

**CAQ Lessons Learned –**

***Performing an Audit of Internal Control***

***In an Integrated Audit***

**February 2009**



**CENTER FOR AUDIT QUALITY**

*Serving Investors, Public Company Auditors, & the Markets*

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## **CAQ Lessons Learned – Performing an Audit of Internal Control in an Integrated Audit**

### **Notice to Readers**

The Center for Audit Quality (CAQ) was created to serve investors, public company auditors and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty and trust. The CAQ consists of approximately 800 member firms that audit or are interested in auditing public companies, and is affiliated with the American Institute of Certified Public Accountants (AICPA).

This "Lessons Learned" publication has been prepared by representatives of member firms of the CAQ and is intended to be used as a reference source for auditors of public companies. The information may help auditors improve the effectiveness and efficiency of their audits and is based on existing professional literature, the information gathered by members of the CAQ task force that drafted the document, and the experiences of CAQ member firms. This information represents the views of the members of the task force, has not been approved by any regulatory body or any senior technical committee of the AICPA, and does not set standards for any purpose. As noted below, auditors are required to adhere to Auditing Standard No. 5 (AS 5), *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, issued by the Public Company Accounting Oversight Board (PCAOB or the Board) and associated guidance published by the PCAOB. Public companies should follow related guidance published by the Securities and Exchange Commission (SEC or Commission). Documents published by the CAQ, on the other hand, are not authoritative. If an auditor applies the materials included in a CAQ publication then he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The materials and views herein are not intended as a substitute for the professional judgments applied by practitioners. The applicability and sufficiency of the material in particular circumstances are matters for such judgment.

Users of this document should be familiar with AS 5 and the terms and concepts used in AS 5, as they are frequently used or referred to within this document. Users of this document also are encouraged to read other publications issued by the PCAOB, SEC, and The Committee of Sponsoring Organizations of the Treadway Commission (COSO) that provide further guidance to auditors and management in performing Section 404 evaluations. These documents are listed in the Introduction and Purpose below. This document is not a substitute for authoritative technical literature and users are urged to refer directly to applicable authoritative pronouncements for the text of the technical standards. Any references to or quotations from authoritative technical literature included in this document are intended only to illustrate certain matters and to help users locate certain information, not to serve as a substitute for careful study of

the relevant pronouncements. The information that is the subject of this document may change in material respects, and the CAQ is under no obligation to update this document for such changes.

## **Introduction and Purpose**

The effective and efficient execution of reporting on internal control over financial reporting (ICFR) pursuant to Section 404 of the Sarbanes-Oxley Act of 2002 (SOX) has been a focus and priority of issuers, auditing firms, investors, the PCAOB, and the SEC since SOX was enacted. Regulatory focus on the improved implementation of Section 404 by both management and auditors culminated with the 2007 issuance of the SEC's *Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* and the PCAOB's AS 5. For auditors, AS 5 superseded Auditing Standard No. 2 (AS 2) and is intended to "focus auditors on the most important matters in the audit of internal control over financial reporting and eliminate procedures that the Board believes are unnecessary to an effective audit of internal control."

One of the areas of specific consideration in AS 5 is scalability of the audit of ICFR for smaller, less-complex companies. In applying the provisions of AS 5 for these companies, careful consideration is given to their unique attributes. In addition to AS 5 and the SEC's *Guidance Regarding Management's Report*, the following guidance has been published to aid in Section 404 evaluations and assessments:

- In 2009, the PCAOB published application guidance for auditors of smaller, less-complex companies in its publication *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* (PCAOB Guidance on AS 5).
- In 2006, COSO published guidance for smaller companies that applies the concepts of the 1992 *Internal Control – Integrated Framework* and demonstrates how these companies may achieve their financial reporting objectives.
- In 2009, COSO also released its *Guidance on Monitoring Internal Control Systems* designed to clarify the monitoring component of internal control (COSO Monitoring Guidance).

To further support the objective of performing effective and efficient integrated audits that benefit investors, and particularly to assist in the initial implementation of integrated audits by smaller auditing firms, auditors with extensive experience implementing and executing integrated audits were assembled to share their insights and experiences obtained as a result of the performance of internal control audit procedures of both accelerated and non-accelerated filers. Also, pilot projects of internal control audit procedures of certain non-accelerated filers – participants who would not otherwise be required to have an integrated audit until fiscal years ending on or after December 15, 2009 -- and of smaller companies that became accelerated filers for the first time in 2007 were conducted in order to further understand

implementation challenges that might be unique to the initial integrated audit for a smaller, less-complex company.

This document is the result of the CAQ's efforts to convey the resulting practical knowledge obtained. It is not intended to duplicate or supplant the standards of the PCAOB or the PCAOB's guidance for auditors of smaller public companies. This collective knowledge is presented here as a series of "Lessons Learned" -- practical insights collected from auditors to benefit auditors. Although the primary intent of this document is to assist auditors performing integrated audits for the first time, many of these Lessons Learned may be applicable and relevant to recurring integrated audits.

## **Executive Summary**

Performing an integrated audit requires that the auditor form numerous judgments about an entity's internal control over financial reporting and how well it addresses risks of material misstatements in that entity's financial statements. As part of this process, the auditor must determine the amount and type of evidence necessary to support a conclusion by the auditor that an entity's system of internal control is effective.

Section 404 reporting requirements challenge both management and auditors to evaluate and assess the effectiveness of entities' internal control systems that contribute to their financial reports. This focus on internal control, and coordinating the internal control audit in conjunction with the existing audit of the financial statements, presents a new environment for auditors.

In the initial year of an integrated audit, comparatively more effort may be necessary for the auditor to form judgments about an entity's internal control over financial reporting, build up the auditor's experience, and obtain support for judgments. In subsequent years, as the auditor becomes more proficient and obtains more experience in forming these judgments, the auditor's effectiveness and efficiency in executing an integrated audit generally increase. Each year the auditor not only re-evaluates his or her judgments, including risk assessments, but also may incorporate and build on knowledge obtained in previous years' audits. Auditors also periodically may review the publications highlighted in the Introduction and Purpose, which contain valuable information and guidance.

Certain concepts are fundamental to performing an effective and efficient integrated audit in accordance with AS 5. These concepts are present throughout this document and are summarized below. The background discussion and suggestions included in each of the individual Lessons Learned provide insight into how these concepts have been applied.

### ***Communicating and coordinating with management***

As noted in the Introduction and Purpose, in 2007 the SEC published guidance to help management of public companies, including small businesses, make assessments in accordance with Section 404(a) of

SOX. Although there is a close relationship between the work performed by management for the purposes of its assessment and that performed by the auditor for the audit of ICFR, differences may exist between the evaluation process and the level of documentation management may consider necessary to support its annual assessment of ICFR and the audit process and the level of documentation necessary for the auditor to support his or her opinion on ICFR. For example, management’s judgment regarding the conduct of its evaluation and the level of documented evidence necessary to support its assessment may be based on its daily interaction with its system of internal controls. The auditor, on the other hand, is responsible for conducting an independent audit. An auditor forms an opinion of the control system only after analysis and testing is conducted with required professional skepticism and documented support for a professional opinion in accordance with professional standards. This may require the auditor to take a different approach to the evaluation of the internal control system and to perform more tests and to obtain more extensive evidence to support an opinion on the effectiveness of ICFR than management needs for its assessment.

Despite differences that may exist in the evaluation processes and in the level of documentation management considers necessary to support its assessment versus that required by the auditor to support the opinion on ICFR, one of the best opportunities for efficiency in the audit of ICFR arises when the auditor can use the documentation already prepared and testing already performed by management. In pursuing these efficiencies, however, the auditor should be careful to avoid even the appearance of attempting to limit the flexibility available to management in designing and implementing its process; both the Commission and the PCAOB have made it clear that the auditor should not be attempting to direct management in the design or implementation of its evaluation process or assessment decision. Nonetheless, the Commission has noted that it “agree(s) with those commenters that suggested coordination between management and auditors on their respective efforts will ensure that both the evaluation by management and the independent audit are completed in an efficient and effective manner.”<sup>1</sup> Balancing the notions of not interfering with management’s process with trying to achieve the

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<sup>1</sup> SEC Release Nos. 33-8810; 34-55929; FR-77; File No. S7-24-06 (June 20, 2007). In addition, in a May 16, 2005 press release, the Securities and Exchange Commission stated:

“We encourage frequent and frank dialogue among management, auditors and audit committees with the goal of improving internal controls and the financial reports upon which investors rely. Management of all companies - large and small - should not fear that a discussion of internal controls with, or a request for assistance or clarification from, the auditor will, itself, be deemed a deficiency in internal control. Moreover, as long as management determines the accounting to be used and does not rely on the auditor to design or implement the controls, we do not believe that the auditor's providing advice or assistance, in itself, constitutes a violation of our independence rules. Both common sense and sound policy dictate that communications must be ongoing and open in order to create the best environment for producing high quality financial reporting and auditing; communications must not be so restricted or formalized that their value is lost.”

most effective and efficient audit may mean that not only should the auditor use the work of management and others when appropriate and as permitted by the current professional standards, but also that the auditor should have an open line of communication with management and the audit committee so that they may discuss how changes in either the company's or the auditor's procedures might save overall time, efforts or costs without diminishing the effectiveness of each process and assessment, or the control each has over its own process and assessment. Auditors historically have had such communications with management regarding the documentation and procedures related to the preparation of the company's financial statements, which have been expanded to include the audit of internal control over financial reporting.

In the years before the auditor is required to issue an attestation report in accordance with SOX Section 404(b) for non-accelerated filers, when the auditor is not opining on the effectiveness of ICFR (unless requested to do so by management), the auditor nevertheless is required to obtain an understanding of internal control in designing audit procedures for the audit of the financial statements<sup>2</sup>. Management of non-accelerated filers is required to file an assessment of internal control over financial reporting in accordance with SOX Section 404(a) in annual reports for fiscal years ending on or after December 15, 2007 and, therefore, even prior to performing the first integrated audit the auditor may consider how to use management's documentation and testing of internal control in conjunction with the audit of the financial statements. The auditor also is encouraged to begin to plan and discuss with management and the audit committee any areas where coordination between management and auditors could increase the auditor's ability to use management's documentation and testing to increase the efficiency in the first integrated audit. Although it is solely management's decision of whether to implement any changes to its evaluation process, the auditor may be able to provide valuable feedback to management regarding its evaluation process as a result of experience the audit firm has obtained in conducting other audits of internal control over financial reporting.

As a separate but related matter, auditors should be cognizant that in the reporting periods before they are required to issue an attestation report in accordance with SOX Section 404(b), if the auditor becomes aware of information that gives rise to the belief that management's assertion on the effectiveness of

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<sup>2</sup> Under the rules of the Securities and Exchange Commission, management of each non-accelerated filer is required to file its report on the company's internal control over financial reporting under SOX 404(a) in annual reports for fiscal years ending on or after December 15, 2007. Those rules require non-accelerated filers to provide auditor attestation reports under SOX 404(b) in annual reports for fiscal years ending on or after December 15, 2009. See SEC Release No. 33-8934; 34-58028 (June 26, 2008). In accordance with AU 319.02 the auditor is to obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determine whether they have been placed in operation.

internal control contains a material misstatement of fact, the auditor has certain responsibilities in accordance with AU 550 and Section 10A of the Securities Exchange Act of 1934.<sup>3</sup>

### ***Planning an integrated audit***

Planning requires a significant amount of judgment, and the decisions made in planning are critical to the effectiveness and efficiency of an audit. The principles involved in the identification of risk and determination of significant accounts and disclosures and their relevant assertions, are the same for the audit of the financial statements and the audit of ICFR (refer to AS 5, paragraph 31). Therefore, planning performed on an integrated basis helps to achieve the objective of an integrated audit and eliminates redundancy.

Once the determination of significant accounts and disclosures and their relevant assertions have been made, the auditor decides how he or she will gather sufficient evidence for the purposes of forming opinions both on the effectiveness of ICFR and on the fairness of the financial statements. To effectively and efficiently integrate the audit of the financial statements and the audit of ICFR, the auditor needs to decide whether to test controls: (1) throughout the period of reliance for purposes of the audit of the financial statements<sup>4</sup> (commonly referred to as a **controls reliance approach**)<sup>5</sup> which, to the extent appropriate, may reduce the amount of substantive work necessary to support the audit of the financial

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<sup>3</sup> Auditors can refer to CAQ Alert #2007-66 – December 19, 2007 with respect to considerations regarding the auditor’s role relative to management’s report on its assessment of internal control over financial reporting when, under the SEC’s transition provisions for non-accelerated filers, an auditor attestation is not required. Auditors also should consider the requirements under AU 325, “Communication of Internal Control Related Matters Noted in an Audit,” to report certain conditions related to an entity’s internal control observed during an audit of financial statements to the audit committee or to those with equivalent authority in organizations that do not have an audit committee.

<sup>4</sup> AS 5 paragraph B4 states: “To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so”.

<sup>5</sup> Note that a planning decision to use a controls reliance approach assumes that controls are operating effectively over the period of reliance, which can not be validated until the operating effectiveness is tested throughout the period. Therefore, for the purposes of planning where a controls reliance approach may be appropriate, the auditor makes planning decisions considering information obtained from management’s testing of controls for its assessment and/or the auditor’s testing of the controls in previous year’s audits (if the controls were tested in prior years).

statements<sup>6</sup>; or (2) not take a controls reliance approach for the audit of the financial statements (commonly referred to as a **substantive approach**) and only test ICFR for the purpose of expressing an opinion on internal control over financial reporting at the “as-of” date (the latest balance sheet date)<sup>7</sup>. An auditor might decide to use a controls reliance approach for certain aspects or portions of the integrated audit and a substantive approach for other aspects or portions of the integrated audit. The auditor’s decisions with respect to testing of controls will depend on facts and circumstances and will be affected by various factors including the nature of the risk of misstatement due to ineffective controls, the reliability of evidence of the effectiveness of the controls, inherent risk with respect to the accounts being tested and the incremental cost of performing sufficient tests of controls during the period of reliance to support a controls reliance approach.

### ***Using a top-down, risk-based approach***

Approaching the audit of ICFR from a top-down, risk-based perspective (as described in AS 5) effectively correlates the amount of audit effort expended with the degree of risk that a material weakness could exist in a particular area of an entity’s ICFR. Using this approach, greater attention is focused in the areas of greater risk. A top-down approach directs the auditor initially to consider risk at the financial statement level and controls at the entity level before moving downward to consider risk -- and controls that address those risks -- to the significant accounts and disclosures and relevant assertions.

The top-down, risk-based approach has been a focal point in improving the implementation of Section 404. Many of the early integrated audits and management assessments were conducted using what is commonly referred to as a “bottoms-up” approach. A bottoms-up approach generally starts with an evaluation of risks, and testing of controls to address those risks, at the process, significant account or relevant assertion level. This approach can result in the unnecessary testing of controls that address risks that are not material to the financial statements overall. A significant amount of guidance on applying a top-down, risk-based approach has been published for both auditors and management by the PCAOB, SEC and COSO as well as by the auditing profession. Some practical suggestions to assist auditors in

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<sup>6</sup> AS 5 paragraph B7 states: “Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.”

<sup>7</sup> AS 5 paragraph B2 states: “To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company’s financial statements.”

successfully applying a top-down, risk-based approach have been listed below and are addressed in further detail in Lesson Learned #13.

- Consider what information may already be available to provide a starting point with respect to assessing the risks to the financial statements. Management’s evaluation process is likely the best and most natural starting point assuming that management has applied a top-down, risk-based approach as encouraged in the SEC’s guidance for management. Discussions with top-level management and the audit committee about the risks they perceive to the financials statements may also provide valuable insight. Inherent risk assessments made for the purposes of the financial statement audit should be the same as the audit of ICFR and information from recent quarterly reviews and prior year audits can inform current year risk assessments.
- Look for the controls that address the most risks. Management or the audit committee may be monitoring or performing activities that address the risk to numerous financial statement line items, significant accounts or disclosures or relevant assertions. These types of entity-level controls may directly address identified risks. More often, however, these entity-level controls will function together with other controls at the process or transaction-level to address the material risks to accurate financial reporting. Therefore, when identifying and evaluating these controls the auditor should consider whether the entity-level control itself sufficiently addresses identified risks or whether testing the identified entity-level control could result in a reduced level of testing of related transaction-level controls. Again, management’s evaluation process is likely the most appropriate starting point for this process because management likely will have identified these entity-level controls for the purposes of its own assessment. Identifying controls to address identified risks in a top-down, risk-based approach is discussed further in Lesson Learned #17.
- Consider “rating” identified risks on a continuum from lower to higher risk. Once a risk has been identified, the nature, timing and extent of testing necessary to address that risk may vary. Rating risks will help the auditor to ensure the amount of audit work being contemplated is appropriate and commensurate with the amount of risk involved<sup>8</sup>. Risk rating is discussed further in Lesson Learned #19.

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<sup>8</sup> AS 5 paragraph 11 states: “A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company’s internal control over financial reporting and the amount of audit attention that should be devoted to that area.... The auditor should focus more of his or her attention on the areas of highest risk. On the other hand, it is not necessary to test controls that, even if deficient, would not present a reasonable possibility of material misstatement to the financial statements.”

## **Organization of the Document**

For the purposes of quick reference and to facilitate ease of use, the Lessons Learned have been aggregated and organized into relevant sections as follows:

**Section 1** (Lessons Learned 1-5): Understand and Use Management’s Assessment and Documentation as a Starting Point. This section discusses how auditors can start to prepare for an audit of ICFR, the importance of communicating with management, using management’s work in the audit of ICFR, identifying risks and controls that may have a pervasive impact on the audit of ICFR, and considering the effect of any unremediated deficiencies.

**Section 2** (Lessons Learned 6-10): Integrate the Audits. This section discusses planning the audit of ICFR and the audit of the financial statements in an integrated manner, considering the approach for the audit of the financial statements and audit procedures that may meet the objectives of both audits, and how the results of substantive procedures informs the auditor’s risk assessments for the audit of ICFR.

**Section 3** (Lessons Learned 11 & 12): Establish the Right Team. This section outlines considerations in selecting and assigning a team to an audit of ICFR and the relevant skills and experience that will help to ensure the effectiveness and efficiency of the audit.

**Section 4** (Lessons Learned 13-16): Identify Material Risks to Reliable Financial Reporting. This section discusses applying a top-down, risk-based approach, effectively performing risk assessments, understanding the likely sources of potential misstatement and tailoring the audit procedures to achieve the objectives of an audit of ICFR, and considering IT in the risk assessment process.

**Section 5** (Lesson Learned 17): Identify Controls Necessary to Sufficiently Address Identified Risks. This section discusses how controls are effectively identified in a top-down, risk-based approach and discusses the evaluation of entity-level controls versus transaction-level controls.

**Section 6** (Lessons Learned 18-21): Take a Risk-based Approach to Testing Identified Controls. This section discusses coordinating with management for use of the work of others, varying the nature, timing and extent of control testing at an appropriate level commensurate with identified risks, and the extent of testing necessary when control deficiencies are identified.

## **Section 1: Understand and Use Management’s Assessment and Documentation as a Starting Point**

### ***Lesson Learned #1***

**Take advantage of the company’s internal control evaluation process and documentation, where practical, in connection with financial statement audits performed in years prior to the first integrated audit.**

#### **Background:**

- Non-accelerated filers were required to report on their ICFR under section 404(a) of SOX and the Commission’s rules beginning with annual reports for fiscal years ending on or after December 15, 2007. However, under SEC reporting requirements, non-accelerated filers are not required to file auditor attestation reports on ICFR under section 404(b) until the filing of annual reports for fiscal years ending on or after December 15, 2009.
- In a financial statement audit, under AU 319.02<sup>9</sup> an auditor is required to gain an understanding of internal control sufficient to plan the audit of the financial statements. (Note: For purposes of opining on the effectiveness of ICFR in an integrated audit, the evaluation of the design of ICFR often is more rigorous in terms of identifying the likely causes of significant misstatements and related control activities than may be performed when understanding the design of internal control for purposes of planning a financial statement audit.) The auditor also decides whether to test internal controls to enable the auditor to take a control reliance approach in the audit of the financial statements.
- In years prior to the first integrated audit for accelerated filers, some auditors began or expanded their testing of internal controls, where practical, in connection with the audit of the financial statements (e.g., particularly for those areas where management was significantly complete with their 404(a)

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<sup>9</sup> AU 319.02 (relevant to audits of financial statements) states the following: “In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation.”

readiness activities and the additional testing of internal control would likely result in some level of reduction of the substantive testing efforts). These efforts often resulted in the following benefits:

- A reduction in the substantive testing for the financial statement audit in the current year.
- A foundation to enhance the effectiveness and efficiency of the integrated audit in the following year. For example:
  - A more thorough understanding of the company's ICFR, including the nature of documentation available from the company. As a result, the auditors were better able to coordinate and use management's evaluation process and documentation to realize greater efficiencies in the first year of performing an integrated audit.
  - An established control reliance approach that facilitated efficiencies in the integrated audit in the first year (refer to Lesson Learned #7).
- Non-accelerated filers represent an added opportunity (as compared to the accelerated filers) in that management for non-accelerated filers began complying with Section 404(a) of SOX in connection with annual reports for fiscal years ending on or after December 15, 2007. Therefore, management will evaluate ICFR in the current year, which may provide more of an opportunity for the auditor to begin benefiting from management's evaluation process and documentation while conducting an audit of a non-accelerated filer's financial statements and before an attestation report is required.

**Suggestions:**

- As part of the financial statement audit in years prior to performing an integrated audit, consider opportunities to expand the auditor's consideration and testing of internal control. For example:
  - Begin by understanding management's evaluation process and the underlying documentation.
  - Educate management and the audit committee about the opportunities, considerations, and benefits of the auditor utilizing the work performed by management or by others in support of management's assessment. Discuss with management any suggestions as to how modifications in their evaluation process and documentation might enhance the efficiency of the integrated audits for fiscal years ending on or after December 15, 2009 (refer to Lesson Learned #2). For example, discuss with management the concepts of sample sizes for control testing commonly accepted throughout the auditing profession to maximize the opportunity for the use of management's work.
  - Utilize management's documentation for purposes of gaining an understanding of internal control sufficient to plan the financial statement audit.
  - Consider beginning or expanding the testing of internal controls, where practical, in connection with the audit of the financial statements. In particular consider those areas where

the additional testing of internal control would likely result in some level of reduction of the substantive testing efforts, using management's work, where appropriate.

### ***Lesson Learned #2***

**Early and frequent communication and coordination between management and the external auditors create a more effective and efficient audit process.**

#### **Background:**

- Management and the auditor have worked together for years in terms of streamlining the auditor's information gathering efforts and documentation requirements (e.g., trial balances, schedules, analyses and reconciliations and supporting evidence) in the audit of the financial statements. The integrated audit expands the scope of these coordination efforts to the audit of internal control; i.e. for the auditor to efficiently obtain the information to perform the necessary audit procedures to comply with AS 5. It is important to recognize that the coordination of efforts is not for the purpose of dictating to management how they should perform their evaluation; rather it is for the purpose of informing management as to how management's existing evaluation process either currently supports the auditor's efficiency or how it could be enhanced. Accordingly, it is management's decision as to what enhancements to make to their evaluation approach and documentation.
- Those accelerated filer and pilot engagement teams that interacted early and often with management to help management understand the auditors' objectives were able to maximize the use of management's documentation, which reduced the need for auditors to create their own documentation.
- Management is responsible for determining what is required to support its assessment conclusion about the effectiveness of ICFR, which may be different from what auditors need to have to support their opinion. Accordingly, the extent to which management's work and documentation will meet the auditor's needs will vary. Under AS 5, the auditor does not evaluate the adequacy of management's assessment process; however, the quality of management's documentation can impact the auditor's efficiency.
  - Some companies decided to supplement their expertise and resources by engaging third party advisors to assist them, for example, in implementing an evaluation process, enhancing documentation or performing testing.

- Many accelerated filers frequently review their approach to evaluating ICFR in order to improve the effectiveness and efficiency of their assessment process of ICFR.
- Because each company’s evaluation process and documentation is different, it is important as a starting point for the auditor to identify those aspects of management’s process and documentation that may be used during the audit. For example:
  - In some cases, management’s documentation may require very little, if any, supplementation by the auditor.
  - In other cases, management’s documentation may represent a viable starting point but may not contain all the information the auditor believes is needed to comply with auditing standards. If management opts not to enhance its documentation, it is suggested that auditors consider supplementing management’s documentation as opposed to “defaulting” to prepare their own, separate documentation.
- A lesson learned in both the integrated audits of accelerated filers and the pilot engagements was to make the decision early in the audit process regarding whether or not management’s documentation may be utilized efficiently by the auditor. If management’s documentation would not make the audit process more efficient, then do not expend time and resources (both the auditor’s and management’s) trying to have management enhance their documentation.

**Suggestions:**

- Start by understanding management’s process and documentation in its latest evaluation of internal controls. Begin this phase as early as possible to provide sufficient time to allow for changes in approach by management or the auditor.
  - Auditors are encouraged to provide management with insights, suggestions and considerations based on the auditor’s experience. Such discussions might include how management may conduct its assessment more effectively and efficiently and also may provide management with a better understanding of how the auditor can utilize management’s work in accordance with PCAOB standards. It is entirely management’s decision, however, whether to change its procedures or documentation. The auditor cannot design or test the internal control system for management as part of management’s assessment process.
- For the following aspects of the auditor’s approach, consider the extent that management’s evaluation process and documentation represents a good starting point to support the auditor’s requirements under AS 5:
  - Risk assessment process, including the risk of fraud (refer to Section 4).

- Scoping of locations or business units, identification of the significant accounts/disclosures and relevant assertions, and linking to the underlying processes, application systems and computing environments (refer to Section 4).
- Documentation of the relevant flows of transactions.
- Identification of controls that are important to the auditor’s conclusion about whether the company’s controls sufficiently address the assessed risk of misstatement ( i.e., controls that are important to the audit) and the description and details of the identified relevant control activities, including the identification of entity-level controls<sup>10</sup> (refer to Section 5).
- Nature, timing, and extent of testing and related documentary evidence of operating effectiveness (refer to Section 6).
- Updating interim conclusions to the as-of date (refer to Section 6).
- Accumulating, tracking and evaluating deficiencies.

### ***Lesson Learned #3***

**Coordinate with management regarding the timing of its work to enable the auditor to utilize management’s work to the extent permitted by PCAOB standards.**

#### **Background:**

- In some cases, management performed ICFR testing and completed documentation too late in the year for the auditor to be able to efficiently use management’s documentation and testing.
- Experience with the pilot engagements has shown that in those cases where management was able to complete its evaluation process and documentation sufficiently in advance of the auditor, the

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<sup>10</sup> Refer to footnote 21 on page 10 of the *SEC Guidance Regarding Management’s Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* for a discussion of the term.

engagement teams believed they were more effective and efficient than those engagements where management and the auditor were both performing their procedures concurrently; for example, typically in the fourth quarter or after year-end.

**Suggestions:**

- Discuss with management its timeline for the various phases of management’s evaluation. This will enable the external auditor to plan their procedures to utilize management’s testing and documentation as efficiently as possible. For example, coordination may occur:
    - When management plans to prepare or update (i) its scoping/risk assessment documentation, (ii) any process descriptions that may be helpful to the auditor and (iii) the documentation of the design of ICFR (the relevant risks and description of the control activities that mitigate those risks).
    - When management plans to obtain and evaluate its evidence of the operating effectiveness of the relevant control activities, including the consideration of any ongoing monitoring controls that operate throughout the year. For example, if reconciliation controls in a given area are deemed to be important to ICFR, an effective internal control monitoring process by management (such as a supervisor effectively reviewing the reconciliation and determining whether it was prepared properly) might provide adequate support as to whether the reconciliation controls are operating effectively. If so, management and the auditor might consider testing those monitoring procedures at an interim date and performing any necessary roll-forward procedures.
- Note: Be sure to include in the discussions the consideration of any relevant activities and controls performed by service organizations and the role and timing of any third parties assisting management with its assessment.<sup>11</sup>
- If management holds periodic status meetings with representatives responsible for the company’s evaluation (including the project team leader, internal audit, third party consultants, and IT personnel) the external auditor could request to attend those meetings. Such meetings are an effective means to enhancing coordination, and may include discussing testing plans, status of work, findings to date, planned timing of remediation of deficiencies and planned testing for remediated items. If management does not hold periodic status meetings for the purposes of its evaluation, explore with

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<sup>11</sup> Auditors may wish to stress with management the importance of addressing control weaknesses and user considerations cited in service auditor reports prepared in accordance with Statement on Auditing Standards No. 70, *Service Organizations*, as amended.

management the possibility of having such meetings for the benefit of coordinating management's evaluation process with the work performed for the audit.

- In coordination with management, also regularly update the audit committee on the progress of the audit and any issues identified to date.

#### ***Lesson Learned #4***

**Early in the process identify and assess those risks and controls that may have a pervasive impact on the assessment and effectiveness of ICFR.**

#### **Background:**

- Auditors have found that certain aspects of ICFR can have a pervasive effect on the company's internal control system such that the ineffectiveness of those aspects of the control system can impair the effectiveness of underlying, lower level controls and can result in the need to reassess the auditor's approach to the financial statement audit. One example may be inappropriate segregation of duties (e.g., there is a lack of segregation of duties within the financial closing and reporting function and higher level mitigating controls such as senior management review are not in place or effective), which could render the underlying lower level controls in one or more processes ineffective in preventing or detecting material misstatements of the financial statements.
- Early identification of pervasive deficiencies can eliminate unnecessary testing of the affected lower level controls.
- Auditors have found that certain effective entity-level controls may reduce or eliminate the need to test lower level controls (refer to Section 5).

#### **Suggestions:**

- Coordinate with management early in the process to identify those areas where ineffective controls may have a pervasive impact on other controls. Carefully consider how the existence of such issues may affect the integrated audit plan for the underlying process level controls and for the financial statement audit.
  - Areas to focus on first may include the entity-level components; e.g. the control environment, risk assessment, monitoring and information/communication (including general computer controls) and the financial reporting and closing process.

- Also specifically consider those risks and characteristics that may typically have pervasive effects on effective internal control in smaller companies such as segregation of duties, management override, financial reporting competencies, and effectiveness of the board of directors and audit committee (Refer to the *PCAOB's Staff Guidance on Auditing Internal Control in Smaller Public Companies* and *COSO Internal Control over Financial Reporting – Guidance for Smaller Public Companies* for considerations specific to smaller, less-complex companies).

### ***Lesson Learned #5***

#### **Consider the implications of any unremediated deficiencies.**

#### **Background:**

- The extent to which management has already identified potential control deficiencies, considered their severity and prioritized them, and developed and executed plans to address them can affect the timing and extent of the auditor's procedures. This includes, but is not limited to:
  - Timing – deferral of testing until after the deficiencies have been remediated to avoid the cost of re-testing those areas affected by the deficiencies.
  - Extent – the determination of the extent of testing necessary to conclude that a control is deficient and the implications to the extent of evidence for other controls impacted by the deficiency (See Chapter 8 of the *PCAOB's Staff Guidance on Auditing Internal Control in Smaller Public Companies*) and whether a control reliance approach, which could reduce the scope of substantive testing, continues to be appropriate (refer to the Appendix of AS 5).
- In addition to deficiencies identified by management, the auditor also considers the impact of any unremediated deficiencies identified in connection with the most recent financial statement audit and quarterly reviews, including the implications of any misstatements identified.
- Management and auditors have identified deficiencies as a result of their testing where some of those deficiencies were not significant to the auditor's opinion on the overall effectiveness of ICFR, yet some auditors felt compelled to retest the controls when remediated by management.
- In the pilot engagements, engagement teams first considered their findings from the prior year audit and quarterly reviews in the current year, including any identified deficiencies. For example, in one

instance, deficiencies noted in the prior year's audit relating to general computer controls were discussed with management early in the process in terms of their plans for remediation. The auditor deferred their testing until after the deficiencies were remediated; however, the auditor determined that a control reliance approach for those accounts impacted by deficiency would not be appropriate because of the severity of the deficiencies, the absence of mitigating controls, and since the deficiencies existed during the period of intended reliance.

**Suggestions:**

- Gain an understanding of existing deficiencies and management's plans to remediate such deficiencies 1) to consider the impact of such deficiencies on both the audit of the financial statements and of ICFR and 2) to determine which controls to retest when remediated. For example:
  - If the deficiency is relevant to the auditor's conclusion as to effectiveness of ICFR, identify and test other mitigating controls or test the remediated control.
  - If the deficiency is not relevant to the auditor's conclusion as to effectiveness of ICFR (e.g., the deficiency is not a material weakness and it is remote that the deficiencies could become a material weakness at the as-of date) the auditor may conclude that it is not necessary to test the remediated control.

Regarding the effect on the audit of the financial statements, consider 1) the impact of a deficiency on the auditor's planned control reliance strategy and 2) the appropriateness of performing interim substantive procedures and rolling forward the interim tests and conclusions. In other words, consider whether the deficiency affects the auditor's conclusion about the reliability of controls. (Note: A control deficiency identified during the period of intended reliance may result in a conclusion that a control reliance strategy is not appropriate even if remediated later in the year.) (Refer to paragraph B6 of AS 5)

## **Section 2: Integrate the Audits**

### ***Lesson Learned #6***

#### **Plan the audit of ICFR and the audit of the financial statements as a single integrated audit.**

##### **Background:**

- The risks of material misstatement to the financial statements and the determination of the significant accounts, disclosures and related relevant assertions are the same for the audit of the financial statements and the audit of ICFR (refer to paragraph 31 of AS 5). In addition, AS 5, paragraph 20, requires that an auditor use the same materiality considerations in planning the ICFR audit that the auditor uses in planning the financial statement audit. Auditors have found that planning the audit of the financial statements and the audit of ICFR together helps to achieve the objective of an integrated audit and eliminates redundancy.
  - For example, many of the pilot engagements integrated the planning of the audit which, in their opinion, eliminated redundant efforts and documentation and the possibility of inconsistent judgments between the audit of internal control and the audit of the financial statements as compared to their experiences in the first year for the accelerated filers.
- The integrated audit requires an audit of the financial statements for the period (typically a year) and an audit of ICFR at the as-of date (the latest balance sheet date). Planning the audit of ICFR and the audit of the financial statements as one audit might allow the auditor to offset part of the increased effort to audit the company's ICFR by reducing the amount of the effort related to substantive testing in the audit of financial statements. This may be done, for example, by taking a controls reliance approach where controls are effective, in areas which had previously been tested by a substantive testing only approach (refer to paragraphs B1-B5 of AS 5). If the auditor performs tests of controls throughout the period of reliance, the auditor may be able to impact the nature, timing, and extent of his or her substantive tests for the financial statement audit.
- Auditors may choose not to take a controls reliance strategy (refer to paragraph 8 of AS 5). Chapter 1 of the *PCAOB's Staff Guidance on Auditing Internal Control in Smaller Public Companies* acknowledges that the auditor's decision about relying on controls in the audit of the financial statements may depend on the particular facts and circumstances. Accordingly, the auditor considers whether to test aspects of ICFR only to the extent necessary to support the opinion on the

effectiveness of ICFR at the as-of date or also to support a control reliance approach by testing the effectiveness of internal control throughout the period of reliance. In some areas, the auditor might decide to rely on certain controls to reduce the substantive testing of certain assertions relating to certain accounts and disclosures. For other areas, the auditor might determine that it is more efficient to perform primarily substantive tests of the assertions without relying on controls. This may occur, for example, when the effort to test internal controls over the period of reliance plus the substantive testing (reduced for a controls reliance approach) is more time consuming than testing the internal controls only at the as-of date plus the substantive testing (without a controls reliance approach). It also might occur in higher risk areas where evidence of the effectiveness of internal controls is less objective (e.g., a monitoring control consisting of management's daily interaction, which is often prevalent at smaller companies, or where the results of the auditor's fraud risk assessment indicate the need for additional procedures) and the auditor decides to use primarily substantive tests as a more effective audit approach.

- Auditors generally decide whether to rely on controls for purposes of planning substantive procedures at the significant account and relevant assertion level, considering both potential efficiencies and any ineffectiveness from pervasive entity-level deficiencies or deficiencies in the controls directly affecting the account and assertion. Different control reliance approaches may be used for different assertions relating to the same significant account. For example, a control reliance approach might be utilized to test accounts receivable existence and completeness but not for valuation. (Note: The controls related to valuation therefore would need to be evaluated and tested at the as-of date for purposes of the ICFR audit even if the controls were not relied upon in the audit of the financial statements.)
- In the pilot engagements, the extent of a control reliance approach was mixed depending upon (a) the existence of deficiencies and timing of remediation during the year and (b) the auditor's decisions as to whether a control reliance approach was effective and efficient in terms of performing the substantive testing for the audit of the financial statements.

**Suggestions:**

- Conduct a single risk assessment that serves as the foundation for both the audit of the financial statements and the audit of ICFR (refer to Section 4).
- The identification of significant accounts and relevant assertions are the same for the financial statement audit and the audit of ICFR (e.g., if accounts receivable was considered to be a significant account for the audit of the financial statements, then accounts receivable also would be a significant account for internal control purposes and thus included in the scope of the audit of ICFR). Similarly, the relevant assertions identified related to accounts receivable for the audit of the financial statements would also represent the relevant assertions for ICFR purposes.

- Prepare the planning documentation on an integrated basis.
- Decide where it is effective and efficient to take a controls reliance approach in the audit of financial statements. Planning the testing approach may take place in conjunction with the performance of walkthroughs or similar procedures as discussed in Lesson Learned # 15. For those areas, plan the testing approach to obtain simultaneously sufficient evidence for those controls to (a) support the opinion on the effectiveness of ICFR at the as-of date, and (b) support a control reliance approach for the audit of the financial statements. If the controls are found to be ineffective the auditor will likely need to revise the scope of the substantive testing (refer to paragraph B6 of AS 5).
- Where a controls reliance approach is not used, consider the results of substantive tests (planned and actual) for risk implications for the audit of ICFR (refer to Lesson Learned #9).

### ***Lesson Learned #7***

**Where appropriate, plan to employ a controls reliance approach in the first year of the required Section 404(b) audit of ICFR.**

#### **Background:**

- In early integrated audits, when the performance of the testing by management and/or the auditor occurred late in the year, the auditor was generally reluctant to use a control reliance approach for financial statement audit purposes due to the uncertainty of the effectiveness of controls. If controls are determined to be ineffective, the auditor will likely have to revise or expand the scope of the substantive tests, which is more difficult later in the audit process. As a result, a controls reliance approach to the audit of the financial statements was deferred until year two in some cases. (Note: For non-accelerated filers, this reluctance may be mitigated, in part, where management has evaluated the effectiveness of ICFR for two years prior to the auditor testing ICFR for the first time.)

#### **Suggestions:**

- Plan to assess the effectiveness of those controls that affect an auditor's control reliance approach early in the process and preferably prior to or in conjunction with performing the interim substantive testing. Coordination with management when using the work of others and testing earlier in the year are both important considerations for an effective and efficient implementation of this approach.

### ***Lesson Learned #8***

**Consider what audit procedures could meet the objectives of both substantive testing and internal control testing. Where practical, perform the internal control tests in conjunction with the substantive tests in those areas.**

#### **Background:**

- AU 319.108 discusses the dual purpose or concurrent testing approach. In some situations, a single test may achieve the objectives of both the financial statement audit and the audit of ICFR. Caution is advised to carefully consider whether a single test does in fact result in persuasive, relevant evidence for both the financial statement audit and ICFR audit. To date, practitioners have identified limited opportunities where a single test is able to achieve both purposes. In other cases, the separate auditing procedures performed in relation to a test of internal control and in relation to a substantive test may be performed at the same time.
- Auditors of both accelerated filers and the pilot engagements are increasing their use of dual purpose/concurrent testing approaches, where appropriate, which, in their opinion, results in increased effectiveness and efficiency.

#### **Suggestions:**

- Identify those areas that lend themselves to dual purpose/concurrent testing, examples of which may include:
  - Management estimates – many of the auditing procedures performed in accordance with AU 342, *Auditing Accounting Estimates*, also may provide direct evidence of the operating effectiveness of a control or may be performed concurrently with the tests of operating effectiveness for the relevant controls related to the preparation and review of the estimate.
    - For example, when testing a management estimate such as impairment of long-lived assets, AU 342.11b states the auditor may consider performing auditing procedures such as:

*“Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable,*

*and sufficient for the purpose based on information gathered in other audit tests.”*

In conjunction with performing and documenting such substantive procedures, the auditor could obtain and document in the same workpaper, the evidence of the effectiveness of the controls related to the sources of such data and factors.

- Disclosures – similar to management estimates, the evidence obtained when auditing footnote disclosures may provide evidence for both substantive and internal control purposes.
  - For example, when testing the accuracy and completeness of the fixed asset footnote disclosure, the auditor also could test the controls related to the preparation and review of the disclosure.
- Account reconciliations – a test of an account reconciliation may be performed in a manner that provides evidence for both substantive and internal control purposes.
  - For example, an auditor may substantively test an account reconciliation and simultaneously obtain evidence of its effectiveness as a control by examination of the documentation thereby re-performing a portion of the reconciliation. Alternatively, an auditor may substantively test a reconciliation and concurrently test the monitoring control related to the reconciliation, such as the supervisor’s review of the preparation of the reconciliation.
- Sampling – areas in which the auditor can utilize a single sample for both internal control and substantive testing purposes.
  - For example, a sample of fixed asset additions may be selected to vouch to the supporting invoice (substantive test) and to inspect evidence of the operation of the review and approval prior to payment (test of internal control). This is generally more efficient than performing two separate tests with two different samples. (Refer to AU 350.44 for further discussion regarding dual purpose samples.)
- Substantive analytical procedures – the performance of substantive analytical procedures also may provide the basis for the auditor’s re-performance test of direct entity-level controls.
  - For example, management may perform financial analytics that are designed to be sufficiently direct and precise to determine that payroll expense is not materially misstated. The auditors in connection with their quarterly review or annual audit may perform their own analytical procedure and identify unusual

fluctuations for payroll which also may represent a re-performance test of management's control procedure. Management's ability to readily provide appropriately precise responses to the auditor's questions may be evidence of the effectiveness of management's own monitoring procedures.

- Roll-forward procedures – when tests of internal control and substantive tests are performed at an interim date, design the roll-forward procedures to obtain evidence for both substantive and internal control purposes to the extent possible.
  - For example, when rolling forward the accounts receivable balance tested at an interim date, one procedure the auditor may perform is to review the latest reconciliation of the sub-ledger to the general ledger, which also may provide evidence of the continued operation of the control related to the timely preparation and review of the account reconciliation.

### ***Lesson Learned #9***

**Substantive tests, the risk assessment process, as well as knowledge obtained from prior audits or reviews of interim financial information inform the auditor with respect to the risks related to internal control (which can affect the nature, timing and extent of tests of controls) and the auditor's conclusions related to the effectiveness of internal control.**

#### **Background:**

- The auditor plans the approach to audit ICFR considering many factors, including preliminary judgments about materiality, risks, and the effectiveness of ICFR (refer to paragraph 9 of AS 5). Substantive tests, the risk assessment process, as well as knowledge obtained from prior audits or reviews of interim financial information may inform these preliminary judgments.
  - The auditor may take into account these preliminary judgments along with the factors discussed in paragraphs 46-49 of AS 5 in considering the risk associated with the related controls. These factors are considered in determining the nature, timing, and extent of the testing necessary to conclude on the effectiveness of the controls (refer to Chapter 1 of the *PCAOB's Staff Guidance on Auditing Internal Control in Smaller Public Companies and Appendix*).

- The actual results of substantive procedures are evaluated in terms of their implication on the effectiveness of internal control (refer to paragraphs B8 and B9 of AS 5).
  - While the actual results of substantive tests of accounts and disclosures do not provide sufficient evidence for the auditor to conclude on the operating effectiveness of controls, such results, either favorable or unfavorable, are considered in the auditor’s risk assessments associated with internal control.
  - Auditors have found that if the actual results of substantive procedures indicate a misstatement in an assertion, an evaluation of the nature, cause, and significance of the misstatement generally results in the identification of a deficiency in the related controls.
- In some circumstances, the auditor might decide it is more efficient and effective to perform both the substantive testing and internal control testing at year-end (i.e., not take a control reliance approach).
  - For example, the auditor might gain an understanding of the design of controls through inquiries, observations, and inspection of relevant documents made in conjunction with planning the audit of the financial statements, and might obtain sufficient evidence that these controls are operating effectively through concurrent or dual purpose tests. Results of substantive testing that indicate that there are no errors in the financial statements may reaffirm the auditors’ preliminary risk assessments. On the other hand, misstatements identified by substantive testing that the auditor determines are related to the failure or absence of controls would be indicative of a deficiency in ICFR, and the severity of the deficiency would need to be evaluated.

**Suggestions:**

- Design the integrated approach to include consideration of preliminary judgments about materiality, risks, and the effectiveness of ICFR. Substantive tests, the risk assessment process, as well as knowledge obtained from prior audits and reviews of interim financial information may inform these preliminary judgments.

### ***Lesson Learned #10***

**Coordinate the planning and performance of the internal control tests and substantive tests among the persons performing the work.**

#### **Background:**

- In larger audits and in some of the pilot audits of smaller companies, some teams involved auditors with specialized skills in IT, tax, internal control or other areas of expertise. Further, some audit teams specified certain members to work only on the financial statement audit and others to work on the ICFR audit.
- When two separate teams are created - one to perform the audit of internal control and one to perform the audit of the financial statements - duplicative efforts may occur and the results may not be properly integrated and considered.

#### **Suggestions:**

- Where appropriate, have the same person(s) test the controls and perform the substantive work in a particular area in order to:
  - Enhance the effectiveness and efficiency of the planning and performance of the substantive procedures based on the knowledge gained in testing internal control.
  - Facilitate the planning of tests to achieve the objectives of both the audit of internal control and the financial statement audit.
  - Promote the integrated consideration of the results and related effects on both the audit of internal control and the audit of the financial statements.
- If the work is split among team members (e.g., to incorporate different skill sets or for work allocation purposes), the staff who are performing the internal control tests and the staff who are performing the substantive tests, at a minimum, should strive to (1) plan the approach and (2) evaluate the results together to achieve an integrated result.

## **Section 3: Establish the Right Team**

### ***Lesson Learned #11***

**Because of the additional complexities in planning and executing an integrated audit, it is important to have experienced members of the engagement team, including specialists, involved at an early stage and for such members to remain close to the engagement as it progresses.**

#### **Background:**

- When a financial statement audit is extended into an integrated audit, audit teams face additional significant judgments both in the first year and on an ongoing basis. These include judgments related to the level of planned reliance on controls, the extent of the use of the work of management or others, the consideration and design of tests to achieve the objectives of both audit opinions, and the impact on the integrated audit of any findings.
- Timely involvement by the partner and manager in the planning phase of the pilot engagements, where many of those judgments are made, helped to mitigate the risk that less experienced staff may be ineffective or inefficient in a particular area.

#### **Suggestions:**

- In the first year of an audit of internal control, plan for more audit partner, manager and specialist time to establish these judgments.
- Perform timely review and supervision of each phase of the audit. This is particularly important because the findings of each aspect of the audit (financial statements and ICFR) impact the other.
- Involve the partner and any specialists such as IT, tax or valuation early in the process and determine which areas require more involvement by the partner, manager and/or specialists in the evaluation of design and operating effectiveness. These might include the more subjective areas such as entity-level controls and period end financial reporting process.

### ***Lesson Learned #12***

**Due to the learning curve associated with implementing the ICFR audit requirement, involve auditors with previous experience auditing internal control or auditors who have been trained specifically on performing integrated audits.**

#### **Background:**

- First-year efforts for auditors implementing the ICFR audit requirements generally include, among other things, understanding the ICFR audit requirements and related standards, rules, and guidance; organizing resources; planning the new audit procedures; and developing the appropriate audit documentation.
- While auditors have knowledge and experience with understanding internal control in connection with performing financial statement audits; the audit approach for smaller companies has more frequently been based on a primarily substantive approach as compared to larger companies. Accordingly the depth of understanding and skills of the auditors related to performing an audit of internal control may need to be enhanced.

#### **Suggestions:**

- Where possible, involve auditors with prior experience auditing internal control.
- Provide team members involved in the audit of internal control appropriate training in auditing internal control, including COSO and the specific requirements of AS 5.
- Embrace on-the-job training related to the audit of ICFR, particularly in the first year. A good understanding of the audit objectives to be achieved, the procedures to be performed and the documentation requirements enhance the effectiveness and efficiency of the audit.
- Implement a continuous improvement culture by holding a brainstorming session among the team members while memories are fresh to identify ideas for improvements in the approach. Use information gathered in these sessions for designing training for the upcoming year.

## **Section 4: Identify Material Risks to Reliable Financial Reporting**

### ***Lesson Learned #13***

**Apply the top-down, risk-based approach set forth in AS 5 by starting at the financial statement level to effectively and efficiently identify significant accounts and disclosures, and their relevant assertions.**

#### **Background:**

- AS 5 directs the auditor to apply a top-down, risk-based approach to identify the significant accounts and relevant assertions. Risk assessments beginning at the financial statement level, and then going down to the significant account and assertions level, allow the auditor to focus first on areas that present a reasonable possibility of material misstatement to the financial statements and related disclosures and, therefore, what should be “in-scope” for purposes of the integrated audit.
- Risks to be identified and included “in-scope” for the integrated audit – often in the form of “what could go wrong” – are those risks that present a reasonable possibility that a material misstatement could occur in the financial statements. Risks may exist where the likelihood of occurrence is not reasonably possible. Risks may also exist where the likelihood of occurrence is reasonably possible, but the resulting potential misstatement could not be material individually or in the aggregate. These risks, and evaluation of the related controls, are not required to be “in-scope” for the integrated audit.
- Companies and auditors that started their assessment at the process level, general ledger account balance level, or detailed control level often included more accounts and controls “in-scope” than were necessary to comply with Section 404 requirements.

#### **Suggestions:**

- Apply a top-down, risk-based approach by beginning the risk assessment at the financial statement level, and then going down to the significant account and assertions level. Do not begin risk assessments at the process, general ledger account balance, location, or control level. As part of this process, consider how potential misstatements could aggregate to result in a material misstatement of the financial statements, including how such risks will be addressed in a multi-location environment.
- When assessing risks at the financial statement level, consider disaggregating financial statement line items if the material component parts of those items do not have common risks and controls and consider aggregating those when material components have common risks and controls.

- As an example, assume the auditor has concluded the following based upon gaining an understanding of a smaller public company’s individual facts and circumstances:
  - The company sells specialty consumer goods and derives its revenues from multiple sources, including customized contractual sales to resellers with higher volume purchases, standardized contractual sales to resellers with lower volume purchases, direct-to-consumer orders taken over the internet, and direct-to-consumer orders taken at the company’s nine regional storefront locations.
  - When considering these different revenue sources on a disaggregated basis, based upon the client’s individual facts and circumstances, the auditor has concluded that risks and controls related to revenues derived from standardized contractual sales to resellers with lower volume purchases and direct-to-consumer orders taken at the company’s nine storefront locations are the same while risks and controls related to revenues derived from customized contractual sales to resellers with higher volume purchases and direct-to-consumer orders taken over the internet are not the same. This conclusion is consistent with the conclusion of management.
- In the above example, the effectiveness and efficiency of the auditor’s risk assessment may be significantly enhanced by disaggregating the financial statement line item “revenues” into the material component parts “revenues from customized contractual sales,” “revenues from standardized and storefront sales,” and “internet revenues” and separately considering the risks of material misstatement, and the controls that address such risks, related to each of these separate components.
- Consider “rating” identified risks that are determined to be “in-scope” on a continuum, such as lower risk to higher risk to better enable a risk-based approach (e.g., for purposes of identifying controls and varying the nature, timing, and extent of testing procedures).

### ***Lesson Learned #14***

**The more refined the risk assessment is, the more the audit approach can be tailored based on the assessed risks.**

#### **Background:**

- Risk assessments that are too broad or high-level may result in the performance of more testing procedures than necessary. For example, if revenue is identified as high risk, that may lead unnecessarily to treating all assertions or components of revenue as high risk.
- On the other hand, unnecessarily detailed risk assessments have resulted in a “bottoms-up” approach and scoping in of risks that are not relevant for purposes of expressing an opinion on ICFR overall. For example, it is not necessary to identify everything that could go wrong in revenue, only the “what could go wrongs” where there is a reasonable possibility of a material misstatement to the financial statements.

#### **Suggestions:**

- Carefully design the risk assessment process at the outset to identify the relevant risks. The most effective and efficient approaches design risk assessment strategies to best facilitate tailoring the nature, timing, and extent of testing procedures to the assessed level of risk. Consider “what could go wrong” questions at least at the relevant assertion level for each significant account and, where effective and efficient, at the next level down such as for detailed control objectives supporting the relevant assertions.

### ***Lesson Learned #15***

**Different combinations of procedures, including walkthroughs, can be performed to achieve the required objectives discussed in AS 5 paragraph 34 in an effective and efficient manner.**

#### **Background:**

- Paragraph 34 of AS 5 states that, to further understand the likely sources of potential misstatements and as part of selecting controls to test, the auditor should achieve certain prescribed objectives.<sup>12</sup>
- AS 5 does not mandate that walkthroughs be performed; however, paragraph 37 of AS 5 states that performing walkthroughs frequently will be the most effective way of achieving the objectives set forth in paragraph 34. Accordingly, auditors need to make judgments about what procedures to perform to achieve the paragraph 34 objectives.
- A walkthrough often involves some combination of the following:
  - Following a transaction, or combination of transactions, from origination through the company's processes, including information systems, until it is reflected in the company's financial records, using the same documents and information technology that company personnel use.

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<sup>12</sup> Paragraph 34 of AS 5 states: "To further understand the likely sources of potential misstatements, and as a part of selecting the controls to test, the auditor should achieve the following objectives –

- Understand the flow of transactions related to the relevant assertions, including how these transactions are initiated, authorized, processed, and recorded;
- Verify that the auditor has identified the points within the company's processes at which a misstatement – including a misstatement due to fraud – could arise that, individually or in combination with other misstatements, would be material;
- Identify the controls that management has implemented to address these potential misstatements; and
- Identify the controls that management has implemented over the prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could result in a material misstatement of the financial statements."

- Performing inquiry, observation, and inspection of relevant documentation to understand the controls identified by management that are relevant to the auditor reaching a conclusion on the effectiveness of the design of controls.
- Obtaining evidence that controls have been placed into operation.
- At the points at which important processing procedures occur, the auditor questions company personnel about their understanding of what is required by the company's prescribed procedures and controls.

**Suggestions:**

- Efficient and effective practices with respect to achieving the objectives discussed in AS 5 paragraph 34, including the performance of walkthroughs, continue to emerge. Rather than defaulting to a walkthrough of each process, tailor procedures to achieve the objectives of AS 5. For example:
  - Consider whether certain activities performed during the audit process – such as planning discussions, risk and control scoping meetings, or quarterly review and substantive audit procedures – can help achieve the objective of confirming auditor understanding of the flows of transactions, material risks, and relevant controls.
  - If controls were effective in the prior year and risk assessments indicate that no significant changes in internal control have occurred in the current year, consider whether the objective of confirming that identified controls are designed effectively and have been placed into operation can be achieved simultaneously with planned testing of control operating effectiveness.
  - Develop and ask probing questions of those in the process about the risks in the process and of those performing the controls and others in the organization to enhance understanding of the process and the control activities. Identify important points at which a control is necessary to prevent or detect a material misstatement of the financial statements and instances where such controls are missing or not designed effectively. Also, ask questions that go beyond the narrow focus of a single transaction to gain an understanding of the different types of transactions handled by the process.
- Consider the experience level of individuals assigned to perform walkthroughs or related procedures. Identifying the points within a company's process at which a misstatement could occur and the controls that management has in place to address potential misstatements may require the judgment of a more experienced auditor, particularly when the transactions being processed are more complex.
- Consider all relevant assertions when understanding the likely sources of misstatement. Some assertions, such as valuation or presentation and disclosure, may be evaluated in a different business

process (e.g., the financial statement close process) and can be inadvertently omitted. Other risks to be considered include those related to system interfaces, computer generated information and reports, and the use of end user applications such as spreadsheets.

### ***Lesson Learned #16***

**The significance, extent, and complexity of IT applications, and their supporting general IT control environment, influence the identification of material risks to reliable financial reporting.**

#### **Background:**

- Smaller public companies may have a less-complex IT environment, which can affect the scoping of IT risks and related controls.
- Risk assessments that are specific to IT, and disconnected from other risk assessments performed as part of the integrated audit, may decrease the effectiveness and efficiency of the integrated audit. IT-specific risk assessments also may result in the inclusion of risks that do not present a reasonable possibility of a material misstatement of the financial statements occurring.
- General IT controls support the environment in which automated controls, including the automated aspects of manual controls, operate. When the auditor selects an automated control for testing, he or she should evaluate that control and the IT general controls that are important to the effective operation of the automated control.
- For various reasons, such as a lack of sufficient personnel to appropriately segregate duties, some smaller public companies may have ineffective general IT controls. When general IT controls that are important to internal control over financial reporting are ineffective, the auditor considers the significance of general IT control deficiencies when evaluating the effectiveness of related automated or IT-dependent manual controls.
- Effective general IT controls are not necessarily a prerequisite for having effective automated or IT-dependent manual controls. Although not a common occurrence, in some situations an automated control or IT-dependent manual control may be effective even if deficiencies exist in general IT controls. (Refer to PCAOB Guidance on AS 5, Chapter 5).

**Suggestions:**

- Consider IT-related risks as part of the overall risk assessment such that the consideration of IT-related risks is linked to identified risks related to significant accounts and relevant assertions, and reflect the company's size and complexity.
- Efficiencies can be achieved through altering the nature, timing, and extent of testing procedures performed related to automated and IT-dependent controls if general IT controls are designed and operating effectively.
- When general IT controls are determined to be ineffective, consider whether related automated controls (or the automated aspects of IT-dependent manual controls) can be tested directly taking into account the higher risk that may be associated with such automated controls and IT-dependent manual controls given the ineffective general IT controls. For IT-dependent manual controls, this would include testing the completeness and accuracy of the information generated by the IT application. For example:
  - At a smaller company with only a few accounting and IT personnel, management might rely primarily on effective manual monitoring controls performed by the CEO and other executives to address risks related to a lack of segregation of duties. In the absence of proper segregation of duties, the auditor may decide general IT controls over system access are ineffective. However, given the effective manual monitoring controls, the auditor may decide to evaluate directly the design and operating effectiveness of application controls, such as a system-generated receivable aging report, taking into account the higher risk that may be associated with ineffective general IT controls over system access.

## **Section 5: Identify Controls Necessary to Sufficiently Address Identified Risks**

### ***Lesson Learned #17***

**Apply a top-down approach, beginning with the identification of entity-level controls, to identify the controls that are necessary to sufficiently address the assessed risk of misstatement to each relevant assertion (i.e., controls that are important to the audit).**

#### **Background:**

- A company’s internal control over financial reporting will include a number of controls, some of which relate to risks that are not material to reliable financial reporting and, therefore, have not been included in the scope of an integrated audit. Only controls that are important to the audit need to be included in the scope of an integrated audit.
- Identifying controls from the “bottom-up” – starting with a listing of controls, or starting with all controls in a particular process or at a particular location – can lead to selection of controls that are not necessary to sufficiently address identified risks.
- The nature and number of controls that are important to the audit will vary based upon a number of factors including the assessed level of risk and the effectiveness of the design of individual controls. The nature of controls often are characterized as entity-level vs. transaction-level, preventive vs. detective, and automated vs. manual. Various combinations of these types of controls, provided that they work together to sufficiently address identified risks, are acceptable.
- Most companies maintain a balance of preventive and detective controls.
  - The absence of effective preventive controls increases the risk that misstatements will occur during the normal flow of processing transactions. The absence of effective preventive controls also may indicate that underlying data used in detective controls may not be complete or accurate.
  - The absence of effective detective controls increases the risk that misstatements that have occurred during the normal flow of processing transactions will not be detected on a timely basis.

**Suggestions:**

- Identify controls that are important to the audit using a top-down approach:
  - Consider direct entity-level controls that are precise enough to detect and correct misstatements, many of which may exist in the company's financial statement close process. Manual detective controls, particularly monitoring controls in smaller public companies, are often pervasive to a number of identified risks and thus often will be part of the most effective and efficient combination of controls in an integrated audit. (Refer to entity-level controls in the PCAOB Guidance on AS 5 and the COSO Monitoring Guidance).
  - Consider other entity-level controls that, while not precise enough to detect material misstatements, may reduce the risk of misstatement when working in tandem with other controls. The presence of these controls may allow the auditor to reduce or change, but not eliminate, the nature, timing, and extent of testing of other controls.
  - Consider automated controls. Automated controls are generally more efficient to test and more inherently reliable.
  - Finally, consider manual transaction-level controls. Test these controls only to the extent that identified risks have not already been addressed by the above types of controls.
- Often the most effective and efficient combination of controls to address identified risks sufficiently will include both preventive and detective controls. However, in smaller public companies, manual detective controls also often will be pervasive to multiple identified risks and, by themselves, may sufficiently address certain identified risks.

## **Section 6: Take a Risk-Based Approach to Testing Identified Controls**

### ***Lesson Learned #18***

#### **Maximize the opportunities for using the work of others.**

##### **Background:**

- Management is generally interested in the auditor using the work of others as part of the integrated audit to increase efficiency, although it is not required.
- When appropriate, the auditor may use the work performed by others that provides evidence about the effectiveness of ICFR. These “others” may include internal auditors, company personnel (in addition to internal auditors), and/or third parties working under the direction of management.
- Whether, and the extent to which, the work of others can be used to reduce the auditor’s work is dependent upon the auditor’s assessment of the competence and objectivity of the persons who performed the work. AS 5 precludes the auditor from using the work of persons who have a low degree of either competence or objectivity.<sup>13</sup>
- The objectivity and competence of persons whose work the auditor intends to use exists along a continuum. The higher the degree of competence and objectivity, the greater the use the auditor may make of the work, and vice-versa.
- When using the work of others, auditors should keep in mind the responsibility to gather sufficient competent evidence to support the audit opinion.
- Early and active discussions with management to understand the scope of their assessment, as well as understanding which members of management will gather evidence and how they will gather it, is integral to the auditor’s success in identifying opportunities to use the work of others. Auditors that have held planning sessions early in the integrated audit with management, including sessions with

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<sup>13</sup> See AS 5, the second Note to paragraph 18, which states: “The auditors should not use the work of persons who have a low degree of objectivity, regardless of their level of competence. Likewise, the auditor should not use the work of persons who have a low level of competence regardless of their degree of objectivity. Personnel whose core function is to serve as a testing or compliance authority at the company, such as internal auditors, normally are expected to have greater competence and objectivity in performing the type of work that will be useful to the auditor.”

other persons who may be performing testing on management's behalf, were often more successful in planning for, and using, the work of others.

**Suggestions:**

- Plan to use the work of others considering the risk associated with controls and the assessed level of competency and objectivity of those performing the work.
  - Levels of competence and objectivity generally exist on a continuum. While internal auditors and third parties are generally more objective, auditors may also consider the potential opportunity to use control testing performed by company personnel in the audit of ICFR and for purposes of assessing control risk in the audit of financial statements.
  - As a practical matter, there may be more opportunity to use the work of others to a significant extent where management uses company personnel whose core function is within a testing or compliance authority.
  - The risk associated with the control being tested may determine whether and the extent to which the auditor may use the work of others. As the risk associated with a control increases, the need for the auditor to perform his or her own work on the control also increases. However, the risk associated with a control also exists along a continuum and this should not be interpreted as permitting the auditor to use the work of others related only to controls having a low risk or to preclude the use of the work of others related to controls having a high risk.
- Discuss with management the following regarding their evaluation process:
  - Nature of testing to be performed;
  - Period of time to cover (e.g., this may be particularly relevant if the auditor plans to use a control reliance strategy for the audit of the financial statements as opposed to testing controls only for the audit of internal control);
  - Timing of when testing procedures will be executed, including a discussion of whether, and to what extent, roll-forward testing is planned if controls are tested as of an interim date;
  - Extent of testing to be performed and the level of evidence to be obtained, including whether testing by re-performance is necessary and, if so, what sampling methods and sample sizes will be used (very generally, sample sizes typically would be larger when testing controls that operate daily than when testing controls that operate monthly or quarterly); and
  - Form and content of documentation.

The auditor may also want to discuss with management the nature, timing, and extent of evidence to be gathered by the auditor to evaluate the quality and effectiveness of others' work.

### ***Lesson Learned #19***

#### **Vary the nature, timing, and extent of testing of identified controls based upon the risk associated with a control.**

##### **Background:**

- For each control selected for testing, the evidence necessary to persuade the auditor the control is effective depends upon the risk associated with the control. The “risk associated with a control” is the risk that the control might not be effective and, if not effective, the risk that a material weakness would result. While the auditor is not required to formally document risk associated with each control, the auditor considers this risk when determining the nature, timing, and extent of testing necessary to conclude the control is operating effectively.
- Factors to be considered related to the risk associated with a control are included in paragraph 47 of AS 5.

##### **Suggestions:**

- Vary the nature, timing, and extent of tests of operating effectiveness depending upon the risk associated with a control. This would apply to tests of controls independently performed by the auditor and tests performed by the auditor to evaluate the quality and effectiveness of the work of others.
  - While not required, “risk rating” controls – considering how controls might relate to each other on a risk continuum such as “higher or lower”, or “high-medium-low” – can help the auditor prioritize his or her audit effort and therefore be an effective and efficient activity within an integrated audit. Depending upon the number and nature of identified controls, auditors should weigh the cost of the incremental effort to assess the risk associated with each control against the effectiveness and efficiency benefits. For example, if the control operates only at year-end, the risk assessment is unlikely to significantly impact the timing or extent of testing.
  - Even though the auditor identifies only those controls that are necessary to sufficiently address identified material risks to reliable financial reporting, controls determined to be

“in-scope” for the integrated audit still exist on a risk continuum. Comparatively, the risk associated with some controls is higher or lower than others. Accordingly, controls that are “in-scope” are not automatically all at the highest possible level of risk.

- Make use of previously acquired knowledge where applicable and appropriate (i.e., every control does not need to be tested to the same extent each year).
- Not all controls need to be tested using statistical sampling methods. This also applies to controls that operate in the same manner across multiple locations. Different combinations of inquiry plus observation, inspection, and/or re-performance may be sufficient, particularly when the risk associated with a control is lower.
- Considerable flexibility exists in varying the timing of control testing. However, controls with a higher risk profile are often tested at or near a company’s fiscal year-end, or tested at an interim date with a greater level of roll-forward testing to ensure they were operating effectively at the “as of” date.
- Where applicable, apply a benchmarking strategy to testing automated controls (refer to AS 5, Appendix B).

### ***Lesson Learned #20***

**Testing controls at an interim date may improve the effectiveness and efficiency of the integrated audit by spreading the auditor’s effort out over the fiscal year and increasing the opportunity to identify control deficiencies at an earlier date.**

#### **Background:**

- Significant flexibility exists with respect to the timing of control testing. Auditors may benefit by performing tests of controls at interim dates, particularly when using a control reliance strategy for the financial statement audit.
- When the auditor reports on the effectiveness of controls as of a specified date and obtains evidence about the operating effectiveness of controls at an interim date, the auditor determines what additional evidence concerning the operation of controls for the remaining period is necessary.
- Risk factors that may influence the auditor’s decision as to whether, and to what extent, to perform roll-forward or update tests of controls are identified in paragraph 56 of AS 5.

**Suggestions:**

- Consider planning and performing tests of operating effectiveness of controls at interim dates for purposes of both the ICFR and financial statement audits. This can increase confidence in planned control reliance for the audit of the financial statements and provide the company the opportunity to remediate any deficiencies in ICFR prior to year-end. However, consider also that the more frequent the number of visits the auditor makes to a company to perform control testing, the less efficient and more disruptive the audit may become.
- If testing controls at an interim date, consider performing substantive testing at the same interim dates.
- Consider concurrent opportunities to extend or leverage any substantive testing procedures performed as part of, or at the same time as, timely quarterly review procedures. The procedures performed may provide evidence as to ineffective controls, or may serve to inform the auditor that controls are designed effectively and have been placed into operation. Consider extending procedures to include those that also provide evidence of the operating effectiveness of identified controls.
- In some circumstances, such as when the auditor concludes there is a low risk that the controls are no longer effective during the roll-forward period, inquiry alone might be sufficient as a roll-forward procedure.

***Lesson Learned #21***

**When a control's design is determined to be ineffective, it is not necessary to test the operating effectiveness of the control. Similarly, once the auditor has sufficient evidence to conclude an effectively designed control did not operate effectively, the auditor may cease testing that control.**

**Background:**

- Generally, a conclusion that a control is not operating effectively can be supported by less evidence than is necessary to support a conclusion that a control is operating effectively. (Refer to PCAOB Guidance on AS 5, Chapter 8 for additional discussion).
  - Auditors may obtain evidence about the ineffective operation of certain controls through their substantive audit procedures, for example when certain audit adjustments indicate that underlying controls were ineffective. When evidence is obtained that indicates a

control has failed, no further testing of such control may be necessary. However, auditors cannot determine controls are effective solely by the absence of errors in substantive audit procedures.

- A control cannot be effective unless it is both designed and operating effectively.
  - However, if deficiencies related to that control have been remediated, a control that was ineffective during a fiscal year can still be designed and operating effectively as of fiscal year-end.

**Suggestions:**

- Once sufficient evidence is obtained to reach a conclusion about a control's ineffective design or operation, cease any further planned testing of that control.
- Understand management's plan for remediation when control deficiencies are identified and the effect of the deficiencies on the integrated audit, including the assessment of control risk and the nature, timing, and extent of substantive procedures. Depending upon the severity of the deficiency, the timing of management's plan for remediation, and the effect on the integrated audit, management or the auditor may (or may not) decide to test the remediated controls.