

# Internal Control and IT Control Issues in Public Companies

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## Disclaimer

- ❑ The views I express this morning are mine and do not necessarily reflect the views of the Board, individual Board members, or other members of the PCAOB staff.



## Discussion Topics



- ❑ Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”
- ❑ Auditors’ Responsibility related to Internal Controls
- ❑ What AS No. 5 Says
- ❑ Smaller Public Company Considerations
- ❑ Internal Control and IT Control Issues – Experiences to Date
- ❑ Smaller Public Companies – Experiences to Date
- ❑ Summary and Conclusion



3



## Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey”



- ❑ Calendar year 2004 was first year reporting on ICFR under Auditing Standard No. 2 (AS No. 2) for SEC Accelerated Filers
- ❑ May 2005, PCAOB announces intent to revise AS No. 2
- ❑ June 12, 2007, AS No. 5 issued to supersede AS No. 2
- ❑ Years ended after December 15, 2007, Non-accelerated filers began reporting under 404(a)



4



## Audits of Internal Control Over Financial Reporting (ICFR) – “The Journey” (cont’d)



- Board’s primary objectives in AS No. 5
  - Focus the audit of internal control on the most important matters
  - Eliminate procedures that are unnecessary to achieve the intended benefits
  - Make the audit clearly scalable to fit any company’s size and complexity
  - Simplify the text of the standard



5



## Auditors’ Responsibility Related to Internal Control



- Second Standard of Field Work (AU 150)
  - “A sufficient understanding of internal control is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed.” (AU 150.02)
- AU 319 *“Consideration of Internal Control in a Financial Statement Audit”*
  - Provides guidance about the auditor’s consideration of internal control in an audit of financial statements in accordance with the standards of the PCAOB.



6



## Auditors' Responsibility Related to Internal Control (cont'd)



### □ AS No. 5

- "...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." (Para 3, AS No. 5)



7



## Auditing Internal Controls and IT Control Issues - What AS No. 5 Says



### Planning the Audit

- Risk assessment underlies entire ICFR audit process
- Scaling the audit
- Assessing the risk of fraud
- Using the work of others



8



## Auditing Internal Controls and IT Control Issues - What AS No.5 Says (cont'd)



### □ Top-Down Approach

- Identify entity-level controls (ELCs)
- Assess the extent of IT involvement
- Understand likely sources of misstatement
  - Flow of transactions
  - Points of potential material misstatement
  - Identify controls implemented by management



9



## Auditing Internal Controls and IT Control Issues - What AS No.5 Says (cont'd)



### □ Testing Controls

- Test controls important to the auditor's conclusion
- Test design effectiveness
- Test operating effectiveness
- Evidence about the design and operating effectiveness of controls
- Nature, timing and extent of tests of controls
- Special considerations in subsequent years



10



## Auditing Internal Controls and IT Control Issues - What AS No.5 Says (cont'd)



- Evaluating Identified Control Deficiencies
  - Evaluate, whether individually or in combination deficiencies are material weaknesses
  - Auditor not required to search for deficiencies less severe than material weaknesses
  - **Severity does not depend on whether a misstatement has occurred**
  - BUT, on reasonable possibility that controls will fail to prevent or detect a misstatement
    - Practical implication: Evaluate IT control deficiencies based on their impact on application processes they support



11



## Smaller Public Company Considerations



- Guidance for Auditors of Smaller Public Companies
  - 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*
  - Published on January 23, 2009
  - The guidance explains how auditors can apply the principles in AS No. 5 to audits of smaller, less complex public companies



12





## Smaller Public Company Considerations (cont'd)



### □ Evaluating Entity-Level Controls

- Auditor must test those entity-level controls that are important to the auditor's conclusion about whether the company has effective ICFR
- 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



13



## Smaller Public Company Considerations (cont'd)



### □ Assessing Risk of Management Override

- Additional opportunities of override exist because
  - Senior management is extensively involved in operations
  - There are fewer levels of management
- Controls that might address risk of management override
  - Maintaining integrity and ethical values
  - Controls over journal entries
  - Active oversight by audit committee
  - Whistleblower program



14



## Smaller Public Company Considerations (cont'd)



### □ Segregation of Duties

- Fewer employees – therefore limited opportunities to segregate duties
- Auditor's approach to evaluating alternative controls may include evaluating --
  - Involvement of external parties
  - Management review
  - Management oversight



15



## Smaller Public Company Considerations (cont'd)



### □ Auditing Information Technology

- Off-the-shelf software commonly used
- Few users and few dedicated IT personnel
- DOD issues with Security Administration
- End-user computing prevalent
- IT-generated reports used in manual controls
- Reliance on Service Organizations



16





## Smaller Public Company Considerations (cont'd)



- Obtaining Sufficient Competent Evidence When Company has Less Formal Documentation
  - Consider using “walkthroughs” to understand the flow of transactions if management documentation is limited
  - Consider other documentation of processes and controls e.g., what company uses to run its business
  - Depending on risk, inquiry combined with other procedures might provide sufficient evidence of control effectiveness



17



## Auditing Internal Controls and IT Control Issues – Experiences to Date



- Risk Assessment
  - Risk at the account level
    - Assessing inherent and control risk
    - Addressing multiple components of an account
  - Using the work of others
    - Competence of organization vs. individuals
    - Objectivity of management control groups
    - How much work to use based on risk
    - Reperformance vs. reviewing



18



## Auditing Internal Controls and IT Control Issues – Experiences to Date (cont'd)



### □ Risk Assessment (cont'd)

- Assessing the risk of fraud
  - Timing of fraud planning meeting - “brainstorming”
  - Procedures resulting from brainstorming
- Smaller public companies
  - Risk of management override
  - Division of duties



19



## Auditing Internal Controls and IT Control Issues – Experiences to Date (cont'd)



### □ Top-Down Approach

- Entity-level controls (ELCs)
  - “All pro safety” control
  - Testing of ELCs
  - Linking results of ELC tests to nature, timing and extent of testing at the process level



20



## Auditing Internal Controls and IT Control Issues – Experiences to Date (cont'd)



- Testing Controls
  - Test controls important to the auditor's conclusion
    - Identifying which controls to test
  - Test design effectiveness
    - “Walkthrough”
    - Inquiry of management
    - Think control “definition”



21



## Auditing Internal Controls and IT Control Issues – Experiences to Date (cont'd)



- Testing Controls (cont'd)
  - Evidence to support design and operating effective
    - The higher the risk the greater the evidence the auditor should obtain
    - Risk generally determines the nature, timing and extent of testing of controls (including interim testing and roll-forward procedures)



22



## Auditing Internal Controls and IT Control Issues – Experiences to Date (cont'd)



### □ Testing Controls (cont'd)

- Testing strategies
  - Sample size and populations
  - Roll-forward procedures
  - Testing considerations in subsequent years
  - “Tests of one”
  - Benchmarking automated application controls
  - Benchmarking “reports”
  - Reliance on SAS 70 Reports



23



## Auditing Internal Controls and IT Control Issues – Experiences to Date (cont'd)



### □ IT General Controls

- Access Controls
  - Unauthorized access to “super user IDs” not consistently recognized by auditors
  - Provisioning processes (the control) receives limited audit focus vs. point-in-time status of access (a substantive test)
  - For ITGC deficiencies, mitigating controls or audit procedures not always considered
  - Access to databases or operating systems not included in audit testing in many cases



24



## Auditing Internal Controls and IT Control Issues – Experiences to Date (cont'd)



### □ IT General Controls (cont'd)

- General observations
  - Controls around critical end user computing capabilities
  - Using reports produced by computer systems without appropriate testing
  - Systems conversions
  - Systems interfaces
  - Reconciliations from same source



25



## Smaller Public Companies - Experiences To Date



### □ Inspections of Triennially Inspected Firms with Accelerated Filers During Pilot Program in Prior Year and Current Year Inspections

- Strengths
  - Top-down risk based approach
  - Risk assessment to identify important controls to test
  - Use of work of others including evaluation of competency and objectivity



26



## Smaller Public Companies - Experiences To Date (cont'd)



- ❑ Inspections of Triennially Inspected Firms with Accelerated Filers During Pilot Program in Prior Year and Current Year Inspections
  - Areas for continued focus
    - Various issues related to use of SAS 70 reports
    - Focus on IT general controls
    - Documentation of tests of controls
    - Scoping issues related to systems, applications, reports, spreadsheets



27



## Summary and Conclusion



- Auditors have always had responsibility related to internal controls; AS No. 5 builds on that.
- ICFR has “stabilized” with the issuance of AS No. 5; efficiency of ICFR work has “improved”.
- AS No. 5 is a top-down risk-based approach that is scalable to smaller public companies.
- PCAOB publication provides guidance on scaling AS No. 5 to small public companies.



28





## Summary and Conclusion

(cont'd)



- IT general controls are a “pervasive” part of internal control and have a relationship to ICFR audits and financial statement audits.
- Auditors should consider IT risks present in less complex IT environments.
- Results from prior year pilot program indicate that small firms have successfully transitioned to AS No. 5 --- with some areas to continue to focus on.



29

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## Questions?



30

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