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May 17, 2005

We Hear You: PCAOB Releases Section 404 Guidance in Response to Roundtable Comments

Acknowledging that first-year costs were too high, the oversight board stresses risk-based approaches and discourages “checklist” audits.

Director Summary >

On Monday, May 16, the Public Company Accounting Oversight Board (PCAOB) released a major policy statement on implementation of internal control audits of public companies. In it, the PCAOB acknowledged that the costs of complying with Sarbanes-Oxley section 404 and Auditing Standard Number 2 (setting standards for assessment of internal controls) were too high during this first year of implementation.

Chairman **William C. McDonough** said, “It is clear to us that the internal control assessment and audit process has the potential to significantly improve the quality and reliability of financial reporting. At the same time, it is equally clear to us that the first round of internal control audits cost too much. Through the guidance we issue today, as well as our upcoming inspections, we are committed to seeing that AS No. 2 is implemented in a manner that captures the benefits of the process without unnecessary and unsustainable costs.”¹ The PCAOB’s guidance shows that the board and the SEC have been listening to their constituents.

Risk-based Auditing

During the April 13 **Securities and Exchange Commission (SEC) Roundtable**, many participants argued that auditors should focus their internal audit assessments toward high-risk areas while downplaying the examination of areas of low risk. <http://www.nacdonline.org/dm/NACD-DMXApr20-2005-final.pdf>

The SEC had convened the Roundtable in part because many companies had found implementation too onerous and expensive—a point made in NACD’s March 31 letter to the SEC. According to the NACD letter, “regulators should allow a risk-based approach to prioritize the scope of internal control audit based on the cumulative knowledge and judgments gained from earlier 404 work, and not simply repeat the same process approach and walk-through as required in the prior year.”²

Speaking two weeks after the Roundtable, PCAOB board member **Daniel L. Goelzer** echoed this thought, even going a step further, stating that a risk-based approach is not only desirable but it is “inherent” in the auditing



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process. In a speech on April 29, Goelzer said, “AS No. 2 encourages the auditor to start with a ‘top-down’ evaluation of controls. By approaching the task in this way, the auditor is steered toward higher risk areas and away from those with less potential for a material impact.”³

The PCAOB’s May 16 policy statement spells this out clearly: “Auditors should exercise judgment to tailor their audit plans to the risks facing individual audit clients, instead of using standardized ‘checklists’ that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas).”⁴

The PCAOB reasoned that many of the costs incurred during the first year of implementation came from audit firms using a single strategy to evaluate 404 compliance rather than crafting individualized strategies that emphasized analysis and testing of high-risk areas and deemphasized less risky areas: “Those auditors have instead

used a one-size-fits-all audit plan driven by standardized checklists that may have little to do with the unique issues and risks of the particular client’s financial reporting processes.”⁵ On the other hand, some external auditors expressed frustration that procedural guidance and compliance deadlines were ambiguous, forcing them to consolidate their audit processes.

As a result, companies incurred unnecessary costs when auditors believed they needed to focus on high- and low-risk areas alike. In addition to the financial costs sustained from assessing low-risk areas, opportunity costs arose in that evaluations of low-risk areas could have distracted auditors from thoroughly evaluating high-risk areas, exposing the organization to greater risk, and long-term costs. However, the new guidance allowing auditors to focus on areas of high-risk should come as welcome relief to all concerned: “A risk-based approach...can further reduce costs while increasing audit effectiveness,” the PCAOB said.⁶

Additionally, consistent with the Goelzer speech, the PCAOB emphasized that audit firms should use a top-down methodology when completing its examinations: “Auditing Standard No. 2 was designed to be applied from the top down. That is, the standard focuses the auditor first on company-level controls and then on significant accounts, which lead the auditor to significant processes and, finally, individual controls at the process, transaction, or application levels.”⁷ The board argued that performing the assessment in this way allows higher impact controls to be evaluated first, which would then flag auditors to more localized problems. As a result, cost savings might occur since auditors would not need to exhaustively consider areas where red flags were not present.

Redundant Work

NACD’s letter argued that “regulators should allow auditors to review and rely on previous and ongoing work by internal audit staffs and previous and ongoing internal controls oversight by the audit committee.”⁸ Such a methodology can lessen costs since auditors would not repeatedly review information previously deemed accurate.

The PCAOB’s guidance states that “auditors should take advantage of the significant flexibility that the standard allows to use the work of others.”⁹ The PCAOB acknowledges that performing redundant work can unnecessarily raise costs without any tangible benefit. Citing longstanding auditing tradition, the board concluded that if external auditors determine that internal auditors are “competent and objective,” then the external auditors may rely on their work when conducting the external audit.

PCAOB Guidance: Major Points

The Policy Statement expresses the Board’s view that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should:

- Integrate their audits of internal control with their audits of the client’s financial statements, so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits;
- Exercise judgment to tailor their audit plans to the risks facing individual audit clients, instead of using standardized “checklists” that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);
- Use a top-down approach that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and use the risk assessment required by the standard to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;
- Take advantage of the significant flexibility that the standard allows to use the work of others; and
- Engage in direct and timely communication with audit clients when those clients seek auditors’ views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

Source: Public Company Auditing Oversight Board, May 16, 2005.

Professional Judgment

In addition, NACD argued that “audit committee members should be able to rely on the protection of the business judgment rule as they determine the nature of internal controls and the scope of the audit of internal controls.”¹⁰ That is, directors acting carefully in good faith and without conflicts should be given the benefit of the doubt for their oversight of internal controls.

While the PCAOB’s guidance does not offer such a safe harbor to directors, it does suggest that auditors possess a great deal of latitude for making decisions. For instance, the board writes that “the auditor must not only exercise judgment to determine how to apply the standard to audit clients of different industries and of different sizes, but also exercise judgment to focus their work on areas that pose higher risks of misstatement, due either to errors or fraud.”¹¹ Arguing once again against a “one size fits all” mentality toward internal control assessment, the PCAOB granted considerable flexibility for assessments tailored to individual companies. In other words, the PCAOB apparently will not second-guess audit firms that produce creative or idiosyncratic plans developed specifically for a certain company in a certain industry.

Additionally, the PCAOB stresses that auditors can use professional judgment to determine how to communicate with their clients—including when to provide advice: “Determining when it is appropriate for the auditor to provide accounting advice requires professional judgment and common sense...Where management makes its own informed decisions regarding how applicable accounting principles apply to its company’s circumstances, however, the auditor may discuss freely with management the meaning and significance of those principles.”¹²

Future Directions

The PCAOB’s guidance should come as welcome relief for all participants in the audit process, especially for smaller companies which, many claimed, bore an especially onerous brunt of implementation. Said Goelzer, “Small companies do not need the same types of controls or the same audit process as do large multi-nationals. It is certainly true that smaller, less complex businesses typically need less complex controls, and the work of the auditor should reflect that fact.”¹³

The PCAOB’s guidance may relieve the frustration felt by companies of all sizes that incurred unnecessary costs due to arduous scrutiny of low-risk items, repetitive checking of (often repetitive) processes, generic audit pro-

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cedures, and forced distancing from overly cautious auditors who feared they were going to be second-guessed by regulators. Consequently, the PCAOB’s policy statement may be an important declaration that will lower the costs of compliance future years.

Endnotes

- 1 Public Company Accounting Oversight Board. “PCAOB Issues Guidance on Audits of Internal Control.” Press Release. May 16, 2005.
- 2 Michele J. Hooper, Roger W. Raber, and B. Kenneth West (representing NACD). Letter to Jonathan Katz, Secretary, Securities and Exchange Commission. March 31, 2005. <http://sec.gov/news/press/4-497/mjhooper1210.pdf>
- 3 Goelzer, Daniel L. “Perspectives on Internal Control Implementation Issues and Reporting.” 31st Annual Meonske Professional Development Conference, Ohio Council IMA and Kent State University. April 29, 2005.
- 4 Public Company Accounting Oversight Board. “Policy Statement Regarding Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements.” PCAOB Release No. 2005-009, May 16, 2005, p. 2.
- 5 PCAOB Release No. 2005-009, p. 7.
- 6 Id. p. 8.
- 7 Id. p. 8.
- 8 Michele J. Hooper, Roger W. Raber, and B. Kenneth West (representing NACD). Letter to Jonathan Katz, Secretary, Securities and Exchange Commission. March 31, 2005.
- 9 PCAOB Release No. 2005-009, p. 2.
- 10 NACD Letter to Jonathan Katz, Secretary, Securities and Exchange Commission. March 31, 2005.
- 11 Id. p. 8.
- 12 Id. p. 12.
- 13 Daniel L. Goelzer speech April 29, 2005.