National Association of Corporate Directors

DM EXTRA!

December 20, 2006

New Roadmap for Risk Oversight Announced

PCAOB Solicits Comments on New Audit Standard 5 for Approval in 2007.

Director Summary >

On December 19, 2006, the Public Company Accounting Oversight Board (PCAOB) voted unanimously to solicit public comments on a proposed new Auditing Standard (AS) 5, "Auditing Internal Control Over Financial Reporting."[1] AS 5 will replace AS 2, "Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statement." PCAOB Chairman **Mark Olson** hailed the new standard as "a much more efficient, risk-based, scalable implementation." The standard will be adopted in 2007, after a comment period of 70 days.

The Changes: Good News for Audit Committees

"This is good news for audit committees," said PCAOB member **Kayla Gillan**, interviewed by DMX staff. "The proposed new standard sets a clear roadmap on risk." Since audit committees oversee internal financial controls as well as financial reporting, the new standard can help them do their jobs. Cost has been an issue for companies implementing the existing standard. At the meeting, Ms. Gillan raised this issue, making three points. 1) Creating an effective system has a cost. 2) The cost cannot be unlimited. 3) High costs are not sustainable over the long term. She expressed her belief that the new standard will resolve this issue. The new standard:

- **is shorter and easier to follow and understand.** The new standard is 65 pages compared to 180. It is structured to follow the main phases of the audit, starting with the planning phase and ending with reporting. Also, it is written in plain English. This is a

BACKGROUND

The Sarbanes-Oxley Act of 2002* established the Public Company Accounting Oversight Board (PCAOB), and directed it to "develop an auditing standard to provide for an integrated audit of both internal control over financial reporting and financial statements," among other tasks. The PCAOB developed the standard and the Securities and Exchange Commission approved it in June 2004. Meanwhile, the SEC developed a separate standard for management's assessment of its own internal controls.** Large public companies, known as "accelerated filers", have had to comply with the SEC's rule for the past two years. Smaller companies, known as "non-accelerated filers" must have an internal control audit for fiscal years ending on or after December 15, 2007, based on the current SEC position.

The PCAOB and SEC held two public roundtable discussions held in April 2005 and May 2006, covered in previous DMXs.

* Specifically, Sections 103 and 404(b). ** See Item 308 of Regulation S-K, 17 C.F.R. § 229.308

NACD
NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

Two Lafayette Centre
1133 21st St. NW
Suite 700
Washington, D.C. 20036

202-775-0509
www.nacdonline.org

Research:
Alexandra R. Lajoux

Editorial:
Deborah J. Davidson and
Suzanne E. Grubb

standard that is not just written for professional auditors. "We wanted to write a standard that could be meaningful also for the CFO of a small company."

- **takes a risk-based approach.** As recommended by NACD directors **Michele Hooper** and **Barbara Franklin** in their comments at the May 2006 meeting (as well as the previous year), the new standard directs the auditor to consider "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." The new standard emphasizes "higher risk stages" of financial statement preparation, such as the timing right around the end of a financial reporting period. The new standards also show auditors can use risk assessment to "eliminate from further consideration" any accounts that are unlikely to contain a material misstatement.
- **works from the top down.** "Like a funnel," notes Ms. Gillan, the new standard takes a broad approach to assessing risk, and only bores down when an area merits attention. This approach to internal controls assessment begins with the financial statements and company-level controls, and then marks for further testing only controls that are deemed important to the effective functioning of a company's internal control over financial reporting.
- **eliminates redundancy of work between external auditors and others.** The new standard "requires" auditors to consider "whether and how to use the work of others," instead of doing it themselves.
- **eliminates separate standards for evaluating management's audit of internal controls** (the SEC will set and assess those standards). The new standard clarifies that "an internal control audit is limited to an evaluation of whether, in the auditor's opinion, the company's internal control is effective, and does not include an opinion on the adequacy of management's process to reach its conclusion." The PCAOB timed its meeting to follow closely on the heels of a December 13th SEC meeting that considered (among other topics) management's responsibility for overseeing controls under Section 404.
- **directs the auditor to use management's audit of internal control** to help set the scope of its own audit. This eliminates redundancy between the two audits.
- **permits auditors to use experience** gained in previous years' audits to make audits in subsequent years more efficient.
- **reduces the extent of required testing,** leaving more up to the auditors' discretion.
- **clarifies standards for material weakness,** significant deficiency, and other key terms. For example, as recommended by the Small Business Advisory Committee, they changed "more than remote" to "reasonably possible." The new rule also clarifies that the auditor's evaluation of materiality for purposes of an internal control audit should be based on the same well-established and well-recognized principles applicable to financial statement audits. (In other words, the Board recognized that there was no need to reinvent the wheel on materiality.)
- **includes a new section on scalability to smaller, less complex organizations as recommended by the Advisory** Committee on Smaller Public Companies (ACSPC), cochaired by **James Thyen,** president and CEO of **Kimball International,** and NACD member **Herbert Wander,** Partner, **Katten, Muchin, Rosenman LLP.** One of the recommendations was a new definition for "smallest" and "smaller" companies—which comprise nearly 80 percent of all U.S. public companies by their definition. The newly proposed standard does not recognize any new definition for small companies. However, it does include language urging auditors to consider the size and complexity of a company when assessing necessary levels of internal controls. The newly proposed standard, which implements almost all of the recommendations from the ACSPC (except the ones not in the PCAOB's jurisdiction), can help an auditor anticipate the various differences in smaller company internal control and tailor the audit for smaller companies. For example, some very small companies may not have an internal audit function. In these companies, "the audit committee may play a more pronounced role," notes Ms. Gillan.
- **includes a new section on information technology (IT).** The existing standard had been faulted for getting involved in too much IT trivia and the PCAOB had issued some guidance on this. The new standard includes two pages on this important subject.
- **gives boards and audit committees more flexibility in assessing auditor independence** with respect to how often they have to approve non-audit work by the auditor.[2]

Directors can help strengthen risk oversight practices by studying and commenting on the proposed new standard.

1 PCAOB webcast the meeting atwww.pcaobus.org.. Archives are available.

2 See also PCAOB Tax update in December 14, 2006: http://www.sec.gov/rules/pcaob/2006/34-54938.pdf