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its review of financial statement audit procedures. The Board believes that this inspections approach will aid in encouraging firms to engage in ICFR auditing that is risk-based and efficient, consistent with the objectives of Section 404 of the Sarbanes-Oxley Act.

The Board's 2006 inspection cycle is scheduled to begin during the week of May 1, 2006.

### The 2005 ICFR Inspection Process

During its 2005 inspection cycle, the Board's Division of Registrations and Inspection ("Division") established a team of PCAOB inspectors to plan and conduct limited inspections of a narrow sample of audits of ICFR. To this end, the Board's inspectors reviewed audit firms' methodologies for performing audits of ICFR, as well as portions of a small selection of ICFR audits for compliance with those methodologies. All of the ICFR audits inspected in 2005 were completed prior to the Board's issuance of the May 16 guidance that discussed efficient and risk-focused implementation of AS No. 2. The Division began, in the fall of 2005, meeting with the leadership of the eight U.S. firms subject to annual inspection by the Board. The objectives of these meetings were to:

- provide feedback to the firms on their implementation of AS No. 2, and
- understand improvements to the firms' methodologies going forward.

In the Board's November 30 report, the Board identified, in its inspections and other monitoring, areas in which auditors should be able to make their audits more effective and efficient in the future, by obtaining sufficient evidence for an opinion in a manner that appropriately conserves time and other resources.<sup>4/</sup>

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documents are collectively referred to herein as "the May 16 guidance." Together with the guidance in the November 30 report, these documents are collectively referred to herein as "the 2005 guidance."

<sup>4/</sup> See the November 30 report.

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### 2006 Inspections of the ICFR Audits

In 2006, the Board's inspection process will focus on how efficiently the firms performed audits pursuant to AS No. 2, in light of the 2005 guidance. Specifically, inspectors will evaluate:

1. the degree of integration between the audit of ICFR and the audit of financial statements;
2. the use of a top-down approach to the audit;
3. the proper assessment of and response to identified risks; and
4. using the work of others.

Through their evaluations of these areas, inspectors will assess the efficiency of the firms' audits of ICFR.

As described below, the inspection process will occur at three distinct levels: (1) meetings with senior firm leadership, (2) national office inspection procedures, and (3) engagement inspection procedures for each accelerated filer audit that is reviewed during 2006.

#### *Level 1: Meetings with Senior Firm Leadership*

Before beginning the inspections, Division leadership, inspection team leaders, and staff from the Office of Chief Auditor will meet with senior leadership of the firms to be inspected. The objective of this meeting will be to hear the firm's perspective on whether, and how, it has achieved efficiencies in the four areas identified above. The firm will also be given the opportunity to address whether it has identified or achieved additional opportunities for efficiency in its second year implementation of AS No. 2. Based on the information gathered during the meeting, and using a detailed inspection program, the inspection team will make a preliminary assessment about the extent to which the firm's strategy supports audit efficiency in the performance of integrated audits. At this stage, the team will also summarize any useful or innovative practices, opportunities for improvement, and items for follow up at the national office.

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### *Level 2: National Office Inspection Procedures*

At the national office, the inspection team will assess how well the firm's guidance and audit tools address the four areas of efficiency identified above. To form this assessment, the inspection team will meet with the firm's technical leadership, review the firm's relevant policies and procedures and its communication of those policies, and evaluate the firm's training programs to determine if the focus described by senior firm leadership has been implemented at the policy level and whether appropriate training was developed and delivered. The inspection team may also consider other matters such as whether the firm has established a monitoring system to ensure that engagement teams are focused on achieving efficiencies during the audit process. Using a detailed inspection program, the inspection team will form an overall conclusion about whether the firm's tools, forms, methodologies, and training are designed to enable the firm to achieve efficiency in the four areas.

### *Level 3: Engagement Inspection Procedures*

At this level, at least one of the four areas of efficiency will be selected for inspection for each accelerated filer audit that is reviewed. The Board anticipates that the engagements reviewed will be evenly divided among the four areas, both at each firm and across the inspection program. The Division's detailed inspection program for engagement-level procedures will focus the inspection teams on whether the tools, forms, and methodologies that were reviewed at the national office level have been used to achieve the desired efficiencies, and allow inspectors to form an overall conclusion as to whether the engagement team implemented firm strategies to realize efficiencies in the selected area.

In addition, inspections of accelerated filer audits will include the review of various portions of the firm's AS No. 2 work as it relates to the inspection of the audit of financial statements. Inspectors will select certain high-risk areas of the financial statement audit for review and will review the portions of the ICFR audit that relate directly to supporting those high-risk areas. Other than the review of the efficiency areas described above, inspectors will limit their review of the ICFR procedures to these particular high-risk areas. In these areas, inspectors will be reviewing ICFR work to evaluate whether the engagement team assessed the effect of any significant deficiencies or material weaknesses in ICFR on the financial statement audit area being inspected, as well as the effect of significant audit adjustments on the audit of ICFR. Inspectors will also evaluate whether the control work that the firm performed supported

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the nature, timing, and extent of the financial statement audit procedures in the selected areas. These inspection procedures reflect the 2006 focus on integrated inspections of integrated audits.

Inspectors will also evaluate the overall results of the integrated audit to determine whether (1) the firm failed to detect a material weakness, or (2) there was a material failure to comply with the auditing standards, or a material misstatement of the financial statements, resulting from a failure to properly consider information obtained in connection with the audit of ICFR. No comments or observations related solely to the effectiveness, as distinct from the efficiency, of the firm's application of AS No. 2 will be issued or communicated to the firms, except in unusual circumstances involving the possible failure to consider a potential material weakness in ICFR.

### **Administrative Matters**

In 2006, the Board's inspectors will combine their review of ICFR auditing with their review of financial statement audit procedures, as opposed to relying on a separate team of inspectors specifically focused on inspection of firms' ICFR procedures. This approach is intended to mirror what the Board understands to have occurred in the more recent audits that will be inspected in 2006 – that the firms conducted integrated audits. In an integrated audit of the financial statements and internal control over financial reporting, the auditor designs and simultaneously executes procedures that accomplish the objectives of both audits. Evidence gathered and tests conducted in the context of either audit contribute to the completion of both audits. In inspections of integrated audits, inspectors will combine the review of the audit of ICFR with the review of the audit of financial statements.

To prepare for the 2006 inspections, the PCAOB developed internal guidance and related training to enable the inspections staff to take an efficient and consistent approach to evaluating the quality of audit work and the progress firms have made in implementing AS No. 2, as well as the 2005 guidance. The Board's Office of Chief Auditor has assisted in this work and will continue to collaborate with the Division throughout the inspection process. This collaboration will provide assurance that firms are receiving a consistent message from the PCAOB about how to apply the Board's standards.

Moreover, to ensure consistency of inspection activities and communications with engagement teams during inspections, monitoring of the ICFR aspects of integrated

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inspections will be performed at two levels throughout the inspection period for each firm. First, as inspections are conducted at the firms' national offices or practice offices, monitoring and consultation will be performed by the leader of that inspection. Second, monitoring and consultation will be performed on a regular basis by Division leadership. This will involve regular conference calls, in which staff of the Office of Chief Auditor will also participate, to discuss results and observations and to allow leadership to communicate any specific messages, observations, or alterations to process or materials that have been implemented as a result of the inspections process to date.

## **Conclusion**

The 2006 inspections of integrated audits will be an important part of the Board's continuing process to further the efficient implementation of AS No. 2. As the Board emphasized in the 2005 guidance, ICFR audits should be conducted in a manner that is integrated with, and complementary to, the financial statement audit, and that devotes attention to higher risk areas and away from those with less potential to have a material impact on the financials. As the Board's November 30 report noted, the initial ICFR audits often did not meet these objectives.

The Board understands that many firms have undertaken significant efforts to refine their methodologies, provide additional training, and otherwise identify and implement improvements in audits of internal control. The Board expects that the 2006 inspections will help firms identify additional areas in which integrated audit efficiency can be enhanced.

ISSUED BY THE BOARD.

/s/ J. Gordon Seymour

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J. Gordon Seymour  
Secretary

May 1, 2006