PDM 404 Guidance July 11, 2006

SEC Issues Concept Release Seeking Input for Section 404 Guidance

As announced in its May 2006 release, the SEC is seeking input on how best to provide guidance to management of SEC reporting companies regarding the evaluation and assessment of internal control over financial reporting. Today, the SEC issued a Concept Release setting forth a series of questions to help it develop appropriate guidance. Comments are to be submitted within 60 days of publication in the *Federal Register*.

Background

Domestic reporting companies that meet the definition of "accelerated filer" were required to comply with the internal control reporting provisions for the first time in connection with their fiscal years ended on or after November 15, 2004. Foreign private issuers that meet the definition of accelerated filer must comply with those provisions for their first fiscal year ending on or after July 15, 2006. In September 2005, the SEC postponed the compliance date for domestic and foreign non-accelerated filers until their first fiscal years ending on or after July 15, 2007. The SEC expects to propose an additional extension of the dates for complying with internal control over financial reporting requirements for companies that are non-accelerated filers, including foreign private issuers that are non-accelerated filers.

In May 2006, the SEC announced, among other things, that it intended to issue a Concept Release seeking comment on a variety of issues that might be the subject of guidance for management. The SEC anticipates that the guidance issued will be in the form of a rule and would address the topics outlined in the Concept Release: risk and control identification, management's evaluation, and documentation requirements. Additionally, the rule is expected to be written in such a manner that if companies follow the rule, they will be deemed to have complied with Rules 13a-15(c) and 15d-15(c) of the 1934 Act. Further, the SEC anticipates that any modifications to Auditing Standard No. 2 would be consistent with the rule.

Request for Comment

The cumulative feedback that the SEC has received overwhelmingly supports the need for further guidance for management on Section 404 issues. The questions posed by the SEC and summarized below are intended to elicit comment on appropriate guidance that would be scalable and thus responsive to individual circumstances. In the SEC's own words: the Concept Release "does not reflect a general dissatisfaction by the [SEC] with the assessments accelerated filers have completed to date. Rather, [it is] issuing [the] Concept Release because [it is] committed to doing as much as [it] can to reduce any concerns about the nature and extent of assessment procedures that management must establish and maintain, to assist in making the requirements scalable for companies of all sizes and complexity, and to help companies evaluate internal control over financial reporting in a practical and cost-efficient manner."

Generally

1. Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies subject to the Section 404 requirements or only to a sub-group of companies?

2. Are there special issues applicable to foreign private issuers that the SEC should consider in developing guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting? Are such considerations applicable to all foreign private issuers or only to a sub-group of these filers?

3. Should additional guidance be limited to articulation of broad principles or should it be more detailed?

4. Are there additional topics, beyond what is addressed in this Concept Release, the SEC should consider issuing guidance on?

5. Would additional guidance in the format of an SEC rule be preferable to interpretive guidance?

6. What types of evaluation approaches have managements of accelerated filers found most effective and efficient in assessing internal control over financial reporting?

7. Are there potential drawbacks to or other concerns about providing additional guidance that the SEC should consider?

8. Why have the majority of companies who have completed an assessment, domestic and foreign, selected the COSO framework rather than one of the other frameworks available, such as the Turnbull Report? Is it due to a lack of awareness, knowledge, training, pressure from auditors, or some other reason? Would companies benefit from the development of additional frameworks?

9. Should the guidance incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control over Financial Reporting"?

10. What is the appropriate role of outside auditors in connection with the management

assessment required by Section 404(a) and on the manner in which outside auditors provide the attestation required by Section 404(b)?

Risk Control and Identification

11. What guidance is needed to help management implement a "top-down, risk-based" approach to identifying risks to reliable financial reporting and the related internal controls?

12. Does the existing guidance, which has been used by management of accelerated filers, provide sufficient information regarding the identification of controls that address the risks of material misstatement?

13. In light of the forthcoming COSO guidance for smaller public companies, what additional guidance is necessary on risk assessment or the identification of controls that address the risks?

14. In areas where companies identified significant start-up efforts in the first year (e.g., documentation of the design of controls and remediation of deficiencies) will the COSO guidance for smaller public companies adequately assist companies that have not yet complied with Section 404 to efficiently and effectively conduct a risk assessment and identify controls that address the risks?

15. What guidance is needed about the role of entity-level controls in evaluating and assessing the effectiveness of internal control over financial reporting? What specific entity-level control issues should be addressed (e.g., GAAP expertise, the role of the audit committee, using entity-level controls rather than low-level account and transactional controls)? Should these issues be addressed differently for larger companies and smaller companies?

16. Should guidance be given about the appropriateness of and extent to which quantitative and qualitative factors, such as likelihood of an error, should be used when assessing risks and identifying controls for the entity?

17. Should the SEC provide management with guidance about fraud controls?

18. Should guidance be issued to help companies with multiple locations or business units to understand how those affect their risk assessment and control identification activities?

Management's Evaluation

19. What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at the individual account or transaction level?

20. Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of controls, such as on-going monitoring activities, be useful?

21. What considerations are appropriate to ensure that the guidance is responsive to the special characteristics of entity-level controls and management at smaller public companies? What type of guidance would be useful to small public companies with regard to those areas?

22. In situations where management determines that separate evaluation-type testing is necessary, what type of additional guidance to assist management in varying the nature and extent of the evaluation procedures supporting its assessment would be helpful?

23. Would guidance be useful on the timing of management testing of controls and the need to update evidence and conclusions from prior testing to the assessment “as of” date?

24. What type of guidance would be appropriate regarding the evaluation of identified internal control deficiencies? Are there particular issues in evaluating deficient controls that have only an indirect relationship to a specific financial statement account or disclosure?

25. Would guidance be helpful regarding the definitions of “material weakness” and “significant deficiency”?

26. Would guidance be useful on factors that management should consider in determining whether management could conclude that no material weakness in internal control over financial reporting exists despite the discovery of a need to correct a financial statement error as part of the financial statement close process?

27. Would guidance be useful in addressing the circumstances under which a restatement of previously reported financial information would not lead to the conclusion that a material weakness exists?

28. How have companies been able to use technology to gain efficiency in evaluating the effectiveness of internal controls (e.g., by automating the effectiveness testing of automated controls or through benchmarking strategies)?

29. Is guidance needed to help companies determine which IT general controls should be tested?

30. Has management generally been utilizing proprietary IT frameworks as a guide in conducting the IT portion of their assessments?

Documentation

31. Were the levels of documentation performed by management in the initial years of completing the assessment beyond what was needed to identify controls for testing?

32. What guidance is needed about the form, nature, and extent of documentation that management must maintain as evidence for its assessment of risks to financial reporting and control identification?

33. What guidance is needed about the extent of documentation that management must maintain about its evaluation procedures that support its annual assessment of internal control over financial reporting?

34. Is guidance needed about documentation for information technology controls

35. How might guidance be helpful in addressing the flexibility and cost containment needs of smaller public companies?

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