

PCAOB FLASH REPORT

PCAOB Announces the Nature of the Forthcoming Proposed Revisions to Auditing Standard No. 2

December 5, 2006

The Public Company Accounting Oversight Board (PCAOB) announced today an open meeting for Tuesday, December 19, to consider proposing for public comment a new auditing standard to replace the Board's existing Auditing Standard No. 2 (AS2) on an integrated audit of both internal control over financial reporting (ICFR) and the financial statements. The Board's press release is available at http://www.pcaobus.org/News_and_Events/News/2006/12-05.aspx. The Board's meeting will follow the open meeting of the Securities and Exchange Commission (SEC) during which the Commission is expected to issue proposed guidance to management and possibly streamline certain aspects of the Section 404 rule. The SEC's meeting is currently planned for December 13.

Earlier this year, the PCAOB announced its plan to revise AS2. That plan was announced in the aftermath of the joint roundtable conducted with the SEC in May. After much deliberation, it appears the Board is about to release its proposed revisions to AS2. The focus of these proposed revisions is on a more efficient, risk-based implementation of audits of ICFR. In addition, the Board is focused on making the implementation process more scalable to alleviate the disproportionate cost burden on smaller companies. According to the PCAOB staff, the Board (1) has closely monitored implementation of AS2 through its inspections of internal control audits and through the two public roundtable discussions it held with the SEC in April 2005 and May 2006 and (2) is applying what it has learned through the monitoring process. The Board's objective is to help auditors make their internal control audits as efficient as possible while preserving the benefits to investors.

Based on the Board's press release, the proposal it will issue in two weeks will address five goals:

1. **Focus the Internal Control Audit on the Most Important Matters** – The Board intends to consider changes that would focus auditors on matters that present the greatest risk that a company's internal controls will fail to detect or prevent a material misstatement in its financial statements. In particular, the Board plans to consider changes that would more clearly focus auditors on identifying control weaknesses before they result in material misstatements in the financial statements. This is an important point because one of the most significant criticisms of the Section 404 compliance process is that financial restatements have often driven the identification of material weaknesses. The original intent of Section 404 was to provide an "early warning" that a financial restatement was imminent. This aspiration has not been achieved.

In addition, the new standard will continue to require auditors to deploy a top-down approach that begins with company-level controls, and to identify for further testing only those controls that are, in fact, important to the effective functioning of a company's ICFR. The standard will also emphasize the importance of a company's control environment, and how it can affect the

risk of financial reporting fraud or other material errors or omissions in the financial statements. The period-end financial reporting close process will also be a point of focus for the auditor because of the risk of management override of established internal controls.

2. ***Eliminate Procedures that Are Unnecessary to Achieve the Intended Benefits*** – The Board reported today that it is evaluating every area of the audit of ICFR to determine whether the existing AS2 standard encourages auditors to perform procedures that are not necessary to achieve the intended benefits of the audit process. For example, the Board is considering the following changes:
 - ***Eliminate the auditor's role in assessing management's evaluation process*** – Under the current standard, auditors issue a report with two opinions. One of those opinions addresses whether management's internal control report is fairly presented and the other opinion addresses the effectiveness of the company's ICFR. The Board is expected to clarify that an internal control audit is limited to an evaluation of whether, in the auditor's opinion, the company's ICFR is effective, and does not include an opinion on the adequacy of management's process to reach its conclusion on the effectiveness of ICFR.
 - ***Allow auditors to consider prior year audit results*** – AS2 included the "each-year-stands-on-its-own" principle. The revision to AS2 will allow for the use of experience gained in previous years and point out that the auditor need not disregard everything he or she knows about the company's internal controls based on the work of prior years. This revision will make audits in subsequent years more efficient and clear up much confusion over the use of prior year information, particularly in conjunction with assessing risk in the current year.
 - ***Increase the emphasis on risk*** – Most audit firms have deployed a quantitative approach to evaluating risk for purposes of identifying the key financial statement elements to consider when planning an audit of ICFR. That approach has largely ignored qualitative factors. The Board plans to clarify how auditors should use risk assessment to eliminate from further consideration those accounts that are unlikely to contain a material misstatement.
 - ***Increase the use of the work of others*** – The Board intends to require auditors to consider whether and how to use the work of others, instead of doing certain procedures themselves.
3. ***Incorporate Guidance on Efficiency*** – Since AS2 was released, the Board has issued guidance to make audits of ICFR more efficient. Much of that guidance was issued in May of 2005 and was not followed by the audit firms as stringently as AS2 itself. This guidance recommended, among other things, that auditors should use a top-down approach, starting with company-level controls and risks, and rely on the work of others to avoid unnecessary, costly independent testing of controls. The Board is expected to incorporate much of this guidance into the standard to improve audit efficiency.
4. ***Provide Explicit and Practical Guidance on Scaling the Audit to Fit the Size and Complexity of the Company*** – The Board intends to provide direction in the new standard to help the auditor differentiate the internal controls of smaller companies from larger companies so the auditor can tailor his or her audit accordingly.

5. **Create a Simplified Standard** – The Board intends to propose a revised auditing standard that is shorter, easier to understand, and more clearly scalable to audits of companies of all sizes and complexity.

This is an important development for companies looking for more cost-effective audits of ICFR. Coupled with the SEC's expected guidance to management and streamlining of the Section 404 rules, the Board's revision of AS2 is expected to take steps toward more cost-effective audits of ICFR.