Chapter 2 focuses on those entity-level controls that are more likely to operate at a sufficient level of precision to result in a reduction of testing of process-level controls in an audit of a smaller, less complex company.

Additionally, another commenter asked for clarification regarding when the auditor can obtain a substantial amount of evidence about the effectiveness of internal control over financial reporting through the evaluation of entity-level controls. In this publication, the discussion following the bullet points at the beginning of Chapter 2, to which the commenter referred, has been revised to state more clearly that the auditor can obtain such evidence if senior management performs many controls – including entity-level controls – that are important to effective internal control over financial reporting.

[22/] See COSO Small Companies Guidance, Volume II: Guidance, page 43.

Chapter 3 – Assessing the Risk of Management Override and Evaluating Mitigating Actions

Some commenters on Chapter 3 were concerned that the introductory statement to a list of mitigating controls in the section entitled Evaluating Mitigating Controls constituted a requirement for management to implement these controls. As stated in the introduction to this publication, the discussions and examples of controls in this publication do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting. Nevertheless, the introductory statement has been revised to remove reference to management's implementation of controls. Additionally, as suggested by some commenters, the fourth item in the list of mitigating controls has been renamed "controls over certain journal entries" to more clearly refer to the related discussion in the subsection entitled Evaluating Controls over Journal Entries later in the chapter.

As recommended by one of the commenters, a statement about the importance of the auditor's exercise of professional skepticism when considering the risk of management override has been added to the section entitled Assessing the Risk of Management Override. Because of the important role that the audit committee may play in mitigating the risk of management override, several commenters suggested providing more details in Example 3-1 about procedures performed by the audit committee. Accordingly, Example 3-1 has been expanded to provide more details on the types of procedures performed by the audit committee to address the risk of management override.

Some commenters suggested adding clarification regarding situations in which a company does not have an audit committee. A footnote reference to COSO Small Companies Guidance has been added to the section entitled Evaluating Audit Committee Oversight for clarification, as suggested.

Chapter 4 – Evaluating Segregation of Duties and Alternative Controls

Most comments on Chapter 4 related to perceived inconsistencies in Example 4-1, which illustrates some audit procedures for testing alternative controls over inventory. In response to these comments, the example has been revised to describe more clearly the access rights of both the company's employee who performs certain incompatible duties, and the manager who performs the alternative controls. The paragraph preceding the example has also been revised to clarify that entity-level controls should operate at a necessary level of precision to effectively address the risk of misstatement.

One commenter suggested using the term "compensating controls" instead of "alternative controls" to describe controls that address the same issues as segregation of duties. The term "compensating controls" is not used in this chapter because it is generally applied to situations in which control deficiencies have been identified and the

auditor is evaluating whether other controls might compensate for the deficiencies. Chapter 4 of this publication, as well as paragraph 42 of Auditing Standard No. 5, use the term "alternative controls" to apply to situations in which management has designed and implemented controls that achieve the same objectives as segregation of duties.

Chapter 5 – Auditing Information Technology Controls in a Less Complex IT Environment

Some commenters cautioned against underestimating risks that are associated with pre-packaged software. They indicated that readers might mistakenly perceive pre-packaged software to be risk-free. In response to these comments, a footnote has been added to the section entitled Characteristics of Less Complex IT Environments in Chapter 5 to indicate that significant user configuration of the pre-packaged software might create additional risks that require additional controls.

In response to other commenters' suggestions, the following sentence has been added to the discussion in the third bullet point in the section entitled Characteristics of Less Complex IT Environments. "Access to systems is typically managed by a limited number of personnel." In the fourth bullet point, the phrase "in many instances" has been inserted to acknowledge that a smaller, less complex company might perform more complex calculations using spreadsheets and other user-developed applications. In the same bullet point, the phrase "to accumulate, summarize, process, and report" has been replaced with "to initiate, authorize, record, process and report" to more accurately describe tasks included in the end-user computing.

Some commenters asked to clarify how the lack of controls over backups might impact the financial reporting process. In response, the second to last paragraph in the section entitled IT-Related Risks Affecting Financial Reporting of this publication has been reworded to refer, more specifically, to the controls that address the financial reporting risk, i.e., the risk of loss of data necessary to prepare the financial statements, and to acknowledge that there may be different controls to address the potential loss of data.

Several commenters suggested modifying Example 5-1 in order to better illustrate the points made in this chapter. In response, the description of controls and software in the Scenario section of Example 5-1 has been clarified, and controls over authorization have been added to the first sub-bullet in the Audit Approach section.

In general, several commenters were concerned about the potential for auditors to use the lists of controls and audit procedures from Chapter 5 as checklists. As previously mentioned, the discussions and examples of controls in this publication do not establish internal control requirements and are not intended as guidance to management regarding establishing or evaluating internal control over financial reporting. These examples of controls in Chapter 5 do not represent required controls for management.

One commenter suggested adding guidance relating to testing of controls over spreadsheets. The purpose of this chapter was to discuss general audit strategies that might be employed regarding the evaluation of IT controls in a less complex IT environment rather than to discuss testing of any particular control activities.

Chapter 6 – Considering Financial Reporting Competencies and Their Effects on Internal Control

Most of the comments on Chapter 6 related to controls over the work performed by outside professionals.

One commenter provided examples of the controls that a company might implement to test work performed by the outside professional. These examples have been added to the discussion of audit considerations in the section entitled Supplemented Competencies with Assistance from Outside Professionals. Additionally, as suggested by commenters, Example 6-1 has been modified to more clearly outline the responsibilities of management and the third-party service provider in a situation typical for a smaller, less complex company. The discussion in the example has also been expanded to provide further details of the procedures performed by the auditor.

Some commenters asked what controls the auditors should expect to see over the work of outside professionals in addition to those over the competence and the accuracy of the information. One commenter asked for specific examples of controls in the situations when the management uses outside professionals in the areas of stock compensation, derivatives and hedging activities, off-balance-sheet accounting, and financial statements preparation. Because of the variety of situations in which outside professionals could be used, including the ones mentioned by the commenters, and the diversity of potential controls that might be implemented by companies using outside professionals, the chapter focuses mainly on the control objectives that might be relevant to those situations rather than the individual controls. However, as noted in the preceding paragraph, some additional examples of controls have been included in this publication as suggested by commenters.

Chapter 7 – Obtaining Sufficient Competent Evidence When the Company Has Less Formal Documentation

Some commenters on this chapter asked the staff to clarify the differences between the terms "formal" and "less formal" documentation and the impact of the distinction on the audit. One commenter asked about the auditor's course of action if there is no documentary evidence at all.

"Formal" and "less formal" documentation are relative terms used in this publication to illustrate differences that might exist in the documentation practices of larger and smaller companies. For instance, the section entitled Documentation of Processes and Controls provides examples of more formal documentation and less

formal documentation of processes and controls. As stated in this chapter, when auditing a smaller, less complex company, it generally is helpful to obtain an understanding of the nature and availability of documentation as early in the audit process as practical, so that the auditor has sufficient time to explore alternatives if the company has less formal documentation. The section entitled Other Considerations discusses various types of documentation that auditors might consider using as audit evidence relating to internal control, including the documentation of company processes and procedures and other documentation that the company uses to run the business. The chapter also addresses situations in which only limited documentation exists.

Additionally, in response to one commenter's concern, Example 7-2 has been clarified to explain that the CFO's review represents one control – rather than the only control – that management relies on with respect to the period-end financial reporting process.

Chapter 8 – Auditing Smaller, Less Complex Companies with Pervasive Control Deficiencies

Several commenters asked for clarification regarding when limited testing of a control that is unlikely to be effective might be necessary. Chapter 8 now includes an example indicating that limited testing of a control might be necessary if walkthrough procedures have not been performed. In response to another commenter's suggestion, the discussion in the section entitled Considering the Effect of Pervasive Control Deficiencies on Other Controls has been expanded to clarify how certain deficient entity-level controls might impair the effectiveness of other controls over relevant assertions.

Other commenters suggested changing the discussion of management override of controls to state that a control that has been "inappropriately overridden" instead of "frequently overridden" is either less likely to operate effectively or ineffective. The wording from the preliminary guidance has been retained in this publication because it best describes the risk associated with management override. Although management override might be appropriate in certain circumstances (e.g., manual override of the old credit limits until the new limits are posted in the IT system), frequent management override of a control could impair the effectiveness of the overridden control.

Appendix A – The Integrated Audit Process

Some commenters expressed concern that auditors might view the audit approach outlined in Appendix A as the preferred approach because this publication would "formalize" it. Others expressed concern that the audit approach described in the appendix does not cover all of the auditing procedures that might need to be performed. As noted in the Introduction to this publication, the guidance is not a rule of the Board and does not establish new requirements. Rather, it discusses how the auditors of smaller, less complex companies may address some (but not all) of the challenges that

might arise in audits of those companies. Thus, this publication does not attempt to "formalize" or endorse any particular approach to the audit of internal control over financial reporting. Auditing Standard No. 5 provides direction on integrating the audit of internal control with the audit of financial statements. Appendix A to this publication has been developed to illustrate one approach for integrating the two audits, and it is not intended to present all of the procedures that are required for a particular audit. Auditors should plan and perform their integrated audits to achieve the objectives of the audits and to comply with standards of the PCAOB.

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