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Sarbanes-Oxley and Auditing Standard II: Criticism and Revision

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The Sarbanes-Oxley Act (the Act) and related auditing standards have been the subject of recent criticism due to some unforeseen consequences in their implementation. In an effort to remediate these problems, the Public Company Accounting Oversight Board (PCAOB, the Board) has proposed a new auditing standard that, if passed, would replace Auditing Standard II, An Audit of Internal Control over Financial Reporting in Conjunction with and Audit of Financial Statements. This proposal came in response to feedback submitted by those involved with compliance as well as the results of two roundtable discussions held on the topic. The purpose of this paper is to evaluate the criticism and suggestions, as set forth by the respondents to the PCAOB's inquiry and the roundtable participants, to determine whether this proposal properly addresses those issues while still upholding the overall intention of the act.

In order to evaluate the effectiveness of the board's proposed standard, it is helpful to consider the general problems perceived to be inherent in the Sarbanes-Oxley legislation. The Act was passed in response to the devastating effects of accounting scandal and fraud at the time. Because it was passed in such haste, and with such far reaching goals in mind, its implementation has been flawed. Many of these flaws are the unintended and unanticipated consequences of compliance, and should be the starting point for revision.

Arguably the most common complaint about the Act has been that the costs were entirely misjudged by its proponents. At the time of the Section 404 proposal, the SEC estimated that issuer companies would incur an extra five burden hours for each quarterly and annual report in connection with the audit of internal control. (Butler, p. 40). It is clear that the SEC did not have a full understanding what such an audit would

entail, as this number was hugely underestimated. The SEC subsequently upped its estimate to around \$91,000 per company, not including additional costs related to auditor attestation. (Butler, p. 40) Though a closer estimate than the mere five burden hours previously projected, this number too was a far cry from the actual costs of the act. Not only do direct audit and compliance costs have to be considered (which alone were highly underestimated) but one must also take into account the opportunity costs associated with compliance work.

In addition to the costs associated with Sarbanes-Oxley, United States public companies are facing other obstacles, putting them at a disadvantage. The work and costs associated with compliance discourage foreign firms from doing business in the United States. Furthermore, due to increased liability on their part, the Act has also forced executives to question whether it is worth it to stay in a public company. Post Sarbanes-Oxley corporations are losing top executives to private equity. Finally, another unintended consequence of the Act has been the forcing out of small firms, who cannot bear the costs and burdens of compliance.

Sarbanes-Oxley has had significant effects on the accounting profession as well. The Act has contributed to confusion regarding auditing standards particularly because there appears to be an overlapping of responsibilities between the PCAOB and AICPA. Also, with a number of different sets of standards and interim standards, conformity with international standards has become nearly impossible. In addition, both executives and accounting firms have reported that the Act has infringed upon their auditor-client relationship. The stricter rules regarding client and auditor relationships, though intended to prevent collusion, have had their negative effects as well. Rotation of

auditors is a step in preventing an inappropriate client/auditor relationship, but it is also a step towards cutting back on the learning process. The same can be said about the prohibition of consulting work by the auditor.

More specific criticism of the Sarbanes-Oxley act includes an assessment of Section 404 (internal control), and in particular, Auditing Standard II (AS 2), An Audit of Internal Control Over Financial Reporting in Conjunction With an Audit of Financial Statements, passed by the Public Company Accounting Oversight Board in March of 2004.

Auditing Standard II: Background

The Sarbanes-Oxley Act itself was passed in 2002 and Section 404 of the Act was implemented by the SEC in June of 2003. The PCAOB drafted AS 2 for the auditor's use when "assessing whether managers of a public company have accurately reported on companies' internal control over financial reporting." (PCAOB Release 2004-001). In the passage of the Sarbanes-Oxley Act, Congress required both that management prepare a report on internal control and that the auditor attest to such a report. The PCAOB did not want this attestation to be equivalent to a generalized "rubberstamp" approval by external auditors and therefore, in its standard, required that the auditor perform an audit of internal control in conjunction with audit of financial statements. In its release, the PCAOB stated that, though defined as an attestation in the Act, the engagement involves the same level of work as would an audit of internal control. The PCAOB mandates that the auditor's responsibility includes both to opine on the effectiveness of the processes by which management deems internal control to be effective, and whether or not the auditor agrees with management on its opinion of. In

this process, the auditor should gain an understanding of how management reached its conclusions, as well as a general understanding of the internal control system of the company. The standard requires that management base its assessment on a recognized internal control framework, such as the COSO Framework.

AS 2 specifically requires auditors to perform walkthroughs of any significant control procedures for all annual audits. The PCAOB cites the detection of any changes in internal control to be the reasoning behind the requirement that walkthroughs be performed every year. The work of others (internal auditors, management, etc.) cannot be used to fulfill this requirement. The standard addresses the idea that the auditor must use judgment in order to choose which procedures are deemed to be “significant”.

The standard explicitly indicated that each audit must “stand on its own”, thus requiring that the auditor obtain sufficient evidence regarding the effectiveness of internal control for each audit. The PCAOB included, in the appendix of AS 2, some examples of extent of testing examples to further the auditor’s understanding. The standard also allows for the auditor to obtain evidence regarding operating effectiveness throughout the year, provided that he updates and/or obtains other evidence at year end.

In AS 2, the PCAOB particularly addresses the concept of the use of the work of others. The requirements regarding such use are based on the concepts of Statement of Auditing Standard No. 65 (“Auditor’s Consideration of the Internal Control Function in the Audit of Financial Statements”), although somewhat adapted to meet the needs of an audit of internal control. AS 2 requires the auditor to understand the results of procedures performed by others, review reports issued by the internal audit function, and to investigate any deficiencies referred to in the reports. The work of others is permitted to

be used as a basis to alter the nature, timing, and extent of auditing procedures, provided that the auditor has taken into consideration the preparer's competency and objectivity.

Once all testing has been performed, AS requires the auditor to evaluate the severity of all identified control deficiencies. The standard defines a control deficiency as existing "when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis." To assist the auditor in the classification of deficiencies, AS 2 includes a list of circumstances that are strong indicators that a material weakness exists.

If no material weaknesses are found to exist after all procedures have been performed, the auditor can issue an unqualified opinion. Like in the audit of financial statements, if the auditor cannot express an opinion, the reasons therefore should be stated. The report should contain two opinions: one on management's assessment and another on the effectiveness of internal control. AS 2 requires, for both the management assessment and the auditor's report, that only material weaknesses (not significant deficiencies) be disclosed. If the auditor concludes that a material weakness exists, he is bound by AS 2 to issue an adverse opinion on internal control. However, if management's assessment properly included the material weakness, the auditor is permitted to issue an unqualified opinion on management's assessment, but must issue an adverse opinion if he disagrees with management regarding the existence of a material weakness. The PCAOB reasoned that the two opinions on internal control would be more informative when a material weakness exists and cites that as the basis for the dual opinion requirement.

The Board stressed the idea of an “integrated audit” in AS 2. In its release, the Board states that “One cannot be separated from the other” because the information, goals, and work related to the audit of financial statements and the audit of internal control are closely related. The board also addressed the concern that internal control is not “one size fits all” and resolved that such an audit should be tailored to the individual client. The standard was adopted after it was proposed, posted for public comment, discussed at a roundtable, and subsequently edited and revised.

AS 2: Criticism

After the first year of implementation, many of the involved parties expressed a concern about the effectiveness of the standard. Criticism included burdensome costs, ambiguities in the standard, and an auditing profession overly concerned with self protection. The SEC and PCAOB recognized the need for improvement of the standard and/or the implementation thereof. A roundtable discussion was scheduled in order to address these issues with a group representative of the involved parties.

In preparation for the roundtable discussion to be held April 13, 2005, the SEC asked for written feedback regarding the implementation of Sarbanes-Oxley internal control provisions. To this query, there were two hundred and thirty six responses. Writers of these comment letters ranged from the “Big Four” accounting firms to college students and professors. Though the responses vary in opinion, an overall opinion is determinable for each of the following groups: Public Company Executives, Public Accounting Firms, Internal Auditors, and Foreign Firms.

AS 2 Criticism: An Executive Perspective

Of the two hundred and thirty six letters, fifty three were submitted by Vice Presidents/Chief Financial Officers; twenty six by Chief Accounting Officers/Controllers; and an additional twenty five by Chief Executive Officers. Collectively, over forty percent of the responses were written from the perspective of a top executive of a public corporation. No other group was represented as strongly. Furthermore, there were several points that were recurrent in the responses. Chief among these points was the concern about the burdensome costs imposed upon corporations. A survey by Financial Executives International found that 94% of public corporations' executives polled felt that the costs of compliance far outweighed benefits.¹ In their responses, executives expressed their belief that many of these costs will be ongoing and not just associated with initial implementation of the Act.

Moreover, subsequent compliance costs must be taken into account when considering changes to the system, processes, or organization. Though these changes may be beneficial to the organization, and maybe even its internal control, their implementation may be hindered by the onerous cost of the related testing and documentation required. This forces companies to choose between not attaining the benefits of constructive change or dealing with (and paying for) these compliance procedures. Such a situation discourages companies from enacting changes that will benefit the company, and more importantly benefit the shareholders. The overall purpose of the Act was to protect the investor. There must be some point where the opportunity costs of compliance surpass the protection offered by the Act. Shareholder protection clearly has its place and importance, but a proper balance must be struck. Take for

¹ "Learning to Love Sarbanes-Oxley" Amy Borrus: Business Week, Novemeber 21, 2005

example, a company wishing to implement a new IT system that would both cut costs and improve internal control. It seems that such a system would increase the possibility of greater shareholder return while reducing the possibility of shareholder loss due to fraud. If the 404 requirements are so oppressive that a corporation would decide against such a decision, then Sarbanes-Oxley (as it has been implemented) has proven to be a self-defeating act. Many of the writers of these comment letters indicated that they understood and agreed with the importance of proper internal control but feel that they are staying in business merely to comply with 404. What's more, costs of compliance can be too much for small companies to bear. The forcing out of small firms was an unintended result of the Act. Bob Baker, chairman of BBJ Environmental Solutions, expressed this concern in his comment letter:

“We cannot tolerate the current burden. I plan to recommend to our Board on Monday that we immediately initiate the process to go private.”

It was also clear that these executives were beginning to see the accounting profession through a new light. In these first year letters, many reported a newly strained relationship with their auditors. The reasoning behind recent corporation-auditor conflict is two fold. Auditors now have a great responsibility (and liability) in their audits. And while corporations are paying, auditors are perceived to be reaping the benefits. Because of the auditor's fear of liability, and because of unclear legislation, auditors may be inclined to take their audits to a level that would objectively be seen as unnecessary.

Alejandro M. Sanchez, CEO of Florida Bankers Association responded:

“Since the cost of the audit process is not borne to them, the result appears to be an exquisite attention to detail.”

Similarly, John E. Keyes, CFO of Urban Outfitters, Inc. wrote:

“The interpretation of the act by the accounting profession has become one of self-protection.”

As noted in several of the comment letters, this attitude of self defense stems partially from a lack of clear guidance. Loretta V. Cangialosi, Vice President and Controller of Pfizer, wrote:

“Moreover, lack of definitive guidance coupled with diverse interpretations by both registrants and the public company accounting firms has resulted in inconsistent application.”

Many of the complaints noted by executives stem from the fact that the guidance offered by AS 2 is not sufficient. Because it is ambiguous, and because there is a new sense of liability and responsibility, the accounting profession has taken auditing to a new level.

Common among the responses was a call for clearer guidance relating to definition and classification of deficiencies, the use of professional judgment, and the reliance on the work of others. Also noted was the fact that guidance comes from multiple sources (SEC, PCAOB) causing further confusion.

Another criticism of the Act, as pointed out by executive respondents, is the fact that documentation seems to prevail over the concept of internal control as a whole. At times, it appears that the essence of the Act has been lost to the minutiae. John E. Keyes (CEO, Urban Outfitters, Inc.) commented:

“The work product is focused more on documentary evidence on the true control aspects of the business....The accounting firms are much more concerned about

having visible documentation to support reviews than they are with the validity of the reviews and the accounting accuracy and control.”

In all steps of implementation, there should be some reference to the bigger picture.

After all, is it more important that the controls are in place, or is it more important that it is documented?

Along those same lines, several of the letters made reference to the “tone at the top”. Many executives indicated that Section 404 focuses too narrowly on the lower level controls, for which these documentation requirements apply. Though these do represent a risk for any company, they believe the largest risk resides at the top. Management integrity coupled with appropriate corporate governance provides a company with a system of controls beyond that achieved by something like the documentation of proper signatures. Case in point: Enron. The epitome of corporate malfeasance, Enron serves as an example of the capabilities of top executives. Since this and similar scandals were the forces behind the passage of the Act, it must be assumed that prevention of similar scandals was largely its intention. If that is true, the real question is, would 404, as it is currently being implemented, prevent another Enron type scandal?

The comment letters from these executives were not without suggestions for improvement. Several of the respondents offered ideas to be discussed at the roundtable. Many executives responded with similar recommendations. First and foremost, they expressed the need for clearer guidance for auditors. Without clear guidance, auditors are forced to go a step further, without knowing if it is truly necessary. While clarification cuts down on ambiguities, they believe it will also help the auditor decide when it is appropriate to use professional judgment, something they believe to be essentially non

existent in the auditing profession today. In the “Suggestions” section of his comment letter, Steve Odland, Chairman and CEO, Office Depot, Inc., wrote:

“We believe that specific amendments could be made to Auditing Standard No. 2 to encourage the auditor to exercise greater professional judgment in the internal control process.”

Respondents also highlighted the definitions of a significant deficiency and a material weakness as areas of key concern. A common response was that the threshold for significant deficiency was too low. Since an auditor’s responsibility is to obtain reasonable assurance (not absolute), they believe guidelines for these deficiencies to be too rigid. Loretta V. Cangialosi, Vice President and Controller, Pfizer, responded:

“We believe that the definition and guidance surrounding the analysis of control deficiencies should focus more on obtaining reasonable, not absolute, assurance and the existence of “material” weaknesses, rather than “significant” deficiencies.”

At the same time, writers complained that management and the auditors have had to spend a significant amount of time (and money) trying to categorize a deficiency. Executives are critical of the fact that a lot of resources are being used in a debate about whether the possibility of a deficiency is more or less than remotely possible.

Letter writers also suggested a greater reliance on the work of others in an effort to cut down on the duplication of some processes. They argued that walkthroughs and other procedures are being performed twice in very similar ways. It has become a great resource burden (both time and money) for which they see no major benefit. In order to reduce these costs, they believe auditors should be able to place greater reliance on things like the work of internal auditors and the assessment prepared by management.

Alternatively, it has been suggested that the standards should ease the requirements for these procedures, such as limiting the number of walkthroughs to a random sampling. Another suggestion was to reduce the requirements on year end testing, and spread the procedures out over the course of the year.

The complaints of top executives encompass the idea that the Act has posed a serious hindrance on the overall running of their businesses. Implementation of AS 2 has had ramifications far beyond those originally considered. The financial, time, and resource burdens of the Act must be at least partially mitigated in order to allow for an environment conducive to corporate growth. Perhaps what is needed, which has not been achieved by the Act so far, is a system where public corporations and accounting firms, and the objectives thereof, are not at odds with one another.

AS 2 Criticism: An Internal Audit Perspective

Internal auditors have also been heavily impacted by this new legislation and have therefore responded to the inquiry by the SEC. Since the enactment of Sarbanes-Oxley, and the implementation of Auditing Standard 2, their focus has been shifted to compliance. Though complaints were similar to those stated by executives (time, resource burdens etc.), the high level of involvement of internal auditors allows them to offer more specific criticism. Overall, internal auditors noted a lack of clear guidance intended for their use. Even with proper attitudes and efforts regarding internal control, insufficient guidance makes compliance difficult. Contradictory interpretation by different parties also poses a risk for internal auditors, whose work is essentially approved by the external auditor. Blake Barney, Internal Audit Manager, Matures Sunshine Products commented:

“...the registrant has no leg to stand on, no guidance designed for our use, and we are virtually at the mercy of firm interpretations...”

Internal auditors criticized the number of key controls identified, as well as the significance of those controls. Their belief is that the classification of a key control is far too liberal, especially for small companies, and would not necessarily be helpful in detecting misstatement. They would like to see a more risk based, top down approach, which would ensure that higher level controls be given their proper treatment and the lower level controls theirs.

Internal auditors also noted an unnecessarily narrow focus on documentation. Though existing controls and procedures may be effective, documentation seems to take precedence. Especially for low level controls, the documentation of the control procedure may actually be as time/resource consuming as the control itself. This again reverts back to the idea of giving each level of control its proper attention based on its overall relevance to the audit.

Duplication of auditing procedures was a complaint common among internal audit respondents. Many procedures and walkthroughs were performed by the internal audit department and then by external auditors. This is largely the result of the duplication of opinions by management and the auditor. Because they opine on essentially the same thing, the processes to arrive at that opinion are basically the same. Dennis M. Stevens, Internal Audit Director of Alamo Group responded:

“Internal and external audit teams visited the same locations at essentially the same time to perform essentially the same tests, putting a severe strain on our operating

people. In some cases, there were more auditors on-site than there were people in the accounting department.”

Professional judgment and reliance on the work of others are two areas that internal auditors indicated as in need of improvement. Without proper guidance for auditors, they tend to err on the side of conservative. Though this conservative approach means extra testing and work on the part of the auditor, it means extra money and employee time for the client. Overall, internal auditors noted more of a focus on satisfying the external auditor than on truly improving the internal control processes. There is little time to make non-compliance related improvements/changes to the internal control system to benefit the business. In essence, the internal audit department exists to please the external auditor.

Overall suggestions for improved AS 2 implementation encompass the idea of a more tailored audit. Allowing the auditor to cater the audit to the specific size and complexity of the client would help mitigate the current burden on public corporations. For example, the number of key controls identified for a small simple corporation would not be the same as a large complex one. The controls identified would truly be significant to the audit and the prevention of misstatement. Internal auditors also called for the correction of duplicate opinions regarding internal control to eliminate repetition of procedures and to alleviate onerous costs. Finally, specific guidance for the registrant would help with overall compliance and auditing procedures.

AS 2 Criticism: An Auditor Perspective

As noted above, many respondents expressed their belief that the attention given to low level controls was unwarranted. Although external auditors agree that some kind

of balance must be achieved, lower level control deficiencies can indicate problems higher up in the company. For example, very little documentation for low level controls may be indicative of management with very little regard for internal control. The “tone at the top” might be assessed by evaluating how that tone trickles down through the organization. If management truly promotes a proper control environment, this would be evidenced with adequate (but not perfect) internal control at low levels. Management’s outlook on Sarbanes-Oxley plays an important role. Work performed merely to comply with 404 requirements will not achieve the same benefits as work performed to actually improve internal control and operating effectiveness.

It also appears that the idea of professional judgment has been lost in the Act. An auditor’s responsibility in an audit is to obtain reasonable assurance that the financial statements are free from material misstatement. Judgment is inherent in the auditing profession. This is evidenced by the fact that there must be some basic judgment in each audit to determine what reasonable assurance is. When little or no professional judgment is used, it appears that the aim of the audit is to achieve absolute assurance, rather than reasonable. When auditors are stripped of their ability to make these kinds of judgments, an audit becomes more like a series of checklists than an evaluation of overall financial statement presentation. The implementation of the act should be realigned with the auditing profession. In a BusinessWeek article, “Mr. McDonough, You Have the Floor”¹ PCAOB chairman, William J. McDonough addressed this concern with the comment:

“Auditors have to use judgment. They have a great deal of leeway. But in a litigious society, there’s no question that some auditors may be protecting themselves by doing work that all of us might think objectively is excessive. That I

¹ “Mr. McDonough, You Have the Floor, August 1, 2005. p. 56

want to see eliminated. The leadership of the firms agrees. But [auditors] have to be convinced that their leader will not be pleased by excessive work.”

External auditors, while acknowledging the significant increase in costs, are optimistic about the future. Several reasons for the burdensome costs of first year implementation were noted. The experience was new for both auditor and client. Learning curve benefits will only appear in subsequent years. Also, auditors indicated that in many cases, compliance costs included improvements to the internal control systems that had been put off for years. Because these improvements are one time events (or once every several years) these costs should not be considered as directly related to the audit.

Improved investor confidence was clearly a goal hoped to be achieved by Sarbanes-Oxley. If implemented correctly, it should improve confidence in public companies and auditors and have a positive economic effect. There can also be a reward for issuers who regard the act as important and beneficial. A business week article¹ discussing the effectiveness of Sarbanes-Oxley included several companies who reported great benefits derived from the act. These benefits include increased efficiency and productivity. The requirement set forth by Section 404 of the Sarbanes-Oxley Act forced them to re-examine their internal control and operating activities, wherein they found opportunities for improvement.

In addition to the comment letters furnished by each of the “Big 4” firms individually, they collectively submitted a letter in which they included the results of a

¹ “Learning to Love Sarbanes-Oxley” by Amy Borrus: Businessweek, November 21, 2005

research project performed by Charles Rivers Associates. The report¹, commissioned by the “Big 4”, took a sample of ninety of the firms’ clients belonging to the Fortune 1000 to collect information regarding revenue, compliance costs, and deficiencies for each. When averaged, compliance costs for these 90 firms represented .10% of revenue. Furthermore, .02% of revenue went towards audit fees. These clients reported an average compliance cost of 7.8 million in 2004. When surveyed regarding estimated compliance costs (including audit fees) for 2005, an average of 4.2 million was reported, predicting a 46% decline in such costs. The report also took into consideration the number of deficiencies identified during 2004 but that were remediated during the year and excluded from disclosure at year end. An average of 348 deficiencies per company were identified during 2004. During that year, an average of 271 were remediated, leaving 77 to subsequently be remediated. The data collected from the companies provided information that of these 77 deficiencies, 74 were thought to be control deficiencies, and three significant weaknesses. Of the 90 companies surveyed, a total of 5 material weaknesses were reported at year end. The audit firms included this report in their comment letter to the SEC because its results lend support to their assertions concerning costs and effectiveness of 404. Not only did the report suggest that audit fees comprised a small portion of compliance cost, but also that compliance costs represented a small percentage of revenue. Furthermore, data indicated that there will be a decline in such costs in subsequent years, as suggested by the public accounting firms. PCAOB chairman William J. McDonough concurred with this prediction as well. In an August 1,

¹ Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample Fortune 1000 Companies, Charles River Associates, April 2005

2005 BusinessWeek article¹, McDonough responded to a question concerning second year compliance costs with the answer:

“For a well-managed company where 404 was not that big a deal, costs will come down. Companies that really had to scramble may have an expensive second year because of investments in the system.”

Finally, the report suggests that 404 efforts were not in vain. The deficiencies corrected prior to year end have received little attention but play an important role in effective internal control and possibly even efficiency in running the business. The Charles River Report provided an empirical basis for support for the “Big Four’s” contentions concerning Sarbanes-Oxley implementation.

Though these firms believe that some of the problems with Sarbanes Oxley will self correct in subsequent years, they did provide some suggestions for improvement. The majority of these suggestions centered on additional guidance for both the issuer and the auditor. Specifically, they believe supplemental guidance regarding management’s assessment would be beneficial for both issuer and auditor. Though AS 2 requires that management support its assessment with sufficient evidence, there is very little indication as to how they the sufficiency of such evidence should be determined. If the PCAOB provided guidance on issues like the nature, timing, and extent of management’s testing and the degree of detail necessary in its documentation, then management would be in a better position to prepare such an assessment and it would simultaneously put the auditor in a better position to evaluate it.

Similarly, auditors responded with requests for further clarification or guidance for some of the terms included in AS 2. Specifically, the use of the phrase “significant

¹ “Mr. McDonough, You Have the Floor” BusinessWeek, August 1, 2005, p. 56

accounts and disclosures” has caused some confusion about how such a judgment should be made. The definitions of “significant deficiency” and “material weakness” were also indicated as areas in need of reconsideration. It was suggested that the guidance be recalibrated so that the audit doesn’t focus too much on low risk aspect of controls, where a deficiency would probably be inconsequential. At the same time, these definitions should not be changed in a way that would weaken the effectiveness of the standard.

The overall response from auditors’ requested that any changes in AS 2 be conducive to a more principles based approach, instead of rules based. This would include the use of professional judgment; something they believe could be more clearly communicated in the standard.

AS 2 Criticism: An Outside Perspective

An important consideration for today’s business environment is the implications the act has on businesses outside the United States. The standards set forth by the SEC and PCOAB are not entirely conducive to international standards. What’s more, the fact that the standards are coming from different standard setting bodies, not to mention interim standards, makes cohesion all the more difficult. Those concerned with Sarbanes-Oxley implementation involving foreign firms also responded with their comments too. Because they may also be subject to other such legislation they offer a unique perspective. They can comment on the ease with which Auditing Standard 2 is implemented in conjunction with the legislation of other countries to which the business is subject. Furthermore, they have the ability to make comparisons of the United States’ standards with those of other countries. Many of their observations were parallel to the comments already highlighted by other involved parties. Letters included concern

regarding cost-benefit relationship of Sarbanes-Oxley, as well as the amount to which it increases shareholder value. Those who have had experience with other internal control legislation suggested that Sarbanes-Oxley, and Auditing Standard 2, do not achieve their intended purposes. In order for that purpose to be achieved, a more risk based approach would have to be developed. The rules based approach now being used is neither an efficient nor effective means of managing internal control. CBI, a United Kingdom based company, providing the SEC with feedback on their experiences with first year implementation, wrote:

“It would appear from the outside that the focus on minutiae has led many US companies to work from the bottom up from detailed lists of risks rather than top down by looking first at the key risks to the business and working back to deal with those key risks first.”

Some of the letters received from foreign firms made reference to the Turnbull Guidance as an example of a more risk based approach.

Finally, letters received from foreign firms expressed a growing concern about the competitiveness of US firms. The effects of Sarbanes-Oxley have been felt by public corporations. High compliance costs resulted in lower shareholder return for the year. In light of the new legislation, many public corporations have lost well qualified executives to private equity companies. Management’s focus has been shifted away from making beneficial changes and improvements to the company. These repercussions have not been felt equally around the world, putting companies listed in the United States at a disadvantage.

Roundtable Discussion

After letters had been received and considered, the SEC hosted a roundtable on April 13, 2005. SEC and PCAOB members, as well as other involved parties, gathered to discuss the implementation of Section 404 of the Sarbanes-Oxley Act as well as the requirements subsequently set forth by the PCAOB. In order to properly assess the matters from all viewpoints, participants included auditors, issuers, and investors. Many of the key topics discussed were those included in the comment letters.

An overall consensus was reached that the Sarbanes-Oxley Act itself was valuable but the subsequent rulemaking and implementation was in need of modification. Additional guidance was requested to be issued as soon as possible, as planning for the next year's audit was quickly approaching. SEC staff was requested to evaluate the roundtable discussion and comment letters received to consider whether and how additional guidance would improve implementation. Additionally, PCAOB chairman McDonough announced his plan to issue staff guidance that would address the issues deemed to be important by the involved parties. This guidance was to be released by May 16, 2005. (Orenstein, Edith)

Such guidance came in the form of a Board Policy Statement as well as a series of staff questions and answers issued by the PCAOB. The board viewed the scope of the internal control audit and the extent of testing to be one of the largest cost drivers of post Sarbanes-Oxley audits and so focused the guidance on these topics. The goal was to correct auditor's misconception that conducting an audit in adherence with Auditing Standard 2 did not involve the use of professional judgment. On the contrary, the board used this guidance as a means to encourage auditors to use professional judgment to plan and perform an audit that is both effective in achieving its purpose and cost efficient.

The Board Policy Statement instructed auditors to use their judgment to tailor the audit to the specific needs and risks of a particular client instead of using a universal “checklist” approach. The problem with such an approach is inherent in the different businesses, environments, and activities and clients. Instead of the checklist dictating the extent of auditing procedures, they should be molded by the particular risks assessed by the auditor. This method safeguards the audit against a focus on insignificant areas of control while neglecting those posing the most serious risks. Along those same lines, the PCAOB suggests a “top down” approach wherein the auditor first assesses the entity level controls in order to subsequently determine the nature and extent of testing performed on lower level controls. This will help direct the auditor’s attention to those areas where it is truly necessary while cutting costs by allowing the auditor to decrease testing where appropriate. As another cost cutting measure, the PCAOB directs auditors to integrate the audits of financial statements and internal control so that procedures performed for one can also be used in the other. The guidance issued at this time also sought to clear up any confusion about the use of work of others, claiming that Auditing Standard 2 offers considerable flexibility on such matters. This again reverts back to the auditor’s use of professional judgment. Knowing that a breakdown in client-auditor relationships is beneficial to neither, the PCOAB suggests the auditor’s communication of his view regarding accounting and internal control decisions, when inquired by the client. Such communication prior to the audit gives the client the opportunity to make decisions after taking the auditor’s viewpoint into consideration. In conclusion, the PCAOB stated its intention to take further measure to ensure the proficient implementation of Auditing Standard 2. One of the areas specifically addressed was

concern about audits of internal control over smaller public companies and foreign companies. In an effort to make the first year of implementation (set to be 2006) go as smoothly as possible, the PCAOB was working with SEC's Advisory Committee On Smaller Public Companies as well as the Committee of Sponsoring Organizations of the Treadway Commission's proposal on implementing the COSO Control Framework in Smaller Businesses. (Orenstein, Edith)

Year Two Experience

The guidance issued in May of 2005 sought to address the issues deemed to be the most significant by roundtable participants and comment letter respondents. However, the board viewed this guidance as more of a work in progress than a final solution. The guidance offered did address the concerns about the costs incurred by issuers and auditors' fear of liability and use of professional judgment. However, the effectiveness of such guidance can only be evaluated after it has been implemented. For this reason, the PCAOB asked for written feedback on year two implementation using the newly issued guidance.

Respondents again ranged from issuers to auditors to investors. Many of the concerns were recurrent with those expressed in the prior year. However, the degree to which they were viewed as problematic is indicative of the partial effectiveness of the May 2005 guidance.

Year 2: Executives

Executives of public companies, still concerned with the burdensome costs of compliance in year two, stated many of the same claims. Some made reference to the PCOAB's guidance issued in 2005 but noted the auditor's reluctance to rely upon it.

Respondents claimed that use of professional judgment and the use of work of others, as permitted by the May 2005 guidance, was not being used to the extent that it could be. In addition to the use of work performed by internal auditors, executive respondents were lobbying for the use of work performed by management. David K. Owens, Executive Vice President, Edison Electric Institute, expressed this concern in his letter dated May 1, 2006:

“The SEC and PCAOB should strengthen and promote reliance on the Board’s May 2005 guidance, which recommends some reasonable approaches to implementing Section 404. EEI members are hearing from their external auditors that the auditors fear being held to a tougher standard by the PCAOB when the auditors themselves are audited by the Board. The Board and Commission should provide assurance that external auditors can fully rely on the guidance and will no be second-guessed during later PCAOB audits.”

The issuance of PCAOB guidance means very little if the auditor lacks the confidence to use it. Even if the guidance, on paper, is efficient and useful, these efficiencies will never be felt by issuers and auditors unless the auditor relies upon it in his audit. Providing some kind of assurance to abate the fear of liability is a step towards gaining the efficiencies the guidance sought to achieve.

The idea of materiality versus cost was again highlighted as an area of concern. The May 2005 guidance did seek to address this concern but it is not clear if issuers’ disappointment in the cost reduction in year two was the result of insufficient additional guidance or the auditor’s reluctance to use it. It was again suggested that a more risk based approach would achieve the purpose of the audit without requiring public

companies to incur unnecessary costs. Like in year one, executives of these public companies suggested a focus on entity level controls and rotational testing of other controls. Comment letter writers again asked for clarification and specification regarding the definitions and evaluations of materiality and deficiencies. Loretta V. Congialosi, Vice President and Controller of Pfizer commented:

“In particular, additional guidance is needed for the measurement of “more than inconsequential”. Although common approaches to this quantification problem are being broadly adopted, there is insufficient guidance to provide authority for such an approach. Without such guidance, issuers must essentially agree with external auditor judgments on materiality, which may be set arbitrarily low”

Additionally, complaints regarding the five-year rotation rule were included in the second year comment letters, claiming it to be a great inefficiency. Respondents claim that it takes time for the auditor to become acquainted with the client, business, and industry. Once the auditor obtains this understanding, he can plan and perform the audit with more ease. When the auditor is rotated off, the client must spend time, money, and other resources to acquaint the new auditor, something they find to be wasteful and burdensome. Partner independence is viewed as being crucial and so the idea of rotation should not be completely abandoned. Executives responding to this PCOAB query ask not for the extinction of this requirement, but for a longer rotation period. They believe it will achieve the same benefits while creating greater efficiencies.

Year 2: Internal Auditors

Internal auditors again responded with similar criticism and proposals. Although improvements were seen in year two as a result of the May 2005 guidance, those in the

internal auditing profession saw more work to be done. Again, a focus on entity level controls and greater reliance on the work of others was requested. They too saw the reluctance of auditors to place full reliance on the additional guidance. Robert Burton, Director of Internal Audit at ADC telecommunications, expressed his concern about the amount of attention given to everyday processes, stating that:

“The risk of a material misstatement to the financial statements is in the following areas where controls are few and risk is high:

- **Entity Level Controls**
- **The Financial Close Process**
- **Revenue Recognition”**

Burton’s letter went on to discuss the root of the problems at Enron, World-Com, and Adelphia, attributing these major cases of fraud to insufficient controls at the entity level and in the financial close process, concluding that:

“ Controls related to routine processes and transactions are important , but the risk does not warrant the extensive amount of time and dollars that SOX 404 currently requires. The PCAOB should re-focus SOX efforts to where the risk really is.”

Year 2: Auditors

The “Big 4” again responded with their thoughts individually. There was a general consensus among the public auditing firms that year two results were conducive with their predictions, meaning that costs were cut while benefits continued to be derived. Decreased costs in year two can be attributed to the fact that, in general, a substantial amount of the documentation had been completed in the prior year. Unless there were major changes in the business, the documentation procedures were far less extensive than

in year one. The additional guidance issued by the PCAOB in 2005, coupled with the experience of both the auditor and issuer, contributed to the progress towards greater efficiency. In their comment letter concerning second year implementation, PriceWaterHouseCoopers noted the following:

“With a significant portion of deferred maintenance completed in Year one, Year two has shown management’s focus on making more permanent control improvements and streamlined control process. During the 2005 audits, we began to observe a shift in management’s focus on making more permanent control improvements and streamlined control processes.”

Not only did auditors see progress in management’s attitude towards compliance, they also noted improvements in the audit committee and board of director’s regard for their responsibilities concerning the financial statements. Increased investor and analyst confidence in and reliance on the financial statements of public companies were also believed to be partially the result of the internal control work completed in the prior year. From the point of view of public accounting firms, the costs of year one had already been incurred. Though they were quite onerous and burdensome, they were the result of years of neglectful internal control consideration. Year two indicated a trend towards reduced compliance costs. To scrap the idea entirely would render worthless the costs and improvements of the first two years. Instead, the SEC and PCAOB should focus on providing any guidance that will create greater efficiency and benefits for the auditor and issuer.

Those speaking from the perspective of an external auditor saw room for improvement in a number of particular areas. Although the PCAOB attempted to clarify

any ambiguities in their May 2005 release, auditors indicated some matters in need of further adjustment. Specifically, auditors found that there was still a lack of guidance relating to the standards for management's assessment. Such ambiguities include the degree to which management is required to document controls, test controls (especially relating to companies with many locations) and the extent of evidence necessary for support. Without such guidance, management may either over-document, over-test, and obtain more than sufficient evidence so as to ensure that their assessment is adequate. Conversely, since there is no set protocol for such procedures, management may not complete the assessment as thoroughly as is desired. Providing the management of public companies with specific standards for their assessments will not only make the procedure uniform across all public companies, but it will save the management the time and resources used to consider the extent to which it must be completed, as well as the time it takes the auditor to determine whether or not it was sufficiently prepared.

Additionally, public accounting firms expressed a growing concern for the imminent internal control audits of smaller public companies. They urged the PCAOB and SEC to take into consideration the special needs and circumstances of such companies and to issue guidance accordingly. Such guidance regarding internal control, assessment, and effectiveness should be provided for both the auditor and the company's management. In their response to the PCAOB inquiry pertaining to second year implementation, Grant Thornton included the following comment:

“There has never been, nor is there now, the practical, ground-level guidance that both companies and auditors need to determine-in a consistent fashion-what

determines an effective internal control environment across all businesses, regardless of size.”

The auditor’s concern regarding Section 404 implementation in smaller firms is that such companies are not in the position to bear such costs. As noted before, an unintended consequence of Sarbanes-Oxley was the forcing out of smaller U.S. public companies. One way to circumvent this outcome would be to provide the management of smaller public companies with proper guidance relating to their specific internal controls needs. For example, smaller companies may not have the same ability to segregate duties as would larger ones, simply due to the smaller number of employees and departments. Another unique challenge of smaller companies is the lack of formality in some documentation processes. Specific guidance relating to these and other issues would be helpful to the auditor and issuer. Several of the letters also recommended a field testing of the guidance so as to properly assess its effectiveness, and to allow for subsequent revision and/or clarification. External auditors suggested that the SEC and PCAOB should include all involved parties in the development of this guidance so that all of their concerns will be addressed. In its second year comment letter to the PCAOB, Ernst and Young, LLP wrote:

“The SEC will need to oversee the process, or at least play an active role in establishing the process and place its stamp of approval on the output such that the resulting guidance is objective, practicable, authoritative, and most important, germane to the issues faced by smaller public companies.”

In a BusinessWeek article entitled “Report From a General in The SEC’s War on Fraud”¹, SEC’s chief accountant, Donald T. Nocolaisen, responded to the question about whether smaller companies should get some relief in the audit of internal control, saying: **“The internal control requirements are making larger companies and auditors dig deeper and produce better information. Small companies need strong controls, too, but we need a different framework-one tailored to their particular structure. Under the current framework the cost may be enormous. These companies make up only 1% or 2% of market capitalization. I have always encouraged entrepreneurship and growth in the small-business arena, so this must be resolved. “**

Roundtable 2

Acknowledging that several more issues had to be addressed, the PCAOB and SEC jointly scheduled a second roundtable for May 10, 2006, inviting a plethora of involved parties, ranging from auditors and issuers to members of the legal and academic communities. Five panel discussions were planned on the following topics: Overview of the Second Year, Management’s Evaluation and Assessment, The Audit of Internal Control over Financial Reporting, The Effect on the Market, and The Next Steps.

Questions regarding second year implementation focused on a comparison with year one, any improvements seen, and any areas in need of modification.

The second panel involved a series of questions concerning Management Evaluation and Assessment, and whether there is sufficient information available for management for these procedures. Panelists were asked whether the May 16, 2005 guidance was helpful and/or sufficient and whether additional guidance is needed in any particular areas. There was also a discussion over the degree to which a risk based

¹ BusinessWeek, September 2005, Report From a General in The SEC’s War on Fraud, p. 96

approach was used. More specific questions related to the evaluation of information technology controls, costs, and documentation requirements. Finally, panelists were asked to offer suggestions about areas that would pose significant challenges for smaller public companies facing AS 2 compliance.

A discussion primarily focused on auditor experiences in year two was the topic for the third panel. The question of whether a risk based approach was adopted and an integrated audit achieved was posed to the panelists. The SEC and PCAOB also wanted feedback on specific aspects of the audit, including the evaluation of the control environment and entity level controls as well as the use of the work of others.

Also important to the roundtable's hosts was the impact of Sarbanes-Oxley on the market. This was the topic of the fourth panel discussion. Questions posed during this discussion included whether the implementation of the Act was in accord with its purpose and whether the auditor's and management's reports were useful to investors. The degree to which investors benefit from internal control was also of key concern to the panel. Along those same lines, the PCAOB and SEC wanted to gain an understanding of the investor's understanding of internal control reporting and disclosures.

Finally, the last panel discussion focused on what had to be done next. Panelists were asked to convey any remaining concerns that they believed should be addressed. The PCAOB also inquired about any specific amendments necessary to improve its standards relating to the audit of internal controls. The panel discussions collectively resulted in the formation of a list of five major goals to be addressed in the impending revision. The purpose of such revision would be to: (1) Focus the internal control audits on the most important matters; (2) Eliminate procedures that are unnecessary to achieve

the intended benefits. (3) Incorporate guidance on efficiency; (4) Provide explicit and practical guidance on scaling the audit to fit the size and complexity of the company; and (5) Create a simplified standard.

The May 10, 2006 roundtable provided the SEC and PCAOB with feedback, opinions, and suggestions regarding the effectiveness of the current Auditing Standard 2. As a result of these efforts, on December 19, 2006, the PCAOB Release No. 2006-007, “Proposed Auditing Standard: An Audit of Internal Control over Financial Reporting That is Integrated with an Audit of Financial Statements”, proposed a new standard that would ultimately replace AS 2. The proposed standard addresses many of the issues discussed above. As outlined by the PCAOB, the proposed standard’s purpose is to “focus the audit on matters most important to internal control, eliminate unnecessary procedures, simplify the requirements, and scale the audit for smaller companies”. The standard specifically seeks to remove barriers on the reliance on the work of others, especially internal auditors and company personnel. The PCAOB’s proposal entirely eliminates the auditor’s evaluation of management’s assessment of internal control.

In its proposal, the PCAOB also addresses the complaints regarding the ambiguities and confusion relating to materiality. The definitions of significant deficiency and material weakness are revised. The standard by which an auditor classifies a material weakness would, according to the new standard, be “reasonably possibly” instead of “more than a remote likelihood”. Furthermore, the proposal revises the “strong indicators” of material weakness to accommodate a conclusion that no material weakness exists even if an indicator is present. In an effort to cut down on costs and procedures, the walkthrough requirements were recalibrated and multi location

testing requirements were based on risk instead of coverage. Finally, consideration of knowledge obtained in previous audits would be allowed by the new standard. The proposal removes the phrase that each audit “stand on its own.” The Board released this standard for public comment in order to properly assess its appropriateness and suitability.

The PCAOB received letters in response to its query regarding the proposed auditing standard. Letters were written from various perspectives, giving the Board a well rounded response. Though not always in accord, respondents gave the PCAOB much needed insight into their previous experiences with AS 2 and their predictions about working with the new standard.

Proposed Changes: Management’s Assessment

Many of the respondents commented that the proposed standard’s provision to drop the opinion regarding management assessment was an improvement over AS 2’s dual opinion requirement. Financial statement issuers, public accountants, and financial statement users alike sent in responses supporting this aspect of the standard.

Peter A. Bridgman, controller, Pepsico:

“We support the change to eliminate the auditor’s requirement to evaluate management’s process and issue an opinion. We agree that it will more clearly communicate the scope and results of the auditor’s work.”

In their comments on PCAOB release No. 2006-007, The New York State Society of CPA’s wrote:

“We strongly support the removal of the separate opinion on management’s assessment.”

But also added:

“However, it is important that the auditor understand the basis for management’s assessment. Therefore, we recommend that the final standard require the auditor to understand management’s processes as part of planning the audit of internal control.”

Though many were in agreement with the removal of the audit, opponents of this provision also commented with their thoughts. For example, Brian G. O’Malley, Senior Vice President, Internal Audit, at NASDAQ wrote:

“ The focus of the independent auditor’s report should be on evaluating the effectiveness of management’s program rather than the effectiveness of individual internal controls. Management should continue to be responsible for the accuracy of their financial statement and the effectiveness of their related internal controls.... [The current proposal] provides, minimal relief, as we believe the primary driver of auditor fees is the opinion on internal controls.”

Management Assessment: Solution

While the elimination of the requirement to issue a second report cuts down on time, costs, and other resources, an understanding of management’s processes for assessment contributes significantly to the “risk based approach” mandated by the standard. Such processes can be indicators of the company’s overall regard for internal control and if taken into consideration when planning, can alter the nature, timing and extent of further procedures. Further efficiencies can actually be achieved by gaining this understanding because properly implemented procedures for internal control assessment could decrease the auditor’s evaluated level of risk in that area. Conversely, improper

processes in this area could point the auditor in the direction of the areas with greater risk. If the auditors interpret the standard in this way, the removal of the opinion without the removal of the requirement to understand, this change would be a positive one for auditor and issuer, without negatively impacting the value to financial statement users. This provision of the proposed standard will address the issues of increasing efficiency, reducing costs and unnecessary procedures, and the idea of a risk based approach.

Another benefit of dropping the second opinion requirement is that it will reduce confusion among financial statement readers. The fact that there are currently two opinions on internal control, and the fact that the auditor may express a different opinion in each, can cause confusion among those outside the auditing profession. For example, in a situation where a material deficiency exists, the auditor may express an unqualified opinion on management's assessment, if the material weakness was properly identified in the assessment, but an adverse opinion on the effectiveness of internal control. There are various incorrect ways that a reader of financial statements could interpret the auditor's report.

Proposed Changes: Multi-Location Testing

There was little disagreement regarding the PCAOB's intent to recalibrate its multi-location testing requirements in the proposed standard. Most involved parties supported this aspect of the proposal, reasoning that it is more conducive to the overall "risk based" approach the PCAOB is seeking to achieve with the new standard. Previous requirements related to multi-location testing were felt to be too closely related to a coverage based approach to auditing. If implemented correctly, the changes to these

requirements will result in greater efficiency, without compromising overall audit quality. Support of this change is evidenced in Pepsico’s letter to the PCAOB:

“This change is consistent with the overall objective of the proposed standard – a focus on the areas with greatest risk of material misstatement.”

Multi-Location Testing: Solution

Though the revised draft is preferred to AS 2 with regard to multi-location testing, there is still some concern about the auditor’s use of judgment in this area. Some writers lacked confidence that auditors would rely upon these new requirements with certainty when deciding upon a level of coverage. If passed, the PCAOB should remind auditors that the purpose of the standard is to help the auditor plan and perform a proper audit, which not only allows, but necessitates, the use of judgment. Furthermore auditors should be assured that they will not be penalized for its use when the auditor himself is subject to PCAOB inspection.

Proposed Changes: Walkthrough Requirements

The PCAOB also proposed changes to its walkthrough requirements set forth in AS 2. Under AS 2, auditors were required to perform a walkthrough for all major classes of transactions. Many respondents to the PCAOB and SEC inquiries indicated this as one of the major cost drivers they deemed to be unnecessary. In its proposal, the PCAOB requires a walkthrough for each significant process. It would also allow for the use of work of others in this part of the audit, something that was not allowed under AS 2. Some respondents are concerned that even the proposal does not allow for enough auditor leeway. William M. Diefenderfer, Audi Committee Chairman of Sallie Mae responded:

“It would be helpful if the guidance confirmed that an appropriate means for achieving the ‘standard of supervision’ could be that the auditor defined specific walkthrough procedures and deliverable....This arrangement would be more efficient than an arrangement where the auditor supervises the company resources as if they worked for the auditor.”

Similarly, Diefenderfer commented:

“AS 5 does not allow the external auditor to apply judgment (e.g., giving consideration to such factors as prior year control evaluation, audit knowledge of area, degree of process change) in determining which significant processes a walkthrough must be performed.”

Walkthrough Requirements: Solution

Walkthroughs provide auditors with integral knowledge and understanding of a system of internal controls that could not easily be achieved by other means. For this reason, walkthroughs should be performed for all significant processes, as mandated by the current PCAOB proposal. The requirement under AS 2 to perform walkthroughs for all major classes of transactions was not conducive with the Board’s plan to eliminate unnecessary procedures. It was a source of redundancy from which no major benefit was derived. However, since the walkthroughs are of so much value to the audit, they should be properly supervised by the auditor. Merely obtaining the results from the work of others would not suffice. The PCAOB appropriately allows the auditor to use the direct assistance of others in performing walkthroughs, but does not relieve him of his responsibility to evaluate and consider the appropriateness of the results.

Proposed Changes: Definitions

The PCAOB's proposal involves three significant changes to the definitions of certain terms. In the definition of "significant deficiency", the current proposal uses the phrase "reasonable possibility" instead of "more than remote likelihood", which was used in AS 2. Secondly, the definition of "significant deficiency" was revised to replace the phrase "more than inconsequential" with "significant". Finally, in the definition of material weakness, the PCAOB replaced the words "a significant deficiency, or combination of significant deficiencies" (as used in AS 2) with the words "a control deficiency, or combination of control deficiencies". Most respondents were content with these changes, as they believed the new definitions more clearly communicate the PCAOB's intent. Peter A. Bridgman, PEPSICO, wrote:

"We believe the proposed changes to the definitions of significant deficiencies and material weaknesses will ease the process of evaluation of deficiencies. In practice, the evaluation is extremely difficult, and we believe that the terminology "more than remote likelihood" forced management and auditors to spend a significant amount of time evaluating deficiencies that could never rise to the level of a significant deficiency nor material weakness."

Definitions: Solution

The changes to the definitions are positive. There is some indication that auditors had misinterpreted the definition of significant deficiency, as set forth by AS 2, and set the threshold lower than had been intended for the PCAOB. Similarly, the removal of the term "significant deficiency" from the definition of "material weakness" is important because it clears up the possible misconception that the auditor's responsibility is to search for deficiencies that are less severe than material weakness. This too was a

concern expressed by many of the comment letter writers, who felt that auditors were performing their audits at a level that would identify all significant deficiencies. The revision of these definitions does not change the essence of these standards, but merely communicates them more clearly. The classification of deficiencies still relies considerably on the judgment of the auditor and so the definitions provided in the proposal are appropriately principles based in nature.

Proposed Changes: Strong Indicators of Material Weakness

The PCAOB's current proposal allows for greater use of auditor judgment when indicators of material weakness are present. Under AS 2, if circumstances indicative of material weakness were present, the auditor was required to identify at least a significant deficiency, if not a material weakness. When the circumstances warrant such a conclusion, the proposed standard would allow the auditor to decide that no control deficiency exists even if certain indicators are present.

Strong Indicators of Material Weakness: Solution

To allow for such a conclusion allows for greater use of auditor judgment. Because they were locked into classification of at least a significant deficiency, auditors were not able to use their own judgment or to appropriately assess the particular circumstances. The flexibility offered in the proposal would ensure that those deficiencies classified as significant were true to the definition, and not just placed there due to a technicality.

Proposed Revision: Removal of the phrase "Stand on its Own"

Unanimity of opinion was not easily achieved concerning the removal of the "each audit stand on its own" clause in the proposed standard. In its removal, issuers of

financial statements see opportunities for reduction in many of the resources associated with compliance. However, others believe that the removal of this statement conflicts with the overall responsibility of an auditor regarding his audit.

Removal of the Phrase “Stand on its Own”: Solution

In removing this phrase from the standard, the PCAOB was seeking to promote the use of cumulative knowledge. However, the idea that each audit need not “stand on its own” is in violation Generally Accepted Auditing Standards. Standard of fieldwork three states that:

"The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit." (Generally Accepted Auditing Standards: Standard of Fieldwork 3)

Direct reliance upon knowledge obtained in previous years would not provide the auditor with a reasonable basis for opinion on the financial statements and internal control of the current year. Additionally, too much reliance on knowledge from prior years would fail to take in consideration things like changes to the system or compliance deterioration.

Because auditors would still be held to the requirements set forth by Generally Accepted Auditing Standards regardless of whether the phrase is included in the new standard, the PCAOB probably did not intend for it to be interpreted to be conflicting with those standards. For the sake of consistency, and to reduce any possible confusion of misinterpretation, the phrase should be included in the standard when passed by the PCAOB. The Board can further indicate that cumulative knowledge is not without a

purpose though; it can be used to assist the auditor in the planning stages of his audit to decide upon the nature, timing, and extent of procedures.

Areas in Need of Further Revision:

There are some issues that would benefit from revision beyond that offered by the current PCAOB proposal. The PCAOB should take this into consideration before passing the proposal they have posted for public comment.

Areas in Need of Further Revision: Misalignment of SEC and PCAOB Guidance

Another area to which respondents devoted a lot attention was the apparent misalignment of SEC and PCAOB guidance. In particular, letter writers pointed out that there are some discrepancies in guidance issued by the two groups regarding indicators of material weakness. If management's and the auditor's perceptions of indicators of material weakness are inconsistent, there may be some disagreements or surprises during the course of the audit.

The Association of Chartered Accountants included this concern in the comment letter to the PCAOB:

“...[W]e suggested that the PCAOB Auditing Standard No2 should be realigned to become consistent with any revised SEC guidance thereby allowing both management and external auditors to apply reasoned judgment. It should be the SEC guidance, rather than any PCAOB auditing standard, which determines the approach that management follows in order to comply with s404; we are not convinced that this has been so, to date.”

Letters also indicated a concern regarding the incongruity of focus on entity level controls in the two sets of guidance. The PCAOB's guidance appropriately places

emphasis on high level controls in an audit. This emphasis is not apparent in the guidance intended for management's use. It would be helpful for management to understand the importance placed upon entity level controls by auditors so that they may properly prepare for their audit of internal control.

Solution: SEC and PCAOB Guidance

Conforming the guidance provided for management and auditors is essential to creating efficiencies and reducing confusion. The PCAOB and SEC can promote audit efficiency by providing auditors and management with the same guidelines to evaluate internal control. Because the guidance issued by the two groups are not perfectly aligned, respondents expressed their concern that management is forced to rely on the PCAOB guidance, intended for auditors, instead of the SEC guidance intended for their own use.

Areas in Need of Further Revision: Focus on the Control Environment

Letter writers also indicated that, although the proposed standard is an improvement to AS 2, they would like to see an even greater focus on and reliance upon the control environment. Still of key concern to respondents is the fact auditor focus on documentation may detract from evaluation of the overall control environment. Though documentation does serve its purpose in the assessment of many controls, it is not always have the same effect in evaluating the control environment, due to its unique nature. This is pointed out in the Associated of Chartered Certified Accountants' comment letter:

“Because the control environment includes people factors such as culture and ethics, much of its assessment has to be subjective. It is therefore something that cannot reasonably be comprehensively and totally documented....There is danger with the

existing practice that the over reliance on documentation could mean that fundamental weaknesses in the control environment are missed.”

Control Environment: Solution

The control environment poses a unique problem, to which the PCAOB should respond with appropriate guidance. Providing both issuers and auditors with more specific guidance regarding the importance of the control environment, as well as how it can be evaluated would help ensure that it gets the proper amount of attention in the course of an audit.

Areas in Need of Further Revision: Entity Level Controls

Even with the new proposal, there still seems to be a lot of confusion and concern regarding entity level controls. Those who expressed the concern that they were not given proper attention in AS 2 are not completely satisfied with the PCAOB’s attempt to address the issue. Auditors, issuers, and financial statement users alike asked for clearer guidance concerning company level controls in their letters to the PCAOB. The “Big Four” firm, PriceWaterhouseCoopers wrote:

“We believe it is critical that the PCAOB clarify the principle for determining the range of impact that company-level controls can have on the audit of internal control over financial reporting.”

Of key concern to auditors is the fact that some entity level controls are directly related to prevention/detection of material misstatement of the financial statements, while others are indirect. Further clarification would be helpful in determining the amount of reliance an auditor should place on the varying levels of entity level controls with regard to this relationship. Such guidance could come in the form of description of the varying levels

of entity level controls as well as any examples that would result in further clarification. Financial statement issuers have recognized this problem the ongoing struggle with the evaluation of and reliance upon these high level controls. William M. Diefender, Audit Committee Chairman of Sallie Mae specifically addressed the problem in his letter to the PCAOB:

“ It would be helpful if the guidance provided specific examples of company-level controls that operate at varying levels of precision that by themselves would sufficiently address the assessed risk that misstatements to a relevant assertion will be prevented or detected in a timely basis. It is often difficult to identify ‘key’ company-level controls that have a direct, clear linkage to mitigating risk associated with financial statement misstatement.”

Entity Level Controls: Solution

It is important for the PCAOB to clarify this issue because the auditor’s reliance on company-level controls will affect the nature, timing, and extent of his auditing procedures. If he does not place appropriate reliance on controls that are directly related to financial statement misstatement, he is missing out on opportunities for further efficiency. However, if he relies too heavily on controls that have only an indirect relationship, then he has incorrectly assessed the level of risk for that company. The PCAOB should attempt to provide guidance that encourages the proper recognition, assessment, and reliance upon entity level controls.

Areas in Need of Further Revision: Fraud Related Controls

In seeking feedback about their current proposal, the PCAOB asked specifically about the appropriateness of its guidance regarding fraud related controls. Because

senior management fraud has been behind many of the recent accounting scandals, this is a particularly sensitive issue. It has been suggested that the PCAOB take a closer look at those particular cases of fraud to try and identify how those frauds occurred and how they went undetected. This study could provide insight into what specific controls should be evaluated in relation to material misstatement caused by fraud. However, some make the case that it is the auditor's responsibility to consider the risk of material misstatement whether it is caused by error or fraud and the auditor should therefore plan his audit to detect either. In its comment letter to the PCAOB Deloitte took this stance:

“...we are concerned that certain aspects of the proposed standard may lead the auditor to believe that consideration of the risk of fraud and identification and testing of the related controls that address fraud risks is a separate and distinct process from the rest of the audit.”

Fraud Related Controls: Solution

Any research concerning fraud related controls would not be unhelpful. If the PCAOB were to undertake such a study, the results could be used to provide further guidance relating to an integrated audit intended to detect misstatement, whatever its cause.

Areas in Need of Further Revision: Use of the Words “Should” and “Must”

Those familiar with the auditing profession commented on a seemingly minor, but important, detail of the proposal. It has been suggested that the PCAOB reconsider the use of the words “should” and “must” in many instances. These words can be interpreted to result in mandatory documentation requirements. Deloitte pointed this out in its comment letter to the PCAOB:

“In some cases, statements drafted as presumptively mandatory requirements (i.e. “should” statements) instead appear to be guidance or factors for the auditor to consider or address in fulfilling responsibilities relative to a higher level requirement.”

Solution: Use of the Words “Should” and “Must”

The PCAOB should reconsider the use of these words throughout the standard and take into consideration any implications attached to the use of these words. Their incorrect use could lead to unnecessary and unintended documentation requirements in a standard that was drafted to promote efficiency.

Next Steps

The proposal should be passed with minor adjustments made, as indicated above. However, in order for the proposal to achieve maximum effectiveness, the PCAOB must reconsider its inspection practices. Many respondents noted that auditor fear of such inspection has created inefficiency and extra work. Specifically, the additional leeway provided for in the PCAOB’s May 2006 guidance was not used to its fullest extent because of this. The Board should take this into consideration in addition to passing its current proposal.

The audit of internal control is still a relatively new practice for issuers, auditors, and standard setters. Though the implementation of Auditing Standard 2 has been far from perfect, the PCAOB has shown its ability to consider feedback and make positive changes. Their willingness to do so, coupled with the experience that will be gained by all parties through actual performance, will eventually result in a standard that is efficient, useful, and in accord with the overall intention of the Sarbanes-Oxley Act.

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<http://www.sec.gov/spotlight/soxcomp.htm>

Auditing Standard 2 of the Public Company Accounting Oversight Board

Available at:

http://www.pcaob.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.2

PCAOB Release 2006-007

Available at:

http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.

1st year Comment letters

Available at: <http://ww.sec.gov/news/press/4-497.shtml>

2nd Year Comment letters

Available at:

http://www.pcaob.org/Standards/Standards_and_Related_Rules/AS2/2006/05-10/Comments/index.aspx

Comment Letters on PCAOB proposal:

Available at: http://www.pcaob.org/Rules/Docket_021/index.aspx

Comment letters Quoted:

Year One Comment Letters:

Baker, Bob	BBJ Environmental Solutions
Sanchez, Alejandro M.	Florida Banker's Association
Keyes, John E.	Urban Outfitters, Inc.
Cangialosi, Loretta V.	Pfizer
Odland, Steve	Office Depot, Inc.
Barney, Blake	Matures Sunshine Products
Stevens, Dennis M.	Alamo Group

Year 2 Comment Letters:

Owens, David K.	Edison Electric Institute
Cangialosi, Loretta V.	Pfizer
Burton, Robert	ADC Telecommunications
PriceWaterHouseCoopers	
Grant Thornton	
Ernst & Young	

Comment Letters on PCAOB Proposal

Bridgman, Peter A.	PEPSICO
O'Malley, Brian G.	NASDAQ
Diefenderfer, Peter M.	SallieMae
Association of Chartered Accountants	
New York State Society of CPA's	
PriceWaterHouseCoopers	
Deloitte	