Audits of Internal Control Over Financial Reporting (ICFR)

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Overview

- Integrating the Audits
- Planning the Audit
- Using a Top-Down Approach
- Testing Controls
- Evaluating Identified Deficiencies

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Integrating the Audits

- **Auditor should design testing of controls to accomplish the objectives of both audits simultaneously:**
  - To obtain sufficient evidence to support the auditor's opinion on ICFR as of year-end, and
  - To obtain sufficient evidence to support the auditor's control risk assessments for purposes of the audit of financial statements.

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Planning the Audit

- **Paragraph 9 provides a list of items the auditor should evaluate to determine how they will affect the auditor’s procedures:**
  - Knowledge of the company's ICFR obtained during other engagements performed by the auditor
  - Matters affecting the industry in which the company operates
  - The auditor's preliminary judgments about materiality, risk, and other factors
  - Control deficiencies previously communicated to the audit committee or management
  - Legal or regulatory matters of which the company is aware

Planning the Audit (cont.)

- **Factors that might indicate less complex operations include:**
  - 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; and
  - Fewer levels of management, each with a wide span of control.

Role of Risk Assessment

- **Risk assessment underlies the entire audit process described by AS No. 5, including:**
  – The determination of significant accounts and disclosures and relevant assertions,
  – The selection of controls to test, and
  – The determination of the evidence necessary for a given control.

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Scaling the Audit

- The size and complexity of the company, its business processes, and business units, may affect the way in which the company achieves many of its control objectives.
- The size and complexity of the company also might affect the risks of misstatement and the controls necessary to address those risks.

Examples of Smaller Public Company Issues

- **Six example areas where tailoring may be necessary:**
  - Obtaining sufficient evidence with limited company documentation
  - Assessing entity-level controls
  - Evaluating risk of management override and mitigating actions
  - Evaluating controls implemented in lieu of segregation of duties
  - Evaluating financial reporting competencies
  - Evaluating information technology ("IT") controls

Addressing the Risk of Fraud

- **Auditor should take into account the results of their fraud risk assessment.**
- **Auditor should evaluate whether the company's controls:**
  - Sufficiently address identified risks of material misstatement due to fraud, and
  - Intended to address the risk of management override of other controls.

Using the Work of Others

- Auditor should evaluate the extent to which they will use the work of others.
- AU sec. 322 applies in an integrated audit of the financial statements and ICFR.
- The auditor should assess the competence and objectivity of the persons whose work the auditor plans to use.

Using the Work of Others (cont.)

- **For the audit of internal control, the auditor may use the work performed by, or receive direct assistance from:**
  - Internal auditors,
  - Company personnel (in addition to internal auditors), and
  - Third parties.
- **Extent to which the auditor may use the work of others depends on the risk associated with the control.**

Using a Top-Down Approach

- **Auditor should use a top-down approach to the audit of ICFR to select the controls to test.**
- **Top-down approach begins at the financial statement level and with the auditor's understanding of the overall risks to ICFR.**
- **Auditor then focuses on entity-level controls and works down to significant accounts and disclosures and their relevant assertions.**

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Identifying 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 would have performed on other controls.**

Identifying Significant Accounts and Their Relevant Assertions

- **Auditor should identify significant accounts and disclosures and their relevant assertions.**
- **Auditor should evaluate the qualitative and quantitative risk factors related to the financial statement line items and disclosures.**
- **Auditor also should determine the likely sources of potential misstatements that would cause the financial statements to be materially misstated.**

Selecting Controls to Test

- **Auditor should test controls that are important to the conclusion about whether the controls sufficiently address the risk of misstatement.**
  - Might be more than one control that addresses the risk of misstatement to a particular relevant assertion.
  - One control might address the assessed risk of misstatement to more than one relevant assertion.

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Testing Design Effectiveness

- **Auditor should test the design effectiveness of controls by determining whether the controls satisfy the control objectives and can effectively prevent or detect errors or fraud.**
- **Procedures the auditor performs to test design effectiveness include:**
  - Inquiry of appropriate personnel,
  - Observation of the company's operations, and
  - Inspection of relevant documentation.

Testing Operating Effectiveness

- **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 possesses the necessary authority and competence to perform the control effectively.**
- **Procedures the auditor performs to test operating effectiveness include:**
  - Inquiry of appropriate personnel,
  - Observation of the company's operations,
  - Inspection of relevant documentation, and
  - Re-performance of the control.

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Special Considerations for Subsequent Years' Audits

- **Auditor should incorporate knowledge obtained during past audits of ICFR.**
- **Auditor should vary the testing of controls from year to year to introduce unpredictability and respond to changes.**

Evaluating Identified Deficiencies

- **Auditor must evaluate the severity of each control deficiency that comes to their attention**
  - To determine whether the deficiencies, individually or in combination, are material weaknesses
- **Auditor is not required to search for deficiencies that, individually or in combination, are less severe than a material weakness.**

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Definitions

- **Alignment of terms between the standard and SEC's management guidance**
- **Material weakness – *reasonable possibility* that a material misstatement will not be prevented or detected on a timely basis**
- **Significant deficiency – less severe than a material weakness, yet important enough to merit attention**

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Indicators of Material Weaknesses

- **Indicators of material weaknesses in internal control over financial reporting include:**
  - Identification of fraud on the part of senior management
  - Restatement of previously issued financial statements
  - Identification by the auditor of a material misstatement in financial statements in the current period
  - Ineffective oversight by the company's audit committee

Questions?

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