What Will the Changes Bring?

As most U.S. management accountants who have gone through an assessment of their internal controls will know, the Public Company Accounting Oversight Board (PCAOB) recently proposed sweeping changes to its auditing standard known as AS2. Some observers suggest that the proposed revisions to AS2 will have a significant impact on the way companies assess and report on their internal controls going forward, the extent of the internal control audit, and, ultimately, the overall audit cost and complexity. It has also been suggested that the revised AS2 could go so far as to repair the creeping degeneration of the auditor-management relationship in the U.S. while, at the same time, maintaining auditor independence and continuing to ensure that the best interests of the investor are upheld through a thorough and reasonable audit of internal controls. Is AS2 (or what may come to be known as AS5) really the panacea thus described, or do we believe those who suggest nothing much will change? Until auditors' liability changes, auditors will continue to use a checklist approach to the internal control audit, management will continue to evaluate and maintain internal controls to facilitate the minimum audit requirements, more judgment in the audit will only lead to more acrimony, and, ultimately, what goes up—as in audit fees—won't be coming down.

In this exclusive interview, Laura Phillips, deputy chief auditor of the PCAOB, provides her views on these and other issues of the potential impacts of the next internal control audit standard, AS5.

AS2

Laura Phillips, PCAOB deputy chief auditor, discusses the impact of the revised AS2.

By Ramona Dzinkowski

RD: In your view, what are the most significant changes to AS2 that address the issues of the cost and complexity of the external audit and testing of internal controls?

LP: From my perspective, there are so many significant changes, most of which are meant to address cost and complexity. To put the changes in context, a lot of observers of this process are already referring to the proposal as AS5. Just to be clear, the standard won't be assigned a number until the Board adopts the final standard. Having said that, the Board has signalled that the proposed standard would become AS5 when it's adopted rather than being AS2 or AS2 revised.

This is symbolic of the extent of change we feel we're making here. It's not AS2 with some tweaks. It will be a brand new auditing standard when we're done.

In terms of some of the specific changes that come to my mind as having the most impact, I hope folks are immediately taken by how much shorter and simpler the Board's proposal is, which we hope will make the standard easier to understand. I think it's also significant that the Board's proposal removes a number of provisions that I call prescriptive, safety net type features: principal evidence, large portion, not using the work of others on the control environment. To take an example, when an auditor's making scoping decisions in a multilocation environment, AS2 would provide some direction around how to do that but would say, wait, in case you went awry, let's layer a "large portion" on top of that. [This refers to paragraph B11 that states, "Testing company-level controls is not a substitute for the auditor's testing of controls over a large portion of the company's operations or financial position. If the auditor cannot test a large portion of the company's operations or financial position by selecting a relatively small number of locations or business units, he or she should expand the number of locations or business units selected to evaluate internal control over financial reporting."]

AS2 establishes some principles around using the work of others and then says, but, wait, in case you went awry there, let's layer "principal evidence" on top of that. [Under AS2, when the auditor uses the work of others, the principal evidence provision requires the auditor to obtain the principal evidence for his or her opinion through the auditor's own procedures. See paragraph 111.] Removing them takes the safety net features away and allows these principles to really float free, if you will. This should eliminate what seems to be unnecessary work, as folks described it to us.

I think it's also significant that the Board's proposal requires an auditor to take a top-down approach. The top-down approach is one of the most important features of the May 16 guidance. We're reflecting that directly in the rule text and articulating it in the proposal in a way that I think is even more thorough and more precise. The top-down approach is a very powerful scoping concept that ought to also result in the elimination of what we have previously viewed as unnecessary work.

RD: Can you explain how the concepts of risk have changed?

LP: In terms of changing risk concepts, this is another area the Board elaborated on in its May 16 guidance: the role of risk assessment in the audit of internal control. This is certainly another area that was on the short list of things we thought were important to clearly reflect in the rule text to get the maximum benefit out of it. I don't think I would characterize this as fundamentally changing risk or redefining risk but, rather, more clearly articulating in the Board's literature, again in the rule text, where it has the highest level of authority—how an auditor ought to be viewing risk. We're establishing directly in the rule text concepts that we would have liked auditors to have understood already, particularly correlating the evidence they need to obtain with the risk associated with a control. In other words, an auditor doesn't need to obtain the same extent of evidence for every control they test. That ought to be rationed in a way that auditors are obtaining greater evidence around higher-risk controls and that they have the confidence to obtain less evidence as it relates to lower-risk controls.

RD: What can management do to lower the cost of the audit under AS5?

LP: Part of the Board's suggested package is another proposed auditing standard on considering and using the work of others in the audit. To the extent that management's internal control evaluation looks much different from or much less than what the auditor would have done, then the auditor won't be able to use as much of management's work as otherwise would have been possible. That kind of asymmetry that auditors and management don't have to do the same work—that management's evaluation might look quite different—is an important possibility to recognize. That's not something that a lot of folks are comfortable with right now. With that in mind, companies ought to think about controlling their total 404 costs as a simultaneous equation. As the company makes decisions about its internal costs and how to conduct management's evaluation, they need to recognize that those decisions will impact their external audit costs in terms of how much of management's work can be equally leveraged by the external auditor. Solving that simultaneous equation ought to be market based. Companies should have a lot of freedom to decide for themselves. The provisions of the Board's proposal taken together with the Securities & Exchange Commission's proposed management guidance provide that kind of flexibility.

RD: Some suggest that AS2 and the revised AS2 serve not only as audit standards but direct management's work with respect to maintaining, assessing, and reporting on internal controls. Can you comment on this view?

LP: It's a little disappointing to me to hear folks talk about AS2 and what would become AS5 in the same breath. Both the PCAOB and the SEC have already acknowledged that, in the past, AS2 had not only directed auditors but also ended up being used to direct management's work. We saw that as a problem that had to be addressed. That's why you see the SEC having proposed guidance for management—addressing management's assessment process. That's why you see that, in its proposed revisions to AS2, the Board omitted any provisions that suggest an auditor needs to evaluate the efficacy of management's evaluation process. So together we're trying to refocus all the participants in the process on the notion that management ought to look to the SEC for direction and auditors ought to look to the PCAOB. Anyone who thinks that the auditing standard that ultimately becomes AS5 ought to be used to direct management's work hasn't been paying very good attention to what the Board and the SEC are trying to do here.

RD: Would you not see a tendency for management to rely on auditors' recommendations, particularly with respect to SMEs that perhaps haven't gone through the assessment process yet? Would there not be an incentive for management to say, "Okay, what do we do to satisfy your requirements?"

LP: Part of your question seems to ask what constitutes effective internal controls and does a company have the controls it ought to have in place? Also, can it look to its auditors for advice? We think there is great opportunity for auditors to provide timely advice to their audit clients on accounting and internal control matters in a way that doesn't impair an auditor's independence or by itself reflect poorly on a company's internal controls. So if companies realize that they want to improve internal controls, I can certainly see a lot of reasons why they might want to ask their auditors for ideas about different types of options.

The other piece of your question seems to focus on the evaluation process. Assuming a company's internal controls are what they are, what does management need to do to have a basis for making its annual report under Section 404A, and what does an auditor need to do to render the opinion called for by Section 404B? We're working hard to potentially put some distance between the two so that management, using the SEC's proposed management guidance and other sources, can independently determine what it wants to do in its evaluation and make its annual report on effectiveness of internal control. Separately, the Board's standard describes the evidence-gathering process an auditor needs to go through in order to render an independent audit opinion on the company's internal controls.

RD: There was the question of scalability of the proposed revisions to AS2. Can you explain this for our small-business audience?

LP: There are a number of provisions and important inflection points for scaling an audit. Requiring a top-down approach would be at the top of the list—establishing clear principles that correlate evidence with the risk being addressed, eliminating any notion that the auditor has to evaluate the efficacy of management's evaluation process, eliminating the safety net provisions. All that, we anticipate, will help auditors become more comfortable exercising the judgment that they need to appropriately scale an audit to a smaller public company. The Board also previously announced a related project to develop guidance for auditors of smaller public companies. Scaling the audit provisions in the rule text provides the clear, authoritative foothold. It's almost a table of contents for the guidance that's being developed that will elaborate more and will provide auditors with even more ideas about how to audit in a practical way in the small company environment.

RD: What is the anticipated impact of injecting more judgment into the audit of internal control? For example, can you comment on the potential impact on the audit relationship—whether it may improve or degenerate further as a result?

LP: I think that you hit on what I hope will be one of the important results here. I hope that the new standard will change the dynamic of the dialogue between management and the auditor. We're bothered when management or audit committee members come to us and describe an experience with their auditor under AS2 that sounds something like this: The company challenged the scope of the auditors' work. They've asked, "Why do you need to do this particular work? It doesn't seem that it could possibly relate to material misstatements of our consolidated financials. You seem to be spending an inordinate amount of time performing work that doesn't seem to have any value. Why are you doing this work?" The auditors' response ultimately devolves into "Well, I can't explain in a substantive way why it matters, and I might even agree with you that it isn't a good use of time, but I have to. AS2 simply requires that I do this work." The Board's proposal, in terms of having much shorter, simpler standards that everyone ought to be able to understand, ought to ensure that when a company asks those kind of questions of their auditor, the dialogue that follows ends with the auditor providing a substantive rationale. The auditor ought to be able to explain in a way that makes sense to reasonable business people why some particular testing is necessary, and that should naturally flow from the decision-making process that is described in the Board's proposal.

RD: What do you see as the general perception from the investment community of financial management today vs. three years ago? Have you seen a shift in mood as a result of all of this?

LP: If we frame the question in terms of internal control, which is certainly where my head is very focused these days, I speak with investors frequently and what they think about the internal control reporting under Sarbanes-Oxley Section 404. If they understand one thing about those internal control reporting provisions, they understand that the Act requires that investors be provided with an independent audit opinion about whether a public company's internal control is, in fact, effective. They certainly still want that level of assurance. They find it helpful.

I hear feedback from them that they understand that to obtain that level of audit assurance, it involves some measure of incremental cost and that, as shareholders of the company, they are the ones paying the cost, not management. Management sometimes paternalistically suggests that investors aren't getting good value here, that they don't need the audit. What I hear from investors is that they can decide that for themselves and that there is good value here. But they're disturbed, as we are, when they hear about auditors testing things that don't seem to have much value, that don't seem that they could possibly translate into having a material effect on the company's financials. Investors are looking to us. They see this type of work as an unnecessary cost that they have no interest in supporting. They think that it is incumbent on us to do whatever it is that we have to do to eliminate those unnecessary costs. I certainly feel a deep duty on behalf of investors to do just that. ■

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