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Client Alert

A report for clients and friends of the firm

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Relief under Section 404 of the Sarbanes-Oxley Act

SEC extends compliance dates for internal control over financial reporting requirements for smaller public companies and newly public companies.

On December 15, 2006, the Securities and Exchange Commission adopted several forms of relief under Section 404 of the Sarbanes-Oxley Act of 2002:

- The SEC further extended the date by which smaller public companies must comply with the internal control reporting requirements mandated by Section 404. Under the extension, a non-accelerated filer will provide management's assessment regarding internal control over financial reporting in its annual reports for fiscal years ending on or after December 15, 2007;

- The SEC also extended the date by which a non-accelerated filer must begin to comply with the auditor attestation requirement. Under the extension, a non-accelerated filer is not required to file the auditor's attestation report on internal control over financial reporting until it files an annual report for its first fiscal year ending on or after December 15, 2008; and

- The SEC granted relief from the Section 404 requirements for companies that are new to the requirements to file annual and quarterly reports. All newly public companies will have a transition period that exempts them from the Section 404 requirements in the first annual report that they file after becoming a reporting company.

PCAOB Proposes Revised Auditing Standard on Internal Control Over Financial Reporting

A new internal control standard

On December 19, 2006, the Public Company Accounting Oversight Board voted unanimously to propose for public comment a new standard on auditing internal control over financial reporting and other related proposals. The proposed standard would replace the PCAOB's existing internal control standard, Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (AS No. 2).

The proposed new standard is designed to focus the auditor on the matters most important to internal control; to eliminate unnecessary procedures; to simplify and shorten the standard by reducing detail and specificity; and to make the audit more scalable for smaller and less complex companies. Among other things, the proposed standard would:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment;

- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness;

- Clarify the role of materiality, including interim materiality, in the audit;

- Remove the requirement to evaluate management's process;

- Permit consideration of knowledge obtained during previous audits;

- Direct the auditor to tailor the audit to reflect the attributes of smaller and less complex companies;
- Refocus the multi-location testing requirements on risk rather than coverage; and
- Recalibrate the walkthrough requirement.

Considering and Using the Work Performed By Others
The PCAOB also proposed for public comment a new auditing standard on considering and using the work performed by internal auditors, management and others in an integrated audit of financial statements and internal control over financial reporting, or in an audit of financial statements only. This proposed standard is intended to further clarify how and to what extent an independent auditor may use that work to reduce the work the auditor otherwise would have to perform.

The proposed standard would supersede the direction currently contained in AS No. 2 regarding using the work of others. Among other things, the proposed standard would:

- Allow the auditor to appropriately use the work of others, and not just internal auditors, for both the internal control audit and the financial statement audit, eliminating a barrier to integration of the two audits;
- Encourage greater use of the work of others by requiring auditors to evaluate whether and how to use the work of others to reduce auditor testing;
- Require the auditor to understand the relevant activities of others and determine how the results of that work may affect the audit;
- Provide a single framework for using the work of others based on the auditor's evaluation of the combined competence and objectivity of others and the subject matter being tested; and
- Eliminate the explicit principal evidence provision previously included in AS No. 2.

New Independence Requirement
In addition, the PCAOB proposed to revise the independence requirement that currently is embedded in the text of AS No. 2, which requires the auditor to seek specific pre-approval by the audit committee of any internal control-related service.

The proposed new independence rule would replace direction currently contained in AS No. 2 regarding independence and internal control-related services. The proposed rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. The new rule would also recognize that audit committees may pre-approve the provision by their independent auditor of internal control-related services on an ad hoc (*i.e.*, specific to each request) basis, or pursuant to committee-approved policies and procedures.

Timing of Final Rules
The PCAOB will seek comments on the proposed standard and other proposals for 70 days. Following the close of the comment period on February 26, 2007, the PCAOB will determine whether to adopt a final standard. Any final standard adopted will be submitted to the SEC for approval.

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