

SEC Advisor

August 2007



PCAOB Auditing Standard No. 5 - New SOX 404 Guidance for Auditors

The Public Company Accounting Oversight Board ("PCAOB") and the Securities and Exchange Commission ("SEC") approved new guidance aimed at improving the effectiveness and efficiency of the assessments performed by a company's management and its auditor of the effectiveness of internal control over financial reporting ("ICFR") under Section 404 of the Sarbanes-Oxley Act of 2002 ("Section 404"). In July 2007, the SEC approved Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with an Audit of Financial Statements* ("AS 5"), which supersedes Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements* ("AS 2"). AS 5 is effective for fiscal years ending on or after November 15, 2007 with early adoption permitted.



In addition, on May 23, 2007, the SEC unanimously approved the issuance of interpretive guidance regarding management's evaluation and assessment of ICFR. The SEC approved the guidance as an interpretive release rather than a commission rule, which will permit companies with established and effective processes not to have to alter their procedures to align them with the new guidance, although they may choose to do so, and will also allow the SEC to more easily update or amend the guidance as needed.

The AS 5 guidance aligns certain key terms and concepts included in SEC interpretive guidance for management to avoid confusion and inefficiency between the two standards. Some examples of the alignment of key terms and concepts between the SEC's guidance and AS 5 include the definition of material weakness and related guidance for evaluating deficiencies, indicators of a material weakness, and use of the term "entity-level" rather than "company-level" controls.

The SEC has indicated that it does not anticipate a further extension of the Section 404 compliance dates for non-accelerated filers. As it currently stands, management of non-accelerated filers will be required to perform an assessment of the effectiveness of ICFR for fiscal years ending on or after December 15, 2007, with the requirement for an auditor attestation becoming effective for years ending on or after December 15, 2008.

AS 5 - An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements

AS 5 is designed to be a principles-based standard that directs the auditor to conduct a top-down, risk-based integrated audit. In addition, AS 5 is intended to achieve the following four objectives:

- (1) focus the internal control audit on the most important matters;
- (2) eliminate procedures that are unnecessary to achieve the intended benefits;
- (3) make the audit clearly scalable to fit the size and complexity of any company; and
- (4) simplify the text of the standard.

Focusing the Audit on the Matters Most Important to Internal Control

AS 5 promotes the top-down approach to identifying the most important controls to test, but enables the auditor to exercise flexibility in developing an understanding of the company's processes. The top-down approach begins with an assessment of company-level controls and financial statement

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elements, and links them to significant accounts, relevant assertions, and finally to significant processes.

It also emphasizes the importance of auditing higher risk areas, such as the financial statement close process and controls designed to prevent fraud by management. At the same time, it provides auditors a range of alternatives for addressing lower risk areas, such as by more clearly demonstrating how to calibrate the nature, timing and extent of testing based on risk, as well as how to incorporate knowledge accumulated in previous years' audits into the auditors' assessment of risk and use the work performed by companies' own personnel, when appropriate.

The new standard also revises the following definitions of significant deficiency and material weakness:

- A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.
- A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.

Consistent with AS 2, if the auditor determines that deficiencies identified, individually or in combination, result in material weaknesses, the auditor must express an adverse opinion on the company's internal control over financial reporting. In addition, all material weaknesses and significant deficiencies identified during the audit are required to be communicated to management and the audit committee in writing.

Eliminating Unnecessary Procedures

AS 5 eliminates the requirement to evaluate the process management used to evaluate its internal control. As a result, only one opinion will now be required on the effectiveness of internal controls over financial reporting and eliminates the auditor's opinion on evaluating management's assessment as required under AS 2. Under the new standard, the auditor needs to obtain an understanding of management's assessment process as a starting point to understanding the company's internal control, assessing risk, and determining the extent to which the auditor can rely on the work of others.

AS 5 also permits the auditor to use the knowledge gained from previous audits as a factor in determining the nature, timing and extent of testing. Although rotation is not permitted, AS 5 provides the auditor with flexibility to decide to reduce testing in some areas based on that knowledge and its effect on the auditor's assessment of risk. AS 5 requires the auditor to obtain evidence each year about the effectiveness of controls related to accounts, disclosures and assertions that present a reasonable possibility of material misstatement to the financial statements and related disclosures. The nature, timing and extent of such evidence should be commensurate with the assessed risk.

The standard also refocuses multi-location testing requirements on risk, rather than coverage. AS 5 omits the provision requiring testing of controls over a "large portion" of a company's operations and financial condition, and instead directs the auditor to use a risk-based approach.

Use of the Work of Others

AS 5 requires the auditor to obtain an understanding of the work of others at the company to determine how that work might impact the nature, timing and extent of the auditor's testing. The auditor must also consider whether the activities of others have identified control deficiencies, fraud, or financial statement misstatements. This would be required regardless of the decision about whether and how to use the work of others. The standard allows reliance on the work of others for testing certain aspects of the control environment when the competence and objectivity of the persons performing the work are sufficiently high. For example, the auditor could use the work of others for determining that a written code of conduct exists and that employees have received and confirmed their understanding of it. On the other hand, evaluating whether a company's code of conduct is actually being followed requires more judgment.

AS 5 requires the auditor to obtain sufficient competent evidence to support the opinion on ICFR. Previously, AS 2 included a requirement that the auditor's own work provide the "principal evidence" for the auditor's opinion.

Walkthroughs

The AS 5 guidance focuses on the objectives to be achieved through a properly performed walkthrough. That is, AS 5 emphasizes the need to understand the likely sources of potential misstatements, and as part of selecting the controls to test, requires the auditor to achieve the following objectives:

- (1) understand the flow of transactions;
- (2) identify the points within the company's processes at which a misstatement could arise;
- (3) identify the controls to address these potential misstatements; and
- (4) identify controls that management has implemented to prevent or detect misappropriation of assets.

While the standard indicates that a walkthrough will frequently be the best way to achieve those objectives, it makes clear that the auditor's focus should be on achieving the objectives rather than performing a walkthrough. In some cases, other procedures may be equally or more effective means of achieving the objectives of a walkthrough. AS 5 also allows the auditor to use the work of others in achieving these objectives, but only as direct assistance. Under AS 5, the auditor will be required to supervise, review, evaluate and test the work performed by others. Previously under AS 2, the auditor was required to perform a walkthrough for each major class of transactions.

Scaling the Audit

The standard requires the auditor to evaluate the size and complexity of the company in planning and performing the audit. The PCAOB acknowledged that the guidance on scaling the audit would be most effective if it was a natural extension of the risk-based approach and was applicable to all companies. Therefore, AS 5 includes a condensed section on scaling the audit and incorporates a discussion of the scaling concepts throughout the standard. By integrating the discussion of scalability throughout the standard, the PCAOB acknowledged that companies of all sizes might have areas that are less complex and the concept of scalability should be applicable to those areas as well.

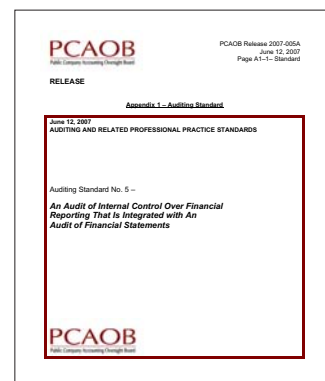
Simplifying the Requirements

The release of AS 5 is intended to simplify the SOX 404 requirements and make them easier to apply while retaining the core principles necessary for an effective audit of internal control. First, the level of detail and specificity has been reduced, which is intended to encourage auditors to apply professional judgment to the individual facts and circumstances. Second, the presentation of the standard has been reorganized to better reflect the sequential flow of an audit of ICFR. Third, the requirements have been presented in a more readable manner that should be understandable to clients as well as auditors.

The entire text of AS 5 can be found on the PCAOB's website:

http://www.pcaobus.org/Rules/Rules_of_the_Board/Auditing_Standard_5.pdf

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