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SEC, SEC Staff and PCAOB Provide Guidance on Section 404 Implementation Issues

In May 2005, various forms of guidance were issued to address concerns over costs and other inefficiencies that had become apparent as a result of the first year of implementation of the rules promulgated under Section 404 of the Sarbanes-Oxley Act of 2002 and related rulemaking by the PCAOB. The guidance includes:

- a statement issued by the SEC (the "SEC Statement")
- guidance issued by the Staff of the Division of Corporation (the " Staff Guidance")
- a policy statement issued by the PCAOB (the "PCAOB Guidance") relating to implementation of the PCAOB's Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("AS 2")
- questions and answers issued by the staff of the PCAOB regarding AS 2.

This memorandum highlights the principal issues addressed in the foregoing.

SEC Statement

The SEC Statement addresses the following four broad concepts, which are given further support in the Staff Guidance and the PCAOB Guidance:

Top-down, risk-based approach using reasoned professional judgment

The SEC notes that many of the complaints raised concerning the new internal control rules relate to the mechanical, and even overly cautious, way in which these rules have been applied. In response, the SEC has stated that both management and external auditors must bring reasoned judgment and a top-down, risk-based approach to the Section 404 compliance process. A one-size fits all, bottom-up, check-the-box approach that treats all controls equally is less likely to improve internal controls and financial reporting than reasoned, good faith exercise of professional judgement focused on reasonable, as opposed to absolute, assurance.

Integration of internal control audit with audit of financial statements

The SEC expects in future years the internal control audit to be better integrated with the audit of the financial statements, thereby reducing both internal and external costs of Section 404 compliance, which the SEC concedes were significant in the first year of compliance.

Internal control to reflect the nature and size of company

Internal control over financial reporting should reflect the nature and size of the company to which it relates. Particular attention should be paid to making sure that implementation of Section 404 is appropriately tailored to the operations of smaller companies. In addition to delaying the implementation of those rules for smaller companies, the SEC has encouraged the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission to develop additional guidance in applying its internal control framework to smaller companies. The SEC has also established the Commission Advisory Committee on Smaller Public Companies to consider the impact of SEC rules, including the internal control reporting rules, on smaller companies.

Dialogue among management, auditors and audit committees

The SEC encourages frequent and frank dialogue among management, auditors and audit committees with the goal of improving internal controls and financial reporting. Management should not fear that a discussion of internal control with, or a request for assistance or clarification from, the auditors will, itself, be deemed a deficiency in internal control. Moreover, as long as management determines the accounting to be used and does not rely on the auditors to design or implement the controls, the SEC does not believe that providing advice or assistance, in itself, constitutes a violation of independence requirements.

Staff Guidance

The Staff Guidance addresses the following:

- The purpose of internal control over financial reporting;
- Reasonable assurance, risk-based approach, and scope of testing and assessment;
- Evaluating internal control deficiencies;
- Disclosures about material weaknesses;
- Information technology issues;

- Communications with auditors; and

- Issues related to small business and foreign private issuers.

An overarching principle of the Staff Guidance is the responsibility of management to determine the form and level of controls appropriate for each organization and to design their assessment and testing accordingly. One size does not fit all, and control effectiveness is affected by many factors.

The purpose of internal control over financial reporting

An overall purpose of internal control over financial reporting is to foster the preparation of reliable financial statements. Reliable financial statements must be materially accurate. Therefore, a central purpose of the assessment of internal control over financial reporting is to identify material weaknesses that have more than a remote likelihood of leading to a material misstatement in the financial statements. The Staff believes that the focus of internal control reporting should be on those items that could result in material errors in the financial statements.

The scope and process of management's assessment of internal control over financial reporting is not prescribed by Section 404 or related SEC rules. Rather, such rules state that the scope and process should be reasonable, and the assessment should be supported by a reasonable level of evidential matter. What is reasonable will be different from company to company. The Staff Guidance emphasizes that management should use its own experience and informed judgment in documenting and testing its controls to fit its own operations, risks and procedures. Management should not allow the purpose of internal control to be overshadowed by the process.

Reasonable assurance, risk-based approach, and scope of testing and assessment

In responding to feedback about the judgment and processes used to determine the appropriate level of identification and testing of controls necessary to achieve reasonable assurance regarding the reliability of financial statements, the Staff Guidance addresses:

- reasonable assurance;

- top-down/risk-based assessment;

- scope of assessment;

- financial periods used in making assessments; and

- timing of testing.

The concept of reasonable assurance. Management is required to assess the effectiveness of a company's internal controls over financial reporting but not other internal controls. In addition, the SEC rules require that management's assessment provide reasonable assurance regarding the reliability of financial statements, which the Staff notes is a high level assurance, but not absolute assurance.

The concept of "reasonable assurance" relates back to similar language used in the Foreign Corrupt Practices Act.[1] Exchange Act Section 13(b)(7) defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." The SEC has long held that "reasonableness" is not an "absolute standard of exactitude for corporate records."[2]

The Staff also states that there is a range of judgment that management may make as to what is "reasonable" in implementing Section 404 and related SEC rules. Thus, the terms "reasonable," "reasonably" and "reasonableness" do not imply a single conclusion or methodology, but encompass the full range of potential conduct, conclusions or methodologies upon which management may reasonably base its decisions. In effect, there should be very few instances where there is only one acceptable choice in implementing Section 404 in any given circumstance.

Top-down/risk-based assessments. In response to evidence that in many cases the internal control assessment became a mechanical, check-the-box exercise in the first year of implementation, the Staff states that instead management should use a top-down or a risk-based approach. What this requires is that management apply in a reasonable manner its cumulative knowledge, experience and judgment to identify the areas that present significant risk that the financial statements could be materially misstated and then proceed to identify relevant controls and design appropriate procedures for documentation and testing those controls. Management should devote resources to the areas of greatest risk and avoid giving all significant accounts and related controls equal attention without regard to risk. For example, management and auditor judgment will typically impact the nature, extent and timing of control testing such that the level of testing for a low risk account will be different than that for a high risk account. In performing these steps, management and the auditors should observe the "reasonable assurance" standard.

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1 The conference committee report on amendments to the FCPA also noted that the standard "does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the cost of compliance." Cong. Rec. H2116 (daily ed. April 20, 1988).

2 Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981).

Scope of assessment. Many have complained that overly conservative interpretations of the requirements and the hesitancy by the auditors to use professional judgment resulted in too many controls being identified, documented and tested. In responding to these comments, the Staff states that the natural result of using the top-down, risk-based approach should be for management to devote greater attention and resources to areas of greater risk.

Management should use both qualitative and quantitative factors when identifying significant accounts and related significant processes in order to determine the scope of its assessment. Qualitative factors include the risk associated with the various accounts and related processes. In addition to qualitative factors, management may use quantitative thresholds, such as a minimum percentage, as a starting point for evaluating significance. However, the Staff cautions that management should exercise judgment, including a review of qualitative factors, to determine if amounts above or below that threshold should be evaluated.

Once the significant accounts and related processes are identified, management should focus on the controls to be tested. The Staff believes that some of the large number of controls identified during the first year of implementation may represent individual steps within what may constitute a broader control. In the future, the Staff recommends that, rather than identifying, documenting and testing each individual step in a broader control, management focus on the objective of the control, and test the effectiveness of the combination of the detailed steps that meet the control objective.

Efficient and effective assessments depend on the skills, training and judgment of company and auditor personnel. The Staff believes that with experience the ability to make such assessments in a consistent and sound manner will improve.

Financial periods used in making assessments. Management generally should determine significant accounts included within a Section 404 assessment by focusing on annual and company measures rather than interim or segment measures.[3] However, if management identifies a deficiency, at that point it should measure the significance of the deficiency by using both quarterly and annual measures, also considering segment measures where applicable.

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[3] The Staff acknowledges that there may be certain limited circumstances where the annual company results are not the most appropriate measure, for example, where a company has one or two key segments that are driving the business and are material to investors or where interim results drive the business (such as the holiday season for retailers) and are similarly of significant interest to investors.

Timing of management's testing. While the reports of management and the auditors must be "as of" year end, this does not mean that all testing must be done within the period immediately surrounding the year-end close. In fact, the Staff believes that effective testing and assessment may, and in most cases preferably would, be accomplished over a longer period of time.[4] For example, management might determine that controls operate effectively through direct and ongoing monitoring of the operation of controls. This may be accomplished through regular management and supervisory activities, monitoring adherence to policies and procedures, and other actions. As a result, management may be able to test a substantial number of controls at a point in time prior to the fiscal year-end, and determine through its direct and ongoing monitoring of the operation of the controls that they also function effectively as of the fiscal year-end date, without performing further detailed testing.

Evaluating internal control deficiencies

If control deficiencies are identified, management must evaluate the significance of those deficiencies and whether the risk of material misstatement is mitigated by compensating controls. In its evaluation of the deficiencies identified, management should exercise reasonable judgment and use both qualitative and quantitative factors. The qualitative analysis should factor in 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.

One particular area of concern has been the implication of a restatement. In response, the Staff states that it is not necessary that a material weakness be found to exist every time financial statements are restated to correct an error. Rather, both management and the auditors should use their judgment in assessing the reasons why a restatement was necessary and whether a restatement was necessary because of a material weakness in controls. Such an evaluation should take into account the probability of occurrence in light of the effectiveness of the company's internal controls, keeping in mind the "reasonable assurance" standard of internal controls.

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[4] In its adopting release, the SEC expressly noted that testing may be done over a period of time. Section II.C.3 to Release No. 33-8238 (June 5, 2003).

Disclosures about material weaknesses

The Staff believes that if a company reports a material weakness, it should disclose:

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

In response to feedback suggesting that Section 404 and related SEC rules do not permit registrants to distinguish among reported material weaknesses, the Staff states that while management must conclude that internal controls are ineffective in case one or more material weaknesses are identified and not remedied by fiscal year-end, registrants may, and are strongly encouraged to, provide disclosure on each particular material weakness. The Staff suggests that disclosure will be more useful if management differentiates the potential impact and importance of the material weaknesses and distinguishes those weaknesses that may have a pervasive impact on internal control from those weaknesses that do not.

The goal underlying material weakness disclosure is to provide information so that an investor who chooses to do so can treat the disclosure of the existence of a material weakness as the starting point for analysis rather than the only point available.

Information technology issues

IT internal controls. The Staff expects management to document and test *relevant* general IT controls in addition to appropriate application-level controls that are designed to ensure that financial information generated from the company's IT systems can reasonably be relied upon. For purposes of Section 404, the Staff would not expect testing of all general IT controls, and especially not those that primarily pertain to the efficiency or effectiveness of the operations of the company but are not relevant to financial reporting.

In response to queries, the Staff confirms that while separate, specific IT frameworks are not required for Section 404 assessments, it understands that some companies have used such frameworks as a guide in conducting the IT portion of their overall COSO framework assessments. In establishing the scope of its IT assessment, management should apply reasonable judgment and consider how the IT systems impact internal control over financial reporting.

IT system implementations and upgrades. In response to requests that new IT systems and upgrades implemented in the later part of a fiscal year be allowed to be excluded from the scope of Section 404 assessment for that year (by analogy to the scope exemption for recent business acquisitions), the Staff Guidance confirms that the Staff does not believe that this would be appropriate. Instead, the Staff cautions management to plan, design and perform preliminary assessments of internal controls in advance of system implementations or upgrades. As noted above, not all testing must occur at year end.

Communications with auditors

There has been a general concern that, since the introduction of Section 404 and AS 2, management will hesitate to ask auditors technical accounting, auditing, and financial reporting questions or provide auditors with early drafts of the financial statements (which, due to their draft nature, may contain errors), for fear that these actions could result in the identification of internal control deficiencies by the auditors. For their part, auditors have a heightened concern that providing management with advice might impair the auditors' independence.

In responding to the latter point, the Staff states that discussing and exchanging views with management does not in itself violate the four basic principles of the SEC's independence requirements,[5] nor does it fall into one of the nine categories of prohibited auditor services.[6] Auditors and management may engage in dialogue, including regarding new accounting standards and the appropriate accounting treatment for complex or unusual transactions. The Staff believes that such dialogue is appropriate and not of itself indicative of a deficiency in the registrant's internal control over financial reporting as long as management, and not the auditors, makes the final determination as to the accounting used, including determination of estimates and assumptions, and the auditors do not design or implement accounting policies.

The Staff also believes that management should not be discouraged from providing its auditors with draft financial statements (including drafts that may be

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5 Those principles are: (1) an auditor cannot function in the role of management; (2) an auditor cannot audit his or her own work; (3) an auditor cannot serve in an advocacy role for his or her client; and (4) an auditor and audit client cannot have a relationship that creates a mutual or conflicting interest. See Preliminary Note to Rule 2-01 of Regulation S-X. These basic principles are consistent with the guidance offered in the Independence Standard Board's Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)*, which specifically addressed the topic of auditor/client communication in the context of applying the new derivatives standard. The PCAOB adopted this interpretation as part of its interim auditing standards.

6 See Item 2-01(c)(4) of Regulation S-X, 17 CFR 210. 2-01(c)(4); Exchange Act Section 10A(g).

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 the auditors of a deficiency. Rather, as with all cases of identifying deficiencies, management and the auditors should determine whether a deficiency exists in the processes of financial statement preparation. That identification is essentially independent of whether an error exists in draft financial statements and who found it.

These views of the Staff on communications with auditors were echoed in the PCAOB Guidance addressed to auditors (see below).

Issues related to small business and foreign private issuers

Small business issuers. The Staff repeated the comments made by the SEC in its Statement discussed above.

Foreign private issuers. The Staff states that it is continuing to assess the effects of the internal control reporting requirements on foreign private issuers.

In its conclusion, the Staff states that it will continue to evaluate the implementation of Section 404. It also strongly encourages the sharing of best practices among companies, auditors and their respective advisors. The Staff will also continue to consider whether there are other ways it can make the Section 404 process more efficient and effective while preserving what it perceives are the benefits.

PCAOB Guidance

In the guidance given to the auditor community, the PCAOB, focusing on the same theme of reducing the cost and related burdens of Section 404 compliance, advised auditors that they should avoid applying AS 2 in a rigid manner and, consequently, in planning and performing an effective audit under AS 2, they should:

- *integrate their audits*, in view of the fact that the two processes are intended to be mutually reinforcing, and use the evidence gathered and the tests performed in the context of one for the other;

- *exercise judgment* to tailor their audits to the risks facing a registrant and avoid a one-size-fits-all audit plan driven by a standardized checklist that has little to do with the risks and issues a particular registrant may face;

- *use a top-down approach*, starting with company-level controls, to identify for further testing only those accounts and processes that are relevant to internal control and use the risk assessment required by AS 2 to eliminate accounts that have only a remote likelihood of containing a misstatement;

- *use the flexibility afforded by AS 2 to use the work of others,* particularly by determining which work does not need to be redone in applying the top down approach and appropriately assessing risk, which in turn should mean that the auditors will perform more work in high-risk areas and use the work of others in low-risk areas, and ascribe more weight in the "principal evidence test" to their work in high-risk areas; and

- *engage in direct and timely communications with the registrant.*

In respect of this last item, mirroring the SEC Staff view, the PCAOB took issue with the view that AS 2 prevents registrants from receiving advice from their auditors on difficult accounting and internal control questions. Although auditors may not make accounting decisions for their clients, and management cannot abandon its responsibilities and rely on the auditors to catch mistakes, they may provide accounting advice. Management must make its own informed decisions as to how to apply accounting principles to the facts and circumstances, but it may discuss freely the meaning and significance of those principles with the auditors.

As for reviewing draft financial statements, auditors should be able to do so. Auditors should be concerned about the existence of a deficiency only where the company has <u>completed</u>[7] its financial statements and related disclosure without recognizing a potential material misstatement. Where it is clear that not all controls have been operational, a material misstatement in the draft financial statements should not be deemed at that point a control deficiency.

Auditors may provide technical advice on the proper application of GAAP, including suggestions to improve disclosure and quality of financial statements and giving updates on developments in accounting standards. In addition, management may provide and discuss with the auditors preliminary drafts of accounting research memos, spreadsheets and other working papers to get the auditors' views on assumptions and methods selected by management. The PCAOB suggests that although the auditors may determine that some of these communications need to be in writing, timely and open communications will often best be accomplished orally. The PCAOB compares providing substantial assistance to management in connection with a proposed transaction, advising how accounting principles may apply to the transaction, offering sample journal entries and reviewing management's preliminary conclusions, which is permissible, with identifying a potential misapplication of accounting principles in connection with the transaction that the auditors learn of

[7] Emphasis added by the PCAOB Guidance.

outside[8] the consultation process (such as during a quarterly review, or after management has completed its financial statements and disclosures), which may well be evidence of a significant deficiency or material weakness.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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8 *Id.*