

## PCAOB FLASH REPORT

### What's New with the Board's Recent Proposals to Revise Auditing Standard No. 2 December 27, 2006

Last week, 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). A prior PCAOB Flash Report, dated December 19, 2006, highlighted these proposals based on the presentation and dialogue occurring during the PCAOB's open meeting. It is presumed that the reader has read this Flash Report. Last week, the PCAOB also published its proposed auditing standard to replace Auditing Standard No. 2 (AS2) and other related proposals, which are available at [http://www.pcaobus.org/Standards/Proposed\\_Standards\\_and\\_Related\\_Rules.aspx](http://www.pcaobus.org/Standards/Proposed_Standards_and_Related_Rules.aspx). Based on Protiviti's review of these published materials, this Flash Report summarizes more specifically what is new with respect to the PCAOB's proposals and is intended to assist clients and other interested parties in understanding the nature and scope of the changes in the Board's direction to auditors performing an audit of internal control over financial reporting (ICFR).

Concurrent with the PCAOB's actions, the Securities and Exchange Commission (SEC) voted unanimously to take action to improve the cost-effectiveness of the implementation of Section 404 of the Sarbanes-Oxley Act (SOA). Protiviti issued a SEC Flash Report, dated December 13, 2006, to highlight the SEC's proposed interpretive guidance as well as the SEC's other related proposals. A SEC Flash Report, dated December 26, 2007, was issued to summarize more specifically the SEC's proposed interpretive guidance. The SEC's proposed guidance is intended for management, whereas the PCAOB's proposals are directed to auditors. Accordingly, clients and other interested parties representing public companies are encouraged to review these two companion SEC Flash Reports, because they address proposed authoritative guidance that is directly relevant to them.

The dialogue in this PCAOB Flash Report addresses the Board's four objectives in replacing AS2. These objectives, which were discussed in the PCAOB Flash Report issued last week, are:

- Focus the audit 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

### 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. The proposed changes that facilitate achieving this focus are summarized beginning on the next page, along with commentary.

<i>Proposed Change</i>	<i>Commentary</i>
Direct the auditor's attention towards the most important controls	<p>The PCAOB's emphasis is two-fold:</p> <ul style="list-style-type: none"> <li>• First, require a top-down approach in which the auditor "identifies the controls to test by starting at the top – the financial statements and company-level controls – and linking the financial statement elements and company-level controls to significant accounts, relevant assertions, and finally to the significant processes where other important controls reside."</li> <li>• Second, encourage an appropriate focus on controls important to the prevention and detection of fraud in which the auditor "evaluate[s] the control environment and controls over the period-end financial close process and test, among other things, controls to address the risk of management override."</li> </ul>
Emphasize the importance of risk assessment	<p>The proposed standard requires risk assessment at each of the decision points in a top-down approach. For example:</p> <ul style="list-style-type: none"> <li>• The PCAOB states that "the auditor's identification of significant accounts and relevant assertions requires an understanding of the related risks and how those risks should affect the auditor's decision-making"</li> <li>• The proposed standard refocuses the multi-location testing requirements on risk rather than coverage by eliminating 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</li> <li>• The proposal expands discussion of the relationship of risk to the evidence necessary for the auditor to conclude that a given control is effective</li> </ul>
Clarify the terms "material weakness" and "significant deficiency"	<p>To encourage correct application of these two terms in practice, the Board proposes to do the following:</p> <ul style="list-style-type: none"> <li>• Replace the term "more than remote likelihood" with the term "reasonable possibility" in the definitions of both terms</li> <li>• Re-articulate the AS2 definition of "material weakness" to exclude the references to significant deficiencies, so auditors would not feel compelled to perform their audits "at a level of detail necessary to ensure that their procedures identify all significant deficiencies, rather than all material weaknesses"</li> </ul>

	<ul style="list-style-type: none"> <li>• Change the term “more than inconsequential” to the term “significant” in the definition of a “significant deficiency,” with “significant” meaning “less than material yet important enough to merit attention by those responsible for oversight of the company’s financial reporting”</li> </ul>
<p>Revise the strong indicators of a material weakness</p>	<p>The Board proposes to do the following:</p> <ul style="list-style-type: none"> <li>• 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</li> <li>• Revise the AS2 guidance that “significant deficiencies communicated to management and the audit committee and remaining uncorrected after a reasonable period of time are a strong indicator of a material weakness” to clarify that such circumstances are a reflection of an ineffective control environment; therefore, “the ineffective control environment – not the uncorrected significant deficiencies – would be a strong indicator of a material weakness”</li> <li>• With respect to the above point, allow the auditor to conclude that the control environment is effective and no material weakness exists when he or she finds that “the company evaluated the significant deficiencies and reasonably determined under the circumstances not to correct them”</li> </ul>
<p>Clarify the role of materiality in the audit of ICFR</p>	<p>Because the Board received feedback that some auditors have interpreted AS2 as directing them to search for all potential defects in internal control, regardless of their effect on financial reporting, the proposed standard:</p> <ul style="list-style-type: none"> <li>• Clarifies that the auditor should plan and perform the audit of ICFR using the same materiality measures used to plan and perform the audit of the annual financial statements</li> <li>• States that: <ul style="list-style-type: none"> <li>– “[A]uditor[s] should use the same consideration of account-level materiality in determining the nature, timing and extent of their procedures in the audit of ICFR as used in the financial statement audit”</li> <li>– Inherent risk is the same for both audits</li> <li>– Significant accounts identified in the audit of ICFR</li> </ul> </li> </ul>

	should be the same as the significant accounts identified in the financial statement audit
Clarify the role of interim materiality in the audit of ICFR	The proposed standard clarifies that quarterly materiality is only used when assessing whether a deficiency materially impacts quarterly financial statements – this guidance clarifies that the auditor should plan the audit of ICFR using the same materiality considerations he or she would use to plan the audit of the company’s annual financial statements

If these proposals are put into effect, a top-down, risk-based approach will be a requirement in performing an audit of ICFR. In the past, company-level controls have often been an afterthought and the approach to the audit of ICFR has typically been bottom-up with a majority of the audit procedures applied at the detailed transaction level. The underlying premise of the PCAOB’s proposals is that the purpose of an audit of ICFR is to formulate an opinion about whether material weaknesses exist as of the date specified in management’s assessment and that risk assessment is applied during the entire process described by the proposed standard. Accordingly, the Board states that “the auditor should focus the majority of his or her attention on the areas of greatest risk to substantially decrease the opportunity for a material weakness to go undetected.” Further, even though company-level controls vary in precision, their effectiveness and impact must be understood by the auditor early, not late, in the audit process.

## Eliminate Unnecessary Auditing Procedures

As a result of its evaluation of 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, the PCAOB proposed changes intended to eliminate unnecessary auditing. The major changes, along with commentary, are summarized below:

<i>Proposed Change</i>	<i>Commentary</i>
Remove the requirement to evaluate management’s process	<p>The proposed standard states the following:</p> <ul style="list-style-type: none"> <li>• 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</li> <li>• The auditor should “obtain an understanding of management’s process as a starting point to understanding the company’s internal control, assessing risk, and determining the extent to which he or she will use the work of others”</li> <li>• “The quality of management’s process is inherently linked to the amount of work the auditor will need to do”</li> </ul>
Permit consideration of knowledge obtained during previous audits	The “each-year-stands-on-its-own principle” of AS2 was often interpreted literally in practice, and resulted in a

	disregard of prior year experience; accordingly, the PCAOB's approach outlined in the proposed standard "directs the auditor to assess, in addition to the risk factors considered in the initial year, three factors when determining the risk related to a given control in subsequent years' audits: the nature, timing and extent of procedures performed in prior years' audits; the results of that testing; and changes in the control or its related process since the last audit"
Refocus the multi-location testing requirements on risk rather than coverage	The Board proposes to require auditors to apply a risk-based approach to the multi-location testing question – auditors will need to rethink their current policies driving a minimum coverage requirement
Remove barriers to using the work of others	<p>Among other things, the proposed standard would:</p> <ul style="list-style-type: none"> <li>• 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 <ul style="list-style-type: none"> <li>– This approach allows the auditor to appropriately use the work of others, and not just internal auditors, for both audits</li> <li>– The auditor's assessment must include a determination that compensation arrangements for individuals performing the work do not impair their objectivity</li> </ul> </li> <li>• Encourage greater use of the work of others by requiring auditors to: <ul style="list-style-type: none"> <li>– Understand the relevant activities of others and determine how the results of that work may affect his or her audit</li> <li>– Evaluate whether and how to use their work to reduce audit testing</li> </ul> </li> <li>• Eliminate the explicit "principal evidence provision" previously included in AS2</li> <li>• Omit the restriction in AS2 precluding the auditor from deploying the work of others with respect to testing controls in the control environment</li> </ul>
Recalibrate the walkthrough requirements	<p>The Board suggests ways to improve the efficiency of walkthroughs through:</p> <ul style="list-style-type: none"> <li>• Direct assistance of others, which requires auditor supervision and involvement</li> <li>• Reduction in the frequency of walkthroughs for</li> </ul>

	<p>transaction types with similar risks. i.e., require the procedure only for each significant process rather than for each major class of transactions</p> <p>The Board is also proposing that the inquiry and observation techniques implicit in performing walkthroughs may be sufficient to test the operating effectiveness of some lower risk controls</p>
Allow the use of an appropriate benchmarking strategy for automated application controls	<p>A new section is included in the proposed standard to address the PCAOB's view on benchmarking, as set forth in its May 2005 guidance to clarify 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."</p>
Consider results of the substantive audit procedures performed in the financial statement audit	<p>The PCAOB directs the auditor to consider the results of these substantive procedures as a risk factor when determining the overall risk related to a control; however, control effectiveness cannot be inferred solely from the absence of financial statement misstatements detected by the audit process</p>
Define the term "relevant assertion"	<p>The Board moved away from the presumptive AS2 guidance that identifying "relevant assertions" is a familiar process to auditors and chose to define the term as follows:</p> <p style="padding-left: 40px;">A relevant assertion is a financial statement assertion that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated</p> <p>The notion is to consider only relevant assertions, not all assertions</p>
Define the term "significant account"	<p>The Board provided a more granular definition of a "significant account" by defining the term as follows:</p> <p style="padding-left: 40px;">An account or disclosure is a significant account if there is a reasonable possibility that the account could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements, considering the risks of both overstatement and understatement... [and] without regard to the effect of controls</p> <p>While the Board does not say this directly, we do not believe</p>

	the above determination can be made based solely on an quantitative approach that ignores qualitative risk factors – the PCAOB makes it clear in the proposed standard that the auditor is NOT required to search for deficiencies that, individually or in combination, are less severe than a material weakness
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In addition to the above changes, the Board points out on the proposed standard that 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.

### 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 require the auditor to tailor the audit of ICFR to the unique circumstances of a smaller and less complex company. The major changes, along with commentary, are summarized below:

<i>Proposed Change</i>	<i>Commentary</i>
Rely on principles rather than detailed instruction	The Board indicates that it believes that a focus on principles would “require auditors to consider each company’s unique facts and circumstances”
Include a new section requiring evaluation of size and complexity	<p>This section on scalability includes a description of some of the attributes of smaller, less-complex companies and a discussion of six areas of the audit that are often affected by these pervasive attributes:</p> <ol style="list-style-type: none"> <li>(1) Obtaining sufficient competent audit evidence with limited company documentation</li> <li>(2) Assessing company-level controls to sufficiently address risks of misstatement</li> <li>(3) Evaluating the risk of management override and mitigating actions</li> <li>(4) Evaluating controls implemented in lieu of segregation of duties</li> <li>(5) Evaluating financial reporting competencies</li> <li>(6) Evaluating information technology controls</li> </ol>

Bottom line, the Board is directing auditors to tailor the audit of ICFR to reflect the attributes of smaller and less complex companies. More guidance on scalability is expected in 2007 as the

Board continues to work with a task force of accounting firms in identifying issues that affect the audits of smaller, less-complex companies.

## **Simplify the Requirements**

The Board indicated that it is proposing a revised auditing standard that is shorter and easier to read and understand. In effect, the Board is proposing a new 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 – and all of this in a standard that is 100 pages less than AS2.

## **Summary**

Consistent with the approach the SEC took with respect to issuing proposed interpretive guidance to management, the PCAOB's proposals are principles-based and do not provide a checklist of steps for auditors to complete. Based on Protiviti's review of the PCAOB's published proposal, this Flash Report summarizes the major changes arising from the Board's actions last week. As indicated in last week's PCAOB Flash Report issued soon after the Board's open meeting, the newly proposed standards and rules are not intended to water down AS2. The Board's objective is to allow for a better alignment of costs with risk. The proposed standards and rules are expected to reduce external audit costs over time across all companies and industries. As auditors apply the PCAOB's proposed approach beginning next year, companies can expect the ICFR audit process to become more efficient as their auditors transition the audit to more substantive internal control-related matters. As companies improve the mix of their controls so that their controls portfolio becomes more automated over time and more effective use is made of robust monitoring controls, consistent with a top-down approach, the efficiency of ICFR audits will improve even further. Time will tell whether the desired alignment of costs and benefits is achieved.