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## **STANDING ADVISORY GROUP MEETING**

### **PROPOSED CHANGES TO AUDITING STANDARD NO. 2**

**FEBRUARY 22, 2007**

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#### **Introduction**

On December 19, 2006, the PCAOB proposed for public comment two auditing standards, several amendments to the interim standards, and an independence rule that together would replace Auditing Standard No. 2, *An Audit of Internal Control Performed in Conjunction With an Audit of Financial Statements* ("AS No. 2").<sup>1/</sup> At the February 2007 meeting of the Standing Advisory Group ("SAG"), the SAG will discuss various aspects of these proposals.<sup>2/</sup>

In particular, the SAG will discuss whether the proposed standard for an audit of internal control: allows for the appropriate use of auditor judgment while sufficiently safeguarding the quality of the audit; adequately emphasizes the importance of company-level controls and the effect they may have on the auditor's testing; and whether the direction in the standard on scaling the audit sufficiently addresses differences in company size and complexity. Additionally, the SAG will discuss whether differences between the process management would follow under the Securities and

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<sup>1/</sup> See PCAOB Release No. 2006-007 (December 19, 2006), *Proposed Auditing Standard An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements and Related Other Proposals* available at [www.pcaobus.org/Rules/Docket\\_021/2006-12-19\\_Release\\_No.\\_2006-007.pdf](http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf).

<sup>2/</sup> The public comment period for the proposals ends on February 26, 2007. Consistent with previous SAG meetings, the SAG's discussion will be webcast. Additionally, a transcript of this portion of the meeting will be made publicly available on the PCAOB's website.

This paper was developed by the staff of the Office of the Chief Auditor to foster discussion among the members of the Standing Advisory Group. It is not a statement of the Board; nor does it necessarily reflect the views of the Board or staff.

Exchange Commission's ("SEC") recently proposed guidance to perform its evaluation of internal control and the process the auditor would follow under the Board's proposed standard to complete his or her audit would result in any implementation issues and, if so, how these issues could be addressed or managed. Finally, the SAG will discuss whether the proposed auditing standard on considering and using the work of others would meet the objective of removing unnecessary barriers to using the work of others and promote better integration of the audits.

This briefing paper provides SAG members with background information about each discussion topic and the questions that will be presented during the discussion. Additional information about these topics, as well as other questions for commenters, is contained in the release accompanying the proposals.

## **Discussion Topics**

### **Auditor Judgment**

One of the objectives in proposing a new standard on auditing internal control over financial reporting is to rely more on general principles rather than detailed direction. The Board believes that certain requirements of the standard can be either omitted altogether or articulated in a manner that is more principles-based to allow for more use of auditor judgment without compromising the quality of the audit. An example of these proposed changes is the removal of the principal evidence provision.<sup>3/</sup> Under the proposal, rather than applying this provision the auditor would apply the principles in the standard along with the use of his or her judgment to determine the appropriate course of action based on the specific facts and circumstances. This approach would bring greater flexibility and judgment to the audit process, while still providing a framework of principles to lead the auditor to a good conclusion.

### **Discussion Questions –**

1. Does the proposed standard on auditing internal control provide for the appropriate level of auditor judgment?

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<sup>3/</sup> Under AS No. 2, when the auditor uses the work of others the principal evidence provision requires the auditor to obtain the principal evidence for his or her opinion through the auditor's own procedures. See AS No. 2, paragraph 111.

2. Would the general principles in the proposed standard sufficiently safeguard the quality of the audit?

### **Company-level Controls**

Company-level controls include, among other things, the overall tone at the top of the organization, management's risk assessment process, and the controls covering the period-end financial reporting process. Although AS No. 2 includes many references to these controls, the proposed standard emphasizes the importance of company-level controls in several important ways. First, the proposed standard requires that the top-down approach be used and that company-level controls be evaluated early in this process. This allows the auditor to determine, early in the process of selecting controls to test, whether certain relevant assertions may be sufficiently addressed by company-level controls alone. When the risks to relevant assertions are sufficiently controlled by company-level controls, testing additional controls is not necessary. The proposed standard also allows the auditor to consider the overall effectiveness of company-level controls when determining the level of testing necessary for controls at the process or transaction level.

### **Discussion Question –**

3. Does the proposed standard adequately articulate the appropriate consideration of company-level controls and their effect on the auditor's procedures?

### **Scaling the Audit for Smaller, Less Complex Companies**

In addition to the broad changes in the proposal that are designed to eliminate unnecessary audit work for all companies, the proposed standard also includes a section that would require the auditor to evaluate the size and complexity of a company when planning and performing the audit. Under the proposed standard, the auditor should scale the audit so that it is appropriate for the company's size and complexity.

The section on scalability includes a description of some of the attributes of smaller, less complex companies that typically make them different from larger and more complex companies. Understanding whether these attributes are present in a particular company is important for the auditor to determine the type and extent of controls that might be appropriate and how the auditor should correspondingly tailor his

or her procedures. To help auditors make these determinations, the section on scaling the audit in the proposed standard also includes discussion of six areas of the audit that are often affected by the attributes of smaller, less-complex companies. For each of these areas, the proposed standard describes the principles the auditor should apply in order to obtain sufficient competent evidence in a manner that is practical and reasonable.

**Discussion Question –**

4. Does the discussion of size and complexity within the proposed standard appropriately describe when and how the auditor should scale the audit?

**Differences between Management's Evaluation Process and the Audit Process**

On December 20, 2006, the SEC issued for public comment proposed guidance for management regarding its evaluation of internal control over financial reporting.<sup>4/</sup> The proposed management guidance describes a process that management could follow to perform its evaluation of the company's internal control over financial reporting. The proposed auditing standard describes the process that the auditor would follow to perform his or her audit. The differences between these two processes take into account the different responsibilities of management and the auditor under Section 404, in order to allow each group to conduct its procedures in a way that is meaningful. For example, under the SEC's guidance, management may gather evidence about the effectiveness of a control from either direct testing of controls or ongoing monitoring and daily interaction. The auditor, on the other hand, would test controls directly under the proposed standard.

One of the significant changes between AS No. 2 and the proposed audit standard on internal control is that, under the proposed standard, the auditor would not be required to evaluate management's annual internal control evaluation process. However, the auditor still would need to 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.

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<sup>4/</sup> See Management's Report on Internal Control Over Financial Reporting, Release No. 34-54976 (Dec 20, 2006) available at [www.sec.gov/rules/proposed/2006/33-8762.pdf](http://www.sec.gov/rules/proposed/2006/33-8762.pdf).

**Discussion Question –**

5. Will differences between management's process for evaluating its internal control under the SEC's proposed guidance and the process the auditor would follow under the Board's proposed standard raise implementation difficulties for auditors or management? If so, how can these difficulties be addressed or managed?

**Using the Work of Others**

The proposals also include a proposed new standard on considering and using the work of others. This proposed standard would provide direction to the auditor for using the work of others in both the audit of internal control over financial reporting and the audit of the financial statements. This proposed standard is intended to remove unnecessary barriers that may have previously existed in AS No. 2 and improve integration of the audits. The proposed standard provides a combined framework for both audits. It achieves the combined framework by focusing, not on the job title of those who perform the work, but on what activities the auditor could reasonably use and the competence and objectivity of those performing the work. Based on the degree of competence and objectivity, and the risk related to the subject matter being tested, the auditor would determine the extent to which he or she would use the work of others.

**Discussion Question –**

6. Does the proposed standard meet the objective of removing unnecessary barriers to using the work of others?
7. Does the proposed standard promote better integration of the audits?

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