

## PCAOB FLASH REPORT

### The PCAOB Proposes Revised Auditing Standard on Internal Control over Financial Reporting

December 19, 2006

Today, the Public Company Accounting Oversight Board (PCAOB) voted unanimously to issue proposed standards and rules for public comment that will replace Auditing Standard No. 2 (AS2). If issued and approved, these proposals will produce (a) two new auditing standards, (b) a new rule and (c) a new amendment to the Board's interim standards. The press release announcing the Board's actions today is posted at [http://www.pcaobus.org/News\\_and\\_Events/News/2006/12-19.aspx](http://www.pcaobus.org/News_and_Events/News/2006/12-19.aspx).

The proposed standards and rules will be exposed for a 70-day comment period which is expected to expire on February 26, 2007. Following the expiration of the comment period, the Board will consider all comments received and determine whether to issue final standards and rules, with or without amendments. If final standards and rules are issued, they will supersede AS2. Any final standards and rules adopted will be submitted to the Securities and Exchange Commission (SEC) for approval.

Last week, the SEC released proposed interpretive guidance to assist management in planning and performing its annual evaluation of internal control over financial reporting (ICFR). In addition, the Commission proposed changes to its requirements for attestation reports to require only an auditor opinion on ICFR. A prior Flash Report, dated December 13, 2006, was issued last week to highlight these proposals. Together with today's revisions to AS2, these actions by the SEC and PCAOB are intended to improve the cost-effectiveness of the implementation of Section 404 of the Sarbanes-Oxley Act (SOA).

### An Overview of the Proposed Standards and Rules

In his opening comments during today's open meeting, PCAOB Chairman Mark Olsen noted that few dispute the benefits of the audit of ICFR, but everyone is concerned about the significant costs required to achieve these benefits. Chairman Olson said that the Board hopes that its proposals will align costs and benefits. The Chairman also pointed out that the PCAOB has closely monitored the progress in implementing Section 404 audits and has met with auditors, issuers and investors. He asserted that the PCAOB has learned how to make audits of ICFR more efficient and, on that basis, believes that substantial improvement in the alignment of costs and benefits can be achieved.

AS2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, was approved by the SEC on June 17, 2004. Since its approval, the annual Section 404 compliance cycle has run its course almost three times with U.S. domestic accelerated filers. Many have questioned whether the Section 404 compliance process has been effective in detecting and reporting material weaknesses before they cause material misstatement of the financial statements, and thereby provide an early warning to investors. The PCAOB

believes that the proposed revisions will increase the likelihood that material weaknesses will be found before they cause material misstatement of the financial statements.

Today, the Board proposed for public comment the following:

- (1) A new standard on the audit of the effectiveness of ICFR that is principles-based and designed to accomplish four objectives:
  - Focus the auditor on the most important matters
  - Eliminate audit requirements that are unnecessary to achieve the intended benefits
  - Provide direction on how to scale the audit for a smaller and less complex company
  - Simplify and significantly shorten the text of the standard
- (2) A new auditing standard on considering and using the work performed by internal auditors, management and others in either (a) an integrated audit of financial statements and ICFR or (b) an audit of financial statements only. This proposed standard is intended to further clarify how and to what extent an independent auditor may use that work to reduce the work the auditor otherwise would have to perform.
- (3) In addition, the Board proposed to revise the independence requirement that currently is embedded in the text of AS2. That provision requires the auditor to seek specific pre-approval by the audit committee of any internal control-related service. The new provision provides more flexibility in obtaining audit committee approval.
- (4) Finally, the Board proposed certain changes to its other standards to conform to the changes being brought about by today's rulemaking.

During today's meeting, the PCAOB staff made it clear that "a principal focus in developing [these] proposal[s] were to retain and strengthen the substantial benefits investors have received from improved internal control over financial reporting."

The above matters are discussed further below.

## Proposed Auditing Standard to Supersede AS2

The PCAOB proposed a new auditing standard – *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements* – to replace AS2. Since AS2 was first released, the PCAOB staff 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 the AS2 standard itself. The Board incorporated much of this guidance into the standard to encourage auditors to (a) apply a top-down, risk-based approach, (b) use the work of others and (c) scale the audit to specific facts and circumstances.

The principles-based approach emphasized in this proposed standard is intended to address the four objectives cited under the first proposal articulated in the above overview section. These objectives and the changes to achieve them are discussed further below.

- **Focus the Audit on the Most Important Matters** – The Board is proposing changes that would focus auditors on matters that present the greatest risk that a company's ICFR will fail

to detect or prevent a material misstatement or omission in its financial statements. In particular, the Board proposes changes that would:

- More clearly focus auditors on identifying control weaknesses before they result in material misstatements or omissions in the financial statements. The Board intends that its proposed changes would focus auditors on matters that present the greatest risk that a company’s ICFR will fail to detect or prevent a material misstatement or omission in the financial statements. In particular, the Board has proposed changes that, in its view, would more clearly focus auditors on identifying control weaknesses before they become problems. As noted earlier, 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 the risk of a financial restatement was significant. This aspiration has not been achieved.
- Require auditors to use a top-down approach that begins with the financial statements and 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. Note: During the open meeting, the PCAOB staff explained that this provision meant that the external auditor should test only those controls that support a conclusion on ICFR. In other words, the auditor should not be overly concerned with “labels” (“company-level” versus “process-level”) and should instead direct his or her focus on the assertions the control mitigates.
- Emphasize the importance of a company’s control environment. In particular, these changes focus on how the control environment can affect the risk of financial reporting fraud or other material misstatements or omissions.
- Emphasize higher risk stages of financial statement preparation, such as the period-end financial close process. This point of emphasis will most certainly address the risk of management override of established internal controls. It is intended to raise the bar with respect to a company’s anti fraud controls, and the importance of considering these controls during an evaluation of the effectiveness of ICFR.

In effect, the amount of evidence required by auditors to support an audit of the effectiveness of ICFR should be a function of the risk. This means that less evidence should be required for lower risk controls. It also means that based on (a) the nature, timing and extent of prior year tests and the results of those tests and (b) changes in the control environment, the current year audit work allocated to areas deemed to be lower risk can be reduced. Finally, it means that anti-fraud and company-level controls are especially important in reducing the amount of testing performed at the transaction level.

- **Eliminate Unnecessary Auditing Procedures** – The Board reported today that it has evaluated every area of the audit of ICFR to determine whether AS2 encouraged auditors to perform procedures that are not necessary to achieve the intended benefits of the audit. As a result of this effort, the Board plans to propose changes that would:
  - Clarify that an audit of ICFR 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 a conclusion as to the effectiveness of ICFR. Under the current AS2, 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 PCAOB is of the view that the AS2 requirement of the external auditor to obtain an understanding of and assess management's process drove unnecessary work. Accordingly, the Board proposes to eliminate this requirement. The proposed standard provides that the external auditor should understand management's process with the objective of determining whether the work of others is sufficient to alter, the nature, timing and extent of the external auditor's work. Therefore, an internal control audit, as proposed, will be limited solely to an evaluation of whether, in the auditor's opinion, the company's ICFR is effective.

- Permit auditors to use experience gained in previous years' audits to make audits in subsequent years more efficient. AS2 included the "each-year-stands-on-its-own principle." This principle was often interpreted literally in practice, and resulted in a disregard of prior year experience. Accordingly, the principle has been eliminated as an explicit statement in the proposed standard. This change makes it clear that the auditor need not disregard everything he or she knows or experiences about the company's internal controls based on the work of prior years. For example, the auditor should consider three risk factors when determining the nature, timing and extent of testing in the current year of a control tested in prior years: (1) the nature, timing and extent of procedures performed in previous years, (2) the results of that testing in previous years, and (3) changes in the control, or in the significant process within which it operates, since the previous audit. The external auditor then determines the appropriate evidence to be obtained in the current year. This change is expected to 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. While this change should not be confused with a rotation of controls testing concept, it does allow for reduction in the extent of audit work based on prior year work performed and results.
- Clarify how auditors should use risk assessment to eliminate from further consideration those accounts that are unlikely to contain a material misstatement. For example, 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. This "bottom-up" approach resulted in the inclusion in the scope of an audit of ICFR of each and every account above a given materiality threshold, because it largely ignored qualitative factors. The Board's proposed revisions now clearly state that auditors should evaluate both qualitative and quantitative risk factors when identifying significant accounts to include in the scope of an audit of ICFR.

In addition, the new standard refocuses the multi-location testing requirements on risk rather than coverage. In effect, the Board proposes to eliminate the provision in AS2 requiring an auditor to achieve coverage constituting a "large portion" of a company's operations and financial position, and instead require auditors to apply a risk-based approach to the multi-location testing question. This change will require external auditors to rethink their minimum percentage coverage requirements.

The Board also noted that automated controls are generally lower risk, if the IT general controls are effective. The proposed standard omits the identification of which domains of IT controls are relevant. It also adds the benchmarking of IT discussion that was included in the May 2005 guidance. That guidance clarifies that “if general controls over program changes, access to programs and computer operations are effective, and the auditor verifies that the automated control has not changed since the auditor established a baseline (i.e., [when the auditor] last tested the application control), the auditor may conclude that the automated application control continues to be effective without repeating the prior year’s specific tests of the operation of the automated application control.”

During the meeting today, the PCAOB staff made a number of statements germane to the importance of a risk-based approach. First, the staff pointed out that the proposed standard states that risk assessment underlies the entire audit and is pervasive to the audit process. Second, the proposed standard states that a direct relationship exists between (a) the degree of risk that a material weakness can occur in a given area and (b) the amount of audit time spent in that area. Finally, the standard asserts that if risk decreases for a particular area, the level of evidence required for that area also decreases.

- Require auditors to consider whether and how to use the work of others, instead of doing certain procedures themselves. A separate standard has been proposed for this purpose and is discussed later in this Flash Report.
- **Scale the Audit for Smaller Companies** – The Board reports that it has provided direction in its proposed standard to help the auditor anticipate the various differences in a smaller company’s ICFR and to direct the auditor to tailor the audit for smaller companies. For example, the proposed standard directs the auditor to assess company size and complexity. This assessment of size and complexity is expected to have a pervasive affect on the audit. The standard details several factors to consider when assessing size and complexity including:
  - The number of business units
  - The complexity of business processes and financial reporting systems
  - The extent of centralization of accounting functions
  - The extent of involvement of senior management in day-to-day activities of the business
  - The levels of management in existence, including the width of the span of control

The above risk-based considerations are expected to be pervasive. One of the concerns with respect to the implementation of Section 404 audits to representatives of smaller companies is the nature and extent of evidence required by auditors. The Board reported today that the amount of evidence required should be directly commensurate with the level of risk. In other words, auditors should only focus on those areas that can result in a material misstatement or omission in the financial statements. The Board also acknowledged in the proposed standard the absence of documentation in smaller and less-complex companies with less formal documentation practices.

The Board is not done with this issue of scalability. In the Board's view, internal control testing should be scalable, i.e., the costs should be proportionate to the size and complexity of the company. More guidance will be issued in 2007 to help achieve this objective. During today's meeting, the PCAOB staff noted that it has been working with a task force of 12 registered accounting firms in identifying issues that affect the audits of small companies. The staff is in process of pulling together an audit guide for these audits. The same task force will use the remainder of the current audit cycle to further assess the guidance, so the staff can factor the resulting feedback into the Board's 2007 guidance.

- **Simplify the Requirements** – The Board indicated that it is proposing a revised auditing standard that is shorter and easier to read and understand. Some of the changes the Board is proposing are summarized below:
  - Shorten significantly the new standard. The proposed standard is 65 pages in length. AS2 was over 100 pages longer.
  - Organize the new table of contents in the same way an audit is executed. For example, the standard begins with audit planning. In addition, an appendix is provided to focus on how to integrate the audit of financial statements with an audit of ICFR to help streamline the auditor's work. This avoids breaking the flow of the standard to address this topic.
  - Clarify the definition of a "material weakness" and a "significant deficiency." For example, the Board proposes to replace the term "more than remote likelihood" with the term "reasonable possibility" in the definitions of both a "material weakness" and a "significant deficiency." The proposed standard also changes the term "more than inconsequential" to the term "significant" in the definition of a "significant deficiency." In this context, "significant" is less than "material" but is nevertheless enough to merit the attention of management and directors responsible for oversight. The Board has also proposed to clarify the list of "strong indicators of a material weakness" to eliminate the requirement to consider the "strong indicators" at least a significant deficiency to accommodate an auditor's "appropriate conclusion that no deficiency exists at all" given the facts and circumstances.
  - Clarify that annual materiality should be used in the scoping process. The new standard clarifies that quarterly materiality is only used when assessing whether a deficiency materially impacts quarterly financial statements. This guidance clarifies that the auditor's evaluation of materiality for purposes of an audit of ICFR is based on the same long-standing principles applicable to financial statement audits.
  - Allow for varying levels of reliance on the work of others depending on the auditor's assessment of their objectivity and competence. This approach allows auditors to use the work of management and others who may not be as qualified as internal auditors. In effect, the proposal offers a framework for reliance based on the nature of the subject matter being tested and the competence and objectivity of the personnel performing the testing. As with AS2, qualified internal auditors are at the high end of the "extent of reliance continuum" for purposes of independent testing. This change, however, would enable the auditor to use personnel other than internal auditors for purposes of "direct assistance" which is performed under the auditor's supervision. In addition, the Board is proposing to eliminate two restrictive requirements. First, the Board is eliminating the

requirement that the external auditor must directly obtain the “principal evidence” needed to support his or her conclusion. Second, the AS2 specific restriction on using the work of others in testing the control environment has been omitted from the proposal.

- “Recalibrate” the walkthrough requirement to make it more efficient to apply. The Board continues to believe that a walkthrough for each material process is a critical procedure and that the auditor must be “significantly and personally involved” in this process. However, the Board suggests ways to reduce costs through (a) the direct assistance of others (requiring auditor supervision and involvement) and (b) a reduction in the frequency of walkthroughs for transaction types with similar risks. In addition, the Board is proposing that the inquiry and observation techniques implicit in performing walkthroughs may be sufficient to test the operating effectiveness for some lower risk controls.

In effect, the Board is proposing a revised auditing standard that remains principles-based, redefines key terms, eliminates specific AS2 requirements and requires a top-down, risk-based approach that is scalable to smaller, less-complex companies.

## **Proposed Auditing Standard to Consider and Use the Work of Others**

In addition to the newly proposed standard on audits of ICFR, the Board is consolidating into one new standard its various standards on using the work of others in conjunction with both internal control audits and financial statement audits. The objective is to better facilitate the integration of the two audits. The proposed auditing standard would supersede AU Sec. 322 and the direction currently contained in AS2 regarding using the work of others.

Among other things, the proposed standard would:

- Allow the auditor to appropriately use the work of others, and not just internal auditors, for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits
- Encourage greater use of the work of others by requiring auditors to evaluate whether and how to use their work to reduce audit testing
- Require the auditor to understand the relevant activities of others and determine how the results of that work may affect his or her audit
- Provide a single framework for using the work of others based on the auditor's evaluation of the combined competence and objectivity of others and the subject matter being tested
- Eliminate the explicit “principal evidence provision” previously included in AS2.

Thus auditors are encouraged to rely more extensively on management's testing, not only on internal audit's work but also on the work of others after an assessment of their objectivity and competence. This assessment includes a determination that compensation arrangements for individuals performing the work do not impair their objectivity.

## Proposed Rule 3525 Regarding Audit Committee Pre-Approval of Services Related to Internal Control

This proposed new independence rule would replace the direction currently contained in AS2 regarding independence and internal control-related services. The proposed rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect auditor independence. The new rule would also recognize that audit committees may pre-approve the provision by their independent auditor of internal control-related services on an ad hoc (i.e., specific to each request) basis or pursuant to committee-approved policies and procedures. According to comments during today's open meeting, this change is proposed to reduce the need for unnecessary approval meetings.

## Proposed Amendments to the Board's Interim Standards

The Board is also proposing amendments that, among other things, would:

- Simplify the internal control standard by moving certain information currently contained in AS2 to other existing interim standards. For example, the proposed amendments would move the auditor's responsibilities for management's internal control certifications under Section 302 of SOA into AU Sec. 722, *Interim Financial Information*.
- Change the dating of the auditor's opinion on ICFR. The existing requirement that "generally, the date of completion of the field work should be used as the date of the independent auditor's report" is being changed to "the auditor should date the audit report no earlier than the date on which the auditor has obtained sufficient, competent evidence to support the auditor's opinion."

## Summary of the Key Changes

While the spirit of AS2 remains unchanged, the new auditing standards and rules are intended to introduce a more efficient approach whereby costs are better aligned with benefits, while maintaining the best possible assurance as to the reliability of the financial statements. For example, the proposed standards are intended to steer auditors toward controls that would prevent or detect material misstatements. They are intended to increase the likelihood that Section 404 becomes an early warning system, rather than just an acknowledgement of a problem after it is determined that a company must restate its financial statements. They would also recognize the importance of company-level controls, especially at smaller companies. Finally, according to the PCAOB, they eliminate provisions that require extra work, drive a more top-down and risk-based approach, and are more concise and easier to understand.

The proposals also incorporate the May 2005 guidance to make that guidance explicit in them. When the new standards are issued in final form, the prior PCAOB Q&A guidance will be eliminated and new guidance will be issued in the future on the new standards.

The key changes in these proposals include:

- Elimination of the "large portion" coverage requirement in the multi-location scoping process and replacing it with a risk-based approach, in effect refocusing the multi-location testing requirements on risk rather than coverage

- Directing the auditor to emphasize the importance of evaluating both qualitative and quantitative factors when assessing risk and identifying significant accounts
- Requiring the external auditor to use a top-down approach to selecting the most important controls, with appropriate emphasis on identifying and testing controls which prevent and detect fraud
- Revising the definitions of a “significant deficiency” and a “material weakness”
- Clarifying the role of materiality, including interim materiality, in the audit planning process and in the evaluation of audit results
- Elimination of the external auditors second opinion on the adequacy of management’s assessment process
- Elimination of the “each year stands on its own” principle, in effect permitting consideration of knowledge obtained during previous audits when assessing risk in the current year
- Directing the auditor to tailor the audit to reflect the attributes of smaller and less complex companies
- Encouraging further the use of the work of others by providing a framework that replaces the AS2 “principal evidence” requirement, eliminates the AS2 specific restriction on the use of others in testing the control environment and allows for varying levels of objectivity and competence to broaden the use of others beyond internal auditors
- Asserting that controls work related to IT should be risk-based, with explicit recognition of the importance of general IT controls in supporting a conclusion to “baseline” automated application controls

The PCAOB also noted that it will release further guidance on how to audit smaller companies in 2007.

## Closing Comments

The commentary during today’s meeting indicated that the new standards and rules are not intended to water down AS2. The objective is to allow for a better alignment of costs with risk. The new standards and rules are expected to reduce external audit costs over time across all companies and industries. The new standard will be supplemented next year with additional provisions, with particular emphasis on additional guidance for auditing smaller companies.

Some observers expected that the Board would permit a "design effectiveness" evaluation only without an "operating effectiveness" evaluation. That did not happen. Both an assessment of controls design effectiveness and controls operating effectiveness will still be required under today’s proposals.