
BRIEFING PAPER

PROPOSED AUDITING STANDARD ON CONFORMING AMENDMENTS TO PCAOB INTERIM STANDARDS RESULTING FROM THE ADOPTION OF PCAOB AUDITING STANDARD NO. 2

MARCH 9, 2004 PUBLIC MEETING OF THE BOARD

At its public meeting on March 9, 2004, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") will consider whether to propose, and seek comment on, an auditing standard, *Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*. If adopted, this standard would clarify the amendments to the PCAOB's interim standards resulting from the adoption of PCAOB Auditing Standard No. 2.

When the Board proposed its auditing standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (PCAOB Release No. 2003-017, dated October 7, 2003) (the "proposed internal control standard"), the Board recognized that some amendments of the professional standards adopted by the Board as its interim standards^{1/} would be necessary to make those

^{1/} Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, five temporary interim standards rules (PCAOB Rules 3200T, 3300T, 3400T, 3500T, and 3600T) that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"). These rules were approved by the Securities and Exchange Commission ("SEC" or the "Commission") on April 25, 2003. See SEC Release No. 33-8222. On December 17, 2003, the Board approved technical amendments to the interim standards rules indicating that, "when the Board adopts a new auditing and related professional practice standard that addresses a subject matter that also is addressed in the interim standards, the affected portion of the interim standards will be superseded or effectively amended. Accordingly, the Board approved adding the phrase 'to the extent not

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standards consistent with the principles and requirements in the proposed internal control standard. The Board also intended to make several amendments to the interim standards that would be applicable to situations in which section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") is not applicable and only the financial statements of the company must be audited.

Some commenters on the Board's proposed internal control standard believed that the Board's proposal was not clear about whether the Board intended to amend the interim standards and recommended that the Board specifically identify changes made by the proposed internal control standard to the interim standards. Accordingly, the Board will consider issuing, for public comment, a proposed auditing standard that identifies the conforming amendments to the interim standards resulting from the Board's adoption of PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

This briefing paper highlights the more significant requirements in the proposed auditing standard, which is relatively narrow in scope and comprises only proposed amendments to the interim standards resulting from the adoption of PCAOB Auditing Standard No. 2. The purpose of this proposed standard is not to reconsider the principles and requirements in PCAOB Auditing Standard No. 2. Instead, it is to ensure that certain of those principles and requirements are appropriately incorporated into the Board's interim standards.

Furthermore, the changes to the interim standards are solely the result of incorporating the requirements of PCAOB Auditing Standard No. 2, and are not the result of a comprehensive review of the existing standards that the Board intends to undertake at a future date.

Conforming Amendments to the PCAOB Interim Standards

As a result of the adoption of PCAOB Auditing Standard No. 2, conforming amendments are proposed to the Board's interim auditing, attestation, and independence standards. The nature and extent of those amendments are described below.

superseded or amended by the Board' to each of the interim standards rules." This rule is pending approval from the SEC.

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Auditing Standards

With regard to the interim auditing standards, the proposed amendments can be classified into two categories: 1) amendments reflecting the addition of references to the standards, and 2) amendments applicable to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements.

The first category—the addition of references—includes reference notes that would be added to the interim standards to assist auditors in performing an integrated audit of financial statements and internal control over financial reporting. For example, in the auditing standard titled, "Management Representations," a proposed reference note would be added to the standard to remind auditors to refer to certain paragraphs in PCAOB Auditing Standard No. 2 for the representations to be obtained from management when performing an integrated audit of the financial statements and internal control over financial reporting.

The second category is composed of amendments that would be applicable to both integrated audits of financial statements and internal control over financial reporting and audits of financial statements. These proposed amendments would conform the existing auditing standards to certain concepts and requirements adopted in the internal control standard. While PCAOB Auditing Standard No. 2 is primarily directed to auditors performing integrated audits of the financial statements and internal control over financial reporting, it also contains requirements that apply when an auditor is engaged solely to audit a company's financial statements.

For example, in the auditing standard titled, "Consideration of Internal Control in a Financial Statement Audit," an amendment is proposed to a sentence in that standard in order to make it consistent with a requirement in PCAOB Auditing Standard No. 2. The sentence currently says "the auditor should perform substantive tests for significant account balances and transaction classes." In the proposed standard, that sentence would be amended to conform to PCAOB Auditing Standard No. 2 and would state "the auditor should perform substantive procedures for all relevant assertions related to all significant accounts and disclosures in the financial statements." The proposed amendment, if adopted, would be applicable to both integrated audits and audits of financial statements, because as indicated in the Board's proposed internal control

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standard, the auditor should perform such tests regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of financial statements. Further, the proposed internal control standard also stated that performing procedures to express an opinion on internal control over financial reporting did not diminish this requirement.

Some additional amendments of this type are included in the proposed auditing standard.

Attestation Standards

With regard to the Board's attestation standards, the attestation standard titled "Reporting on an Entity's Internal Control Over Financial Reporting" would be superseded and removed as a standard of the Board. This change is being proposed primarily because auditors performing an integrated audit of financial statements and internal control over financial reporting in order to comply with Section 404 of the Act will be required to follow PCAOB Auditing Standard No. 2 when reporting on a company's internal control over financial reporting. Accordingly, auditors will not be permitted to use the Board's attestation standard for this purpose.

Since auditors will not be permitted to use this attestation standard when performing an integrated audit of financial statements and internal control over financial reporting, the proposed standard would have the effect of superseding the attestation standard and removing it from the Board's standards, in its entirety.

In the release to the proposed standard, commenters would be requested to provide information on whether there is a need for an auditor's report on internal control in addition to the auditor's report on the integrated audit of financial statements and internal control over financial reporting. If there is such a need, commenters would be requested to indicate what type of information should be included in the report, in which circumstances would such a report be issued, and who would use the report.

Independence Standards

Finally, with regard to the Board's independence standards, the proposed standard includes an amendment to incorporate the requirement from PCAOB Auditing Standard No. 2 that a registered public accounting firm and its associated persons must not accept an engagement to provide internal control-related services to an issuer the

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financial statements of which the registered public accounting firm also audits, unless that engagement has been specifically pre-approved by the audit committee.

Proposed Effective Date

Although early implementation of the proposed standard would be permitted, the proposed standard would be effective for audits of financial statements and integrated audits of financial statements and internal control over financial reporting for periods ending on or after November 15, 2004.

Public Comment

If the Board issues the proposed standard, it will seek comment on this proposal for a 45-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 014 in the subject or reference line and should be received by the Board no later than 5:00 p.m. EST on April 23, 2004.

The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt a final auditing standard. Any final auditing standard adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are deemed to be rules under the Act.

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The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.