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SEC Adopts New Guidance for Management's Internal Control Over Financial Reporting

On May 23, 2007, the Securities and Exchange Commission unanimously approved interpretive guidance to help public companies strengthen their internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002. The full text of the interpretive guidance and related rules are not yet available, but they will be posted on the SEC's web site at www.sec.gov in the near future. The effective date of the interpretive guidance and related rules will be 30 days from their publication in the Federal Register. In coordination with the SEC, on May 24, 2007, the PCAOB adopted the New Auditing Standard in the form of Audit Standard No. 5: *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements* (AS No. 5).[1]

Section 404

Section 404 requires public companies to provide in their annual reports a management report on internal control over financial reporting (management report) and to provide a registered public accounting firm's attestation report on internal control over financial reporting (auditor's attestation).

No Further Section 404 Compliance Extensions for Filers

In December 2006, the SEC released final rules extending the compliance deadline for non-accelerated filers to provide a management report and an auditor's attestation.[2] The SEC has not changed these deadlines. They are still the current deadlines.

Management Report

In December 2006, the SEC extended the compliance deadline for a non-accelerated filer to provide a management report from the date it files its annual report for a fiscal year ending on or after July 15, 2007, to the date it files its annual report **for a fiscal year ending on or after December 15, 2007**. A "non-accelerated filer" is a public company with an aggregate market value held by non-affiliates as of the last day of the second fiscal quarter of less than $75 million.

Auditor Attestation

In December 2006, the SEC also extended the deadline for a non-accelerated filer to provide an auditor's attestation from the date it files its annual report for a fiscal year ending on or after July 15, 2007, to the date it files its annual report **for a fiscal year ending on or after December 15, 2008**.

The New Interpretive Guidance

Will Benefit Non-accelerated Filers

According to the Chairman of the SEC, Christopher Cox, the new interpretive guidance will enable companies of all sizes to tailor their internal control evaluation procedures according to specific facts and circumstances. The SEC expects that non-accelerated filers in particular will benefit from the scalability and flexibility provided under the new interpretive guidance.

Will Allow Companies to Keep Existing Procedures

The SEC believes that the interpretive guidance will clarify what constitutes a reasonable approach to management's evaluation of its internal control and procedures, and at the same time will allow flexibility for companies that have already developed their own

1 AS No. 5 is available on the PCAOB's website at http://www.pcaob.org/Rules/Docket_021/index.aspx

2 Release 33-8760 (December 15, 2006) is available on the SEC's website at http://www.sec.gov/rules/final/finalarchive/finalarchive2006.shtml

assessment procedures and tools. Companies will be able to continue using their existing assessment procedures if they choose, as long as those procedures comply with Section 404.

New Rule Amendments

In connection with the new interpretive guidance, the SEC also approved rule amendments providing:

- a safe harbor for a company that performs an evaluation of internal control in accordance with the new interpretive guidance, which will satisfy the annual evaluation required by Exchange Act Rules 13a-15 and 15d-15;

- the definition of the term "material weakness" is "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis"; and

- the current auditing standard for the attestation report on the effectiveness of internal control over financial reporting will be revised to create a new auditing standard (New Auditing Standard) that more clearly conveys that the auditor is not evaluating management's evaluation process, but is instead opining directly on internal control over financial reporting (for further discussion please see below).

PCAOB Adopts AS No. 5

AS No. 5 will replace PCAOB Auditing Standard No. 2: *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (AS No. 2).

AS No. 5 will not become effective until it is approved by the SEC. In addition to adopting AS No. 5, the PCAOB also adopted related Rule 3525, *Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting*. AS No. 5 may be used by auditors immediately following SEC approval, and it, along with Rule 3525, would be required for all audits of internal control for fiscal years ending on or after November 15, 2007.

AS No. 5 is principles-based and has four main objectives:

- Focus auditors on areas that present the greatest risk that a company's internal control will fail to prevent or detect a material misstatement in the financial statements, by:

    - endorsing a top-down approach to planning the audit;

    - emphasizing the importance of auditing higher risk areas, such as the financial statement close process and controls designed to prevent fraud by management; and

    - suggesting alternatives for addressing lower risk areas, like calibrating the nature, timing and extent of testing based on risk, and using knowledge from prior audits and from work performed by company personnel.

- Eliminate unnecessary procedures, by:

    - omitting detailed requirements to evaluate management's own evaluation process;

    - clarifying that an internal control audit does not require an opinion on the adequacy of management's process;

    - omitting the requirement that auditors test a large portion of a company's operations or financial position

- Explain how to tailor internal control audits to fit the size and complexity of the company being audited, by:

    - including notes on how to apply AS No. 5 principles to smaller companies; and

    - discussing relevant attributes of smaller companies and less complex units of larger companies.

- Simplify AS No. 5, by

    - making it briefer and easier to read;

    - starting with a discussion of the audit itself;

    - eliminating a discussion of materiality; and

    - stating that an auditor should evaluate materiality in an internal control audit according to the same principles that apply to financial statement audits.

Compared to AS No. 2, AS No. 5:

- aligns key terms and concepts with terms used in the SEC's new interpretive guidance and related rules (for example, the definition of "material weakness," and replacing "company-level controls" with "entity-level controls";

- starts by discussing fraud risk and anti-fraud controls, to emphasize the importance of these factors in assessing risk;
- explains how different kinds of entity-level controls have different effects on the selection and testing of controls;
- focuses auditors on fulfilling objectives that a properly performed walkthrough achieves, rather than endorsing a checklist approach;
- still requires auditors to evaluate all deficiencies that are identified;
- still requires auditors to communicate material weaknesses and significant deficiencies, in writing, to the audit committee;
- reminds auditors they need not scope the audit to find deficiencies that do not constitute material weaknesses;
- retains AU sec. 322, The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements;
- permits auditors to use testing and other internal control work of persons other than internal auditors; and
- does not require auditors to identify major classes of transactions and significant processes before they identify relevant assertions.

In the coming months, the PCAOB will adjust its inspection program to make it consistent with AS No. 5. The PCAOB is in the process of developing further guidance tailored for auditors of smaller public companies in applying AS No. 5.

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