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REPORT ON THE INITIAL IMPLEMENTATION OF AUDITING STANDARD NO. 2, *AN AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING PERFORMED IN CONJUNCTION WITH AN AUDIT OF FINANCIAL STATEMENTS*

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Overview

This report discusses issues identified in the course of the Board's monitoring of the implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2" or "AS 2"). That standard implements Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act") by establishing a process for auditing a public company's internal control over financial reporting ("internal control") in conjunction with an audit of financial statements.

The Board's monitoring has focused on whether firms' audit methodologies, as well as firms' execution of those methodologies, have resulted in audits of internal control that are effective and efficient. The Board found that both firms and issuers faced enormous challenges in the first year of implementation, arising from the limited timeframe that issuers and auditors had to implement Section 404; a shortage of staff with prior training and experience in designing, evaluating, and testing controls; and related strains on available resources. These challenges were compounded in those companies that needed to make significant improvements in their internal control systems to make up for deferred maintenance of those systems.

The Board's monitoring revealed that audits performed under these difficult circumstances were often not as effective or efficient as Auditing Standard No. 2 intends (and as the Board expects they can be in the future, given the benefits of experience, adequate time and resources).[1/] Accordingly, the Board has identified, in its inspections

[1/] This report uses the term "effectiveness" to refer to the auditor achieving the objectives described in the Board's standards. An effective audit culminates in the

and other monitoring,[2] areas in which auditors should be able to make their audits more effective and efficient in the future, by obtaining sufficient evidence for an opinion in a manner that appropriately conserves time and other resources. These areas are summarized below and detailed in the body of the report along with further explanation about certain aspects of Auditing Standard No. 2. The Board understands that, based on first-year experiences and on previous Board guidance, firms are already modifying their audit methodologies and training materials in a number of these areas, to improve the effectiveness and efficiency of their internal control audits.

Summary of the Board's Observations

The inefficiencies observed by the Board varied in form and degree among firms and engagement teams. The most common reasons why audits were not as efficient as the Board expects them to be include the following –

- Some auditors did not integrate their audits of internal control with their audits of financial statements. Consequently, the amount of reliance placed on controls in establishing the nature, timing, and extent of financial statement audit work was limited. The Board expects that auditors will better integrate their audits in the future.

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auditor obtaining reasonable assurance that his or her opinion is correct. This report uses the term "efficiency" to refer to the auditor achieving the objectives described in the Board's standards with the least expenditure of effort and resources. For the reasons described in this report, the Board expects that auditors will increase both the effectiveness and efficiency of their audits in future years.

[2] The Board's observations in this report are based in significant part, but not exclusively, on information obtained by the Board in the Board's inspection process, which in the 2005 cycle included review of portions of a limited selection of audits of internal control. Information received or prepared by the Board in connection with any inspection of a registered public accounting firm is subject to certain confidentiality restrictions set out in Sections 104(g)(2) and 105(b)(5) of the Act. Under the Board's Rule 4010, however, the Board may publish summaries, compilations, or general reports concerning the results of its various inspections, provided that no such published report may identify the firm or firms to which any quality control criticisms in the report relate. The Board's reports under Rule 4010 also may include information that was not gathered during the inspection process.

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- Some auditors did not effectively apply a top-down approach. To varying degrees, auditors often approached the audit of internal control from the bottom up. Using a top-down approach, the auditor begins by evaluating company-level controls and significant accounts at the financial statement level and then works down to relevant individual controls at the process, transaction, or application levels. The results of the auditors' testing at each level help the auditor tailor the remainder of the work. The Board expects that auditors will use a top-down approach to a greater extent in the future, which will make audits both more effective and more efficient.

- Some auditors did not alter the nature, timing, and extent of their testing to reflect the level of risk. Auditors often appeared to take a uniform approach to their testing, inadequately considering the unique risk factors within each company. As a result, some auditors appeared to have expended more effort than was necessary in lower-risk areas. This approach also compromised audit effectiveness because, in some cases, a higher-risk area should have received more audit attention than it did. The Board expects that auditors will tailor their procedures to focus on the particular risks facing audit clients' systems of internal control as they gain more experience in auditing internal control.

- Some auditors performed inefficient, and sometimes ineffective, walkthroughs of major classes of transactions because they used different transactions to test each control separately rather than walking a single transaction through the entire process. In addition, some auditors did not ask sufficiently probing questions of the company's personnel to gain a complete understanding of the transaction process. Making such inquiries assists the auditor in identifying any points at which a necessary control is missing or inadequate. In the future, the Board expects auditors, in most cases, to simplify their walkthroughs by following a single transaction.

- Some auditors did not use the work of others to the extent permitted by Auditing Standard No. 2. Auditors who more effectively use the work of others as permitted by AS 2 will likely be able to make more efficient use of their own time in performing their audits of internal control. The Board expects auditors to use the work of others more consistently in the manner intended by the Board as they gain more experience in applying the standard.

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In addition, the Board identified areas in which, on the whole, auditors could have performed their work more effectively. While varying among firms and engagement teams, the most common reasons why audits were not as effective as the Board expects them to be include the following –

- In the face of identified control deficiencies, often discovered late in the audit process, some auditors failed to sufficiently evaluate the adequacy of compensating controls. For example, in some cases, auditors relied on management assertions about compensating controls without testing those controls in operation. The Board expects that, in future years, auditors and issuers alike will have more time to address identified control deficiencies and evaluate compensating controls.

- Some auditors did not perform sufficient testing of the controls over preparing financial statement disclosures. The controls in this area are among the most important in the financial reporting process because of the relatively high risk of material misstatement or omission due to fraud or error. Sufficient testing of controls in this area also can make the auditor's substantive testing of financial statement disclosures more efficient.

This report also explains certain aspects of Auditing Standard No. 2 and amplifies the guidance issued by the Board on May 16, 2005 on effective and efficient implementation of the standard, as follows –

- The term "more than remote," which appears in the standard's definitions of "significant deficiency" and "material weakness," means "at least reasonably possible." These definitions, based in part on longstanding accounting terms, are designed to lead to a determination as to whether there is a deficiency that would prevent a prudent official from concluding that he or she has reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles.

- Circumstances identified in Auditing Standard No. 2 as "strong indicators" of a material weakness are not automatically material weaknesses; rather, these circumstances require heightened auditor scrutiny to determine whether a material weakness, in fact, exists.

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- The objective of an audit of internal control is to identify whether any material weaknesses exist in the company's internal control over financial reporting. Therefore, an audit in accordance with AS 2 should not be designed to detect deficiencies that, individually or in the aggregate, are less severe than a material weakness.

- When the auditor identifies control deficiencies, Auditing Standard No. 2 requires the auditor to evaluate the existence and effectiveness of any compensating controls. Such an evaluation is important because compensating controls may mitigate the effects of deficiencies that would otherwise be considered significant deficiencies or material weaknesses.

- In performing an integrated audit of internal control and the financial statements, the auditor may perform tests of controls that simultaneously satisfy the objectives of both audits. Auditing Standard No. 2 does not require or suggest that the auditor perform separate tests of controls for the purposes of the audit of internal control and for the purposes of the audit of financial statements. To the contrary, AS 2 encourages such integration of testing.

Background

Section 404 of the Act aims to assure that the controls that underpin the accuracy and reliability of a company's published financial information are adequate. That section, along with the Securities and Exchange Commission's (the "Commission" or "SEC") implementing rules, requires a public company to annually report its assessment of the effectiveness of its internal control. The section also requires such a company to provide investors its auditor's attestation to, and report on, that assessment.

It would be difficult to overstate the efforts expended by both corporate managements and auditors to comply with Section 404's new requirements, especially given the short deadline for compliance that many of the largest companies confronted. Since 1977, the Foreign Corrupt Practices Act has required public companies to maintain internal controls. Nevertheless, in 2004, many companies had to undertake the daunting task of making significant improvements to their internal controls as part of their preparation for complying with Section 404. For many companies, this involved documenting controls for the first time and identifying and remediating control deficiencies (in some cases, numerous deficiencies) under severe time pressure. In

addition, managements had to simultaneously devise and execute procedures to assess the effectiveness of their controls. For most companies, this assessment was an entirely new process. As a result of the scope of this undertaking, many companies completed their management assessment processes later than anticipated. This, in turn, compressed the time for the audit even more, in many cases forcing auditors to plan their audits before companies had established a stable and complete set of controls.

Given the importance of Auditing Standard No. 2 and the challenges of a compressed timeframe for implementation, the Board made the monitoring of firms' implementation of the standard one of its top priorities. Based on early questions from auditors and their audit clients, on June 23, 2004, the Board's staff issued 26 questions and answers on how to interpret provisions of the standard related to, among other things, scope and extent of testing, using the work of others, and evaluating deficiencies. The Board's staff issued additional questions and answers on October 6, 2004; November 22, 2004; and January 21, 2005. In addition, on May 16, 2005, the Board issued a policy statement regarding the implementation of the standard, accompanied by additional staff questions and answers.[3/] Both May 16 documents addressed how auditors can make the internal control audit more effective and efficient, and provided guidance on integrating the audits, using a top-down approach, using the work of others, assessing risk, and other topics. At that time, the Board also indicated its intention to use its 2005 inspections to evaluate how efficiently and effectively firms conducted the first round of audits under the standard.[4/]

The Board's monitoring has taken two forms. First, to ensure that firms' internal policies and procedures related to AS 2 implement the standard effectively and efficiently, the Board's staff met with several large firms in June and July 2005. The purpose of these meetings was to evaluate portions of their audit methodologies, as

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[3/] See PCAOB Release No. 2005-009, Policy Statement Regarding Implementation of Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (May 16, 2005) (available at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2.aspx); Staff Questions and Answers, *Auditing Internal Control Over Financial Reporting.* Staff Questions and Answers are available at http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/index.aspx.

[4/] See PCAOB Release No. 2005-009.

well as their internal training materials, and to understand whether and, if so, how these firms intended to modify their methodologies and training in light of experience gained in the first year of implementation. Each of these firms represented that it had made changes to its policies, procedures, and training materials in various areas, including areas addressed in the Board's May 16 policy statement.

Second, the Board included in its 2005 annual inspections of firms whose audit clients were subject to Section 404 during the first year an evaluation of a limited selection of those firms' audits of internal control. One of the Board's objectives in conducting these inspections was to provide auditors with timely feedback on their first year's implementation of this significant standard. The inspection process has, therefore, involved ongoing discussions with engagement teams and firm leadership about the matters described in this report.

Each inspection began with a visit to the firm's headquarters, in order to probe and understand the firm's leadership's perspective on its first year of implementation. During this part of the inspection, inspectors also evaluated the firm's documented audit policies, tools, and training materials to gain an understanding of both the firm's method of communicating with its field auditors on individual engagements and its policies regarding consultations on internal control matters. Next, the Board's inspectors visited practice offices to evaluate the performance of individual audit engagements, focusing on specific areas deemed to be high-risk for most engagements, such as controls over revenue and the evaluation of deficiencies.

The audits selected for inspection were conducted – and most were completed – prior to the issuance of the Board's additional guidance on May 16, 2005. Many of the observations described in this report, therefore, relate to matters that were addressed in that guidance. Further, many auditors acknowledged before the start of these inspections that they had not implemented certain areas of Auditing Standard No. 2 as well as they could have and that they planned to make improvements in subsequent years. Areas that auditors recognized needed improvement included integrating the audits, taking a top-down approach, and using the work of others to a greater extent. The Board understands that many firms already have undertaken significant efforts to refine their methodologies, provide additional training to their personnel, and otherwise identify and implement improvements in the second-year audits of internal control.

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Board Observations Regarding the Performance of Audits of Internal Control

The Board's inspections and other monitoring revealed that, on the whole, there are opportunities for greater effectiveness and efficiency, as both issuers and auditors gain more experience evaluating and testing internal control. More time to meet regulatory deadlines and adequate resources in the future also should help issuers and auditors become more effective and efficient in their work. Specific performance issues observed by the Board's inspectors are described below.

The Integrated Audit

As described in the Board's May 16, 2005 guidance, Auditing Standard No. 2 encourages integration of the financial statement audit and the internal control audit. In an integrated audit of the financial statements and internal control, the auditor designs and simultaneously executes procedures that accomplish the objectives of both audits. These objectives are not identical, but are interrelated. By obtaining sufficient evidence to support a control risk assessment of low during the audit of internal control, the auditor may reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements. At the same time, integration of the two audits means that evidence gathered and tests conducted in the context of either audit contribute to the completion of both audits. For example, the knowledge of a company's controls and procedures derived from the audit of internal control may lead to improvements in the design of financial statement audit procedures.

Due largely to externally imposed timing constraints, most auditors were unable to integrate their first-year audits under Auditing Standard No. 2. The Board's inspectors observed that in most of the engagements selected for inspection, auditors performed two separate, parallel audit processes. This approach may have been used because, in many cases, auditors were concerned that they might not be able to complete the evaluation and testing of controls until late in the audit period and that unfavorable results of testing of controls would require last-minute increases in audit procedures related to the financial statement audit. In these cases, the result was a less efficient process than AS 2 intends.

In some cases, auditors' failure to integrate the two audits also reduced audit effectiveness. For example, in some of the engagements reviewed by inspection teams, auditors identified deficiencies in internal control as a result of discovering misstatements during the audit of the financial statements. In a significant number of

these cases, however, the auditors did not re-evaluate the original risk assessments used in planning the audit of internal control. In other cases, some auditors identified a control deficiency during the audit of internal control but did not determine the effect of the deficiency on the nature, timing, and extent of substantive procedures to be performed as part of the financial statement audit.

Top-down Approach

Auditing Standard No. 2 was designed to encourage the auditor to take a top-down approach to the audit. As described in the Board's May 16, 2005 guidance, in a top-down approach, the auditor performs procedures to obtain the necessary understanding of internal control and to identify the controls to test in a sequential manner, starting with company-level controls and significant accounts at the financial statement level and then working down to relevant individual controls at the process, transaction, or application levels. Successful implementation of a top-down approach requires the auditor to evaluate company-level controls (such as the control environment, the period-end financial reporting process, controls to monitor other controls, and management's risk assessment process) early in the audit.[5/] By doing this, the auditor is able to tailor the remainder of his or her testing of controls over significant accounts to reflect the conclusions reached while evaluating company-level controls. In this way, when companies have well-designed controls at the higher levels that operate effectively, auditors may be able to reduce tests of internal control over individual processes, transactions and applications. (Of course conversely, if companies have poorly designed controls or controls that do not operate effectively at the company level, auditors will need to focus more closely on lower-level controls.)

Most of the audit engagements reviewed by the Board's inspectors did not use a top-down approach. Rather, to varying degrees, auditors approached the audit of internal control from the bottom up, focusing first on performing detailed tests of controls at the process, transaction, and application levels, much as many of their audit clients had approached their assessments. Auditors who used a bottom-up approach often spent more time and effort than was necessary to complete the audit.

Moreover, even in those cases in which auditors spent a significant amount of time testing and evaluating company-level controls, inspectors observed that most auditors did not alter their testing of controls at the process, transaction, or application

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[5/] See Auditing Standard No. 2, paragraphs 52-59.

levels in response to the results of that testing. Other audit engagement teams appeared to have spent relatively little time testing and evaluating company-level controls and instead relied almost exclusively on detailed tests of controls over individual processes, transactions and applications.

Risk-Based Approach

An auditor's assessment of the risk that the financial statements could be materially misstated has a pervasive effect on the amount of work that the auditor performs. Thus, as explained in the Board's May 16, 2005 guidance, risk assessment allows the auditor to focus on higher-risk areas while expending less effort in areas of lower risk.

In most of the engagements reviewed, the nature, timing, and extent of the auditor's testing were not altered to reflect the level of risk assessed within a given area. Instead, auditors on the whole appeared to take a uniform approach to their testing. As a result, some auditors appeared to have expended more effort than was necessary in lower-risk areas. Inspectors noted that this approach also compromised audit effectiveness because, in some cases, a higher-risk area should have received more audit attention than it did.[6/]

Ineffective use of standardized firm tools may have contributed to audit engagement teams' failure to vary the scope and extent of testing in response to the assessed risks. Inspectors observed, in some cases, that key decision points, such as the identification of significant accounts and controls to test, might have benefited from more judgment and input from senior members of the audit engagement team in addition to the assistance provided by the firm tools.

Standardized tools play an important and necessary role in encouraging consistency in the performance of quality audits. Auditors must recognize, however, that these tools cannot replace sound auditor judgment applied to the facts and circumstances of each audit. Without this judgment, the use of these tools can turn the audit into an exercise in rules-based compliance. In this regard, the Board's inspectors

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[6/] Indeed, some high-risk areas, especially areas such as the formulation of accounting estimates that are easily manipulated notwithstanding controls, can justify additional effort in the audit of internal control, as well as additional substantive work in the financial statement audit, irrespective of the reliability of controls.

will continue to focus on whether auditors have applied the provisions of Auditing Standard No. 2 in a risk-focused manner, rather than on the basis of compliance with forms and checklists.

Using the Work of Others

As explained in the Board's May 16, 2005 guidance, Auditing Standard No. 2 permits auditors to use the work of others in a way that corresponds directly with the auditor's assessment of the risk associated with particular controls. An auditor who appropriately uses the work of others enhances the overall efficiency of the audit by avoiding duplication of effort in lower-risk areas, as well as facilitating the auditor's focus on higher-risk controls. In some cases, however, auditors did not use the work of others to the extent permitted by the standard.

Auditors' reluctance to use the work of others to the extent that AS 2 allows may have been due to one or more factors, including –

- Some auditors' decisions to perform all the work in the first year themselves based on the theory that, irrespective of the standard's provisions on using the work of others, this approach was the best way for the engagement team to conduct a high-quality audit in the first year and to increase efficiency in future years.

- The timing of management's assessment, which, in many cases, was not completed until near year-end or concurrently with auditors' testing. Specifically, some auditors were concerned that planned reliance on others' work, when that work was not yet completed or available for evaluation, could cause the auditor to miss required deadlines.

- Auditors' uncertainty about whether the principal evidence requirement[7/] involves primarily a quantitative or qualitative assessment. This confusion led some auditors to take a highly quantitative approach. The PCAOB

[7/] When using the work of others, AS 2 requires the auditor to obtain the principal evidence supporting his or her opinion as to whether internal control is effective overall. See Auditing Standard No. 2, paragraph 108.

staff guidance issued on May 16, 2005 clarifies that the principal evidence requirement is primarily qualitative.[8/]

Inspectors also noted that most of the firms' methodologies used in 2004 described three general categories for using the work of others—much like the three categories described in the Board's initially proposed standard on auditing internal control over financial reporting.[9/] When the Board adopted Auditing Standard No. 2 in its final form, however, it did not include these three categories. Instead, the final standard describes a more flexible framework for using the work of others. The fact that this aspect of the final standard was not consistently incorporated into the firms' methodologies probably influenced auditors' decisions not to use the work of others to the extent permitted by Auditing Standard No. 2.

[8/] See Staff Questions and Answers, *Auditing Internal Control Over Financial Reporting* (Q&A No. 54) (May 16, 2005).

[9/] The proposed standard defined three categories of controls and the extent to which the auditor could use the work of others in each of those categories:

- Controls for which the auditor should not rely on the work of others, such as controls in the control environment and controls specifically intended to prevent or detect fraud that is reasonably likely to have a material effect on the company's financial statements;

- Controls for which the auditor may rely on the work of others, but his or her reliance on the work of others should be limited, such as controls over nonroutine transactions that are considered high risk because they involve judgments and estimates; and

- Controls for which the auditor's reliance on the work of others is not specifically limited, such as controls over routine processing of significant accounts.

See PCAOB Release No. 2003-017, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (Oct. 7, 2003). These categories were not included in Auditing Standard No. 2.

Walkthroughs

Auditing Standard No. 2 requires the auditor to perform a walkthrough of each major class of transactions. In a walkthrough, the auditor follows a transaction from its origination through the company's information systems until it is reflected in the company's financial reports. The objectives of a walkthrough are to obtain a complete understanding of the process flow of transactions and to determine the points in the process at which misstatements could occur; confirm the auditor's understanding of the design of controls in that process; evaluate the effectiveness of the design of controls; and ascertain whether controls have been placed in operation.[10/] Focusing on a single transaction, from start to finish, is generally the most effective and efficient way to accomplish these objectives.

Inspectors found, however, that a significant number of engagement teams chose not to use a single transaction for their walkthroughs. In some of these cases, the auditor appeared to have obtained a complete understanding of the process by undertaking additional, less efficient procedures. Other auditors failed to perform the procedures necessary to achieve the objectives of the walkthrough. For example, many auditors who chose not to use a single transaction for a walkthrough switched their focus to a new transaction at points in the transaction process that involved a higher risk of material misstatement. As a result, these auditors needed to take special care to determine that their understanding of the entire process was complete, especially at those riskier transition points. The inspectors noted a number of engagement teams that failed to focus the necessary attention on these transition points.[11/]

[10/] See Auditing Standard No. 2, paragraph 79.

[11/] Inspectors also noted that many walkthroughs were ineffective because the auditor did not ask sufficiently probing questions of the company's personnel to gain a complete understanding of the transaction process and to be able to identify any points at which a necessary control was missing or inadequate. Under Auditing Standard No. 2, the auditor should question the company's personnel about their understanding of the company's procedures and controls. See Auditing Standard No. 2, paragraphs 80 and 81. These questions should go beyond a narrow focus on the single transaction used as the basis for the walkthrough so as to understand all the types of significant transactions handled by the process. For example, the auditor should evaluate whether matters that come to his or her attention during the processing of an

Testing and Evaluating Compensating Controls

When the auditor identifies control deficiencies, Auditing Standard No. 2 requires the auditor to evaluate the existence and effectiveness of any compensating controls.[12/] This evaluation is important because compensating controls may mitigate the effects of deficiencies that would otherwise be more significant.[13/] Inspectors noted, however, that some auditors failed to sufficiently evaluate the adequacy of compensating controls.

Inspectors observed that, in several cases, auditors identified control deficiencies early in the process but did not evaluate their severity until after year-end. When these deficiencies were evaluated, management and the auditor often tried to identify compensating controls that mitigated the control deficiency. If a compensating control had not been identified previously in management's assessment, management and the auditor then would need to test it to determine that it was designed to operate at the level of precision necessary to compensate adequately for the deficiency and that it indeed operated effectively.

In some cases, auditors did not adequately test late-identified compensating controls to form a conclusion about their operating effectiveness. In other cases, auditors agreed that certain controls – such as senior management's oversight of financial reporting generally – mitigated deficiencies even though they did not appear to operate in a manner that compensated for deficiencies at the process, transaction, or application levels. The Board expects that, in the future, auditors and issuers alike will have more time to consider and evaluate appropriate compensating controls.

Testing Controls Over Financial Statement Presentation and Disclosure

Auditing Standard No. 2 provides that the period-end financial reporting process is always a significant process because of its importance to the company's financial

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individual transaction merit broader follow-up discussion with company personnel as part of confirming that the auditor's understanding of the process is complete.

[12/] See Auditing Standard No. 2, note to paragraph 10.

[13/] This is because, "[i]f a deficiency is effectively mitigated by compensating controls, then the likelihood of a misstatement occurring and not being prevented or detected may very well be remote." Auditing Standard No. 2, paragraph E86.

reporting.[14/] The period-end financial reporting process ordinarily consists of a combination of manual and automated functions, requires considerable judgment to evaluate, and presents numerous opportunities for misstatements to occur. Given the high degree of risk that misstatements could occur during the period-end financial reporting process, significant attention to this process is necessary in virtually all audits.

In auditing the period-end reporting process, auditors should assess the risk that the company's financial statement disclosures include material misstatements or omit material information. That assessment allows the auditor to determine an appropriate audit response.

Inspectors observed several instances in which auditors had not focused adequately on the period-end financial reporting process and had not identified and tested sufficient controls over financial statement presentation and disclosure. Although auditors usually identified and tested some controls over financial statement presentation and disclosure, this testing, in some cases, was insufficient because it did not include consideration of the company's underlying process for generating the financial statement disclosure information. As a result, these auditors could not demonstrate that they sufficiently understood the company's process for assembling financial statement disclosure information and ensuring that no material omissions occurred, that they had adequately assessed the risks associated with that process, or that they had evaluated whether the information underlying the company's financial statement disclosures was complete and accurate.

Evaluating Control Deficiencies and Implementing the Definition of Material Weakness

The objective of an audit of internal control is to obtain reasonable assurance as to whether any material weaknesses exist.[15/] An important corollary to this fundamental principle is that the standard does not require auditors to search for deficiencies other

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[14/] See Auditing Standard No. 2, paragraph 78.

[15/] See Auditing Standard No. 2, paragraph 4. Auditing Standard No. 2 does not require the auditor to plan the audit to detect significant deficiencies. Paragraph 27 of Auditing Standard No. 2 states, in part, "Thus, the audit is not designed to detect deficiencies in internal control over financial reporting that, individually or in the aggregate, are less severe than a material weakness."

than material weaknesses. Further, the standard does not re-define materiality for the purposes of auditing internal control. Rather, the standard provides that the same conceptual definition of materiality that applies under the federal securities laws to financial reporting applies to information on internal control.[16/] This means that the auditor should plan and perform the audit of internal control using the same materiality measures as the auditor uses to plan and perform the annual audit of the financial statements.

When auditors do identify control deficiencies in the course of the audit, however, the standard requires them to evaluate whether those deficiencies are significant deficiencies or material weaknesses.[17/] The definitions of deficiency, significant deficiency, and material weakness in Auditing Standard No. 2[18/] focus on the likelihood and magnitude of potential misstatements in the financial statements to classify deficiencies in order of increasing severity. Anecdotal claims have suggested that some auditors applied a more stringent threshold to the evaluation of control deficiencies than the definitions in Auditing Standard No. 2 require. In addition, mechanical reliance on standardized tools appears to have contributed to unnecessary work in this area.

More Than Remote Likelihood

In defining the terms "significant deficiency" and "material weakness" in Auditing Standard No. 2, the Board used terms defined in Financial Accounting Standards Board's Statement No. 5, *Accounting for Contingencies* ("FAS No. 5"). The Board chose to use terms with which auditors were already familiar in order to promote consistency in the evaluation of deficiencies.[19/] FAS No. 5 describes the likelihood of a future event occurring as "probable," "reasonably possible," or "remote." The definitions in Auditing Standard No. 2 refer to a "more than remote" likelihood of a misstatement occurring. In accordance with FAS No. 5, the likelihood of an event is "more than

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[16/] See Auditing Standard No. 2, paragraphs 22 and 23. The federal courts and the SEC have defined materiality for purposes of the federal securities laws. See, e.g., Staff Accounting Bulletin No. 99, *Materiality* (Aug. 12, 1999).

[17/] See Auditing Standard No. 2, paragraph 130.

[18/] See Auditing Standard No. 2, paragraphs 8 through 10.

[19/] See Auditing Standard No. 2, paragraph E73.

remote" when it is either "reasonably possible" or "probable." Therefore, the words "more than a remote likelihood" in the definitions of significant deficiency and material weakness mean "at least a reasonably possible likelihood."[20] The definitions in the standard, based in part on these longstanding accounting terms, are designed to lead to a determination as to whether the deficiency would prevent a prudent official from concluding that he or she has reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles.[21]

Further, the terms "probable," "reasonably possible," and "remote," should not be understood to provide for specific quantitative thresholds. Proper application of these terms involves a qualitative assessment of probability. Therefore, the evaluation of whether a control deficiency presents a "more than remote" likelihood of misstatement can be made without quantifying the probability of occurrence as a specific percentage.

Use of Judgment

This evaluation requires an exercise of judgment, based on an assessment of what constitutes reasonable assurance under the circumstances, not on the mechanical application of a predetermined probability formula. Inspectors observed, however, that the quest for quantitative rules of thumb in the application of the definitions described above may have resulted in some auditors exercising less judgment than the standard requires in this area. Many engagement teams used a framework developed through the collective effort of nine firms for evaluating deficiencies. That framework uses terms such as "gross exposure," "adjusted exposure," and "upper limit deviation rate." The statistical precision suggested by these terms may have driven auditors' decision-making process unduly toward simplistic quantitative thresholds and away from the qualitative evaluation that may have been necessary in the circumstances.

This evaluation framework can result in decisions that are consistent with the provisions of Auditing Standard No. 2. Further, the use of the framework promoted

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[20] See Auditing Standard No. 2, note to paragraph 9.

[21] See Auditing Standard No. 2, paragraph 137. If the auditor determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance, then the auditor should deem the deficiency to be at least a significant deficiency.

consistency among different audit teams within and across firms. Nevertheless, the framework is not a substitute for the professional judgment that Auditing Standard No. 2 requires. Moreover, using this framework could, in some cases, lead auditors to spend more time evaluating the severity of a deficiency than otherwise would be necessary.

Strong Indicators of a Material Weakness

Auditing Standard No. 2 describes certain circumstances that should be regarded as at least significant deficiencies and as strong indicators of a material weakness in internal control.[22/] The identification of one of these strong indicators is the beginning of the auditor's evaluation process of whether a material weakness, in fact, exists. Such indicators require heightened scrutiny, but they are not automatically material weaknesses. The Board's inspectors found that, in general, with respect to evaluating strong indicators – such as restatements of previously issued financial statements – auditors understood that the indicator required heightened scrutiny but was not irrefutable evidence of a material weakness.[23/]

Conclusion

While this report describes several opportunities for auditors to improve audit quality and efficiency, the Board remains confident that auditors will be able to perform more effective and efficient audits in future years, particularly as auditors gain

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[22/] See Auditing Standard No. 2, paragraph 140.

[23/] That is, in the case of a restatement to correct an error, the restatement itself is not a control deficiency; rather, the restatement is an indicator of a control deficiency. When there has been a restatement, the auditor must evaluate the underlying facts and circumstances using professional judgment to identify the cause of the misstatement and to determine whether a material weakness exists.

It should be noted that, even if management and the auditor determine that a material weakness does not exist notwithstanding a restatement, under Auditing Standard No. 2 a significant deficiency does exist and must be reported to the audit committee. Significant deficiencies identified due to restatements of prior period financial statements may nevertheless be remediated relatively easily, if management and the audit committee determine that only minor changes are necessary to strengthen internal control.

experience and as challenges unique to the first year's implementation abate. A number of the matters discussed in this report have been the subject of an ongoing dialogue with the larger firms and have been communicated in public forums. Thus, while many of the inspectors' observations were expected, the inspections further focused the dialogue on steps that auditors can take to perform quality audits as efficiently as possible.

The Board intends to continue to monitor closely the implementation of the standard and, as always, will use its inspection authority to focus the firms on those aspects of their practice that impede them from performing audits as effectively and efficiently as possible. The Board also intends to continue, as needed, to issue interpretive guidance (either by the Board or through staff) concerning the application of Auditing Standard No. 2. The Board believes that the supplemental guidance provided in this report, in conjunction with the guidance issued on May 16, 2005, should result in significant improvement in the effectiveness and efficiency of audits of internal control going forward. Finally, the Board intends to continue to gather feedback – from investors, issuers, auditors, and others – on audits under Section 404.