



Audits of Internal Control Over Financial Reporting (ICFR)

Highlights From CAQ Symposium Breakout Discussions

**Atlanta, Georgia
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At the CAQ Symposium, attendees were assigned to smaller groups to discuss different sets of issues that had been covered in the earlier panel discussion. The topics addressed in the breakout groups included the following: Planning for Audits of ICFR; Evaluation of Controls; Control Testing; and Accounting Curriculum and Training. Each breakout group, comprised of research academics and senior practice leaders, was assigned a set of questions dealing with one of the breakout topics.

Below is a brief summary of the highlights from each of the four breakout group topics. The statements expressed by the attendees during these discussions do not necessarily reflect the views of the CAQ or of its member firms.

I. Planning an Audit of ICFR

Audit planning begins with risk assessment. The challenge with an audit of ICFR is that while some of the overall processes may be the same, the rigor of substantive testing conducted during an ICFR audit is often greater than that of a financial statement audit. Quantifying the degree of risk in control testing is often more complex because it is not usually tied to a quantifiable account balance. PCAOB's concern is whether an audit plan is able to detect material weakness in the design and implementation of an internal control. To determine whether a control is designed correctly, the auditor has to ask what could go wrong: Will an issue with the control impact the financial statement? If so, the auditor not only has to determine what could go wrong, but also how wrong it could be, and how material the resulting error would be.

Company size and complexity play a key role in planning an audit of ICFR. Among the variables that auditors consider are geographic locations (and local cultures), level of centralization of operating controls, level of integration of systems and controls, to name a few. Less centralization and integration exponentially increases the need for testing of controls. Does the company aspire to have "one culture" or do different divisions/countries/locations abide by a different code? These factors will also impact testing around the effectiveness of operating controls.

Another important factor that auditors consider is how management integrity impacts ICFR risk. In large organizations, mid-level accounting staff may provide insights into potential unethical behavior by upper

management. Auditors also consider how management addresses ethical breaches as well as how the company addresses the risk of management override.

Understanding how the controls are designed is integral to understanding the business as a whole.

Familiarity with the company's information systems (IS) is also important. Most controls are system-driven. Thus, the firms' IS assurance specialists play an increasingly important role in auditing ICFR. There may be knowledge asymmetry between the financial statement auditors and the IS assurance specialists.

II. Control Testing

In their discussions about control testing, the breakout groups focused primarily on entity-level controls and controls that address non-recurring transactions.

The unique and qualitative nature of entity-level controls presents challenges with respect to control testing. There is more judgment involved in testing entity-level controls, which makes it difficult to develop practice aids or audit firm guidance, as each engagement is different. Entity-level control testing requires input from more experienced team members (e.g., managers and partners). The practitioners indicated that testing has become more rigorous. Whereas in the past, auditors had to rely on checklists and read through meeting minutes for certain controls, in many cases today they are actually invited to relevant meetings when management is implementing a control process (in particular the management review controls).

To test controls that address things like management integrity or tone at the top, observation may be one of the more effective tools. Practitioners noted that observing how management responds to issues, such as proposed adjustments, or potential significant deficiencies or material weaknesses in other controls, can provide insights into motivations. Another example provided by a practitioner was a company's hiring and retention practices – do they have policies and procedures in place? Are they followed? Are they thorough when screening applicants for company leadership positions?

The practitioners noted that it is hard to test the operating effectiveness of particularly troublesome nonrecurring transactions/infrequent processes. All one can do is assess the design via a walkthrough and see if the process has been implemented. However, one practitioner noted that it is not unusual for a company not to have a documented control for a one-off transaction (not having a process in place is an entity-level control issue). Another issue discussed was the competency of the staff in being able to properly book an unusual transaction – although sometimes management would confer with the auditor prior to booking the transaction.

Tension between management and the auditor can arise when transactions are thought to be too immaterial to require a control around the process, but are important to certification requirements, specifically the 302 certification.

III. Evaluating Controls

An effective control should be able to predict what could go wrong. Several practitioners noted that when there is an issue with a control, it usually stems from the fact that the control was not designed well. The control does not accomplish the goal that the client thought it would, or the control was designed to cover an event or process that has evolved, but the control has not been updated to reflect the change.

Practitioners also indicated that when an issue is found with the design of a control, more often than not management won't have a compensating control in place because they didn't realize there was a need. Auditors also have to evaluate whether the control environment addresses the risks identified – one needs to ask: What can go wrong? How would this control address that risk?

Evaluating operating effectiveness is more concrete – controls are either followed or they are not. When you find a deficient control, the auditor needs to ask: What else was going on? Did they not do what they should have done? Is there crossover to other controls? How big is the account in question? Are there compensating controls in place?

The use of technology can make it increasingly more challenging to prove that controls are being followed. For example, there are controls that require a signature, and if the signature is electronic, it is not enough to verify the existence of the electronic signature, but also to verify its authenticity. Review controls also pose certain challenges insofar as the auditor is not always present in the meetings where the controls are implemented. The situation is exacerbated if management does not do a good job of documenting the review. Auditors want to see documentation of what the review consisted of, what the document was compared to, and what the review entailed. It is no longer good enough for the company to say that person X performed a review and that the review document was signed.

When evaluating controls, audit firms take a team approach. Documentation of the control is done by more junior staff, but the assessment of the control's design is done by the more senior engagement team members. The firms also include team members with different backgrounds, such as IT specialists.

Non-routine transactions and events are often the most problematic because management may not have given enough thought to the controls that will be necessary, or they don't have the knowledge and experience to identify the potential problems. Designing controls to address business combinations or contracts with heterogeneous terms can also prove to be a challenge.

Assessing management competency is critical for auditors, particularly in companies that have non-routine transactions. Key factors considered are education and experience. One practitioner pointed out the importance of determining if the company's ICFR assessment team is smart enough to know what they don't know.

Once a control deficiency is found, audit teams must consider the severity of the deficiency – whether it is a significant deficiency or a material weakness. The determination is a qualitative analysis. For an audit team, it is easier to find material weakness in a control if a material error in the financials is identified.

IV. Accounting Curriculum and Training

One of the breakout groups focused their discussion on how the current accounting curriculum teaches students about auditing in general and ICFR in particular. There is a significant amount of material that is required to be taught at the undergraduate level. Auditing is a small fraction of the material – in most cases it comprises only one class at the undergraduate level. The focus of the curriculum tends to be on what students need to know to pass the CPA exam. While audit and ICFR are important, technical accounting issues are also vital.

Currently, a typical accounting program covers ICFR and the entire integrated audit as part of an undergraduate accounting systems course, though the material covered is rather limited. In fact, one participant noted that ICFR is covered in one chapter in a typical auditing textbook. There is more flexibility in graduate level accounting programs. Additional auditing topics that might be covered include integrated audit, systems or analytics. One possible solution for both graduate and undergraduate education is to “flip” the classroom. In a “flipped classroom,” students watch pre-recorded lectures online prior to attending class, so that the instructor/professor can use class time to cover additional material or to focus on actual cases.

The academics in the breakout group noted that accounting systems classes are widely unpopular among graduate and undergraduate students. One group member opined that students (and firm personnel) tend to consider IT auditing and financial statement auditing to be mutually exclusive subject areas. The group agreed that both academia and the profession needed to do a better job of disavowing students of that notion.

Two other required skills were identified – how to make judgments and how to think critically. Teaching judgment and critical thinking can prove to be a challenge in both the classroom and in firm training.

All of the material not covered at the undergraduate or graduate level becomes part of the firms’ training programs. The profession concentrates most of its initial efforts on teaching new auditors how to apply what they learned in school to real world scenarios.

The group agreed that there is a benefit to using real world examples of how an integrated audit is conducted. Case studies could also be useful. Inviting professionals into the classroom could help to provide some additional perspective.