

CAQ Alert #2007-6 – February 28, 2007

DEAR CENTER MEMBERS

Highlights of the PCAOB's February 2007 Standing Advisory Group Meeting

The PCAOB held its Standing Advisory Group (SAG) meeting on February 22, 2007 in Washington, DC. The [SAG](#) is composed of 31 people representing the auditing profession, public companies, investors, and others and was convened by the Board to advise them on the establishment of auditing and related professional practice standards. The SAG meeting, which has been archived, is available by clicking on the following [link](#).

During this meeting, the SAG held discussions on the [following topics](#), for which the Center for Audit Quality (CAQ or the Center) has summarized below:

- Proposed Changes to Auditing Standard No.2;
- Panel Discussion on Forensic Audit Procedures; and
- Emerging Issues

Proposed Changes to Auditing Standard No. 2

The SAG meeting commenced with discussions of the recently proposed auditing standard – [An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals](#) (ICFR Proposal) which would replace the current PCAOB Auditing Standard No. 2, [An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements](#) (AS 2). The public transcript of this part of the meeting will be included within the rulemaking docket for the ICFR Proposal.

View the [briefing paper](#) that discusses whether the ICFR Proposal allows for the appropriate use of auditor judgment while sufficiently safeguarding the quality of the audit; adequately emphasizes the importance of company-level controls and the effect they may have on the auditor's testing; whether the direction on scaling the audit sufficiently addresses differences in company size and complexity; whether the differences between management's process for evaluating its internal control under the SEC's proposed guidance and the process the auditor would follow under the Board's proposed standard raise implementation difficulties for auditors or management and how these difficulties can be addressed or managed; whether the proposed standard on using the work of others meets the objective of removing unnecessary barriers; and finally whether the ICFR Proposal promotes better

integration of audits.

SAG Members discussed the specific topics below which the Center also addressed in our [comment letter](#) on the ICFR Proposal (Refer to [CAQ Alert 2007-5](#) for a summary of our comment letter):

Auditor Judgment

Below are highlights of some commentary from the SAG meeting on the topic of auditor judgment whereby members discussed whether the ICFR Proposal provides for the appropriate level of auditor judgment and whether the general principles in the proposal would sufficiently safeguard the quality of the audit. Common themes that encompassed the discussion were the notion of **efficiency** within an auditing standard and the **public's perception** as it relates to this; a **risk-based** audit approach; and the need to **emphasize** the auditor's procedures surrounding **fraud**.

- Historically, the role of a regulator was to prescribe a certain level of performance effectiveness. The test of efficiency was best met via market tests. Focusing on efficiency in an auditing standard by a regulator may easily lead to insufficient audit work and a decline in audit quality.
- When you introduce efficiency as a requirement, there may be a risk that you are not protecting investors.
- While efficiency is a fine term, the quality of the audit is first and foremost. There may be a perception that the PCAOB is relaxing standards. However, there were SAG members that suggested that no one in the field views this as "relaxing" the standards.
- Support for a risk-based approach using payroll as an example. Payroll is a large item on the financial statements; however, the risk that there would be a material misstatement in payroll may be extremely low. The ICFR Proposal allows an auditor to look at where the risk of material misstatement would occur and that is where judgment should be applied.
- Essential components of an audit include the need to understand the business industry in which the company operates and to know how financial statements are prepared and where errors may lie. These are important factors to risk assessment.
- Auditor judgment should be allowed to flourish and should not be second guessed, however, judgment should not be used as a "trump" card. There are ranges of reasonableness.
- Reference was made to the [Public Oversight Board's \(POB\) Panel on Audit Effectiveness](#) report whereby all the major firms indicated that they were performing a full top-down risk-based assessment and the panel found that there were problems with the existing standards. It was recommended that the PCAOB consider this.
- Tom Ray stated that, in substance, the ICFR Proposal is not that different from AS 2 but what the PCAOB is attempting to do in the revision is to emphasize and focus the internal control standard on risk and judgment. The environment is different today with the existence of the PCAOB and the inspection function that is independent of the audit profession. This is a significant factor in completing the rulemaking in this standard.

- Suggestion that those who are trying to do it right get assistance in doing it right and have supplied statements in accordance with GAAP. Those who are doing it wrong (e.g., fraud; "bad actors") are not addressed in the ICFR Proposal.
- From an audit committee perspective, there was a suggestion that there needs to be a much more robust dialogue between the auditor and the audit committee about risks and judgments because audit committee members are focused on risk assessment and spend a lot of time looking at the performance of their company as compared to others to understand why their company is in a better or worse position.
- There was a suggestion that the PCAOB should keep public perception in mind when setting standards. The focus of standard setting should be on the quality of audits and not on the efficiency. A Board member responded by indicating that the proposal was not intended to "water down" the standard in order to cut costs. If the proposal is perceived as intended to "water down" the standard in order to cut costs, then commenters need to send in their comment letters indicating such so that the Board can address this.
- A statement was made that PCAOB inspectors and inspection report comments are critical of the auditor judgments applied.
- With respect to the strong indicators of a material weakness in the SEC guidance, specifically the ineffective oversight of an audit committee, there is no guidance provided by the SEC or PCAOB as to what this constitutes.
- The ICFR standard should have a more robust discussion of fraud.

Company-level Controls

Below are highlights of commentary from the SAG meeting on the topic of company-level controls whereby the SAG discussed whether the proposal adequately articulates the appropriate consideration of company-level controls and their effect on the auditor's procedures. Common themes that encompassed the discussion were the possible ***over-reliance on effective company-level controls*** and the ***timing of consideration of company-level controls***.

- Company-level controls are the underpinning of a good audit and are not a substitution for other audit procedures.
- The success of the ICFR standard is in two areas (1) getting the risk assessment correct and (2) how auditors deal with company-level controls and discern the difference between those that are directly linked to assertions and those that are indirectly linked which has an effect on the audit approach. For those that are directly linked - is the precision enough to discern that no additional work is needed? How the auditors implement that aspect of the proposal is important and that is the place where the PCAOB staff could possibly offer more guidance (i.e. practice aid).
- Starting early in the audit with company-level controls is important to a top down risk-based approach. Many company-level controls indirectly affect whether you get something right, very few are direct. When you have effective company-level controls, you can not just infer that there is no risk of material misstatement and that financial statements are correct.

- The timing of when you look at company-level controls must be early in the process. Experience may show that company-level controls are looked at during the tail end of the audit.
- There was a suggestion that the discussion of company-level controls in the proposal should be moved up earlier in the standard so that it is clear that company-level controls need to be considered in the auditor's assessment not just in what you need to test.
- It is dangerous to over-rely on company-level controls to reduce substantive testing and it is important that auditors do not forget the risk that they are trying to mitigate.
- If company-level controls are bad, it tells the auditor that there is a problem. However, company-level controls are somewhat difficult to assess and more guidance is probably necessary and needed to guide an auditor as to where their reliance will enable them to reduce testing. There is a concern that the way the standard is drafted in paragraph 17 which suggests that "the auditor must test the company-level controls" appears to be very definitive and many auditors may read it as this is the keystone and once they have tested those and have found that those are all right, they can greatly limit whatever else they do, which is not what the Board intended to convey.

Scaling the Audit for Smaller, Less Complex Companies

Below are highlights of commentary from the SAG meeting on the topic of scaling the audit for smaller, less complex companies, whereby members discussed whether the sections within the standard that discuss size and complexity appropriately describe when and how the auditor should scale the audit. Common themes that encompassed the discussion were whether there is even a ***need for such a section given a risk-based approach***; and the clear distinction that ***size and complexity are two different things***.

- Size and complexity are two different things and the ICFR Proposal allows for scalability for all companies.
- The Board was urged to strongly resist any approaches that would tier the process or hold smaller companies to a lower standard.
- There was concern expressed that there is potential for the misunderstanding that the section on scalability is suggesting two separate standards under one cover.
- A suggestion was made that the Board rethink the references to the SEC's Advisory Committee on Smaller Public Companies (i.e., paragraph 9 and footnote 6) size cut-offs, which may be misleading, as it is possible that a company can be below these size cut-offs and be complex.
- Question was raised as to why there is a need for a scalability section if you are using a risk-based approach since a risk-based approach would cover all of the considerations related to scalability? Other SAG members suggested that for the Board to deal with the perception that AS2 is not one size fits all, the Board may have deemed it necessary to include this section. It was suggested that the Board consider this question and response.
- For smaller entities, the ICFR Proposal states that control objectives can be met with daily interaction of top management, but what if senior management is corrupt? Fraud research documents that there is a higher risk of fraud with founder involvement.

- Suggestion that for smaller companies, complexity is going to drive the work that an auditor does.

Differences between Management's Evaluation Process and the Audit Process

Below are highlights of commentary from the SAG meeting on this topic whereby members discussed whether differences between management's process for evaluating its internal control under the SEC's proposed guidance and the process the auditor would follow under the Board's proposed standard would raise implementation difficulties for auditors or management and if so, how can these difficulties be addressed or managed. A common theme that encompassed the discussion was that **management and auditors have different roles** and that they should be expected to have different processes that accompany their specific roles.

- Keep the potential for divergence going forward to a minimum which has been done with the principles proposed.
- Management is in a different place than auditors and it makes sense that the approaches to internal control be different. However, what management does will have an effect on what auditors do and collectively this should be done in the most effective manner.
- The elements of documentation within the proposed standards should be considered as this would ultimately help the entire process.
- There are differences between the proposals related to strong indicators of a material weaknesses and the two should conform.
- Management is responsible to ensure there are adequate internal controls. The auditor's role is to provide a check. The auditor's work should not drive management's work and both parties should have a constant dialogue.

Using the Work of Others

Below are highlights of commentary from the SAG meeting on the topic of using the work of others, whereby members discussed whether the proposal meets the objective of removing unnecessary barriers to using the work of others and whether it will promote better integration of the audits. Common themes that encompassed the discussion were the "**principal evidence**" notion and the **auditor's responsibility to obtain sufficient competent evidence** to support their opinion.

- Job titles matter because they create a mindset. There is a different mindset between management and internal auditors, for example. Internal auditors have a code of conduct, code of ethics and professional standards that they observe and that is not necessarily the case when relying on management. Competence and objectivity are important, but so is the job title.
- There was concern with the principal evidence provision elimination, based on the potential consequences. If management personnel appear objective and competent, can they gather the principal evidence for the ICFR audit and the financial statement audit? If that's true then what do you need the auditors for?

- Support for the principal evidence elimination. There was a notion of principal evidence long before AS2 and it will always be embedded in the auditor responsibility to issue an audit report.
- It must be clarified in that this standard does not take any burden off the auditor and that the auditor must still obtain sufficient evidence so that they can conclude on the financial statements.
- There was a suggestion that if an auditor uses someone else's work for the audit, then investors should be notified.
- This standard creates a liability hurdle as some may point to the standard and state that it allowed them to rely on the work of the preparer.
- Ultimately, the auditor is responsible for the use of the work of others (i.e., the auditor must obtain sufficient competent evidential matter; the auditor must look at the objectivity and competence of the others).

Other Topics Related to the Internal Control Proposal

SAG member were asked if there were additional topics for discussion related to the ICFR Proposal. Some of the following items were raised by the SAG members:

History of Internal Controls – Internal controls have been around forever but were not necessarily at the top of the list in practice within audits. This is an opportunity for the PCAOB, that has a lot of insight as to what is going on in the audits through the inspection process, to elevate the assessment of the audit of internal control one more step so that we can understand "why" the auditor failed at something (e.g., Was it a matter of competence?, Was it lack of experience?, Were the incentives wrong?). The suggestion was that until we approach this from a implementation perspective, "we are not going to tackle the big picture." This was not suggested as an attempt for criminal or civil proceedings or a fault finding process, but rather a learning process.

Limitation of Liability Provisions – One of the SAG members indicated that she had read press accounts or heard speeches given by the SEC indicating that they were considering incorporating liability limitation provisions into the revised AS 2 standard. If this is, in fact, true, she indicated that it would be a significant detriment to the investing public. In response, SEC Chief Accountant Conrad Hewitt, stated that he believes that the SEC will not incorporate anything similar to what the SAG member described and that they do not have any plans to incorporate safe harbor provisions into AS 5.

Definitions – The change in definition of "weaknesses" may need to be considered by the Board in terms of how the auditors operationalize these terms. AS2 had language such as "more than remote" and now the language has changed to "reasonable possibility"- Is it really appropriate to use the SFAS 5 language in an auditing standard?

CAQ filed the following comment letters on the proposed Section 404 proposals:

[CAQ Comment Letter on PCAOB Release No. 2006-007](#)

[CAQ Comment Letter on SEC File Number S7-24-06](#)

Panel Discussion – Forensic Audit Procedures

The Board's current standards related to fraud require auditors to consider the risk of fraud in planning a financial statement audit. The PCAOB recently issued a ["rule 4010 report" on fraud](#) that discussed observations derived from its inspections program concerning the procedures auditors apply to meet this requirement.

View the [briefing paper](#) that discusses issues relating to the performance of forensic audit procedures as a part of or in addition to an audit of financial statements. The briefing paper makes reference to the [Global Public Policy Symposium](#), whereby the CEOs of the six largest international audit networks issued their perspective on investor needs and the role of the auditor in their paper entitled [Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks](#). This vision paper highlights the need for constructive dialogue among investors, other company stakeholders, policy makers and audit professionals about what should be done to narrow the expectation gap related to fraud. The paper also discusses current forensic audit procedures in an audit of financial statements.

Presentations and discussions during this panel discussion included the following:

- Characteristics that distinguish an audit of financial statements from a forensic audit.
- Lessons or best practices from the field of forensic auditing that could improve the quality of financial statement audits.
- The potential objectives of the forensic audits envisioned by the November 2006 Paper.

An Overview of Forensic Auditing and How it Compares to the Financial Statement Audit

This discussion provided the foundation for what constitutes a forensic audit by defining some of the key terms and contrasting a forensic audit with a financial statement audit. The basics of a forensic audit are the need to address a question and an element of some sort of legal proceeding or setting. A forensic audit looks at a detail of a specific aspect of the records to determine why things do not add up. There is a lot of cost and time involved in these targeted procedures. Based on a 2003 [Journal of Accountancy Article \(by: Joseph Wells\)](#), a forensic audit can be contrasted to a financial statement audit as follows:

Issue	Auditing	Fraud examination
Timing	Recurring Audits are conducted on a regular, recurring basis.	Nonrecurring Fraud examinations are nonrecurring. They are conducted only with sufficient predication.
Scope	General The scope of the audit is an examination of financial data.	Specific The fraud examination is conducted to resolve specific allegations.
Objective	Opinion An audit is generally conducted for the purpose of expressing an opinion on the financial statements or related information.	Affix blame The fraud examination's goal is to determine whether fraud has occurred or is occurring and to determine who is responsible.
Relationship	Nonadversarial The audit process is nonadversarial in nature.	Adversarial Fraud examinations, because they involve efforts to affix blame, are adversarial in nature.
Methodology	Audit techniques Audits are conducted by examining financial data and obtaining corroborating evidence.	Fraud examination techniques Fraud examinations are conducted by (1) document examination; (2) review of outside data such as public records; and (3) interviews.
Standard	Professional skepticism Auditors are required to approach audits with professional skepticism.	Proof Fraud examiners approach the resolution of a fraud by attempting to establish sufficient proof to support or refute a fraud allegation.

Source: Fraud Examiners Manual, Association of Certified Fraud Examiners, 2003.

Description of Forensic Audits (Staff Qualifications, Type of Evidence Obtained, Documentation of Work Performed)

There is a general lack of understanding regarding forensic procedures and their application. In addition, there are no generally recognized standards to perform a "forensic audit".

Forensic investigations should be performed by those with sufficient skills, knowledge, experience, education and training. A forensic investigator should be knowledgeable in the fields of accounting; economics; auditing; finance; sampling; evidence gathering, preservation and analysis; fraud; and the law. Communication skills are paramount.

Overview of Ideas for Forensic Audit Procedures Outlined in the Global Public Policy Symposium Paper

Below is an overview of three forensic audit procedures that were discussed in the vision paper- *Global Capital Markets and the Global Economy: A Vision From the CEOs of the International Audit Networks* and were summarized by the panel member:

1. A forensic audit on a regular basis – Most thorough but the most costly implementation approach (perhaps every 3 or 5 years)
2. A forensic audit on a random basis – Sample of companies which could create fraud deterrence at a much lower cost.
3. Other "choice-based" options – Allowing shareholders or their representatives to make the decision.

Historical Background of the Auditor's Responsibility as it Relates to Fraud

This included a historical discussion of SAS 82 (predecessor to SAS 99) and the enhancement and expansion of this previous standard into [SAS 99, Consideration of Fraud in a Financial Statement Audit](#). SAS 99 added operational guidance to the auditor and for the first time required the auditor to have a brainstorming session early in the audit to think through the possibilities of fraud. SAS 99 also instructed the auditor to assess fraud with professional skepticism and outlined the amount of inquiry that the auditor needed to conduct with all different parties (i.e., management, audit committee, etc.). This led into the discussion of how auditing standards should consider forensic procedures in today's environment.

Sample of SAG Questions Posed to the Panel

- *Does the general auditor have the sufficient level of skills to perform a forensic audit and if not, what are the incremental skills needed?* The unique characteristic of a forensic auditor is the skill of forensic investigative experience in seeing how frauds are executed which comes with experience and exposure to fraud schemes (i.e., seeing how documents have been altered or modified; seeing how transactions have been recorded.)
- *Is SAS 99 really a doable standard?* Yes, if implemented by those who are trained appropriately.
- *Has technology moved at a pace faster than the standard setting process?* One of the tools used now is transactional data-analysis whereby you can search and scan a large volume of data very easily and quickly to detect vendor and customer fraud. Once you organize the data in a usable form, you can run tests. For example, does a vendor address in the payables file match an employee address in the master payroll file system, which may raise a flag. This can very easily be done through technology using comparison tests. However, to detect revenue recognition manipulation is much more difficult to do. Therefore, technology has advanced at different speeds for different items.

- *If the PCAOB were to challenge forensic auditors to establish a program to evaluate the tone at the top and the risk of management override, what would that turn out to be, how effective would it be, and what would it cost? Tools to accomplish this are already available and the PCAOB should get feedback from these already available tools.*
- *Do forensic auditors look at top-side post-closing adjusting journal entries since 83% of frauds involve management override using this technique? Yes*
- *Do these fraud techniques apply across the board for all size companies? Yes- any size company depending on circumstances.*
- *Have any off-the-shelf software vendors offered packages to help with fraud techniques? Yes, there are commercially available software packages that are improving. But the challenge is the disparity of the data not the tool being used. Need to get data in a readable form.*
- *What does the audit opinion tell the reader of the financial statements about fraud? Auditors are engaged to opine on the fairness of the financial statements and there is a limitation to that. There may always be that expectation gap.*

Overview of Panelist Commentary

- There is no standard forensic audit program to follow or apply as it is all based on facts and circumstances. Determining the cost and scope of a forensic audit up front is difficult before documents and the situation is evaluated.
- Look carefully at risks and then look at the opportunity where you could apply the forensic auditor's expertise and techniques.
- Knowledge and experience of a forensic auditor is extremely important but another component is attitude and mindset. Students are passionate about the topic of forensic auditing and as a result, it is a popular course.
- Many schools have only one course related to forensic auditing, which is more of an awareness building course, but the educational opportunities have been increasing, with the possibilities of a forensic auditing curriculum.

Suggestions to the PCAOB

Below are some of the suggestions made to the PCAOB.

- Most firms have a quantitative scoring of client risk and if a client is above a certain level of risk, they need a forensic audit person on the engagement. The Board, through the inspection process, should look at the different tiers (i.e., engagements that included a forensic audit person and those that did not) and see what the outcomes were (i.e., were restatements less likely; were frauds less likely).
- Useful if the SEC and PCAOB could provide more detail and clarity with respect to the auditor's

responsibility when dealing with illegal acts under Section 10A of the Exchange Act as there is confusion among audit firms, boards of directors and audit committees.

- Suggest the PCAOB convene a group of people that committed fraud to obtain insight about how they were able to fool the auditors.
- Suggest the PCAOB consider required communications between the auditor and audit committee specific to fraud and fraud controls as suggested in the POB's Panel on Audit Effectiveness Report.

EMERGING ISSUES

Recently the Delaware Chancery Court issued decisions (http://www.delawarelitigation.com/Gifford_Opinion.pdf and http://www.delawarelitigation.com/TYSON_OPINION.pdf) related to stock-options granting practices. At least one of these decisions provides discussion on when the practice of spring-loading may be improper. People were encouraged to obtain these decisions and be aware of how this might affect financial statements.

ADDITIONAL INFORMATION

The complete [agenda and briefing papers](#) for this SAG meeting can be accessed by clicking on the respective link.

To view a compilation of past SAG topics and corresponding briefing papers discussed by year, visit the [CAQ SAG Topics and Briefing Papers Web Page](#).

For information regarding past SAG meetings and SAG members, visit the member's only section of the [CAQ – PCAOB Standing Advisory Group Web Page](#).

Visit the [CAQ Antifraud Resource Page](#) by clicking on the respective link.

Visit the [CAQ Internal Control over Financial Reporting Resource Page](#) by clicking on the respective link.

Stay Informed

As a member of the Center, your firm will receive periodic updates on important developments related to the PCAOB and the SEC, as well as the activities of the Center, particularly with respect to the submission of comment letters on PCAOB and SEC proposals. To stay abreast of these and other relevant events in public company audit practice, please visit the Center Web site at theCAQ.aicpa.org. Also, we welcome any suggestions or questions - please send them by email at center@aicpa.

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