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SECURITIES ALERT

SEC AND PCAOB RELEASE GUIDANCE ON INTERNAL CONTROLS

On May 16, 2005, the Securities and Exchange Commission's Division of Corporation Finance and Office of the Chief Accountant issued a *Staff Statement on Management's Report on Internal Control over Financial Reporting*. The Staff Statement was issued in response to a variety of concerns that have been voiced over the first-year implementation of Section 404 of the Sarbanes-Oxley Act of 2002. In many respects, the Staff Statement draws on information gathered at an all-day roundtable discussion conducted by the Commission on April 13, 2005, regarding implementation of the internal control reporting provisions. The Commission also solicited written submissions from the public regarding Section 404.

Simultaneously with the issuance of the SEC Staff Statement, the Public Company Accounting Oversight Board issued a policy statement regarding implementation of Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements*, and the staff of the PCAOB issued "Staff Questions and Answers" on the topic. Many of the basic points addressed by the PCAOB policy statement and staff questions and answers are similar to those expressed by the SEC in its guidance.

STATEMENT BY THE COMMISSION

The Commission issued its own statement to accompany the release of the SEC Staff Statement. In its statement, the Commission highlighted several concepts concerning compliance with Section 404 that are the subject of the Staff Statement, including the following:

- **Top-down, Risk-based Approach.** Companies and their independent auditors must bring reasoned judgment and a "top-down, risk-based" approach to the Section 404 compliance process, one that recognizes that internal controls over financial reporting should reflect the nature and size of the company and that, in assessing the controls, the most resources should be devoted to those controls involving the greatest area of risk.
- **Integration of Audits of Financial Statements and Internal Controls.** In future years the Commission expects the internal control audit to be better integrated with the audit of a company's financial statements, which should help reduce costs.

- **Communication Between Companies and Auditors.** Management, auditors and audit committees should communicate frequently, with the goal of improving internal controls and the financial reports upon which investors rely. Management should not fear that a discussion of internal controls with, or a request for assistance or clarification from, the auditor will itself be deemed a deficiency in internal control. The Commission affirmed that, as long as management determines the accounting to be used and does not rely on the auditor to design or implement the controls, the auditor's providing advice or assistance in itself will not constitute a violation of the SEC's independence rules.

SEC STAFF STATEMENT

The principal issues addressed by the SEC Staff Statement are:

- reasonable assurance, risk-based approach, and scope and timing of testing and assessment
- evaluating internal control deficiencies
- disclosures about material weaknesses
- information technology issues
- communications with auditors
- issues related to small business and foreign private issuers.

A summary with respect to each of these areas is set forth below.

REASONABLE ASSURANCE, RISK-BASED APPROACH, AND SCOPE AND TIMING OF TESTING AND ASSESSMENT

Reasonable Assurance – Section 404 requires companies to determine whether their internal control over financial reporting is effective in providing reasonable assurance concerning the reliability of financial reporting. The staff observed that although "reasonable assurance" is a high level of assurance, it does not mean absolute assurance. Moreover, it noted that the reasonable assurance standard means, in almost all instances, that there is a range of judgments (a "zone of reasonable conduct," in the staff's words), rather than a single conclusion or methodology, that an issuer might make as to what is "reasonable" in implementing Section 404 and the Commission's rules.

Top-down, Risk-based Assessments – The staff emphasized that management, in conducting its assessment of internal control over financial reporting, should employ a "top-down, risk-based" approach – that is, apply its cumulative knowledge, experience and judgment to identify those areas that present the most significant risk that financial statements could be materially misstated, and then proceed to identify relevant controls and design appropriate procedures for documentation and testing of those controls.

Scope of Assessment – The Staff Statement pointed out that management needs to consider qualitative as well as quantitative factors when identifying significant accounts and processes for purposes of determining the scope of its assessment under Section 404. Even though management may establish quantitative thresholds, such as use of a percentage as a minimum threshold, as a starting point for evaluating the significance of an account or process, management must also consider qualitative factors, such as the risk associated with various accounts, to determine if amounts above or below that threshold must be evaluated. Furthermore, once significant accounts and processes are identified, management must focus on the controls to be tested that are relevant to those processes. But, the staff pointed out, management need not test every individual step comprising a control in order to determine that the overall control is operating effectively. According to the staff, rather than identifying, documenting and testing each individual step involved in a particular control, it would be far more useful for management to test the effectiveness of the combination of detailed steps that meet the control objective.

The staff also expects that management will adjust its future assessments of internal control based on its experience in prior years. For instance, management may determine that certain controls require more extensive testing while other controls require little testing in a given year, or may find it appropriate to adjust the nature, extent and timing of testing from year to year. Also, the staff noted that companies generally should determine the accounts included within their Section 404 assessment by focusing on annual and company measures rather than interim or segment measures. However, if management identifies a deficiency as a result of testing a control, it must then measure the significance of the deficiency by using quarterly, as well as annual, measures and also consider segment measures where applicable.

Timing of Management's Testing – Although the internal control reporting provisions require that management's assessment and the auditor's report on the assessment be "as of" year end, the staff noted that effective testing and assessment may, and in most cases preferably would, be accomplished over a longer period of time. By virtue of its daily involvement with the internal control system, management may be able to test a substantial number of controls at times prior to its fiscal year end and determine that they also function effectively as of the fiscal year-end date without performing further detailed testing.

EVALUATING INTERNAL CONTROL DEFICIENCIES

Once a control deficiency is identified, management should undertake an analysis to determine the significance of the deficiency and whether the risk is mitigated by compensating controls. As with a determination of the scope of the assessment, management must exercise reasonable judgment in making such evaluation, including appropriate consideration of both qualitative and quantitative analyses. The qualitative analysis should include such elements as the nature of the deficiency, its cause, the relevant financial statement assertion the control was designed to support, its effect on the broader control environment and whether other compensating controls are effective.

In this regard, the staff noted that neither Section 404 nor the Commission's implementing rules require that a material weakness in internal control over financial reporting be found to exist in every case where a restatement is the result of an error. Rather, management and the external auditor should use their judgment in assessing the reasons for the restatement, and particularly whether the need for the restatement resulted from a material weakness in controls.

DISCLOSURES ABOUT MATERIAL WEAKNESSES

The Staff Statement included a recommendation that when a company identifies a material weakness that has not been corrected prior to its fiscal year end and therefore must conclude that its internal control over financial reporting is ineffective, it include the following disclosures:

- the nature of any material weakness
- its impact on financial reporting and the control environment, and
- management's current plans, if any, for correcting the weakness.

The goal of the disclosure is to enable an investor to distinguish between material weaknesses that have a "pervasive impact" on internal control and those that do not.

INFORMATION TECHNOLOGY ISSUES

Although the staff does not expect companies to test general IT controls that do not pertain to financial reporting, it expects management to document and test relevant general IT controls (e.g., controls over program development, program changes, computer operations, and access to programs and data) in addition to appropriate application-level controls designed to ensure that financial information generated from a company's application systems can reasonably be relied upon. In addition, the staff declined to provide an exclusion for new IT systems or upgrades implemented in the latter part of a fiscal year from the scope of management's assessment for that year.

COMMUNICATIONS WITH AUDITORS

One potential unintended consequence of implementing Section 404 and PCAOB Auditing Standard No. 2 has been a chilling effect on the level and extent of communications between auditors and management regarding accounting and financial reporting issues. Experience to date has indicated that some companies have hesitated to ask auditors technical accounting, auditing and financial reporting questions, or to provide auditors with early drafts of financial statements, because of a concern that these actions could result in the unwarranted identification of internal control deficiencies by the auditors. Additionally, auditors have indicated some concern that providing management with advice might be deemed to impair the auditor's independence.

The staff affirmed that so long as management makes the final determination as to the accounting used, including determination of estimates and assumptions, and the auditor does not design or implement accounting policies, auditor involvement is appropriate and is not of itself indicative of a deficiency in the company's internal control over financial reporting.

Moreover, the staff noted that management should not be discouraged from providing its auditors with draft financial statements (including drafts that may be incomplete in certain respects). In the staff's view, errors in draft financial statements in and of themselves should not be the basis for the determination by a company or an auditor of a deficiency in internal control over financial reporting.

SMALL BUSINESS ISSUERS AND FOREIGN PRIVATE ISSUERS

Issuers who are not "accelerated filers" and foreign private issuers are not required to comply with Section 404 until they file their annual report for their first fiscal year ending on or after July 15, 2006. The staff indicated that it will continue to assess the effects (including the costs and burdens of assessment) of the internal control reporting rules on the smaller public companies and foreign private issuers, suggesting that it may show more flexibility in the application of Section 404 to those issuers.

CONTACT INFORMATION

If you have any questions or would like to learn more about this topic, please contact the partner who normally represents you, or:

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