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Retooling the Internal Control Process—A Welcome Relief

After several years of steady criticism over the high costs of complying with rules on internal control over financial reporting, public companies have been given a welcome dose of regulatory relief by the Securities and Exchange Commission and the Public Company Accounting Oversight Board. In coordinated actions in late May, the SEC adopted new interpretive guidance to help management of public companies evaluate the effectiveness of their companies' internal control, and the PCAOB adopted a new and improved standard, Auditing Standard No. 5, to be used by auditors when auditing internal control over financial reporting.

Key highlights of the SEC's and PCAOB's actions:

- Management of public companies now has its own guidance to follow when evaluating internal control instead of relying on a standard directed to auditors
- The new interpretive guidance emphasizes a top-down, risk-based approach focusing on controls in areas posing the greatest risk of a material misstatement
- A new safe harbor provides that an evaluation of internal control conducted in accordance with the new interpretive guidance is one way to satisfy management's obligation to evaluate the effectiveness of its internal control
- Auditing Standard No. 5 is a complete re-write of the prior standard - it is significantly shorter and more principles-based than its much-maligned predecessor
- The new auditing standard seeks to eliminate unnecessary procedures - e.g., it eliminates the "principal evidence" requirement, which many felt significantly restricted the auditor's ability to use the work of others, and it softens the requirement for "walkthroughs"
- Public companies and their auditors will be able to use the new guidance and auditing standard during the 2007 reporting and audit cycle
- The SEC rejected calls for further delay in the phase-in period for non-accelerated filers, which must begin providing management's assessment of internal control in their annual reports for 2007

The new interpretive guidance[1] and Auditing Standard No. 5[2] are designed to improve the efficiency and cost-effectiveness of both management assessments and audits of internal control over financial reporting by emphasizing more forcefully a top-down, risk-based approach focusing on controls in areas posing the greatest risk of a material misstatement. The SEC's guidance is a welcome development in that it provides management of public companies, for the first time, their own template to consult when evaluating internal control over financial reporting, instead of having to rely on a standard directed to outside auditors. At the same time, the new auditing standard is a complete re-write of the previous standard and represents a marked improvement in many respects. Public companies and their auditors will be able to use the new guidance and auditing standard during the 2007 reporting and audit cycle.[3] Notably, the SEC rejected calls for further delay in the phase-in period for smaller public companies.

In addition to issuing the new interpretive guidance, the SEC adopted amendments to rules under the Securities Exchange Act of 1934 to define the term "material weakness" and to create a safe harbor providing that an evaluation of internal control over financial reporting conducted in accordance with the SEC's interpretive guidance is one way to satisfy management's obligation to evaluate the effectiveness of its internal control.[4] The PCAOB, in addition to adopting Auditing Standard No. 5, approved new rules governing audit committee pre-approval of non-audit services related to internal control over financial reporting.[5] In a separate action in July, the SEC adopted a definition of the term "significant deficiency."[6]

In this advisory, we first review the history of the SEC's and the PCAOB's rulemaking in this area, as well as recent developments and factors contributing to the adoption of the interpretive guidance and the new auditing standard. We then summarize the key aspects of both the interpretive guidance and Auditing Standard No. 5.

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[1] *See* Release No. 33-8810 (Jun. 20, 2007) (the "Interpretive Release"). All references to page numbers in the Interpretive Release refer to the page numbers in the pdf version of the release that is available on the SEC's website at http://www.sec.gov/rules/interp/2007/33-8810.pdf.

[2] Auditing Standard No. 5 - An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements. See PCAOB Release No. 2007-005 (May 24, 2007) (the "PCAOB Release") http://www.pcaobus.org/Rules/Docket_021/2007-05-24_Release_No_2007-005.pdf. Auditing Standard No. 5 replaces Auditing Standard No. 2 - An Audit of Internal Control Over Financial Reporting Performed in Conjunction With An Audit of Financial Statements ("Auditing Standard No. 2").

[3] The SEC's interpretive guidance became effective on June 27, 2007. The new auditing standard was approved by the SEC on July 25, 2007 and will be effective for audits of fiscal years ending on or after November 15, 2007, with early adoption also permitted.

[4] *See* Release No. 33-8809 (Jun. 20, 2007) (the "Rule Amendments Release") http://www.sec.gov/rules/final/2007/33-8809.pdf. The rule amendments become effective on August 27, 2007.

[5] *See* the PCAOB Release and Appendix 2 thereto.

[6] *See* Release No. 33-8811 (Jun. 20, 2007) (the "Proposing Release") http://www.sec.gov/rules/proposed/2007/33-8811.pdf. The SEC adopted the definition as proposed on July 25, 2007.

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A Brief History — How Did We Get Here?

Regulators in the United States have long recognized the importance of internal control systems as a way to prevent and detect fraud and financial irregularities. Since 1977, public companies have been required to maintain internal accounting controls.[7] In 1993, the Federal Deposit Insurance Corporation required certain federally-insured depository institutions to prepare annual internal control reports and to have their outside auditors attest to management's assessment of the internal control systems.[8] In 2002, in the wake of highly publicized corporate accounting scandals at Enron, WorldCom and other companies, Congress enacted the Sarbanes-Oxley Act.[9] Section 404 of the Sarbanes-Oxley Act directed the SEC to make rules requiring that annual reports filed by public companies include an "internal control report" containing management's assessment of the effectiveness of the company's internal control structure and financial reporting procedures. Section 404 also required each public company's registered public accounting firm to attest to management's internal control assessment.[10]

Prior SEC and PCAOB Rulemaking and Guidance - A Chronology

The SEC adopted the rules required by Section 404 of the Sarbanes-Oxley Act in June 2003.[11] As part of these rules, the SEC defined internal control over financial reporting as a process to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements in accordance with generally accepted accounting principles, or GAAP.[12] The rules require management to evaluate, as of the end of each fiscal year, the effectiveness of the issuer's internal control over financial reporting and to include management's assessment of such effectiveness in the company's annual report filed with the SEC. The company must also identify the framework used to conduct the assessment of internal control over financial reporting and disclose any "material weaknesses" in internal control over financial reporting.[13]

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[7] *See* Section 13(b)(2)(B) of the Securities Exchange Act of 1934, added by the Foreign Corrupt Practices Act of 1977 ("FCPA").

[8] *See* Annual Independent Audits and Reporting Requirements, 58 Fed. Reg. 31,332 (Jul. 2, 1993) (codified at 12 CFR § 363.3).

[9] Sarbanes-Oxley Act of 2002, Pub. L. 107-204 (Jul. 30, 2002).

[10] Sections 404(b) and 103 of the Sarbanes-Oxley Act made the newly-created PCAOB responsible for developing standards governing the Section 404 auditor attestation.

[11] *See* Release No. 33-8238 (Jun. 5, 2003) (the "Original Release"); Exchange Act Rules 13a-15(c) and 15d-15(c); Item 308 of Regulation S-K. *See also Internal Control*, Covington & Burling LLP Client Advisory (Jun. 13, 2003).

[12] *See* Exchange Act Rules 13a-15(f) and 15d-15(f). The definition adopted by the SEC was based on the financial reporting element of the definition of internal control contained in the COSO Report. COSO refers to the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission. In 1992, COSO published *Internal Control -- Integrated Framework* (the "COSO Report"), which defined "internal control" and established a broad framework of criteria against which companies could evaluate the effectiveness of their internal control systems. The COSO Report and information about COSO is available at http://www.coso.org.

[13] Item 308 of Regulation S-K. The Original Release specifically endorsed the evaluation framework outlined in the COSO Report but indicated that other frameworks may be used as long as they satisfy certain "due process" criteria articulated in Exchange Act Rules 13a-15(c) and 15d-15(c). As a practical matter, the COSO framework has become the standard used by virtually all reporting companies. The term "material weakness" was not defined in the SEC's rules; the Original Release and guidance provided by the SEC's staff indicated that such term was to be defined by reference to the meaning given it under generally accepted auditing standards, including those promulgated by the PCAOB.

The PCAOB adopted Auditing Standard No. 2 to govern audits of internal control in March 2004.[14] This auditing standard requires auditors to conduct an integrated audit of a registrant's financial statements and its internal control over financial reporting and to conduct a separate evaluation of management's process for assessing the effectiveness of internal control over financial reporting. Auditing Standard No. 2 also adopted new definitions of the terms "material weakness" and "significant deficiency."

In response to numerous questions regarding the implementation and interpretation of the SEC's rules and Auditing Standard No. 2, during 2004 and 2005 the staff of both the SEC and the PCAOB issued interpretive guidance to public companies and auditors. This guidance took the form of Frequently Asked Questions, or FAQs, and covered a number of issues, including the appropriate scope of review of internal control over financial reporting of entities acquired during the most recent fiscal year, evaluating deficiencies, and assessing controls with respect to outsourced activities.[15]

In April 2005, the SEC hosted a roundtable discussion on first-year experiences with Auditing Standard No. 2. The feedback from this roundtable reflected a general dissatisfaction with the high costs of the internal control reporting requirements and a concern that management and auditors were taking an overly conservative approach to audits of internal control because of fears of legal liability. Many participants suggested that the SEC should issue specific guidance to management on how to incorporate a more efficient, risk-based approach into the evaluation of internal control effectiveness.

In response to feedback from the first roundtable, in May 2005, the SEC and its staff and the PCAOB released separate statements aimed at improving the implementation of the Section 404 rules and Auditing Standard No. 2.[16] These statements emphasized that public companies and their auditors should use a "top-down, risk-based" approach in evaluating internal control. Management and auditors were directed to employ greater judgment to determine which elements of the financial statements pose a significant risk of material misstatement and to identify, document and test only those controls relevant to those elements.

In May 2006, the SEC hosted a roundtable discussion on second-year experiences with the internal control reporting requirements. While appreciative of the May 2005 guidance, participants reiterated their concern that implementation costs remained too high in comparison with the benefits realized. Participants repeated their requests for clearer guidance to management and auditors on how to perform the evaluation and audit of internal control more efficiently, as well as for explicit guidance to smaller public companies.

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[14] Auditing Standard No. 2. *See* PCAOB Release No. 2004-001 (Mar. 9, 2004). Auditing Standard No. 2 was approved by the SEC in June 2004. *See also A New Standard for Auditing Internal Control Over Financial Reporting*, Covington & Burling LLP Client Advisory (Mar. 26, 2004).

[15] *See, e.g.*, Office of Chief Accountant, Division of Corporation Finance, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Reports: Frequently Asked Questions (rev. Oct. 6, 2004); Office of the Chief Auditor, Public Company Accounting Oversight Board, Auditing Internal Control Over Financial Reporting: Staff Questions and Answers (Jun. 23, 2004 (Questions 1-26); Oct. 6, 2004 (Questions 27-29); Nov. 22, 2004 (Questions 30-36); Jan. 21, 2005 (Question 37); and May 16, 2005 (Questions 38-55)).

[16] *See* Commission Statement on Implementation of Internal Control Reporting Requirements (May 16, 2005); Office of Chief Accountant, Division of Corporation Finance, SEC, Staff Statement on Management's Report on Internal Control Over Financial Reporting (May 16, 2005); PCAOB, Policy Statement Regarding Implementation of Auditing Standard No. 2, PCAOB Release No. 2005-009 (May 16, 2005).

Shortly following the second roundtable, the SEC released a "roadmap" of actions that it and the PCAOB planned to take to improve implementation of the internal control reporting rules.[17] Then, in July 2006, the SEC issued a concept release seeking to gauge the extent of public interest in additional guidance regarding the evaluation of internal control and requesting public comment on various topics, including what sort of guidance would be useful to smaller public companies.[18]

Finally, in December 2006, the SEC proposed interpretive guidance for management regarding its evaluation of internal control over financial reporting.[19] According to SEC Chairman Christopher Cox, the proposed guidance was intended to help management make their evaluation process more efficient and cost-effective. Shortly thereafter, the PCAOB proposed a new auditing standard to govern audits of internal control over financial reporting which would replace Auditing Standard No. 2.[20]

Concerns of Smaller Public Companies

Since the implementation of the Section 404 rules, there have been consistent concerns about the disproportionate effect of the rules on smaller companies. When smaller companies implement the rules, it has been argued, the costs of compliance will be greater, in a relative sense, than the costs incurred by large companies, because many small companies do not have adequate systems, infrastructure and/or personnel to conduct an efficient and cost-effective assessment of internal control over financial reporting.[21] Several reports have been published focusing on the disproportionate impact of the Section 404 rules on smaller public companies, some of which are described below.

- *GAO Report to Senate Committee on Small Business.*[22] This report concluded that the costs of compliance with the Section 404 rules were much higher than anticipated and that smaller public companies incurred disproportionately higher internal control audit costs. Noting that the SEC must balance the competing considerations of protecting investors—the motivating principle behind the Sarbanes-Oxley Act—and reducing unnecessary regulatory burdens on smaller public companies, the report made three broad recommendations. First, the report recommended that the SEC assess whether its current guidance to management was sufficient to meet the needs of smaller public companies or whether additional guidance should be issued. Second, the report recommended that the SEC coordinate more closely with the PCAOB to ensure that Section 404-related audit standards and guidance are consistent and encourage auditors to conduct more efficient and cost-effective audits. Finally, the report suggested

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[17] SEC Announces Next Steps for Sarbanes-Oxley Implementation, Press Release No. 2006-75 (May 17, 2006). Among other things, the SEC's roadmap contemplated the issuance of interpretive guidance to management, the amendment of Auditing Standard No. 2, SEC inspections of the PCAOB inspection program and a further extension of the compliance deadlines for non-accelerated filers.

[18] Release No. 34-54122 (Jul. 11, 2006).

[19] Release No. 33-8762 (Dec. 20, 2006) http://www.sec.gov/rules/proposed/2006/33-8762.pdf.

[20] *See* PCAOB Release No. 20006-007 (Dec. 19, 2006) (the "Proposed Auditing Standard").

[21] On the other hand, some contend, the lack of such resources may itself contribute to a higher proportion of internal control problems at smaller companies, presenting investor protection concerns.

[22] U.S. General Accountability Office, Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies (Apr. 2006) http://www.gao.gov/new.items/d06361.pdf.

identifying a subset of smaller public companies for which additional relief may be appropriate.

- *Report of SEC Advisory Committee on Small Public Companies*.[23] Partly in response to criticisms that Auditing Standard No. 2 lacked sufficient direction to auditors of smaller public companies, in December 2004 the SEC announced the establishment of the Advisory Committee on Smaller Public Companies.[24] The committee's report, released shortly after the GAO report, highlighted a number of flaws in the implementation of the internal control reporting rules and noted several characteristics of smaller public companies that make the Section 404 rules particularly burdensome for them, such as fewer resources and personnel, lack of ability to segregate duties and less revenue to offset the costs of compliance. Like the GAO report, the report recommended exempting a subset of smaller public companies from all or some of the Section 404 requirements as long as they adopted specified corporate governance controls.[25]

- *COSO Internal Control Guidance for Smaller Public Companies*.[26] In July 2006, COSO issued guidance for smaller public companies. The guidance does not replace or modify the framework set forth in the COSO Report; rather, it identifies fundamental concepts associated with the components of the COSO framework that management of smaller companies should consider when evaluating the effectiveness of internal control.

Impetus for the SEC's and PCAOB's Current Actions

In proposing and adopting the new interpretive guidance and Auditing Standard No. 5, respectively, the SEC and PCAOB were clearly swayed, at least in part, by a pervasive sense within the business and policy communities that the benefits generated by the Section 404 rules have been far outweighed by the excessive costs of compliance. These costs include the direct financial outlays related to management's assessment of the effectiveness of internal controls as well as the opportunity costs of diverting management's attention from critical business strategy decisions. Although studies have shown that average Section 404 compliance costs declined after the first year,[27] several recent reports have cited the exorbitant costs of complying with Section 404's requirements as one factor contributing to the declining global competitiveness of U.S. capital markets.

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[23] SEC Advisory Committee on Smaller Public Companies, Final Report (Apr. 23, 2006) http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.

[24] *See* Release No. 33-8514 (Dec. 16, 2004).

[25] The Advisory Committee suggested exempting microcap companies with less than $125 million in annual revenues and smallcap companies with less than $10 million in annual product revenue from all Section 404 requirements as long as the companies adopted certain corporate governance standards, including adherence to the audit committee standards set forth in Rule 10A-3 under the Exchange Act and adoption and disclosure of a code of ethics within the dictates of Item 406 of Regulation S-K. In addition, smallcap companies with less than $250 million in annual revenues but more than $10 million in annual product revenues and microcap companies with between $125 million and $250 million in annual revenue would be exempted from the attestation requirements of Section 404(b). The report recommended maintaining these exemptions "unless and until a framework for assessing internal control over financial reporting for such companies is developed that recognizes their characteristics and needs."

[26] COSO, Internal Control over Financial Reporting -- Guidance for Smaller Public Companies (Jul. 2006), http://www.coso.org/publications.htm.

[27] A March 2006 survey by Finance Executives International (FEI) reported an average decrease in Section 404 compliance costs after the first year of 11.8%. FEI Survey on Sarbanes-Oxley Section 404 Implementation (March 2006).

For example, the Interim Report of the Committee on Capital Markets Regulation[28] stated that the costs of compliance with the Section 404 rules were many times higher than the original SEC estimates and would impact smaller companies more severely because of the regressive nature of the costs.[29] The report suggested that these high compliance costs may cause some companies, particularly smaller companies, to flee U.S. equity markets. Other recent high profile reports have made similar findings and recommendations.[30]

Implementation Deadlines

After adopting the rules in 2003, the SEC has approved several extensions of the compliance deadlines for the required management assessment and auditor attestation. The chart below shows the current compliance deadlines by category of filer.

Type of Filer[31]	Management's Assessment	Auditor's Attestation
Non-accelerated filer (domestic or foreign private issuer)	Required in annual reports for fiscal years ending on or after 12/15/07 Furnished, not filed, in first year	Required in annual reports for fiscal years ending on or after 12/15/08
Foreign private issuer accelerated filer (that is not a large accelerated filer)	Required now	Required in annual reports for fiscal years ending on or after 7/15/07
All others (large accelerated filers and domestic accelerated filers)	Required now	Required now
First-time registrant (domestic or foreign private issuer)	Second annual report	Second annual report

Notably, despite calls from numerous quarters, including Congress, to further delay the compliance date for smaller public companies,[32] the SEC declined to change the current phase-in schedule. Thus, non-accelerated filers must begin providing management's assessment of the effectiveness of internal control over financial reporting in their annual reports covering fiscal years

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[28] Committee on Capital Markets Regulation, Interim Report (Nov. 30, 2006) http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

[29] The report cited several causes of the excessive costs: the failure to apply top-down, risk-based approach to audits of internal control; an overly conservative interpretation by auditors of the materiality standard in Auditing Standard No. 2; and audits of internal control that focus too much on low-risk areas because of fears of legal liability.

[30] *See, e.g.*, Shadow Financial Regulatory Committee, Statement on a Financial Agenda for the New Congress, Statement No. 236 (Dec. 4, 2006); U.S. Chamber of Commerce, Commission on the Regulation of U.S. Capital Markets in the 21st Century: Report and Recommendations (Mar. 2007) http://www.uschamber.com/publications/reports/0703capmarketscomm.htm.

[31] Rule 12b-2 under the Exchange Act sets forth the definitions of "accelerated filer" and "large accelerated filer." Non-accelerated filers are public companies that do not meet the criteria of either definition, and are generally companies with a public equity float of less than $75 million.

[32] *See, e.g.*, Letter from Sen. John Kerry and Sen. Olympia Snowe to Christopher Cox, Chairman, SEC, and Mark Olson, Chairman, PCAOB (May 8, 2007); Letter from Sen. John Kerry and Sen. Olympia Snowe to Christopher Cox, Chairman, SEC, and Mark Olson, Chairman, PCAOB (Feb. 23, 2007). At the SEC's open meeting on July 25, 2007, Commissioners Atkins and Casey expressed support for a further delay in the compliance deadline for the audit requirement for non-accelerated filers.

ending on or after December 15, 2007. The SEC stated that the publication of its interpretive guidance at this time affords management of smaller companies enough time to plan and carry out the required assessment for 2007. Further, the SEC said that the principles-based nature of the guidance allows it to be adapted in a flexible way by companies of all sizes, meaning that no further delay for smaller companies is needed. The SEC also observed that smaller public companies will not be required to comply with the auditor attestation requirement until reports for fiscal 2008.[33]

The SEC's New Interpretive Guidance to Management

Overview

The SEC's interpretive guidance is organized around two broad principles.

- First, management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner. The assessment should employ a top-down, risk-based approach, focusing only on controls needed to address adequately the risk of a material misstatement in its financial statements.

- Second, management should base its evaluation of evidence about the operation of its controls on its assessment of risk. This principle lets management allocate more resources to gathering evidence and performing extensive testing in high-risk areas and fewer resources to gathering evidence in low-risk areas.

The principles-based approach of the guidance is generally consistent with previous SEC guidance and reflects the SEC's opinion that management should use its experience and judgment to design an evaluation process that meets the company's needs and that provides a reasonable basis for management's annual assessment of the effectiveness of its internal control over financial reporting. The guidance does not specify how companies should design their systems of internal control over financial reporting, nor does it provide a checklist of required steps for management to refer to in conducting its assessment.

According to the guidance, the purpose of management's evaluation of internal control over financial reporting is to provide management with a reasonable basis for determining whether, as of the end of the fiscal year, there are any material weaknesses in internal control over financial reporting that could negatively impact the reliability of the company's financial statements. The guidance emphasizes that the "reasonable assurance" standard included in the definition of internal control over financial reporting does not mean absolute assurance, but, rather, a "degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[34]

Changes Made in Response to Comments

The SEC received over 200 comment letters on its proposed interpretive guidance, the majority of which were supportive. While the interpretive guidance was adopted generally in the form in which it was proposed, some refinements were made in response to comments received, as well as

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[33] On June 28, 2007, the House of Representatives approved an amendment to pending appropriations legislation that would preclude the SEC from using appropriated funds to enforce the requirements of Section 404 with respect to non-accelerated filers. *See* H. Amdt. 463 to H.R. 2829.

[34] Interpretive Release at 2-3 (quoting language in the FCPA, 15 U.S.C. 78m(b)(7)).

direction provided by the SEC at its open meeting in April 2007.[35] Most importantly, in shaping the final interpretive guidance, the SEC's staff worked closely with the staff of the PCAOB to align various aspects of the interpretive guidance with Auditing Standard No. 5. For example, the definition of "material weakness" and the guidance for evaluating deficiencies, including the indicators of a material weakness, were modified to be consistent with the new auditing standard. However, the SEC consciously chose to retain some differences between its guidance to management and the new auditing standard. As a general matter, the SEC's guidance to management is more principles-based and less prescriptive than the new auditing standard, reflecting, in part, the different roles and responsibilities that management and auditors have with respect to evaluating and auditing internal control over financial reporting.[36]

In response to comments, the final form of the interpretive guidance includes more guidance about how management's evaluation of entity-level, or company-wide, controls can affect, and in some cases reduce, the scope of review necessary with respect to lower-level (transaction-level) controls. In response to comments, the SEC has also given management more guidance on the use of evidence arising from self-assessment in evaluating the effectiveness of internal control over financial reporting and amplified the discussion of fraud risks and information technology controls. In an effort to preserve future flexibility and avoid "bright line" standards, however, the SEC resisted calls from some commenters to flesh out the principles-based guidance with more specific examples in several areas. The SEC also rejected a suggestion made by numerous commenters to allow management to rotate its evaluation of evidence of the operation of certain controls, noting that such an approach could result in an arbitrary review process instead of one based on actual risks in any given year.

The SEC declined to exempt foreign private issuers from the internal control reporting requirements, as some commenters had requested. The SEC noted that the internal control reporting requirements are rooted in the Sarbanes-Oxley Act and apply to all issuers, including foreign private issuers. The SEC also rejected the suggestion by some commenters to exclude the U.S. GAAP reconciliation required under Items 17 and 18 of Form 20-F from the internal control reporting process.[37] Noting the implementation issues that are unique to foreign private issuers, the SEC instructed its staff to consider whether such issues should be addressed in a FAQ document.

Key Topics Addressed by the SEC's Interpretive Guidance

The guidance addresses a number of key topics relevant to management's evaluation of internal control over financial reporting, which are described below. The sequence of the topics addressed in the SEC's guidance reflects the natural flow of steps in an evaluation of internal control, as shown in the chart below.

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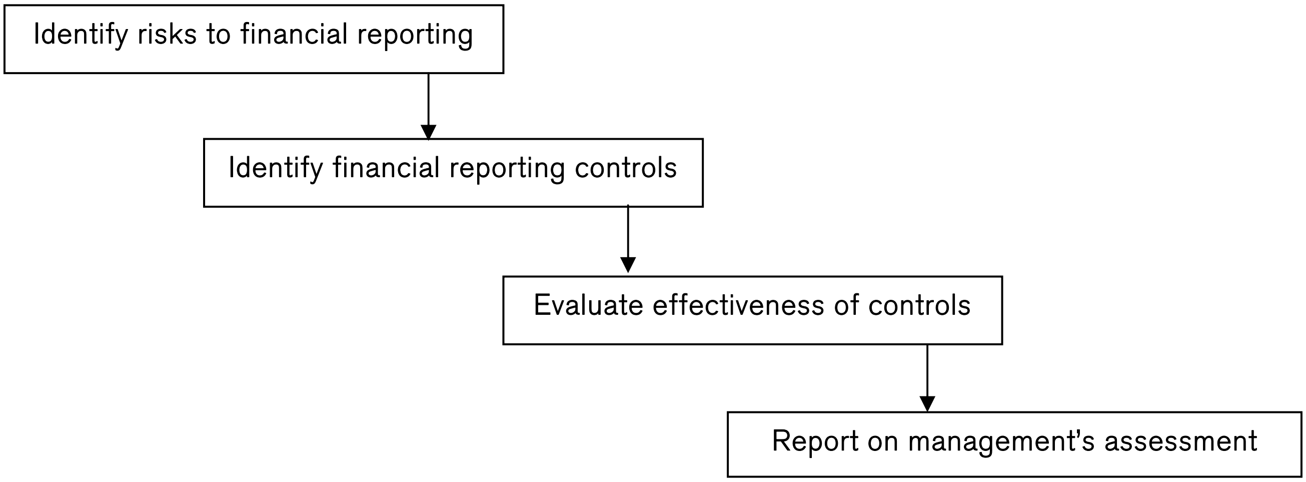
[35] SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation To Ease Smaller Company Burdens, Focusing Effort On 'What Truly Matters,' Press Release No. 2007-62 (Apr. 4, 2007).

[36] The Interpretive Release states that the differences between the interpretive guidance and Auditing Standard No. 5 are not contradictions or misalignment. Rather, they reflect the fact that management's daily involvement with its company's internal control over financial reporting provides it with knowledge and information that may allow management more flexibility in structuring its evaluation of internal control than would be available to the auditor. Interpretive Release at 44.

[37] The SEC noted that it is separately considering whether to eliminate the U.S. GAAP reconciliation requirement for foreign private issuers that report in accordance with International Financial Reporting Standards. *Id.* at 76. *See* Release No. 33-8818 (Jul. 2, 2007) http://www.sec.gov/rules/proposed/2007/33-8818.pdf.



Identifying Risks to Financial Reporting

Management's annual assessment of internal control over financial reporting should begin by identifying risks of misstatement that could, individually or in combination with others, result in a material misstatement of the financial statements ("financial reporting risks"). Sources of financial reporting risks include the initiation, authorization, processing and recording of transactions and other adjustments reflected in financial reporting elements, as well as external and internal factors that impact the operations of the business. A company's characteristics, including its size, complexity, organizational structure and financial reporting environment and the control framework employed by management, will determine the methods and procedures that management should use to identify financial reporting risks.[38] The risk identification process should include an assessment of the vulnerability of the company to fraudulent activity and the likelihood that such vulnerability could lead to a material misstatement in the financial statements. The guidance singles out the risk of improper override of internal controls in the financial reporting process as a fraud risk that may occur in companies regardless of size or type.

Identifying Financial Reporting Controls

After identifying financial reporting risks, management should next evaluate whether it has put in place controls that adequately address the financial reporting risks.[39] The guidance explains the different types of controls, such as preventive controls and detective controls, and notes that management may identify either type of control, or a combination of both, as adequately addressing financial reporting risks. In a situation where multiple controls adequately address the same financial reporting risk, management may choose to evaluate only the control for which evidence of operating effectiveness can be most efficiently obtained.

[38] For example, effective identification of financial reporting risks for a large business or a company with complex business processes may require the involvement of employees with specialized knowledge of the business transactions, the process activities, and GAAP requirements. In a smaller company with less complex business operations, management's daily involvement with the business may be sufficient to allow it to identify financial reporting risks. Interpretive Release at 13.

[39] [39] The guidance defines "control" as a "specific set of policies, procedures, and activities designed to meet an objective." *Id.* at 15, n.27.

Entity-Level Controls. Both the interpretive guidance and Auditing Standard No. 5 include similar guidance on the role of entity-level controls, which are those aspects of the internal control system that have a pervasive effect on the entity's overall internal control over financial reporting.[40] The guidance describes three different categories of entity-level controls and notes how management's evaluation of each type of entity-level control can affect the level of testing that is required of lower-level controls. In considering these entity-level controls, management should consider the nature of the entity-level controls and how they relate to an individual financial reporting element. Generally, the more indirect the relationship between the entity-level control and the financial reporting element, the less likely management will be able to rely solely on such entity-level control to adequately address the financial reporting risk to the element. However, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.[41] Certain entity-level controls may also be part of the company's disclosure controls and procedures.

Information Technology Controls. The guidance directs management to integrate its assessment of the risks and controls within its information technology, or IT, systems into its overall process for identifying risks and controls rather than evaluating IT general controls separately. The guidance specifies, however, that management need only evaluate IT general controls that are "necessary for the proper and consistent operation of other controls designed to adequately address financial reporting risks." The guidance states that it is unnecessary to evaluate IT general controls that primarily pertain to efficiency or effectiveness of a company's operations, but which are not relevant to addressing financial reporting risks.[42]

Evaluating the Operating Effectiveness of Internal Control

After identifying the financial reporting risks and controls addressing such risks, management should evaluate the evidence of the operating effectiveness of the controls. The evaluation of operating effectiveness should address whether the control operated as designed, whether the control was applied properly and consistently, and whether the person performing the control possessed the necessary authority and competence to perform the control effectively.

Evaluating a Control's Operating Effectiveness:

- Has the control operated as designed?
- Was the control applied properly?
- Was the control applied consistently?
- Did person performing the control have the requisite authority and competence?

Risks of misstatement and control failure. Generally, management's evaluation of the operating effectiveness of controls should focus on areas posing the highest internal control risk. In determining the evidence needed to support its assessment of operating effectiveness, management should

[40] Examples of entity-level controls include controls related to the control environment (for example, management's philosophy and operating style, integrity and ethical values; board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; controls to monitor other controls; and controls over the period-end financial reporting process. *Id.* at 10, n. 21.

[41] *Id.* at 5. The interpretive guidance provides a specific example of a financial reporting risk - the misstatement of interest expense - that might be adequately addressed by a control within the company's period-end financial reporting process (i.e., an entity-level control) such that no testing of transaction-level controls is necessary. *Id.* at 16.

[42] *Id.* at 19-20.

consider the risk of misstatement in financial reporting elements and the risk that the internal control that addresses such risk will fail.[43] The guidance lists examples of financial reporting elements that generally carry a higher risk of misstatement, as well as factors affecting the likelihood that an internal control might fail to operate effectively. Some financial reporting elements—those involving significant accounting estimates, related party transactions, or critical accounting policies—generally have both a higher risk of material misstatement and of control failure, particularly if the related controls are subject to management override, involve significant judgment, or are complex.

Evidence of effectiveness. Evidence of the operating effectiveness of controls may come from direct testing and on-going monitoring activities. The guidance emphasizes that there is no one prescribed formula for determining the sufficiency of evidence for an individual control. Instead, the sufficiency of the evidence to support management's assessment depends on both the quantity (e.g., sample size) and quality (e.g., nature of evaluation procedures performed, period of time covered by evidence, and objectivity of personnel evaluating controls) of available evidence. Further, the methods for evaluating effectiveness may be integrated with the daily responsibilities of employees, or implemented specifically for purposes of the evaluation of internal control. Activities that are performed for other reasons (for example, day-to-day activities to manage the operations of the business) may also provide relevant evidence.[44]

Framework for evaluating whether a control deficiency is a material weakness. If management concludes that a control does not operate effectively, then a deficiency exists, and management must evaluate the deficiency to determine if it is a material weakness. The guidance provides management with a framework, separate and apart from Auditing Standard No. 5, for evaluating whether control deficiencies, either individually or in combination, constitute a material weakness that renders a company's internal control over financial reporting ineffective. In evaluating the severity of a control deficiency, management should make two determinations:

- whether there is a reasonable possibility that the company's internal control over financial reporting will fail to prevent or detect a misstatement of a financial statement amount or disclosure; and
- the magnitude of the potential misstatement resulting from the deficiency.[45]

Management should also evaluate the effect of compensating controls when it determines if a control deficiency is a material weakness.

The interpretive guidance directs management to consider whether any of four specifically-described circumstances indicate the presence of a material weakness:

- identification of fraud of any magnitude by senior management;

[43] Ordinarily, more evidence will be required to assess the operating effectiveness where both the misstatement risk of the financial reporting element and the risk of internal control failure are high. Conversely, less evidence will be required where both risks are low. *See id.* at 24.

[44] *Id.* at 28.

[45] The interpretive guidance lists a number of factors that can affect the likelihood that a material misstatement will fail to be detected or prevented because of a control deficiency, as well as factors that can affect the magnitude of a misstatement. *Id.* at 35-36.

- restatement of previously issued financial statements to reflect correction of a material misstatement;
- identification of a material misstatement of the financial statements in the current period where circumstances indicate the misstatement would not have been detected by the company's internal control; or
- ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

Reporting on Management's Assessment

Management must disclose its assessment of the effectiveness of the company's internal control over financial reporting. Management's assessment should not be qualified or be made subject to exceptions. The existence of a material weakness precludes a finding that internal control is effective. If management concludes that a material weakness exists, Item 308 of Regulation S-K requires only that management disclose the existence of a material weakness in its annual report. The interpretive guidance urges management to consider including additional information, however, to give investors a clearer picture of the deficiency and its potential impact. This would include the nature of the material weakness, its impact on financial reporting and internal control over financial reporting, and management's current plans, or actions already undertaken, for remediating the material weakness. Management is also encouraged to identify which material weaknesses have a "pervasive impact" on the company's internal control over financial reporting. The guidance also stresses that management may not qualify its assessment of the effectiveness of internal control over financial reporting by stating that internal control is effective except to the extent to which material weaknesses have been identified.

The existence of a material weakness precludes a finding that internal control over financial reporting is effective.

The guidance states that management is not required to consider the effect of a restatement of previously issued financial statements on its prior conclusion about the effectiveness of the company's internal control. However, management should consider whether it should supplement its original internal control-related disclosures to prevent the disclosures from being misleading in light of the restatement.

Documentation

Although management's assessment must be supported by evidence, including documentation, that provides reasonable support for its assessment, the SEC's guidance confirms that management has a great deal of flexibility in determining the amount and form of such evidence and acknowledges that the form and extent of the evidentiary documentation will depend on the company's size, nature and complexity. The documentation of design of controls should be focused solely on those controls identified by management as adequate to address the financial reporting risks. Management has a similar degree of flexibility in determining the form and extent of documentation of the operating effectiveness of its internal controls. The guidance suggests that management can document its assessment in a memorandum setting forth the evaluation approach, the evaluation procedures, the basis for management's conclusions, and the entity-level and other pervasive elements important to management's assessment. However, management is not required to maintain separate copies of evidential matter if it decides that evidence within the company's books and records is sufficient to provide reasonable support for management's assessment.

Other SEC Actions

In addition to adopting the interpretive guidance, the SEC:

- amended Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to add definitions of the terms "material weakness" and "significant deficiency" in a manner consistent with the definition of such terms in Auditing Standard No. 5 (see box below);[46]

- amended Exchange Act Rules 13a-15(c) and 15d-15(c) to create a safe harbor providing that an evaluation conducted in accordance with the SEC's interpretive guidance would be one way of satisfying management's annual obligation to evaluate the effectiveness of internal control over financial reporting as required by those rules. The SEC emphasized, however, that compliance with the procedures described in the interpretive guidance is not mandatory and that there is no need for companies to alter their established internal control processes solely to conform to the interpretive guidance; and[47]

- amended Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to eliminate the current requirement for the auditor to express an opinion on management's assessment of internal control, while retaining the opinion on the effectiveness of the company's internal control.

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[46] The SEC considered, but rejected, a number of suggested alternatives to the "reasonable possibility" formulation in the definition of material weakness. *See* Rule Amendments Release at 17. The definition of significant deficiency removes the probability of misstatement concept from the current definition of such term in the auditing literature.

[47] *Id.* at 7.

Key Definitions

A "*deficiency*" in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.*

A "***significant deficiency***" is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.**

A "***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.** (There is a "***reasonable possibility***" of an event, as used in this standard, when the likelihood of the event is either "reasonably possible" or "probable" as those terms are used in FASB Statement No. 5, *Accounting for Contingencies*.)

* As defined in Auditing Standard No. 5.
** As defined in Exchange Act Rule 12b-2, Rule 1-02 of Regulation S-X and Auditing Standard No. 5.

Auditing Standard No. 5

Overview

Auditing Standard No. 5 represents a complete re-write of Auditing Standard No. 2. It is significantly shorter than Auditing Standard No. 2 and strives to be more principles-based than its much-maligned predecessor. As compared with the prior standard, Auditing Standard No. 5 is intended to achieve four main objectives.

- *Focus the audit on matters most important to internal control* - the new standard emphasizes the importance of focusing the internal control audit on areas that pose the greatest risk of failure in internal control over financial reporting.

- *Eliminate unnecessary procedures* - the new standard eliminates the requirement that the auditor evaluate management's internal control evaluation process and reduces the work necessary to audit the internal control at multiple locations of a company by focusing on risk rather than on percentage of operations covered. The new standard also greatly expands auditors' ability to rely on the work of others and permits auditors to incorporate knowledge obtained during past audits to reduce the level of work during an audit of internal control.

- *Scale the audit for smaller companies* - the new standard provides guidance for auditors on how to tailor the internal control audit process to the needs of smaller companies using notes incorporated throughout the standard.

- *Simplify the standard's requirements* - the new standard has been streamlined and reorganized for greater ease of reading and application.

Key Changes from the Proposed Auditing Standard

The PCAOB received a significant amount of input on the proposed auditing standard, including comment letters on the proposal, guidance from the SEC at an open meeting of the SEC on April 4, 2007, informal input arising from the close collaboration between the staffs of the PCAOB and the SEC, and consultation with the PCAOB's Standing Advisory Group.[48] This input resulted in some noteworthy changes from the auditing standard proposed in December 2006, as described below.

- *Closer alignment with SEC's interpretive guidance for management.* Auditing Standard No. 5 reflects the PCAOB's acknowledgment that the general concepts necessary to an understanding of internal control should be described in the same way in the PCAOB's standard and in the SEC's guidance, notwithstanding the inherent differences in the roles of management and the auditor in assessing the effectiveness of internal control over financial reporting. Accordingly, Auditing Standard No. 5 uses the same definition of "material weakness" that the SEC uses in its guidance to management and in Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X. Further, both Auditing Standard No. 5 and the SEC's guidance to management describe the same indicators of a material weakness and contain consistent discussions of entity-level controls.

- *Elimination of requirement to identify major classes of transactions and significant processes.* In response to concerns that the proposed auditing standard, while an improvement over Auditing Standard No. 2, still prescribed more procedures than are reasonably necessary to conduct an audit of internal control over financial reporting, the PCAOB eliminated the requirements to identify major classes of transactions and significant processes before identifying the controls to test. The PCAOB noted that identifying such classes of transactions and processes still might be a necessary component of the audit process for some companies; however, it concluded that mandating these steps could contribute to a "checklist approach" to compliance and that auditors should use more of their professional judgment to determine whether such steps were necessary for particular audits, based on relevant facts and circumstances.

- *Greater emphasis on fraud controls.* In response to comments, the PCAOB made a number of changes from the proposed standard to put more emphasis on fraud controls. For example, the discussion of fraud risk and anti-fraud controls was moved closer to the beginning of the standard, and management fraud is identified in the standard as an area of higher risk. Auditing Standard No. 5 also contains added guidance on the types of controls that might address fraud risk.

- *More guidance regarding entity-level controls.* In response to comments, Auditing Standard No. 5 includes more guidance regarding entity-level controls (see discussion below).

- *Softening of walkthrough requirement.* Auditing Standard No. 2 requires a walk-through of each major class of transactions within a significant process, and the auditing standard originally proposed by the PCAOB would have required auditors to perform a walk-through of each significant process each year. Auditing Standard No. 5 changes the

[48] The PCAOB discussed the proposed auditing standard with its Standing Advisory Group at a meeting on February 22, 2007.

focus from the performance of the walkthrough to the objectives intended to be achieved through a walkthrough, acknowledging that in some cases alternative procedures may effectively accomplish the intended objectives of a walkthrough (see further discussion below).

- *Integration of "scalability" concepts throughout standard.* The proposed auditing standard included a section on scaling the audit for smaller, less complex companies. The PCAOB agreed with commenters that the scalability concept is a natural extension of the more over-arching risk-based approach and, therefore, is applicable to all companies. Accordingly, Auditing Standard No. 5 includes discussions of scaling concepts, similar to those contained in the proposed standard, throughout the entire standard.[49]

- *Clarifying auditor's ability to use the work of others.* When the PCAOB proposed Auditing Standard No. 5 in December 2006, it also proposed a separate standard on the use of the work of others that would have superseded the PCAOB's interim standard, AU sec. 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* ("AU sec. 322"). After considering comments on this aspect of the proposal, the PCAOB decided to drop the proposed new separate standard and to retain AU sec. 322. The new standard also eliminates the requirement in Auditing Standard No. 2 that the auditor's own work provide the principal evidence for the opinion (see further discussion below).

Overview of the Audit Under Auditing Standard No. 5

As with Auditing Standard No. 2, the auditor's objective in an audit of internal control over financial reporting is to express an opinion on the effectiveness of the company's internal control over financial reporting by obtaining evidence sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date of management's assessment. If one or more material weaknesses exist, the company's internal control over financial reporting cannot be said to be effective, and the auditor is required to express an adverse opinion. As with Auditing Standard No. 2, the new standard provides that the audit of internal control over financial reporting should be integrated with the audit of the financial statements.

Planning the audit

The standard directs the auditor to consider a number of company- and industry-specific factors in planning the audit's procedures, including, among other things, previously-communicated control deficiencies, relevant legal or regulatory matters, preliminary judgments about the effectiveness of internal control, materiality, risk and other factors relating to the determination of material weaknesses, and the relative complexity of the company's operations. Noting that many smaller companies have less complex operations and that some larger complex companies have less complex units or processes, the standard lists several factors that might indicate less complex operations, including fewer business lines, less complex business processes, more centralized accounting functions, and extensive involvement by senior management in day-to-day business activities.

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[49] The PCAOB has announced that it plans to publish additional guidance later this year on auditing internal control over financial reporting in smaller companies.

Role of risk assessment

The standard reminds auditors that risk assessment underlies the entire audit process. Auditors should apply an assessment of risk in determining significant accounts and disclosures and their relevant assertions, selecting controls to test, and determining the evidence necessary for a given control. While risk-based evaluations were arguably called for by Auditing Standard No. 2, the new standard places greater emphasis on a risk-based approach in which the auditor should focus attention on those areas that present the highest risk for the existence of a material weakness. In assessing risk, the new standard calls out fraud risk for special consideration, noting that the risk that internal control over financial reporting will fail to prevent or detect misstatement caused by fraud usually is higher than the risk that such controls will fail to prevent or detect error.

Using the work of others

The new standard gives auditors greater discretion to use of the work of others than did Auditing Standard No. 2. The new standard explicitly permits auditors to use work performed by, or receive direct assistance from, internal auditors, other company personnel and third parties. In planning and conducting the audit, the auditor should consider the competence and objectivity of the individuals whose work the auditor intends to use, as well as the risk associated with the control being tested. More importantly, the new standard eliminates the "principal evidence" provision from Auditing Standard No. 2, which required auditors' own testing to provide the principal evidence for the auditors' opinion. Many commenters felt this requirement significantly restricted the auditor's ability to use the work of others.

Consistent with its overall risk-based approach, the standard provides that the ability of the auditor to use the work of others increases as the level of competence and objectivity of the other person increases. Similarly, as the risk associated with a control increases, the need for the auditor to perform his or her own work on the control increases. The standard directs the auditor to balance these considerations, but notes that the auditor should not in any case use the work of persons who have a low degree of objectivity or low degree of competence.

Top-down approach

Although Auditing Standard No. 2 directed auditors to use a top-down approach in selecting controls to test, the new standard places even greater emphasis on using the top-down approach. The auditor should begin at the financial statement level to understand the overall risks to internal control over financial reporting, then focus on entity-level controls, and finally work down to significant accounts and disclosures and their relevant assertions. This approach is meant to steer the auditor's attention to those accounts, disclosures and assertions that present a reasonable possibility of material misstatement to the financial statements.

Entity-level controls

The standard requires the auditor to test those entity-level controls (referred to as "company-level controls" in Auditing Standard No. 2) that are important to the auditor's assessment of whether there is effective internal control over financial reporting. Examples of such entity-level controls include controls related to the control environment, controls over management override (particularly important in smaller companies), the company's risk assessment process, centralized processing and controls, controls to monitor other controls, and controls over the period-end financial reporting process.

Unlike Auditing Standard No. 2, the new standard explicitly authorizes auditors to modify the level of testing they perform on lower-level controls based on their evaluation of entity-level controls. The standard describes three different categories of entity-level controls and notes how the auditor's evaluation of each type of entity-level controls can affect the level of testing that is required of lower-level controls. This guidance should help auditors reduce the number of lower-level controls required to be tested in some cases.

Understanding likely sources of misstatement; Walkthroughs

As part of selecting the specific controls to test as part of the audit, the standard directs the auditor to achieve a list of specific objectives designed to gain an understanding of the most likely sources of misstatement. These objectives are:

- to understand the flow of transactions related to the relevant assertions, including how transactions are initiated, authorized, processed and recorded;
- to identify the points within the company's processes at which a misstatement could arise that would be material; and
- to identify the controls implemented by management to address these potential misstatements and the controls related to the prevention or timely detection of unauthorized acquisition, use or disposition of assets of the company that could result in a material misstatement.

The new standard does not mandate walkthroughs or any other specific procedures to achieve these objectives. However, the standard does state that walkthroughs are frequently the most effective way to achieve the foregoing objectives and thereby identify the likely sources of misstatement.[50]

Testing of controls

Like Auditing Standard No. 2, the new standard directs the auditor to test the design effectiveness and the operating effectiveness of controls. To test the design effectiveness, the auditor should determine whether the company's controls, if operated as prescribed, effectively prevent or detect errors or fraud that could result in material misstatements. To test the operating effectiveness, the auditor should establish whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The standard provides detailed guidance on the nature, timing and extent of such testing of controls, including specific commentary focused on smaller, less complex companies. The standard also states that in planning the current year's audit, the auditor may rely on the results of past audits but should also vary the nature, timing and extent of controls to introduce unpredictability into the testing and to respond to changes in circumstances.

[50] In a walkthrough, the auditor follows a transaction from origination until it is recorded in the financial statements using the same documents and information technology that company personnel use.

Evaluating identified deficiencies

The standard requires the auditor to evaluate the severity of each control deficiency identified to determine if the deficiency (individually or in combination with others) is a material weakness. The severity of a deficiency depends on whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement, and the magnitude of the potential misstatement. The standard also lists several examples of factors that may affect whether there is a reasonable possibility that a deficiency will result in a misstatement, as well as factors that can affect the magnitude of the misstatement that may result from a deficiency. However, the new standard makes it clear that the auditor need not search for deficiencies that, individually or in combination, are less severe than a material weakness.

Indicators of material weaknesses

The standard sets forth the same list of indicators of material weaknesses in internal control as are set forth in the SEC's interpretive guidance (discussed above).[51] The standard provides that when evaluating the severity of a deficiency, the auditor should treat as an indicator of a material weakness a deficiency that might prevent prudent officials from having reasonable assurance that transactions are recorded to permit the preparation of financial statements consistent with GAAP.

Auditor's opinion on internal control

The auditor's opinion on the effectiveness of internal control over financial reporting should be based on an evaluation of evidence obtained from all sources, including the auditor's testing of controls, misstatements detected during the financial statement audit and any identified control deficiencies. The auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. In both cases, the standard outlines the specific elements that must be included in the audit report on internal control. If there are any deficiencies that, individually or in combination with others, result in a material weakness, the auditor must express an adverse opinion on the company's internal control over financial reporting, unless there is a restriction on the scope of the engagement, in which case the auditor does not express an opinion at all. When expressing an adverse opinion because of a material weakness, the opinion must identify the material weakness and, if the material weakness is not identified in management's assessment, must also describe the material weakness in enough detail to provide users of the report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the financial statements.

Required Auditor Communications

Auditing Standard No. 5 imposes four specific communications directions on the auditor. The auditor

- *must* communicate to management and the audit committee, in writing prior to the issuance of the auditor's report, all material weaknesses identified during the audit;

[51] While the new standard retains Auditing Standard No. 2's reference to ineffective audit committee oversight as an indicator of a material weakness, it eliminates the explicit requirement for the auditor to evaluate the effectiveness of the audit committee's oversight of the company's financial reporting process and internal control over financial reporting.

- *must* communicate to the audit committee, in writing, all significant deficiencies identified during the audit;
- *should* communicate to management, in writing, all control deficiencies of a lesser magnitude than material weaknesses identified during the audit, and should inform the audit committee when such a communication has been made;[52] and
- *must* inform the board of directors in writing whenever the auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective.

Other PCAOB Actions

The PCAOB also adopted, in the form proposed, new Rule 3525. This rule requires a registered public accounting firm seeking audit committee pre-approval of permitted internal control-related non-audit services to describe, in writing, the scope of the service, to discuss with the audit committee the potential effects of the service on the firm's independence and to document the substance of its discussion with the audit committee.

Conclusion

By any measure, the twin developments of the SEC's interpretive guidance and the PCAOB's new auditing standard constitute real progress in the regulatory system involving internal control over financial reporting. For companies, the SEC's interpretive guidance provides a useful template for management's evaluation of internal control over financial reporting after several years of management having no guidance other than an auditing standard. In prior years, management's use of Auditing Standard No. 2 as a reference point in designing and conducting evaluations of internal control undoubtedly led to wide variation in processes and unnecessary procedures and costs. With the new guidance, there is no longer a need for management to discern the proper way to do an evaluation of internal control based on a trial and error stand-off with the independent auditor. Moreover, the SEC's principles-based guidance should afford companies great flexibility to plan and conduct the evaluation of their internal control over financial reporting in a manner tailored to their own particular financial and operating characteristics.

Similarly, for auditors (and, indirectly for companies), the new auditing standard is a marked improvement over Auditing Standard No. 2. By using a more principles-based, less prescriptive approach than the prior standard, the new standard should allow auditors to conduct the required audit of internal control more cost-effectively and efficiently. In particular, the new auditing standard's guidance on using the work of others is an improvement over the current auditing standard. In a similar vein, the guidance on selecting and testing entity-level controls should help auditors reduce the number of lower-level controls required to be tested in many cases. These and other improvements in the new auditing standard should, on balance, help auditors determine that an effective audit can be conducted in a more efficient and less costly manner than has been the case under Auditing Standard No. 2.

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[52] The standard clarifies that, notwithstanding this requirement, the auditor is not required to perform audit procedures sufficient to identify *all* control deficiencies. Rather, the auditor is merely required to communicate control deficiencies of which he or she is aware. Auditing Standard No. 5 at para. 82.

There are, of course, more skeptical takes on these developments. First, it is axiomatic that the actual benefits realized will depend on how the auditing profession implements the new standard, a topic on which many still hold reservations. The PCAOB has indicated that it intends to monitor auditors' compliance with the new standard, including subjective elements such as the exercise of professional judgment and reliance on the work of others, in its inspections of member auditing firms. Some commenters have expressed a concern that although the SEC's interpretive guidance is more "principles based" than the new auditing standard, there may nevertheless remain a tendency on the part of companies (perhaps influenced by their auditors) to view the new auditing standard as the "de facto" template to use for evaluating the effectiveness of internal control over financial reporting, as has been the case with Auditing Standard No. 2. Such a tendency could negate the benefits intended to be achieved by the interpretive guidance.

Some commenters have also questioned whether the changes to the definition of "material weakness," which were adopted substantially as proposed, constitute a substantive change in the threshold for determining when a control deficiency rises to the level of a material weakness. Critics of the previous definition, which some contended resulted in too many low-probability deficiencies getting caught by the definition, may be skeptical that the new definition represents a meaningful change. Another area of some skepticism concerns the new safe harbor in Exchange Act Rules 13a-15(c) and 15d-15(c). Commenters in the rulemaking process voiced concern that the principles-based nature of the SEC's interpretive guidance did not lend itself to a conventional safe harbor which fixes clear-cut compliance standards.

Finally, and in the short term, it is unclear whether the timing of the SEC's guidance and adoption of the new auditing standard allows enough time for public companies to incorporate the new guidance and standard into the 2007 audit and reporting cycle. For many companies that have already been through such reviews in prior years, it may be difficult to alter existing procedures for the 2007 audit significantly this late in the audit cycle. At the same time, smaller public companies undoubtedly will encounter unanticipated challenges when they are faced with the prospect of their first required management's assessment. As was the case with larger companies in the first years of compliance, it will not be a surprise if the number of late filings and/or restatements for smaller public companies increases next filing season.

Five years ago, Congress embraced, with firm conviction, a rigorous commitment to a new regulatory regime for internal control over financial reporting. In short order, this conviction was shaken, perhaps mostly by the alarming realization that neither companies nor audit firms had sufficient capabilities or resources to implement internal control processes at the level required to match the legislative commitment. Faced with this discovery and in response to constituent concerns, Congress has prodded the SEC and the PCAOB both to temporize and modulate the overall approach to the implementation of the original mandate, one which appears in hindsight to have been simply unrealistic. After five years, it still remains to be seen whether the latest interpretive guidance from the SEC and the revised audit standard by the PCAOB will do the trick. Surely, they represent some relief, but more experience will be needed to answer the question of whether this latest round of Section 404 revisionism will result in a more appropriate balance between the costs of regulation and the benefits to investors.

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