Finding the Jugular: Using AS5 to Refocus on Risk

By Robert J.A. Zito

"Focus on the jugular." SEC Chairman Christopher Cox recently used these words to describe how Auditing Standard No. 5 (AS5) and the SEC's management guidance would refocus Sarbanes-Oxley Section 404 (SOX 404) compliance on the material risks to the financial reporting system—the specific problem which originally drove Congress to enact the law.

Section 404 has been called the "heart" of the Sarbanes-Oxley Act. Since its implementation in 2004, compliance with SOX 404 has proven to be challenging. SOX 404 requires companies to include a statement by management in their annual reports assessing the effectiveness of internal control over financial reporting. SOX 404(b) requires a company's independent auditor to attest to the accuracy of management's report, providing shareholders and the public with an independent reason to rely on management's assessment. However, there is a lack of guidance for management about its role in assessing internal controls, as distinct from the role of the auditor.

The costs of complying with SOX 404 have far exceeded the SEC's original estimate of $91,000 per company. A recent survey by Financial Executives International reported that for 200 public companies with average revenues of $6.8 billion, complying with SOX 404 cost an average of $2.9 million during fiscal year 2006. The costs and other problems associated with SOX 404 have been fueled by auditors' reluctance to exercise professional judgment in implementing the existing auditing standard.

In response to these problems, the SEC and the Public Company Accounting Oversight Board (PCAOB) have worked together to develop AS5 and new guidance for management, which they hope will prove to be a cost-efficient, workable regulatory model for internal control over financial reporting. This article will examine how AS5 and the SEC's management guidance will change public companies' internal control assessments and audits, and provide directors with practical solutions in using AS5 to bring value to the bottom line.

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Director Summary: In response to the problems associated with SOX 404 compliance, the SEC and the PCAOB have worked together to develop a more cost-efficient, workable regulatory model for internal control over financial reporting. The author examines how the new AS5 and SEC management guidance will change public companies' internal control assessments and audits, and he provides directors with practical solutions in using AS5 to bring value to the bottom line.

SEC Rules—Management Reports

In June 2003, the SEC adopted Item 308 of Regulation S-K which implemented the requirements of SOX 404(a). The SEC rules require annual reports to include a report of management on the company's "internal control over financial reporting"—that is, the process designed by management to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (GAAP). Internal control over financial reporting includes policies and procedures that:

- relate to the maintenance of records that accurately and fairly reflect the transactions of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the registrant's assets that could have a material effect on the financial statements.

The guidance abandons a "one-size-fits-all" approach, allowing companies of all sizes and complexities to tailor the evaluation process to their unique problems and circumstances.

The SEC's rules require management's report on internal control over financial reporting to contain:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- a statement identifying the framework used by management to evaluate internal control over financial reporting;
- management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective; and
- a statement that the registered public accounting firm that audited the company's financial statements has issued an attestation report on management's assessment.

The SEC's rules did not provide any specific guidance as to how management would assess internal controls, as distinct from the role of the auditor. As a result, management generally relied on the existing standard for auditors (AS2), which was heavily criticized for being overly complex.

PCAOB's Auditing Standard No. 2

In March 2004, the PCAOB adopted AS2 to govern the audits of internal control over financial reporting. Under AS2, the auditor's report on internal control over financial reporting expresses two opinions: (i) an opinion on whether management's assessment of the effectiveness of internal control over financial reporting as of the end of the most recent fiscal year is fairly stated, and (ii) an opinion on whether the issuer has maintained effective internal control over financial reporting as of that date.

AS2 specifies an extensive process for conducting an audit of internal control over financial reporting involving several steps, including:

- planning the audit;
- evaluating the process used by management to perform its assessment;
- obtaining an understanding of internal control;
- evaluating the effectiveness of the design and operation of internal control; and
- forming an opinion about whether the internal control over financial reporting is effective.

As part of obtaining an understanding of internal control, AS2 requires the auditor to identify (i) significant accounts or disclosure, (ii) relevant assertions, and (iii) significant processes and major classes of transactions.

PCAOB's Auditing Standard No. 5

On May 24, 2007, the PCAOB adopted AS5 to replace AS2, which was widely viewed as inefficient. The primary objectives of AS5 are to:

- focus the internal control audit on the most important issues, especially high-risk areas;
- eliminate unnecessary procedures, including focusing testing requirements on risk;
- make the audit flexible to fit the size and complexity of any company; and
- simplify the text of the standard and coordinate SEC and PCAOB definitions

The first objective is accomplished through both top-down and risk-based approaches. Although the name may be deceiving, the top-down approach actually refers to the auditor's thought process in identifying which risks and controls to test, offering flexibility to focus testing on the most important controls. Additionally, auditors are directed to focus on the highest risk areas that an internal control may fail to find a material misstatement in the financial statements. Many unnecessary procedures have been eliminated as well.

AS5 allows auditors to address low-risk areas in a variety of ways including incorporating knowledge of previous audits and adjusting the form and extent of their tests based on risk rather than coverage of a certain portion of the company. They no longer have to evaluate management's evaluation of internal controls, which was one of the major redundancies under AS2. In addition to the previous year's audit, auditors may use others' information in performing their audit including that of company personnel and third parties working under management or the audit committee. Departing from the checklist-like walkthrough of each major transaction with a specific process required under AS2, AS5 directs auditors to fulfill the objectives that a well-executed walkthrough would achieve without an exact requirement as to how the auditors should do that.

The standard also goes into detail on how smaller, less complex companies may apply these principles in order to tailor them to their specificities, rather than requiring AS5

to be a "one-size-fits-all" standard. Additionally, the PCAOB plans to issue further guidance with regards to smaller companies to further assist them in the auditing process.

Finally, the actual text of the standard uses simpler terms and cross-references to concepts which are already in place in the SEC or PCAOB. The definitions of material weakness and significant deficiency were changed in order to conform with the SEC's definitions. AS5 also clarifies that material weaknesses should be the focus of the audit, and deficiencies that would not constitute material weaknesses should not consume auditors' attention.

Overall, these major changes have streamlined the auditing process to some degree and allow auditors and managers greater flexibility in the manner and scope that they conduct their audit, which will ultimately enable them to be more effective and more cost-efficient.

SEC Guidance on Management Reports

The SEC issued interpretive guidance for management regarding its evaluation and assessment of internal control over financial reporting, complementing the PCAOB's AS5. This guidance is the first time that the SEC has set out a substantive standard for management to follow regarding their reports on internal control over financial reporting. Previously, management looked to AS2 in order to determine how they should proceed with reporting. The SEC's guidance is organized under two broad principles.

The first principle under the SEC's guidance is that management should use a top-down, risk-based approach in evaluating whether it has implemented controls that sufficiently combat the risk that a material misstatement of the financial statements might occur. This means that management does not have to record every single control in the process, and instead can hone in on the specific controls that are essential for addressing the risk of a material misstatement of its financial statements. This makes perfect sense given that different businesses have different risks.

When net profits and dividends are being reduced due to administrative and audit costs, one must ask: Is this good for the shareholders?

The second principle under the SEC's guidance is that management's assessment of risk should be the foundation in evaluating evidence about the operation of its controls. Using risk-based judgment to determine necessary evidence, management is able to align the breadth, scope, and format of its evaluation procedures with the highest risk areas to reliable financial reporting. Management may alter its evidence-gathering process by performing more extensive analyses in high-risk areas while using more efficient approaches for low-risk areas. This guidance is intended to abandon a "one-size-fits-all"

Compliance Dates

The SEC has extended the dates for compliance with SOX 404 on several occasions in light of the substantial time and resources needed by companies to implement the rules. The extension of the compliance deadlines apply to smaller companies, foreign private issuers, and newly public companies. The extended deadlines do not apply to U.S. companies that qualify as "large accelerated filers" or "accelerated filers."

Compliance Dates		
Filer Status	**Management's Report**	**Auditor's Attestation**
Non-accelerated filer (U.S. domestic company or foreign private issuer)	Required in annual reports for fiscal years ending on or after December 15, 2007. (Furnished, not filed in first year)	Required in annual reports for fiscal years ending on or after December 15, 2008.
Foreign private issuer accelerated filer	Currently required.	Required in annual reports for fiscal years ending on or after July 15, 2007.
All other issuers (Large accelerated filers and U.S. domestic accelerated filers)	Currently required.	Currently required.
Newly public companies	Required in second annual report.	Required in second annual report.

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approach, allowing companies of all sizes and complexities to tailor the evaluation process to their unique problems and circumstances which should provide for a more efficient and effective process across the board.

Conclusions

This is all good news to small and medium-sized public companies, most of which have been struggling with the costs of SOX 404 compliance since its inception. What remains to be seen, however, is the manner by which AS5 will be implemented. Seminars on the topic of AS5 implementation are quickly becoming a cottage industry for accountants, lawyers, and various specialist consultants who worship at the SOX altar. Moreover, while the SEC and the PCAOB may provide guidance on any number of issues, the proof will be in the examination and enforcement arenas. Fundamentally, most regulation policy is about the regulators in the trenches who enforce the regulations on a day-to-day basis, as opposed to the policymakers at the top or even the regulations themselves.

It also remains to be seen how auditors will respond to an audit process that is prioritized and not wholly comprehensive. Auditors are naturally motivated to provide comprehensive services for two reasons: first, they are generally paid by the hour, and second, they do not want to be subjected to future criticism. Performing a fully comprehensive audit that leaves no stone untouched serves to generate billable hours for the auditors and reduces the risk of hindsight inquiries as to why certain aspects of an audit were ignored. This is good for the auditors and even good for the protection of directors. But when net profits and dividends are being reduced due to administrative and audit costs, one must ask: Is this good for the shareholders? This is where the rubber meets the road and where directors will be tested on their business judgment.

This is a time of opportunity for directors, especially outside directors, to display real corporate leadership and courage. In the wake of the Enron, Tyco, and WorldCom scandals and the resulting SOX regulation, companies have seemingly surrendered control to auditors, lawyers, and consultants and their associated costs. While SOX was intended to protect the so-called "ma and pa" investor, the ma and pa investor will lose investment opportunities to the hedge funds, the institutions, and the very rich, if the end result of regulation is that public companies choose to go private to eliminate the rigmarole of costly compliance. Indeed, companies are losing the benefit of many talented director candidates who are reluctant to serve on company boards for fear of being sued or becoming the subject of a regulatory inquiry.

Shareholders are entitled to value, plain and simple. Auditors, lawyers, and consultants are indispensable to a company. Layers upon layers of auditors, lawyers, and consultants in the name of compliance-for-compliance's-sake are expensive and rarely result in value to the shareholder unless the company has a peculiar history of compliance issues. This leads to the emergence of a new role for auditors, lawyers, and consultants, driven by shareholder value.

AS5 will, no doubt, result in an increase in tension between boards and company auditors because decisions will have to be made regarding the depth and breadth of the SOX 404 audit. Directors will be faced with making important business judgments regarding what is necessary and what is not. Boards are charged with reducing costs and delivering value to shareholders. Auditors, on the other hand, are inescapably faced with avoiding hindsight criticism, which often results in an increase in audit costs. Yet, audit committees and boards rarely buck auditors' recommendations. The dissonance from these two potentially competing interests will ultimately have to be harmonized.

Here enters the new role: the accountant, lawyer, or consultant who is not working for the company, but who is engaged independently by the board to aid in making the difficult decisions regarding the scope of the SOX 404 audit. This is a win-win for all concerned: With the advice of an independent attorney, accountant, or consultant, the board can find comfort and support in reaching those tough business decisions through a second opinion. Likewise, with the aid of the same independent party, the risk of a future hindsight attack against the auditors is ameliorated. This is a time for company directors to assert greater independence and stronger leadership by making the right business decisions regarding SOX 404 compliance, even if it means risking a confrontation with the company's auditors. ■

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