

PCAOB FLASH REPORT

The PCAOB Finalizes the Revised Auditing Standard

May 24, 2007

Today, the Public Company Accounting Oversight Board (PCAOB) voted to issue a final standard on auditing internal control over financial reporting (ICFR), as well as a related independence rule and conforming amendments to the Board's auditing standards. The new standard, Auditing Standard No. 5, *An Audit of Internal Control over Financial Reporting Performed that is Integrated with an Audit of Financial Statements*, supersedes Auditing Standard No. 2 (AS2). The full text of the standard is available at http://www.pcaobus.org/Rules/Docket_021/index.aspx.

The new auditing standard (AS5) is focused on maintaining the benefits investors have received from improved financial reporting. The new standard is intended to raise the auditor's "line of sight" by focusing the attestation process on obtaining reasonable assurance that a material weakness does not exist. The standard applies to all companies, irrespective of size, that need to comply with Section 404. Although the principles from AS2 have been retained, the PCAOB staff pointed out during today's open meeting that the magnitude of change in the new standard should not be underestimated. These changes were focused on achieving a quality audit, consistent with the four objectives articulated by the PCAOB last December:

- (1) Focus the internal control audit on the most important matters
- (2) Eliminate procedures that are unnecessary to achieve the intended benefits
- (3) Provide explicit and practical guidance on scaling the audit to fit the size and complexity of the company
- (4) Simplify the standard

The proposed standard was covered by two PCAOB Flash Reports issued last December – (1) *The PCAOB Proposes Revised Auditing Standard on Internal Control over Financial Reporting*, dated December 19, 2006, and (2) *What's New with the Board's Recent Proposals to Revise Auditing Standard No. 2*, dated December 27, 2006. Both Flash reports are available on www.protiviti.com.

During today's meeting, the PCAOB staff outlined the following changes made to the proposed standard:

- Align the PCAOB's audit standard with the SEC's interpretive guidance for management regarding the process for evaluating and assessing ICFR. The SEC's interpretive guidance to management was approved yesterday by the Commission. Both the SEC staff and the PCAOB staff worked closely to align the terms, definitions and approaches, whenever appropriate, in the two documents. This alignment theme was emphasized strongly during the two meetings conducted today and yesterday. The PCAOB staff provided several examples of changes made to align the two documents, including the coordination of terms and the definitions of a material weakness and a significant deficiency. They also alluded to the alignment of the discussion of entity-level controls. The PCAOB replaced references to

“company-level controls” with “entity-level controls.” The new definition of significant deficiency is as follows:

A deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness yet important enough to merit attention by those responsible for oversight of the company's financial reporting.

Note that there isn't a probability threshold in this definition. The SEC is proposing the above definition for public comment.

- Differentiate between management's assessment process and the auditor's attestation process. The PCAOB staff noted that they were mindful of the distinctive differences in roles and responsibilities of the auditor and management when they wrote the final standard. Management's assessment and the auditor's attestation are complementary, and must be conducted in a manner that addresses reliable financial reporting. However, management is an insider. Therefore, management's daily interactions with internal controls make its assessment process different than that of the auditor, who does not have the familiarity with the business that management does. The auditor also does not interact with internal controls as regularly as management.
- Reduce the number of prescriptive requirements thus allowing the auditor to use judgment in applying a top-down approach. The final standard eliminates references to significant processes and major classes of transactions, allowing auditors to exercise more professional judgment in keeping with a principles based-standard. The number of presumptively-mandatory “musts” and “shoulds” that might drive unnecessary audit procedures, has been reduced to allow the auditor to vary the nature, timing and extent of procedures based on the individual company's facts and circumstances. Accordingly, the final standard puts a stronger emphasis on auditor's professional judgment.
- Provide additional guidance on entity-level controls. The new standard includes a discussion of three broad categories of entity-level controls and how each category affects the tests of other controls. The categories include (1) entity-level controls with a direct impact of financial reporting elements, (2) entity-level controls with an indirect impact on financial reporting elements and (3) controls designed to monitor the effectiveness of other controls.
- Clarify the requirement for walkthroughs. After evaluating the comment letters, the PCAOB staff stated that they concluded that the AS2 guidance on walkthroughs “overshadowed the objective.” Accordingly, the revised standard focuses the auditor on the objectives, not the mechanics, of the walkthrough. Rather than requiring walkthroughs for specific types of processes, the standard requires the auditor to obtain an understanding of the likely sources of misstatement and identify the controls to test.
- Integrate the discussion around scaling the audit for size and complexity. The new standard eliminates the separate section on scalability and integrates the discussion on scaling the audit throughout the standard. Commentary related to scaling an audit of ICFR addresses less complex processes and business units in addition to less complex companies. The PCAOB staff also referred to future guidance that they plan to release related to tailoring an audit of ICFR to smaller, less complex companies. This guidance will assist auditors in

tailoring the audit of ICFR to fit the circumstances of each company and will further develop the principles outlined in the new standard.

- Eliminate the proposed auditing standard, *Considering and Using the Work of Others in an Audit*, which would have superseded previous standards. The PCAOB staff is no longer recommending adoption of this proposed standard. Instead, the staff incorporated the most important aspects into AS5 to encourage the auditor's use of the work of company personnel other than internal auditors. The existing AU Section 322 continues in force.

Other changes include the elimination of the requirement for the auditor to assess and give an opinion on management's evaluation process and refocusing the multilocation scoping process to address the quality of evidence, not the quantity.

The Board and PCAOB staff also discussed the increased emphasis in the final standard on timely prevention and detection of fraudulent financial reporting and noted that every company has an inherent level of fraud risk. This point is similar to the commentary yesterday by the SEC staff. The message is that controls must be designed to address the risk of management override. Fraud consideration is integral to testing entity-level and other pervasive controls. The audit committee has an important role to play in this regard.

In addition, during today's meeting, the Board voted to accept the independence Rule 3525 as proposed. This new independence rule replaces the direction currently contained in AS2 regarding independence and internal control-related services. The 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.

The new auditing standard is effective, subject to SEC approval, for audits for fiscal years ended on or after November 15, 2007. Auditors may adopt the new standard as soon as it is approved by the SEC. However, any auditor who continues to use AS2, after AS5 is approved by SEC, must use the definition of a material weakness, as that term is articulated in AS5. The Staff's expectation is that most auditors will embrace early adoption of AS5.

See http://www.pcaobus.org/News_and_Events/News/2007/05-24.aspx for the PCAOB's press release regarding the above actions.