

SEC approves guidance on internal controls over financial reporting PCAOB adopts Auditing Standard No. 5

On May 23rd the SEC approved guidance for management to use in evaluating internal controls over financial reporting (ICFR). The next day, May 24th, the PCAOB adopted Auditing Standard No. 5 (AS5) which replaces Auditing Standard No. 2 (AS2).

The SEC's guidance, which is primarily directed to management, addresses: 1) identifying risks and controls, 2) evaluating control effectiveness, 3) reporting results and 4) documenting results. It suggests that management exercise appropriate judgment in evaluating financial reporting risk and determining what controls to evaluate and how to evaluate them. The SEC expects this guidance to appreciably improve the efficiency of companies' internal evaluations of ICFR.

The PCAOB's revised auditing standard codifies some previously issued auditing guidance (e.g., calling for a "top-down, risk-based" audit approach, modifying the definitions of material weakness to make it clear that related errors must be "reasonably possible" and clarifying the role of annual vs. interim materiality). The revised standard also make some new changes that will improve audit efficiency, including:

1. No longer requiring the auditor to evaluate management's ICFR evaluation process
2. Allowing multi-location site visits to be determined based on risk rather than coverage
3. Allowing audit risk assessments to be influenced by the results obtained in prior audits
4. Allowing more of the use of the work of others who are competent and objective (e.g., internal audit).

The impact that the SEC's guidance and the PCAOB's revised auditing standard will have on companies and integrated audits will vary significantly. The following are some factors that could increase or decrease the efficiencies these latest releases might generate for any given company.

Company factors:

1. The degree of centralized vs. decentralized processing and financial reporting control
2. The competence and objectivity of the people performing ICFR testing/evaluation work for the company
3. The quality and extent of the company's ICFR evaluation documentation
4. The strength of the company's entity-level controls, including the effectiveness of:
 - a. The control environment
 - b. The risk assessment process
 - c. Management's and the audit committee's ICFR monitoring procedures
 - d. Controls that monitor and evaluate results of operations
 - e. Controls over management override
 - f. Controls over the period-end financial reporting process
5. The degree of change in a company's processes, risks and controls from year to year.
6. A history of financial reporting problems or material audit adjustments

Auditor factors:

1. The extent to which the auditor applied the PCAOB's previously issued guidance
2. The extent to which the auditor's previous audit scope was driven by AS2's coverage requirements (especially for companies with a large number of homogeneous locations)
3. The extent to which the auditor is able to place reliance on the work of others

Some companies are expecting audit cost savings of up to 10 percent. While it is not possible to predict exactly how much efficiency might be generated by the issuance of this new company guidance and the new auditing standard, there is room for substantial overall savings for some companies, particularly in their own ICFR evaluation processes. In addition, as long as reasonable judgment is used in planning and performing these ICFR evaluations/audits, those efficiencies should not come at a cost of diminished effectiveness.

While it will take some time for companies and their audit firms to fully evaluate and implement these changes, it would be wise to begin to have discussions now with your auditor about the following:

1. What changes you are thinking of making to your ICFR evaluation process and the related documentation
2. Areas where the auditor might reasonably consider using more of the work of others
3. Areas (i.e., locations, accounts or classes of transactions) that are currently viewed as higher risk and the reasons for that assessment.
4. Areas that are generally lower risk, with a high degree of stability, where the auditor's results in the prior year's audit indicated controls were effective, which might lead to less intense testing in the current year.