

April 2007, No. 07-02

SEC and PCAOB Proposed Changes to Internal Control Assessments and Audits: Considering Near-term Implications

Audit committees, boards, and others supporting the financial reporting process should be aware of the following development potentially affecting a company's financial statements and/or disclosures.

The SEC and PCAOB are in the final stages of providing additional guidance and revised auditing standards to make S-O 404 more effective and efficient, and many companies and their auditors are moving ahead to plan how best to incorporate these proposals.¹

The Issue

Together, these related proposals are intended to improve the effectiveness and efficiency of internal control assessments (by management) and integrated audits (by external auditors). Each encourages a top-down, risk-based approach, with emphasis on using judgment and applying principles (versus following detailed instructions).

The **SEC's proposed guidance** is intended to help management enhance the effectiveness and efficiency of its process for evaluating internal control. As observed by the SEC, management has, in the absence of guidance, looked to the PCAOB's auditing standard to conduct its internal control evaluations; the proposed guidance is designed to provide management "with its own guidance—without the need to look to auditing standards—for evaluating internal control over financial reporting."² The guidance would enable management to scale and tailor its evaluation procedures to fit the company's facts and circumstances (which may be of particular benefit to smaller, less-complex companies) and to exercise more judgment.

The **PCAOB's proposed standard** is designed to promote a more effective, efficient, risk-based, and scalable approach to conducting an integrated audit by (1) focusing on the matters most important to internal control, (2) eliminating unnecessary procedures, (3) scaling the audit for smaller companies, and (4) simplifying the requirements.

Examples of potential efficiencies may include reduced multilocation testing requirements, reduced auditor testing in some areas using knowledge gained from audits in prior years, and increased use of direct assistance of others when performing required walkthroughs. (Note: The level of potential benefit may vary greatly by company.)

The PCAOB proposal also would have the effect of removing some barriers to using the work of others in an audit, including the prohibition of using the work of others in testing the control environment.

Considerations for Audit Committees and Boards

The SEC and PCAOB proposals—which are likely to affect assessments and audits for 2007 calendar year-end companies—will impact companies and their auditors differently; however, matters that audit committees and boards should begin to consider (and discuss with management and/or auditors) include:

- Management's plan for scaling/tailoring its internal control assessments and its potential impact on the level of the external audit effort. (A reduction in the scope of management's assessment and related documentation may decrease the auditor's ability to use management's work, thereby increasing the auditor's work.)
- How management and auditors plan to communicate about their respective assessment and audit approaches and coordinate their activities in light of the proposed changes.
- How management and auditors anticipate exercising judgment in making their risk assessments (including consideration of knowledge obtained during previous audits).
- Whether management's work/activities may be leveraged differently as a result of the new proposals.

SEC and PCAOB Proposals At-a-Glance

Proposed SEC Guidance

(Directed to management)

- Provides management with its "own guidance" for internal control assessments
- Top-down, risk-based approach to evaluating internal controls
- Encourages "frequent and frank dialogue among management, auditors, and audit committees"
- Likely effective upon SEC adoption

Proposed PCAOB Auditing Standard ("AS-5")

(Directed to auditors)

- Top-down, risk-based approach to integrated audits
- Allows more judgment
- Eliminates requirement for auditors to opine on management's assessment
- Would remove some barriers to using work of others (via separate proposed standard)
- Clarifies/revises definitions of "significant deficiency" and "material weakness"
- Likely effective upon SEC approval

Additional Resource

KPMG's *Defining Issues*[®] 06-34, Proposed SEC and PCAOB Guidance on Internal Control Over Financial Reporting (www.kpmg.com/aci/docs/DI_06_34_SEC&PCAOB_Proposals.pdf)

Audit Committee Institute
www.kpmg.com/aci

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2007 KPMG International. KPMG International is a Swiss cooperative. Member firms of the KPMG network of independent firms are affiliated with KPMG International. KPMG International provides no client services. No member firm has any authority to obligate or bind KPMG International or any other member firm vis-à-vis third parties, nor does KPMG International have any such authority to obligate or bind any member firm. All rights reserved. *Defining Issues* is a registered trademark of KPMG LLP. KPMG and the KPMG logo are registered trademarks of KPMG International, a Swiss cooperative. 070403

¹ SEC Release 33-8762, Management's Report on Internal Control Over Financial Reporting, December 20, 2006, and PCAOB Proposed Auditing Standard, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements, December 19, 2006.

² SEC Press Release, December 13, 2006.