

Sarbanes-Oxley New Auditing Standard Seeks to Streamline

With the closely aligned releases of new interpretive guidance by the SEC and the Public Company Accounting Oversight Board (PCAOB), the managements of public companies as well as external auditors are breathing sighs of relief.

The SEC's release, entitled Management's Report on Internal Control Over Financial Reporting, offers management specific guidance – for the first time – on meeting Sarbanes-Oxley compliance obligations. To address criticism that Auditing Standard No. 2 (AS2) was confusing and inflexible, the SEC's guidance now allows for greater flexibility and the exercise of truly significant judgment. Management can design and conduct an internal control evaluation that is tailored to the company's specific circumstances.

Also, non-accelerated filers in particular will benefit from the scalability and flexibility of the new guidance.

Hot on the heels of the SEC's guidance, the PCAOB separately released its closely aligned Auditing Standard No. 5 (AS5), which, when approved by the SEC, will replace AS2 and is effective for audits in fiscal year 2007. AS5's top-down orientation emphasizes the impact of the control environment on fraud risk and other material failure, while its risk-based approach requires testing of higher-risk areas, including entity-level controls such as those designed to prevent fraud by management and the financial close process. It also allows for

less testing of lower-risk processes. Among the other specific features of the new standard is the flexibility it gives auditors in using the work of others, including management. This approach allows for the use of the results of prior integrated audits to determine the nature, timing and extent of the current year's audit work. In addition, AS5 recalibrates the walkthrough requirement and eliminates auditors' separate opinions on management's assessment. Since AS5 is relevant to companies of all sizes, non-accelerated filers that did not previously comply with SOX Section 404 will now have to demonstrate compliance through this new standard.

Despite its much-touted recommendations, AS5, in actuality, features little new information, instead the auditing standard simply formalizes what the SEC

and the PCAOB have been encouraging since May 2005: a top-down, risk-based approach. For companies of all sizes, J.H. Cohn has always encouraged a focus on higher-risk areas with the most potential impact on the client's financial statement and limited time spent on less significant areas. Some companies will immediately benefit from the enhancements of AS5 while other companies – those with auditors that are already using a top-down, risk-based approach – will see few changes to the process.

“Mellowing with age.”

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