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## National Economic Council

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Folder Title:

Sarbanes-Oxley

CHAMBER OF COMMERCE  
OF THE  
UNITED STATES OF AMERICA

DAVID CHAVERN  
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September 13, 2006

Ms. Nancy M. Morris  
Secretary  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

RE: Release No. 34-54122; File No. S7-11-06

Dear Ms. Morris:

The U.S. Chamber of Commerce is the largest business federation in the world, representing the interests of some three million companies of every size and industry. We have been an advocate for the issuance of specific guidance by the U.S. Securities and Exchange Commission (the "SEC") for issuers under Section 404 of the Sarbanes-Oxley Act ("SOX"). In that regard, we very much appreciate the opportunity to provide comments in response to the SEC's Concept Release on such guidance.

The Chamber has been very supportive of most provisions of SOX and, with respect to Section 404, strongly advocates for good systems of internal control in public companies. We agree that SOX has had positive effects in causing boards, management, and external auditors to be more thorough and attentive in fulfilling their responsibilities. However, we believe that Section 404 has been implemented in such a way as to create extraordinary and unnecessary burdens that are disproportionate to identified benefits. This has had an extremely negative effect on the overall health and competitiveness of the U.S. capital markets.

Our overall comments regarding improvement in the implementation of Section 404 are set forth in our comment letters of April 12, 2005, October 24, 2005, April 3, 2006, and May 3, 2006. In addition, Chamber representatives participated in the SEC/Public Company Accounting Oversight Board (PCAOB) Roundtables on April 13, 2005, and May 10, 2006. We have been an active voice for the business community on this issue because it is critically important to a broad cross-section of domestic and foreign companies.

### *Overview*

The implementation of Section 404 has, to date, failed for several interrelated reasons:

- Auditing Standard # 2 (“AS2”) is a vague and difficult to apply standard – and, to date, there has been no formal standard for issuers.
- The auditing profession has legitimate concerns about being second guessed by the plaintiffs’ trial bar and its new regulator, the PCAOB. The long-term risks to the profession are very significant<sup>1</sup>, and there has been every incentive to apply AS2 (such as it is) in a conservative way.
- Issuers have been trapped between the uncertain demands of AS2 and their own concerns about diverting critical resources from research, development, investment, and employment.

The result has been generally bad for any public companies with securities available in the United States – as well as any foreign or domestic companies who may have hoped to list here in the future. The implementation of SOX 404 has damaged our capital markets and there is an immediate need for corrective action.

We are, therefore, hopeful about the dual undertakings of (i) the SEC to promulgate issuer guidance regarding internal controls, and (ii) the PCAOB to revise AS2. We are also encouraged that the SEC and PCAOB are seeking to align their activities to avoid unintentional confusion. There is now a real opportunity for regulatory action on SOX 404 that would obviate the need for any legislative adjustment to the Act. We trust that the SEC and PCAOB will seize the opportunity and drive real improvement in the system.

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<sup>1</sup> For further discussion of this issue, please see a U.S. Chamber of Commerce publication entitled *Auditing: A Profession at Risk*, dated January 2006. <http://www.uschamber.com/publications/reports/0601auditing.htm>

With respect to the Concept Release, our specific comments below reflect three basic themes:

- There must be a risk-based focus on those controls that are most likely to have a material impact on the financial statements. This includes an emphasis on entity-level, rather than transaction-level, controls.
- The guidance for issuers should have as much specificity and clarity as possible. Where this is not achievable, issuers should have some ready means to seek and obtain on-going guidance from the SEC.
- It should be emphasized that the design, creation, and maintenance of good internal controls is a primary obligation of management. While auditors evaluate and determine the sufficiency of controls, they should not – and should not be expected to – decide how companies best manage their operations.

### *Discussion*

#### Risk and Control Identification

As mentioned, it is critical to employ a risk-based focus on those internal controls that are most likely to have a material impact on financial statements. We agree with the SEC that the evaluation framework of internal controls will vary depending on what is reasonable for the issuer. This framework, however, must be aligned with specific guidance that alleviates the implementation issues that caused the overly conservative application of SOX 404 and AS2.

#### *Specific Responses*

- We would suggest that the SEC begin by clearly stating the goal of an appropriate examination of internal controls under SOX 404. We believe that an implicit expectation has evolved – supported by the plaintiffs' trial bar, among others – that the purpose of SOX 404 is to prevent every fraud and, in fact, every other possible type of business risk. Until the SEC is extremely clear that the purpose is to reach an appropriate level of assurance about controls – but not obviation of all risk – then the problems with overly conservative implementation will remain.

- We would suggest that the SEC identify those entity-level controls that it will always consider relevant. Further, it should provide examples of entity and transaction-level controls that it would not consider material. While no guidance can address every possible factual circumstance, it should be possible to establish guideposts that show the limits of the analysis. We would also ask that the SEC indicate what constitutes a test failure and when requirements on additional sampling are necessary.
- The Chamber supports the idea of placing greater reliance on assuring that issuers have a proper base control structure and good entity-level controls, along with management processes that assure broadly that these controls are effective.
- We would strongly encourage the SEC to specifically address fraud controls. As noted above, one of the most fundamental problems is a popular misunderstanding about the reasonable role of SOX 404 analysis - and auditing generally - in preventing fraud. Experienced accounting professionals know that there will be companies with excellent internal controls and superb audits that will, nonetheless, fall victim to collusive fraud. While it may not be easy or pleasant, the SEC has a core obligation to educate the public about this fact and provide issuers with guidance as to the reasoned limits on control evaluation under SOX 404. We also encourage the PCAOB to quickly and thoughtfully bring closure on the procedures that should be employed by external auditors to detect fraud.
- The Chamber supports the SEC's August 9, 2006, release proposing a one-year transition period for newly public companies. We believe that this will provide relief for start-up costs incurred during the first year. We continue to urge the SEC to delay implementation for non-accelerated filers and foreign private issuers until the new and revised standards have been tested by experience and proven to have been successful in alleviating key implementation issues.

- It is important that the SEC and PCAOB address smaller public companies as they are – in terms of personnel and resources – and not apply SOX 404 in a way that requires them to radically alter their operations or business objectives. Developing “scalable” guidelines means clearly defining what is “acceptable,” even if that means something less than “perfect.” As a clear example, appropriate span of control should – as a matter of logic – have a different application at a company with \$1 million in revenues when compared to a company with \$1 billion in revenues. “Scalable” doesn’t mean two (or more) different standards or fundamental differences in levels of assurance. It does, however, mean acknowledging that what might be necessary at one type of company may not be required for assurance at another.
- We continue to believe that not all internal controls need to be evaluated annually. Appropriate analysis of entity-level controls can include (i) periodic testing, and (ii) the testing of controls that have changed from established baseline conditions. In addition, testing by external auditors should reflect the work of internal parties. This would reduce some of the unnecessary cost burdens while maintaining a structure that protects the validity of financial statements.
- One of the unintended consequences of SOX is that companies are forced to delay system implementations or business process changes planned for the second half of the year in order to obtain a clean attestation result from the audit firms. We encourage the SEC to consider solutions to avoid these unnecessary delays.
- We would encourage the PCAOB to unify the approach of its standard setters and investigators. While the standard setters are encouraging the use of judgment, the inspections appear to be far-reaching.

#### Management’s Evaluation

In absence of direct guidance for issuers, management has been forced to rely on AS2 in its evaluation of internal controls. Unfortunately, AS2 was not well-designed for this purpose (nor was the PCAOB ever intended to be a regulator of issuers). Among other things, this has served to de-emphasize the importance and primacy of management’s own assessment of its internal controls.

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*Specific Responses*

- Our members tell us that the application of AS2 to IT systems has been particularly problematic. Issuers do not have enough guidance to determine which systems – and which levels of systems – need to be evaluated in order to obtain a reasonable assurance as to the effectiveness of internal controls over financial reporting. As an example, excessive time, energy, and expense have been devoted to the evaluation of access controls without regard to whether the access points in question could pose a significant risk to the validity of the financial reporting of the company. This is certainly an area where SOX 404 has been presumed to be about eliminating all business risks, instead of simply assuring the reasonable validity of the financial statements. In addition, significant confusion exists on how to assign monetary exposure to IT deficiencies, especially when they have been mitigated by entity-level or business process controls. We would strongly urge the SEC to work with the issuer community and the IT industry to develop specific standards regarding the evaluation of IT systems that limit the analysis to the intent and purpose of SOX 404.
- As noted above, while no standard could comprehensively address every situation faced by every affected public company, we would encourage the SEC to provide as many illustrative examples as possible (including examples of overly conservative implementation) and also establish a system for the provision of on-going advice and guidance. It would be flatly inappropriate for the SEC to issue a standard and then make it “the issuer’s problem” to figure out what it means. This comment most particularly applies to the meaning of critical but fundamentally hard-to-define terms, such as “material weakness,” “significant deficiency,” and “more than remote.”
- We have received a number of complaints to the effect that asking for advice – from outside auditors or others – can itself be construed as a “material weakness.” In short, if you need to ask then you don’t know, and if you don’t know then there must be a material weakness. This only creates a disincentive to seek expert advice on difficult issues. The SEC must make it clear that a request for guidance should not be used as evidence as to whether a “material weakness” does or does not exist. After all, the recognition by an issuer that a problem might exist should be seen as a strength on its part – not a weakness.

- The SEC should issue guidance as to the appropriate application of the requirement that the management assessment be “as of” the year end. There is tremendous confusion about the timing of the examination of internal controls and the value – or, more appropriately – lack of value of the experience with controls that is obtained over the course of an entire year.
- There is currently an excessive number of restatements. Many are driven by “reinterpretations” of long-standing accounting treatments. Accounting is not an exact science and disagreements about appropriate application of complex accounting standards are not necessarily evidence of failure. In fact, the view that “change = failure” does a disservice to the investing public by implicitly communicating a false precision surrounding financial statements. The SEC has a basic obligation to educate investors about the limits of accounting and financial statements. In that regard, we believe that there are many circumstances when a restatement should not be construed as evidence of a “material weakness” in internal controls.

Separately, we continue to support an overall review by the SEC and the PCAOB of the current standards for restatement, including an examination of the impact on investors of restatements that do not result in a material change in the overall financial performance or prospects of an issuer. Restatements can undermine investor confidence in an otherwise sound system of accounting principles. To that end, when the SEC considers the need for a new interpretation of GAAP that has previously been generally accepted in the marketplace, it should do so prospectively as opposed to retroactively so as not to undermine investor confidence.

### Documentation to Support the Assessment

During the first two years of implementation, it is clear that accelerated filers often over-documented internal controls in absence of specific guidance. Non-accelerated filers do not have access to the same resources and therefore would be put at a significantly greater disadvantage by overzealous documentation requirements.

#### *Specific Responses*

- A lack of documentation should not be confused with poor internal controls. Smaller public companies, in particular, often have good internal controls that are simply insufficiently documented. While documentation is important in order for systems to be auditable, we would urge the SEC to closely evaluate documentation alternatives and determine whether there are "low resource cost" solutions that might be acceptable for smaller companies, even if they are not appropriate for larger companies with more complex control systems.
- We would encourage the SEC to further examine footnote level information, particularly as how to measure the materiality of a deficiency. Not all footnotes are created equally and those that merely give information on routine accounts such as the composition of inventory are demonstrably less important than others like the disclosures of off balance sheet contingencies. One solution would be to expressly rule some footnotes out of the 404 scope and develop bright lines test for inclusion/exclusion for all other footnotes.


#### *Conclusion*

In summary, the Chamber is very supportive of systems of good internal controls maintained by management. We look forward to the forthcoming guidance from the SEC and PCAOB providing clear and specific recommendations for issuers and auditors. In absence of specific guidance, we fear that the current ambiguity will continue to cause unintended consequences, including diverting management time away from valuable business operations.

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The Chamber commends your dedication to achieving a long-term solution that will benefit issuers, auditors, investors, and the health and competitiveness of our capital markets. Thank you for your consideration, and we would be happy to discuss our comments with the relevant staff.

Sincerely,



David C. Chavern  
Vice President  
Capital Markets Programs

cc: Christopher Cox, Chairman, U.S. Securities and Exchange Commission  
Paul S. Atkins, Commissioner, U.S. Securities and Exchange Commission  
Roel C. Campos, Commissioner, U.S. Securities and Exchange Commission  
Kathleen L. Casey, Commissioner, U.S. Securities and Exchange Commission  
Annette L. Nazareth, Commissioner, U.S. Securities and Exchange Commission  
Mark W. Olson, Chairman, Public Company Accounting Oversight Board  
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**BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)**  
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**SEMICONDUCTOR INDUSTRY ASSOCIATION (SIA)**  
**ADVANCED MEDICAL TECHNOLOGY ASSOCIATION (ADVAMED)**  
**MEDICAL DEVICE MANUFACTURERS ASSOCIATION (MDMA)**  
**ASSOCIATION OF BIOSCIENCE FINANCIAL OFFICERS (ABFO)**  
**CALIFORNIA HEALTHCARE INSTITUTE (CHI)**

September 12, 2006

Chairman Christopher Cox  
Commissioner Paul S. Atkins  
Commissioner Roel C. Campos  
Commissioner Annette L. Nazareth  
Commissioner Kathleen L. Casey  
U.S. Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

Re: Concept Release Concerning Management's Reports on Internal Control Over  
Financial Reporting (File No. S7-11-06, Release No. 34-54122);

Internal Control Over Financial Reporting In Exchange Act Periodic Reports Of  
Non-Accelerated Filers and Newly Public Companies (File No. S7-06-03, Release  
No. 33-8731).

Dear Mr. Chairman and Commissioners:

On behalf of the biotechnology, healthcare technology, high technology, information and communications technology, electronics, and semiconductor industries, we urge the Securities and Exchange Commission to expeditiously adopt Section 404 reforms, in the form of a rule, based on a reform framework that is cost effective, "scaled", and "proportional" to the size and complexity of corporate structures.

Our member companies include the management of a majority of microcap and smallcap companies in the U.S. high-growth sectors. As we indicated in our letter to the Commission on April 3, 2006, we fully support the original goals of the Sarbanes-Oxley Act (SOX) and recognize the need for responsible internal control standards that create meaningful and transparent financial reporting for investors.

The implementation of the SOX Section 404 requirements, however, continues to have a significant impact on smaller public companies that is disproportional to its benefits for the investors. The result has been a negative impact on America's ability to innovate and maintain its

global competitiveness in the high-growth sectors of our nation's economy. For these reasons, we urge the Commission to expeditiously adopt Section 404 reforms as described below.

We welcome this opportunity to provide comments on the Concept Release and appreciate the Commission's recognition of the compliance challenges and costs faced by small businesses as detailed in the Final Report of the Advisory Committee for Smaller Public Companies (Advisory Committee) and the April 2006 report of the U.S. Government Accountability Office (GAO). It is our hope that the changes proposed by the Commission and the Public Company Accounting Oversight Board's (PCAOB) plans to provide further Auditing Standard #2 (AS2) reforms will be critical steps towards fundamental reform of Section 404 that addresses the significant compliance burdens on smaller public companies and supports innovation.

#### The Reform Framework Should Be Principles-Based

For the high-growth industries, the implementation of SOX Section 404 has had a significant impact on the long-term competitiveness of American companies and the U.S. capital markets. Section 404 has imposed cost burdens on high-growth companies and their management far beyond what Congress intended and what is needed to protect investors against corporate fraud. These disproportional compliance burdens have been described to the SEC and the PCAOB by participants in the Section 404 Year Two Roundtable discussions and were well documented in the Final Report by the Advisory Committee.<sup>1</sup>

As currently implemented by the Commission and through the guidance provided by AS2, Section 404 places disproportional cost burdens on America's smaller companies, while specific benefits are difficult to identify.

As the Advisory Committee recommended after its year-long review of Section 404 impacts, without a revised implementation framework, the current "one-size-fits-all" approach of Section 404 and AS2 will continue to hamper the ability of smaller public companies to invest in research and development and to gain access to public capital markets, thereby jeopardizing the competitiveness of smaller companies.

To ensure the continued innovation and vitality of America's public companies, including the smaller companies engaged in the high-growth industries -- high technology, biotechnology, medical devices, electronics, telecommunications and semiconductors, as well as the American institutions that provide access to public capital -- **a principles-based reform framework should be adopted in the form of a rule by the SEC to be implemented through AS2 revisions.**

#### The Reform Framework Should Be Based On The Following Principles:

- Reforms must reflect rational cost/benefit balance. Cost burdens imposed by increasing complexity of required internal controls must yield increased benefits in assuring greater investor confidence.

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<sup>1</sup> During the May 2006 SEC Roundtable on SOX Section 404 Year Two Compliance, the former SEC Commissioner Joe Grundfest also recommended fundamental Section 404 reforms for smaller public companies. Mr. Grundfest suggested that the Commission and PCAOB amend AS2 to incorporate many of the findings made by the Advisory Committee. He also recommended that AS2 reforms should redefine the objective of the control audit process so as to reduce auditors' incentive to examine controls that are unlikely to have material impact on smaller public companies. Fixing 404 by Joseph A. Grundfest, Stanford Law School, May 1, 2006.

- Internal control requirements should be “scaled” and “proportional” to the size of product revenues and complexity of corporate structures.
  - Scaled and proportional reform should be based on the principle that the level of risk and product revenues are intricately tied; product revenues drive the complexity of corporate structures and the corresponding need for more rigid and established internal control processes.
  - Reforms should support management’s incentive to maintain an effective and integrated system of internal controls to produce accurate financial reports, which are most important to investors. The internal controls necessary to meet Section 404 should be “integrated” and consistent with the level of controls necessary to meet the CEO and CFO certifications of company financials as required under Section 302 of SOX.
- Reforms should provide clear rules that are risk-based and material to the integrity of the financial statements.
  - The rules must provide a clearly defined scope of required assessments with a focus on entity-level controls material to financial statements.
- Frequency of internal control testing should be determined by changes in established baseline controls and not merely by the calendar.

1) Reforms Must Achieve Cost/Benefit Balance.

We fully appreciate the Congressional intent behind Section 404 – ensuring that companies have in place effective policies, procedures and controls to protect against material misstatements in financial statements, and to prevent fraud. However, as currently implemented, AS2 does not require a cost/benefit balance as part of its objectives.

The majority of smaller public companies simply do not have the manpower or the resources to perform the requirements under AS2. As most do not have more than one or two dedicated staff to the internal audit function, these companies are forced to either hire additional internal audit personnel or engage external consultants to perform the management assessments necessary to meet the requirements of AS2. As a result, many of our companies are incurring additional consulting fees in addition to external auditing fees. Many smaller companies, in order to complete the mandated internal control processes and the “checklist” dictated by AS2, are required to increase their accounting staff by as much as 50% in addition to hiring additional consultants.

Smaller public companies have limited resources, leaner staffs and tighter budgets. Given the disproportionately high cost of Section 404 compliance for smaller companies, it is our experience that many are forced to redirect funding from other investments, including R&D and the hiring of additional engineers or scientists, all of which are critical for continued innovation and survival of a company. For example, a small company with \$150 million in market capitalization but no product revenues recently paid more than \$1 million for costs associated with Section 404 compliance. Such costs are typical and often do not include a company’s indirect costs of complying with Section 404, or the costs associated with non-accounting staff performing the internal control work due to the shortage of available resources.

Due to Section 404, audit firms now have a required audit process, entirely separate from the typical financial statement audit process, generating fees almost equal to or greater than the charges for a financial statement audit. This was clearly not the Congressional intent. The Senate Committee Report on Section 404 was specific: "The Committee does not intend that the auditor's evaluation be the subject of a separate engagement or the basis for increased charges or fees". Such windfall is attributable not only to the process imposed by the large accounting firms but also to AS2, as promulgated by the PCAOB. The current standards require very prescriptive procedures that auditors must follow to perform the separate attestation, with little room for an auditor's judgment.

Investor confidence and trust in public companies has increased as a result of the passage of SOX as a whole in spite of Section 404 and not necessarily because of it. Important and effective provisions of SOX include whistleblower protections; increased enforcement powers, such as the SEC's increased ability to obtain officer and director bars; auditor independence requirements; and, perhaps most importantly, CEO and CFO certifications of company financial statements under Section 302. As we saw in the first and second years of Section 404 implementation, investors and the market generally had no market reaction when a company reported a "material weakness" in internal controls under Section 404.<sup>2</sup> Thus, we believe the costs of the implementation of Section 404, particularly for smaller public companies, clearly outweigh any benefits that are directly related to Section 404.

## 2) Reforms Must Be "Scaled" And "Proportional" To The Level of Product Revenues.

In achieving scaled and proportional reforms that are risk based, it is critical that Section 404 reforms establish a concrete basis for the required levels of internal controls. As recognized by the Advisory Committee in its Final Report and strongly supported by our members, Section 404 reform should be based on a "revenue filter" or revenue metric, particularly product revenues. This approach reflects corporate reality in that product revenues drive the complexity of corporate structures and the corresponding need for increased internal controls to protect against financial fraud.

Scaling Section 404 requirements, in part, on product revenues is critical to smaller companies in our industries. Biotech and other innovative start-up companies generally have very low revenues compared to their market capitalizations. For example, it is not uncommon for an early stage public biotech company with a market capitalization of \$700 million to have product revenues of \$1 million or less.

For smaller public companies, as defined by the level of product revenues, the reform framework should focus on the internal controls necessary for CEO and CFO certifications of company financials as currently required under Section 302 of SOX. The proposed reform supports management's incentive to maintain effective systems of internal controls and produce accurate financial reports which are most important to financial markets and investors. Section 13(b)(2)(B) of the Exchange Act requires, as it has since 1977, that public companies maintain a system of internal controls that provide reasonable assurances as to the accuracy of financial reports. Under section 302, each CEO and CFO must certify that the financial statements fairly present in all material respects the financial condition of the company, and disclose all

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<sup>2</sup> See, e.g., Neil O'Hara, An Analysis of the (Non) Impact of SOX 404, Compliance Week, March 8, 2005. In addition, at the 2005 SEC and PCAOB Roundtable on Section 404, a representative of Moody's on one of the panels stated that, of the 71 companies disclosing material weaknesses they considered in detail, they ultimately issued a negative rating action on 12, or 20%, of the companies. Thus, credit rating agencies had no adverse reaction to approximately 80% of the companies.

weaknesses in the internal controls that could adversely affect the company's ability to record, process, summarize and report financial information, among other things.

### 3) Reforms Must Be Risk-Based.

The prescriptive nature of AS2 in its current form deters both management and auditors from taking a risk-based approach to prioritizing key financial controls under Section 404. As currently implemented, for smaller companies, management has little say in determining the scope and identification of necessary internal controls. Often, management implements extensive assessment plans developed by their auditors. As currently required, AS2 provides limited opportunity for management or external auditors to take a risk-based approach. AS2 thereby limits the ability of management and auditors to focus on the necessary controls, especially at the entity-wide level, which ultimately could have a material impact on their financial statements as required under Section 302. In short, the management and auditors are compelled to focus on the breadth of controls rather than the depth of necessary controls.

In fact, most small companies currently match their internal reviews to the requirements of the external reviews. They do not see how it could work any other way. If companies were truly performing their own internal audits for fraud and accuracy, they would not follow the current AS2 internal control requirements because many of these processes evaluate items that are immaterial for smaller companies.

Just to provide two examples of processes lacking a rational basis: a biotech company's management was required to sign off on every page of its Controller's 150-page close book; and the same company also received a deficiency because its accounting software did not require passwords to be alpha-numeric. Additionally, for smaller public companies, cross-training and interchangeability of staff is often more valuable than the strict segregation of duty that is required under Section 404, sometimes to a point of dysfunction.

Other examples include a lack of rationale in addressing certain information technology (IT) controls. The current external auditor-driven approach requires extensive testing of internal controls over IT as it relates to entire company and not just IT systems related to financial reporting. Under the current system, company management cannot rely on the capabilities of external service providers (i.e. payroll providers, tax firms and transfer agents) if no SAS 70 reports are in place. Thus, most companies are left to either pay for the external service provider to obtain the SAS 70 or put extensive controls in place surrounding the information that the service providers provide, including extensive manual recalculations.

Under AS2, auditors are so focused on the detail and the sheer breadth of the internal controls and testing that there is little room for judgment and clear perspective over the overall process goals. Additionally, management has such extensive compliance requirements, including sign offs, recalculations and documentation, that many company managers have less time to evaluate the reasonableness of their disclosures.

As previously discussed, the opportunity cost of time spent on complying with documentation, testing and review of internal controls is time that could be directed toward functions that add value to the company and its shareholders (i.e. training staff, forecasting, modeling, monitoring, bringing in-house tasks done by external parties).

4) Frequency Of Internal Control Assessments Should Be Determined By Material Changes In Key Financial Controls.

Frequency of internal control testing should be determined by changes in established baseline entity-wide controls. As currently implemented, AS2 fails to recognize the value of cumulative knowledge and relevance of changes in key control areas that matter to the reporting of financial statements. Periodic testing or testing when a material change has occurred could alleviate the excessive duplication year after year that further adds to the high cost and burdens imposed by Section 404.

5) Additional Deferrals For Non-Accelerated Filers And Newly Public Companies Should Be Provided Until A New Reform Framework Is Implemented.

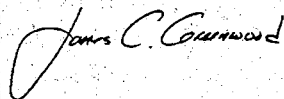
We fully support the Commission's proposal to provide further implementation deferrals for non-accelerated filers (small companies under \$75 million in market capitalization) and for newly public companies. In light of the current uncertainties due to the anticipated reforms by the Commission and the PCAOB and potential changes to AS2 requirements, we believe it is critical to further delay both the management assessment and external auditor attestation requirements for non-accelerated filers as well as newly public companies until a settled guidance can be provided and revised AS2 rules have been implemented for a reasonable time. In fact, non-accelerated filers and newly public companies should not be required to comply with Section 404 until a full assessment can be made by the GAO on the cost/burden impact of the newly revised AS2 rules.

Conclusion

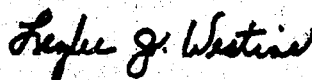
As representatives of the high-growth sectors of the U.S. economy, we appreciate this opportunity to comment on the concept release. We believe that principles-based reforms that focus on cost effectiveness, that are risk based, and that are scaled and proportional to the level of product revenues and complexity of corporate structures will achieve the original intent of Section 404 – achieving internal controls that provide investors with the optimal level of confidence in the financial integrity of a public company.

We thank you for your consideration of our views and we urge you to expeditiously adopt a reform framework that provides fundamental relief to smaller public companies and that supports innovation in the U.S. high-growth sectors. We look forward to working with you to achieve these important goals.

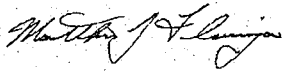
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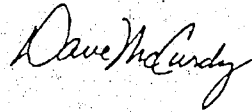
James C. Greenwood  
President and CEO  
Biotechnology Industry Organization



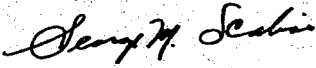
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President and CEO  
TechNet



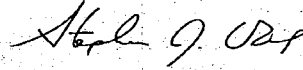
Matthew J. Flanigan  
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Dave McCurdy  
President and CEO  
Electronic Industries Alliance



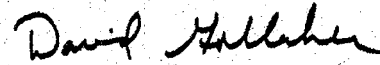
George M. Scalise  
President  
Semiconductor Industry Association



Stephen J. Ubl  
President and CEO  
Advanced Medical Technology  
Association



Mark B. Leahey  
Executive Director  
Medical Device Manufacturers Association



David L. Gollaher, Ph.D.  
President and CEO  
California Healthcare Institute



Alain Cappeluti  
Chairman  
Association of Bioscience Financial  
Officers (B/W Chapter)  
Past Chairman, ABFO International



November 1, 2006

COMMENTARY

## DOW JONES REPRINTS

### To Save New York, Learn From London

By CHARLES E. SCHUMER and MICHAEL R. BLOOMBERG

November 1, 2006; Page A18

In recent months, there has been a lot of media chatter about the possibility of London taking over New York's position as the world's financial capital. Such speculation, although overblown, has focused our attention on a broader and legitimate concern: Unless we improve our corporate climate, we risk allowing New York to lose its pre-eminence in the global financial-services sector. This would be devastating both for our city and nation.

One of the engines of growth for the U.S. economy, the financial-services industry in New York has long possessed significant comparative advantages over London and all other cities. These advantages include the broadest, most efficient and liquid capital markets in the world, and a concentration of the world's biggest financial firms -- which have a much larger presence here than anywhere else. This city dominates global private-equity markets, secondary trading markets, and mergers and acquisitions.

New York has unparalleled quality of life and cultural diversity, which global companies increasingly seek, as well as a dynamic labor market -- our unemployment rate is lower than the nation's. Taken together, these advantages explain why New York's financial-sector employment numbers are greater than any other city's.

Yet while New York remains the dominant global-exchange center, we have been losing ground as the leader in capital formation. In 2005 only one out of the top 24 IPOs was registered in the U.S., and four were registered in London. London is gaining ground in other areas too, but it is not only London we need to worry about. Next year, more money will be raised through IPOs in Hong Kong than in either London or New York.

We cannot ignore these warning signs. That is why New York has hired a consulting firm, which will issue a report in November identifying the specific variables that are negatively impacting our financial-services industry and recommending an action plan to correct them.

Based on the work completed so far, there are four factors that bear close attention: globalization of the capital markets, overregulation, frivolous litigation and incompatible accounting standards. The first factor is beyond our control; advances in technology and communication are allowing capital to flow more freely, making it much easier to locate financial activities anywhere in the world. But we can, and must, do something about the other three factors to maintain and expand our competitive edge.

First, what lessons can we learn from other nations' regulatory systems? Currently, there are more than 10 federal, state and industry regulatory bodies in the U.S. The British have only one such body. Industry experts estimate that the gross financial regulatory costs to U.S. companies are 15 times higher than in Britain. Beyond cost savings, the British enjoy another advantage: While our regulatory bodies are often competing to be the toughest cop on the street, the British regulatory body seems to be more collaborative and solutions-oriented.

With the benefit of hindsight, the Sarbanes-Oxley Act of 2002, which imposed a new regulatory

framework on all public companies doing business in the U.S., also needs to be re-examined. Since its passage, auditing expenses for companies doing business in the U.S. have grown far beyond anything Congress had anticipated. Of course, we must not in any way diminish our ability to detect corporate fraud and protect investors. But there appears to be a worrisome trend of corporate leaders focusing inordinate time on compliance minutiae rather than innovative strategies for growth, for fear of facing personal financial penalties from overzealous regulators.

Second, what lessons can we learn from other nations' legal environments? The total value of securities class-action lawsuits in the U.S. has skyrocketed in recent years, to \$9.6 billion in 2005 from \$150 million in 1997. The U.K. and other nations have laws that far more effectively discourage frivolous suits. It may be time to revisit the best way to reduce frivolous lawsuits without eliminating meritorious ones.

Third, what lessons can we learn from other nations' experiences with international accounting standards? Most European and Asian countries have already begun to adopt international accounting standards, which businesses tend to prefer over the American system. Yet we have set no timetable for doing the same.

In the last quarter of the 20th century, we achieved an almost exquisite balance between regulation and entrepreneurial vigor in American financial markets. We learned that too much regulation stifles entrepreneurship, competition and innovation; while too little regulation creates excessive risk to industry, investors and the overall system.

This delicate balance has been upset by technological advances, making it much easier to locate financial-services activities anywhere in the world. As a result, foreign markets may be tempted to lower regulatory requirements to achieve a temporary competitive advantage. Though deregulation may help some countries gain more business in the short term, over the long term it could hurt the stability and reliability of the global marketplace.

New York cannot afford to lose its place as the global leader in financial services. We have to carefully redefine this balance of innovation and regulation. That is what we seek to do over the next several months.

Our ability to do that, and to answer these three questions, will determine the future of New York - and, in many ways, the nation. If we do not rise to the challenge, the speculation that New York is losing its pre-eminence in the global marketplace will become more than just chatter.

***Mr. Schumer is a Democratic senator from New York. Mr. Bloomberg is mayor of New York City.***

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<http://online.wsj.com/article/SB116234404428809623.html>

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# Sarbox Setback

EASIER COMPLIANCE FOR SMALL BIZ WAS WITHIN REACH, BUT THE SEC IS BACKPEDALING BY JEREMY QUITTNER

**SMALL COMPANIES** that were hoping for some regulatory relief from the most onerous provision of the Sarbanes-Oxley Act are out of luck, at least in the short term.

On Apr. 23, the 21-person Advisory Committee on Smaller Public Companies handed the U.S. Securities & Exchange Commission a list of 33 recommendations on how to make Sarbox compliance easier for small public companies. The most striking proposal would have exempted the smallest from the burdensome Section 404 until the SEC can figure out a way to tailor it to them. Section 404 requires that companies complete an internal audit of controls they've already established. It's not uncommon for businesses to spend hundreds of thousands of dollars trying to comply with it.

But on May 17, SEC Chairman Christopher Cox signaled his opposition. "He and the other commissioners have indicated that they would rather make 404 work more efficiently...than [talk] about exempting smaller companies," says SEC spokesman John Heine. He adds that companies with less than \$75 million of public stock outstanding

have until July 15, 2007, to file their first annual report. The best they can hope for, he says, is to see the date postponed.

The idea of making 404 work more efficiently is likely to be "a very lengthy process and not an easy task," says Thomas Hartmann, a partner at Detroit law firm Foley & Lardner. He says that's partly because there is no existing regulatory framework for small companies around which to build such an approach.

Some in Congress are trying to keep the exemption idea afloat. On May 17, Representative Tom Feeney (R-Fla.) introduced a bill that would amend 404 to exempt companies with a market cap of less than \$700 million. "I was disappointed by the SEC response," says Feeney. "For now it seems they have not fully appreciated the enormity of the problems with Sarbox, or they have appreciated the problems and are not ready to act aggressively to reform the implementation." Senator Jim Demint (R-S.C.) introduced a similar bill in the Senate. Even so, Feeney says the chances of his bill passing are slim while Representative Michael Oxley

(R-Ohio) remains chair of the House Financial Services Committee.

The SEC committee's recommendations followed a 13-month review of the accounting and financial reporting of smaller businesses, including their audit procedures and the process of going public. The committee had recommended that companies be grouped into tiers by market size and that those with less than \$787 million in market capitalization be exempted from 404. About 7,400 businesses would have qualified. That's 79% of public companies but only about 6% of the total public market capitalization. The exemption would have remained in place until a new set of internal audit rules was established specifically for smaller companies. Now it may not go into place at all. ■



ILLUSTRATION BY TIM BOWEN



SMALLBIZ EDITOR KIMBERLY WEISUL ASKS NAPOLEON BARRAGAN: WHAT'S THE ONE THING YOU WISH YOU KNEW BEFORE STARTING 1-800-MATTRESS?

“In 1998 we started asking all our customers five simple questions. Until we did that, it was hard to know if we were giving the customer what they wanted. We have to be measuring constantly. We have to look at last week and last year and be prepared for tomorrow and next month. And at that time they call you a visionary.”

—NAPOLEON BARRAGAN  
founder and chief executive of 1-800-MATTRESS

Iran, Israel and Palestine

## Rejecting Israel, again

The refusal to accept Israel's right to exist harms Palestinians too



EVERY so often, unpopular Muslim regimes on the periphery of the Palestine conflict find it expedient to propose eliminating the Zionist entity. Since his election last year, Mahmoud Ahmadinejad, Iran's president and chief holocaust denier, has become a leading exponent of this familiar ruse. His promise last week that Israel would soon be wiped from the pages of history in accordance with the prophecy of the late Ayatollah Khomeini was therefore neither especially new nor—till Iran acquires nuclear weapons—especially frightening. And, of course, even with a bomb, even Mr Ahmadinejad might think twice about launching a nuclear attack that could lead to Iran's own swift destruction.

What is more depressing is the rise of a similarly atavistic strain of Israel-destroying rhetoric among the Palestinians themselves. It took the Palestine Liberation Organisation until the late 1980s to abandon its self-defeating fantasy that it had the power and the right to wipe Israel off the map. Now the Palestinians are in danger of revisiting the same dead end.

Like many successful Islamist movements, Hamas combines strong ideology with a shrewd pragmatism. But winning January's Palestinian elections has been discombobulating (see page 47). Since then its leaders have broadcast a blizzard of crossed and mixed signals about whether they would be content with a state in the West Bank and Gaza instead of all historic Palestine, and for how long. Yet they still seem unable to accept the request of America, Europe, Russia and the United Nations to renounce terror and violence, accept Israel's right to exist and honour the Palestinians' previ-

ous international undertakings. Worse still, Hamas this week sent out an unambiguously wrong signal by justifying as "self defence" the deadly Passover suicide-bombing in Tel Aviv by a smaller pro-Iranian Palestinian group, Islamic Jihad.

Right now it is Israel that has the better claim to be defending itself. Islamic Jihad makes ceaseless attempts to mount suicide-bombings in Israel and, with other groups, has been firing rockets at Israeli towns ever since Israel evacuated the Gaza Strip last summer. Israel has killed many members of the rocket-launching teams—and, by accident, some innocent bystanders too. But the deliberate targeting of civilians is a war crime in anyone's book, and under the agreements which Hamas refuses to honour, the Palestinian Authority (PA) undertook to make an effort to stop such attacks. Its president, Mahmoud Abbas, rightly denounced the Tel Aviv atrocity.

By condoning the attack instead, Hamas will find it harder to win broad international acceptance. That may be a price it is willing to pay. As Western countries give the PA less, Russia, Iran and the Arab states may give more. Moreover, any attempt by Israel to force the collapse of Hamas's government is liable to fail. For all Israel's power in the territories, it should be prevented by its own scruples and world opinion from starving the Palestinians into reversing their democratic decision.

By the same token, however, Hamas's efforts to establish a free Palestine look doomed to fail unless it pays Israel the basic price of admission to talks: recognition of its right to exist and an end to terrorism. On present showing, Hamas's leaders are not willing to make that leap. It is to be hoped that they can still change their mind. If they think Israel's offer of a decent two-state solution is a bluff, let them call it. History suggests that although both sides suffer when there is deadlock in this miserable conflict, the Palestinians tend to suffer more. ■

Corporate regulation

## In search of better SOX

What can be done to loosen America's burdensome post-Enron rules?



ONLY yesterday companies the world over flocked to America to list their shares. For bigger, more established firms, the razzmatazz of a listing on the New York Stock Exchange was the mark of blue-chip status. For younger firms, a NASDAQ listing was a crucial step on the way to becoming the next Microsoft. Today, however, foreign listings have become a rarity, especially on NASDAQ. Even some of America's home-grown would-be Microsofts now list not in New York, but overseas, especially on London's Alternative Investment Market.

It used to be taken for granted in the United States that the country's stockmarkets were the best-regulated in the world,

and that their attraction to overseas companies was proof of the fact. So what does it mean that many of those firms now opt to list elsewhere pin much of the blame on the burden of America's corporate regulations—above all the Sarbanes-Oxley act (SOX) passed by Congress in 2002 after the scandalous collapse of Enron and WorldCom?

To its defenders, and there are still many, SOX has done just what was asked of it and raised the quality of corporate regulation so as to minimise the risk of the next Enron or WorldCom. If the price of that is for flakier Russian companies to choose laxer jurisdictions overseas, so much the better.

That argument might wash were SOX a well-crafted piece of legislation, rather than a rush-job hurried through a Congress with its eye on 2002's mid-term elections. SOX's sceptics are not restricted to fundamentalists who think that the legis-

lation was always unnecessary or went after the wrong targets. Today, many people who supported SOX in principle—ranging from the boss of NASDAQ to the sainted former chairman of the Federal Reserve, Alan Greenspan—are increasingly disturbed by SOX in practice.

### Strangled by red tape

How could SOX be improved? Divisions in Congress mean that thorough reform is unlikely anytime soon, even though some parts of the legislation could do with a second look. The priority is to modify the most hated part of SOX, the 20 lines of text called Section 404, which regulates the internal controls used by firms in their financial reporting and extends scrutinizing to such minutiae as travel expenses and petty cash. The cost of implementing Section 404 has been far higher than expected, especially in smaller firms. Happily, several changes could lighten the burden of Section 404 and these can proba-

bly be seen through by America's main markets regulator, the Securities and Exchange Commission (SEC) without troubling Congress (see page 59).

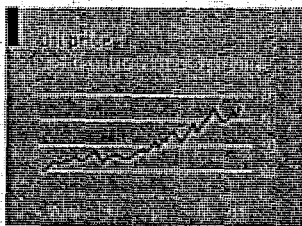
A good start would be for the SEC to follow the likely advice of its own Advisory Committee on Smaller Public Companies and exempt companies with a stockmarket value below \$128m and sales of less than \$125m. That would still leave the bigger firms that account for 94% of the value of America's stockmarkets subject to Section 404. The SEC should also try to lighten the burden on them too. It could, for example, narrow the scope of the internal-control review carried out by auditors so that they examine only the larger risks, not the size of people's lunch expenses.

Small technical changes, perhaps, but in SOX, the detail is what costs the money. At the least such reforms would help restore the reputation of America's stockmarkets. They might even make America's own companies more competitive. ■

## The oil market

# Nostalgia for calmer days

### Uncertainty looks a bigger problem than high prices



**H**OW high can the oil price go? It is striking that so many people are even asking the question—let alone answering it, in some cases, with frightening triple-digit numbers. For most of the 1980s and 1990s, the oil price rarely strayed far from \$20 a barrel. With the exception of a brief interlude following Iraq's invasion of Kuwait in 1990, the world grew used to the joys of cheap oil. But over the past four years, the price has more than tripled, to more than \$70 a barrel. It is still climbing and prices in the futures market imply that oil will remain dear for several years to come. Clearly, investors believe that some comfortable old certainties have gone out of the window.

Chief among them is the idea that Saudi Arabia will always act to cap prices. The Saudis have many decades-worth of oil left in the ground, and so have an incentive to keep the stuff cheap enough to ward off conservation or substitution. To this end—and to help its protectors in Washington, DC—the kingdom used to maintain spare pumping capacity of a few million barrels a day, enough to deal with an unexpected surge in demand or a sudden cut in supply. During the first Gulf war, for example, Saudi Arabia turned on the taps to compensate for the loss of Iraq and Kuwait's normal output. But as demand has grown over the past few years, particularly from booming places like China, supply has not kept pace, so Saudi Arabia's buffer has gradually worn through. For the first time in more than two decades demand is straining at capacity.

A freer oil market is no bad thing. In time, higher prices will lead to conservation—a bonus in a world worried about global warming (though one better achieved through taxes). In addition, oil firms should respond to higher prices by redoubling their efforts to procure more of the stuff. And so they are: by one estimate, 15m barrels of new capacity should come on-stream by 2010 (see page 65). Moreover, despite a lot of scare-mongering, the geological evidence suggests that there is still

plenty of black gold in the ground.

The hitch is that the most promising territory for exploration lies in unstable places such as the Middle East and Russia. What is more, the oil is controlled by state-owned firms, which often seem blind to the signals sent by the market. While the supply remains tight any political or meteorological hiccup in a producing country (and there always seems to be at least one) will resonate through the markets.

Three other factors will add to the uncertainty. The first is the flood of new speculative investment in commodities, especially oil. Speculators are thought to have put more than \$100 billion into commodities markets in the past few years, helping to propel the price of oil ever higher. But this new hot money could quit the oil market in an instant, causing prices to plunge (and throwing the energy industry's investment plans into disarray).

The second unknown is how expensive oil will affect the world economy. Past surges in the oil price have led to rises in inflation and interest rates that have triggered recessions. This time might be different, partly because growing demand, rather than a reduction in supply, has underpinned the price rise. That means it has been steady and gradual, giving consumers more time to adjust. In addition, inflation remains low and oil exporters are supporting consumption in the United States, the biggest importer (see page 74). Dearer oil will eventually curb demand—but at what price, and at what cost to the world economy, nobody knows.

### Making oil

In the long run, the biggest uncertainty is technology. Western oil firms are beginning to address their difficulty in finding oil by manufacturing fuel instead. Man-made fuels, such as ethanol derived from plants, or diesel conjured from coal and gas, hold out the promise of secure and almost unlimited supply. But with today's technology these are much more expensive to produce than oil pumped from the deserts of Arabia. Until that changes, the oil market is set for an unnerving period. ■



Regulating business

## The trial of Sarbanes-Oxley

NEW YORK

The corporate regulation brought in after the Enron scandal stands accused of making matters worse

**D**OWN in Houston the Enron trial proceeds apace. But far more significant for business, in America and beyond, than the fate of the energy company's former bosses is the outcome of another "trial" that is now at a crucial stage—that of the legislation introduced by Congress in 2002 in the wake of the Enron scandal.

The act was named after its two main sponsors, Senator Paul Sarbanes (pictured right above) and Congressman Mike Oxley (left). Sarbanes-Oxley, or SOX, as it has become known, was unpopular with business people from the start. In recent years it has been hard to find a chief executive of a public company who does not complain vehemently about the burdens imposed by the dreaded SOX. Indeed, rather than diminish as the initial shock wore off, the complaints have only got louder. The SOX-bashers have been joined by such luminaries as Alan Greenspan, the former head of the Federal Reserve and Bob Greifeld, the boss of the NASDAQ stockmarket. And the critics are not just American. Because of SOX, says Mr Greifeld, "international business clearly perceives a 'problem' with US markets today."

SOX packaged together five different categories of reforms intended to protect investors from future Enrons. First, rules requiring better internal monitoring for potential fraud by a company's board and executives, including making the people at the top certify the quality of their firm's fi-

nanial reports. Second, new measures to improve the monitoring of firms by relevant outside professionals, such as lawyers and auditors, who got their own regulatory body, the Public Company Accounting Oversight Board (PCAOB). Third, more disclosure, including of a firm's internal-control structure. Fourth, new rules on the conduct of corporate insiders, such as a prohibition on loans to executives. Finally, new rules to ensure that securities analysts at banks operate independently from their firms' investment-banking activities.

SOX-bashers have found fault, to varying degrees, with all five reforms. Henry Butler, an economist, and Larry Ribstein, a law professor, set out the most comprehensive critique yet in a recent paper, "The Sarbanes-Oxley debacle: How to fix it and what we've learned", which was presented at the conservative American Enterprise Institute. Describing SOX as a "colossal failure, poorly conceived and hastily enacted during a regulatory panic", they argue (among other things) that the costs of implementing SOX are far higher than expected, both in cash terms, and even more so when they count the indirect costs—such as managers' reluctance to take risks because of the new "climate of fear" in the boardroom, and the missed opportunities of foregone investment. Although they admit that SOX may have reduced the risk of fraud, they argue that this benefit is

far outweighed by the costs.

Messrs Butler and Ribstein would ideally like SOX to be repealed. But even if a court case challenging the constitutionality of the PCAOB (and by extension, SOX) is successful, it is more likely that Congress will simply amend the law.

All SOX critics agree that the top priority for reform is Section 404 of the law, which regulates the internal controls that firms use to reduce the risk of fraud or error in their financial statements. The burdens imposed by Section 404 are the main reason why formerly enthusiastic supporters of SOX, such as Mr Greenspan, are now demanding reform.

Section 404 has almost certainly improved the quality of internal controls at the firms where it has been implemented. But the question is not whether better controls lead to less risk—how could they not?—but whether that reduction in risk is worth the price. According to a recent study by CRA International, a research firm, in the first year of SOX implementation, for larger companies (with a market capitalisation of at least \$700m), the average direct cost of Section 404 was \$8.5m; for smaller public companies (\$75m-700m), the average cost was around \$1.2m. The SEC has not yet asked the very smallest public companies, with a value of less than \$75m, to comply with Section 404.

The good news is that Section 404 costs are expected to fall by around 40% in the second year, says CRA, as the new system beds in. Even so, the costs are still higher than anyone expected them to be—the SEC initially forecast an average cost of \$91,000 per company—and the burden is disproportionately heavy for smaller companies.

Much of the blame for this should be pinned on accounting firms, which, despite being seen by the public as big offenders in the Enron and WorldCom scan-

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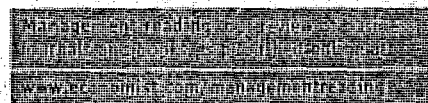
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dals, have emerged as the big beneficiaries from SOX. According to Joe Grundfest, a former SEC commissioner, the audit industry has several incentives to "push Section 404 compliance to a point of socially inefficient hyper-vigilance." To avoid further damage to their reputations, and to minimise the risk that they will be sued over accounting irregularities, audit firms are adopting the most prudent possible interpretation of the Section 404 rules—rules that are vague and open to argument. And, as Mr Grundfest points out, the "more

onerous the requirements of Section 404, the more money the audit profession can earn" by selling its services.

A couple of proposals could help tackle this problem, neither of which would require a wholesale reform of SOX by Congress. In a report due on April 23rd, the SEC's Advisory Committee on Smaller Public Companies was expected to recommend that companies be exempted from Section 404 if their market capitalisation is less than \$128m and their revenues are under \$125m. Firms with a market value of up

to \$788m, and revenues of under \$250m would be partially exempted.

This proposal has run into strong opposition, not least from Mr Sarbanes himself, who points out that it would "effectively exempt four out of every five companies". True, but it was failures at big firms that gave rise to SOX, not at small ones, which investors have always thought riskier. In all, the exemption would cover firms accounting for only 6% of total American stock market value, leaving 94% of public companies by value still subject to Section 404.

Rather than exempt companies, Section 404 should be refined to make it more palatable for all firms, argues Robert Pozen, the head of MFS, a fund-management firm. At the moment, audit companies are looking at far too many internal controls—some 669 on average at the biggest firms, according to CRA—including items such as travel expenses and the handling of petty cash that are highly unlikely to have any serious impact on a company's financial reporting. Mr Pozen reckons that the SEC has the authority to require a narrower focus on those internal controls that look at material risks to a firm's financial reports.

Mr Grundfest goes further. As it stands, the PCAOB can penalise auditors that are too lax. He would like it to punish those audit firms that are over-zealous in their interpretation of Section 404, too. What could be fairer than that? ■

The Enron trial

## The grilling of Skilling

A frustrating week for Jeffrey Skilling

THIS is the same man who once flaunted a licence plate reading WRE, for "World's Leading Energy Company". Under cross-examination this week, the once-brash Jeffrey Skilling was mostly cool and respectful, despite spasms of annoyance. The former chief executive of Enron, a bankrupt energy trading firm, was accused by a courtroom prosecutor that he had "nothing to hide" even as he allegedly engaged in securities fraud, insider trading and false earnings reports with auditors.

But Mr Berkowitz, the government prosecutor, like prosecutor, produced a lot of accusations. Among them, that Mr Skilling had manipulated the company's earnings to meet analysts' targets, siphoned reserves from a "contaminated" fund, and wanted 73 cents per share, then what Enron would report, said Mr Berkowitz in the second quarter of 2001, near the apex of Enron's fortunes. Mr Skilling has said he did tell another executive to "shoot for 34" cents a share

but insists there was no manipulation. Mr Berkowitz also argued that Mr Skilling kept big problems and trading risks away from investors—a charge Mr Skilling has fully denied.

As the *Journal* recalls, recounted Mr Berkowitz played up Mr Skilling's haziness. He grilled him about a private company called Phoenix, run by a former friend, which had dealings with Enron. Mr Skilling's estimate of how much he invested in Phoenix was "much and low," he gazed away. Far greater questions about why Mr Skilling tried to sell 200,000 shares of Enron on September 6th, 2001, which were said he had resigned from the company for "personal reasons".

Though this appears to be a major failure of Mr Skilling's Enron that explains all the time, he claims not to remember the transaction, which was taped. Soon thereafter, he sold 200,000 shares, which he attributes to September 11th. Mr Berkowitz also questioned why Mr Skilling, his ex-wife and girlfriend all sold substantial stock in the autumn of 2001.

So how did he do? For a self-confessed "controls freak", Mr Skilling emerges, at best, as oddly unaware of his responsibilities and of the peculiar goings-on at his company, which he claims to have left in its "best shape" in 2001. "You're out of town, the lights are out," said Mr Berkowitz sceptically of Mr Skilling's various explanations for why he was out of the loop. Mr Skilling will get a friendlier face next. His lawyer, Daniel Petrocelli, will re-examine him; then comes another chance for Mr Berkowitz, and some other defence witnesses. After that, Kenneth Lay, Mr Skilling's co-defendant, could take the stand next week.

Then, the long-suffering jury—now in its twelfth week of immersion in off-balance sheet vehicles and hedging strategies—will decide their fates.



Controls freak

Software

## Universal service?

Proponents of "software as a service" say it will wipe out traditional software

SOMETHING momentous is happening in the software business. Bill Gates of Microsoft calls it "the next sea change". Analysts call it a "tectonic shift" in the industry. Trade publications hail it as "the next big thing". It is software-as-a-service (saas)—the delivery of software as an internet-based service via a web browser, rather than as a product that must be purchased, installed and maintained. The appeal is obvious: saas is quicker, easier and cheaper to deploy than traditional software, which means technology budgets can be focused on providing competitive advantage, rather than maintenance.

This has prompted an outbreak of iconoclasm. "Traditional software is dead," says Jason Maynard, an analyst at Credit Suisse. Just as most firms do not own generators, but buy electricity from the grid, so in future they will buy software on the hoof, he says. "It's the end of software as



# Federal Register

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Tuesday,  
July 18, 2006

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Part IV

## Securities and Exchange Commission

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17 CFR Part 240

**Concept Release Concerning  
Management's Reports on Internal  
Control Over Financial Reporting;  
Proposed Rule**

## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Part 240

[Release No. 34-54122; File No. S7-11-06]

RIN 3235-AJ58

### Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Advance notice of proposed rulemaking; Concept Release; request for comment.

**SUMMARY:** The Commission is publishing this Concept Release to understand better the extent and nature of public interest in the development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting so that any guidance the Commission develops addresses the needs and concerns of public companies, consistent with the protection of investors.

**DATES:** Comments should be submitted on or before September 18, 2006.

**ADDRESSES:** Comments may be submitted by any of the following methods:

#### Electronic Comments

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/concept.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7-11-06 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

#### Paper Comments

- Send paper submissions in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549-1090.

All submissions should refer to File Number S7-11-06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/concept.shtml>). Comments also are available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change;

we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

**FOR FURTHER INFORMATION CONTACT:** Lillian Brown, Division of Corporation Finance or Michael Gaynor, Office of Chief Accountant, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

#### SUPPLEMENTARY INFORMATION:

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#### I. Background

Section 404(a) of the Sarbanes-Oxley Act of 2002<sup>1</sup> directed the Commission to prescribe rules that require each annual report that a company, other than a registered investment company, files pursuant to section 13(a) or 15(d)<sup>2</sup> of the Securities Exchange Act of 1934<sup>3</sup> to contain an internal control report: (1) Stating management's responsibilities for establishing and maintaining adequate internal control structure and procedures for financial reporting; and (2) containing an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal controls and procedures for financial reporting. On June 5, 2003, the Commission adopted rules published at 68 FR 36636, June 18, 2003, implementing section 404 with regard to management's obligations to report on internal control over financial reporting.

Domestic reporting companies that meet the definition of "accelerated filer" under the Commission's rules were required to comply with the internal control reporting provisions for the first time in connection with their fiscal years ending on or after November 15, 2004. Foreign private issuers that meet the definition of accelerated filer must comply with those provisions for their first fiscal year ending on or after July 15, 2006. On September 22, 2005, in a document published at 70 FR 56825, September 29, 2005, the Commission postponed the compliance date for domestic and foreign non-accelerated filers until their first fiscal years ending on or after July 15, 2007.

On May 17, 2006, the Commission announced through a press release its intent to issue an additional postponement for compliance for non-

accelerated filers. As announced in that press release, the Commission expects to propose an additional extension of the dates for complying with our internal control over financial reporting requirements for companies that are non-accelerated filers, including foreign private issuers that are non-accelerated filers.

Section 404(b) of Sarbanes-Oxley, as well as the Commission's rules adopted to implement the requirements of that section of the Act, require every registered public accounting firm that prepares or issues a financial statement audit report for a company also to attest to and report on management's assessment of internal control over financial reporting, in accordance with standards to be established by the Public Company Accounting Oversight Board (PCAOB). On June 17, 2004, the Commission issued an order approving PCAOB Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of the Financial Statements" (AS No. 2), published at 69 FR 35083, June 23, 2004, which established the requirements that apply when an independent auditor is engaged to provide an attestation and report on management's assessment of the effectiveness of a company's internal control over financial reporting.

In the release adopting the Commission's rules implementing section 404, we expressed our belief that the methods of conducting assessments of internal control over financial reporting will, and should, vary from company to company.<sup>4</sup> We continue to believe that it is impractical to prescribe a single methodology that meets the needs of every company. However, we have received feedback that the limited nature and extent of detailed management guidance available has resulted in management's implementation and assessment efforts being driven largely by AS No. 2. Therefore, we are planning to issue additional guidance to assist management in its performance of its assessment of internal control over financial reporting. On May 17, 2006, we announced, among other things, our intent to issue this Concept Release seeking comment on a variety of issues that might be the subject of Commission guidance for management. As we noted in that announcement, in writing any guidance we will be sensitive to the fact

<sup>4</sup> See SEC Final Rule: *Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Release No. 34-47986 (June 5, 2003) [68 FR 36636, June 18, 2003] (hereinafter "Adopting Release") at Section II.B.3.d.

<sup>1</sup> 75 U.S.C. 7262.

<sup>2</sup> 15 U.S.C. 78m(a) or 78o(d).

<sup>3</sup> 15 U.S.C. 78a et seq.

that many companies already have invested substantial resources to establish and document programs and procedures to perform their assessments over the last few years.

## II. Introduction

Based on the cumulative feedback received since the adoption of the rules implementing section 404, the Commission deems it necessary to issue additional guidance for management on its assessment of the effectiveness of internal control over financial reporting. We currently anticipate that the guidance issued would be in the form of a rule, which would address the topics that we have outlined in this Concept Release: Risk and control identification, management's evaluation, and documentation requirements (each of these topics is addressed separately throughout the remainder of this document). Additionally, we anticipate that the rule would be written in such a manner that if companies followed the rule, they would be deemed to have complied with Rules 13a-15(c) and 15d-15(c) of the Exchange Act. Further, we anticipate any modifications to AS No. 2 would be consistent with the rule.

The Commission is publishing this Concept Release to solicit public comment on the provision of additional guidance to management of public companies that are subject to the SEC's rules related to management's assessment of internal control over financial reporting and, to assist the Commission so that any guidance it ultimately develops addresses the needs and concerns of all public companies. We raise a series of questions throughout this release on assessing risks, identifying controls, evaluating effectiveness of internal control, and documenting the basis for the assessment. Through the questions in this Concept Release, we seek to elicit specific public comment on such matters including, but not limited to, the extent and nature of public interest in the development of additional management guidance, whether additional guidance would be useful for all reporting companies or just a subset of those companies, the particular subject areas that any additional guidance should address, and the extent of additional guidance that would be useful.

Since the Commission adopted rules in June 2003 to implement section 404 of the Sarbanes-Oxley Act, companies and third parties have devoted considerable attention to the methods that management may use to assess the effectiveness of internal control over financial reporting. To date, many public companies have developed their own assessment procedures internally. Many also have retained consultants or purchased commercial software and other products to establish or improve their assessment procedures. When the Commission first adopted the internal control over financial reporting requirements, we emphasized two broad principles: (1) That the scope and process of the assessment must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness;<sup>5</sup> and (2) that the assessment, including testing, must be supported by reasonable evidential matter.<sup>6</sup> We stated that it was important for each company to use its informed judgment about its own operations, risks, and processes in documenting and evaluating its controls. We continue to believe that management must bring its own experience and informed judgment to bear in designing an assessment process that meets the needs of its company and that provides reasonable assurance as to whether the company's internal control over financial reporting is effective.

While we emphasized the concept of management flexibility in adopting our rules implementing section 404, our rules do require management to base its assessment of a company's internal control on a suitable evaluation framework, in order to facilitate comparability between the assessment reports. It is important to note that our rules do not mandate the use of a particular framework, because multiple frameworks exist and others may be developed in the future. However, in the release adopting the Section 404 requirements, the Commission identified the *Internal Control—Integrated Framework* created and published by the Committee of Sponsoring Organizations of the

Treadway Commission (COSO) as an example of a suitable framework.<sup>7,8</sup>

While the COSO framework provides an integrated framework that identifies the components and objectives of internal control, it does not set forth detailed guidance as to the steps that management must follow in assessing the effectiveness of a company's internal control over financial reporting. We, therefore, distinguish between the COSO framework as an internal control framework and other forms of guidance that illustrate how to conduct an assessment of the effectiveness of internal control over financial reporting. Any additional management guidance that we may issue is not intended to replace or modify the COSO framework or any other suitable framework.

In determining the need for additional guidance to management on how to conduct its assessment, it is important to consider the steps that already have been taken by the Commission and others to provide guidance to companies and audit firms. The Commission held its first roundtable discussion about implementation of the internal control reporting provisions on April 13, 2005. The Commission held the 2005 roundtable to seek input to consider the impact of the section 404 reporting requirements in view of the fact that the

<sup>7</sup> See COSO, *Internal Control—Integrated Framework* (1992). In 1994, COSO published an addendum to the *Reporting to External Parties* volume of the COSO Report. The addendum discusses the issue of, and provides a vehicle for, expanding the scope of a public management report on internal control to address additional controls pertaining to safeguarding of assets. In 1996, COSO issued a supplement to its original framework to address the application of internal control over financial derivative activities.

The COSO framework is the result of an extensive study of internal control to establish a common definition of internal control that would serve the needs of companies, independent public accountants, legislators, and regulatory agencies, and to provide a broad framework of criteria against which companies could evaluate and improve their control systems. The COSO framework divides internal control into three broad objectives: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Our rules relate only to reliability of financial reporting. Each of the objectives in the COSO framework is further broken down into five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring. Under the COSO framework, management is able to monitor, evaluate, and improve their control systems through the use of the five components.

<sup>8</sup> In that release, we also cited the *Guidance on Assessing Control* published by the Canadian Institute of Chartered Accountants and the *Turnbull Report* published by the Institute of Chartered Accountants in England & Wales as examples of other suitable frameworks that issuers could choose in evaluating the effectiveness of their internal control over financial reporting. We encourage companies to examine and select a framework that may be useful in their own circumstances and the further development of alternative frameworks.

<sup>5</sup> See Adopting Release at Section II.B.3.d.

<sup>6</sup> See Adopting Release at Section II.B.3.d.

implementation of the requirements resulted in a major change for management and auditors. A broad range of interested parties, including representatives of managements and boards of domestic and foreign public companies, auditors, investors, legal counsel, and board members of the PCAOB, participated in the discussion. We also invited and received written submissions from the public regarding section 404 in advance of the roundtable.

Feedback obtained from the 2005 roundtable indicated that the internal control reporting requirements had led to increased focus by management on internal control over financial reporting. However, the feedback also identified particular implementation areas in need of further clarification to reduce unnecessary costs and burdens without jeopardizing the benefits of the new requirements.

In response to this feedback, the Commission and its staff issued guidance on May 16, 2005.<sup>9</sup> An overarching message of that guidance was that it is the responsibility of management, not the auditor, to determine the appropriate nature and form of internal controls for the company and to scope their evaluation procedures accordingly. Additionally, based on feedback received, a number of the implementation issues arose from an overly conservative application of the Commission rules and AS No. 2, and the requirements of AS No. 2 itself, as well as questions regarding the appropriate role of the auditor. Accordingly, much of the guidance in the staff statement emphasized and clarified existing provisions of the rules and other Commission guidance relating to the exercise of professional judgment, the concept of reasonable assurance, and the permitted communications between management and auditors.

The staff's guidance addressed implementation issues in the following seven areas:

<sup>9</sup> *Commission Statement on Implementation of Internal Control Reporting Requirements*, Press Release No. 2005-74 (May 16, 2005) (hereinafter "May 2005 Commission Guidance"); Division of Corporation Finance and Office of Chief Accountant: *Staff Statement on Management's Report on Internal Control Over Financial Reporting* (May 16, 2005) (hereinafter "May 2005 Staff Guidance") available at [SEC.gov/spotlight/soxcom/.htm](http://SEC.gov/spotlight/soxcom/.htm).

Also on May 16, 2005, the PCAOB and its staff issued guidance to auditors on their audits under Auditing Standard No. 2. The PCAOB's guidance focused on areas in which the efficiency of the audit could be substantially improved. Topics included the importance of the integrated audit, the role of risk assessment throughout the process, the importance of taking a top-down approach, and auditors' use of the work of others.

- The purpose of internal control over financial reporting;

- The concept of reasonable assurance, the importance of a top-down, 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 businesses and foreign private issuers.

Overall, the May 16, 2005 guidance was well-received, and some commenters have indicated there has been some improvement in the effectiveness and efficiency of section 404 compliance efforts. However, some constituents, especially smaller public companies, continue to request the provision of additional guidance. For example, in its Final Report to the Commission, issued on April 23, 2006, the Commission's Advisory Committee on Smaller Public Companies raised a number of concerns it perceived regarding the ability of smaller companies to comply cost-effectively with the requirements of section 404. The Advisory Committee identified as an overarching concern the difference in how smaller and larger public companies operate. The Advisory Committee focused in particular on three characteristics: (1) The limited number of personnel in smaller companies constrains the companies' ability to segregate conflicting duties; (2) top management's wider span of control and more direct channels of communication increase the risk of management override; and (3) the dynamic and evolving nature of smaller companies limits their ability to maintain well-documented static business processes.<sup>10</sup>

The Advisory Committee suggests these characteristics create unique differences in how smaller companies achieve effective internal control over financial reporting that may not be adequately accommodated in AS No. 2 or other implementation guidance as currently applied in practice.<sup>11</sup> In addition, the Advisory Committee noted serious cost ramifications for smaller public companies stemming from the cost of frequent documentation change

<sup>10</sup> *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission* (April 23, 2006) (hereinafter "Advisory Committee Report") at 35-36, available at <http://SEC.gov/info/smallbus/acspc.shtml>.

<sup>11</sup> Advisory Committee Report at 37, available at <http://SEC.gov/info/smallbus/acspc.shtml>.

and sustained review and testing for perceived compliance with section 404.

The Advisory Committee's final report set forth several recommendations for the Commission to consider regarding the application of the section 404 requirements to smaller public companies. The Advisory Committee recommended partial or complete exemptions for specified types of smaller public companies from the internal control reporting requirements under certain conditions, unless and until a framework is developed for assessing internal control over financial reporting that recognizes the characteristics and needs of those companies. The Advisory Committee also recommended, among other things, that COSO and the PCAOB provide additional guidance to help facilitate the design and assessment of internal control over financial reporting and make processes related to internal control more cost-effective.<sup>12</sup> In addition, some commenters on the Advisory Committee's exposure draft of its report suggested that the Commission reexamine the appropriate role of outside auditors in connection with the management assessment required by Section 404.<sup>13</sup>

Further, in April 2006, the U.S. Government Accountability Office issued a Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, entitled *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, which recommends that in considering the concerns of the Advisory Committee, the Commission should assess the available guidance on management's assessment to determine whether it is sufficient or whether additional action is needed. The report indicates that management's implementation and assessment efforts were largely driven by AS No. 2, as guidance at a similar level of detail was not available for management's implementation and assessment process.<sup>14</sup> Further, the GAO report recommended that the Commission coordinate with the PCAOB to help ensure that the section 404-related audit standards and guidance are consistent with any

<sup>12</sup> Advisory Committee Report at 52, available at <http://SEC.gov/info/smallbus/acspc.shtml>.

<sup>13</sup> See, e.g., letter from BDO Seidman, LLP (April 3, 2006), available at <http://SEC.gov/info/smallbus/acspc.shtml>.

<sup>14</sup> United States Government 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* (April 2006) (hereinafter "GAO Report") at 52-53.

additional management guidance issued.<sup>15</sup>

On May 10, 2006, the Commission and PCAOB conducted a second Roundtable on Internal Control Reporting and Auditing Provisions to solicit feedback on accelerated filers' second year of compliance with the section 404 requirements. Although some participants expressed reservations about changing the processes they have already implemented, a number of the participants expressed at the roundtable and in their written comments the view that additional guidance was needed.<sup>16</sup>

COSO plans to publish additional application guidance on its control framework in the near future.<sup>17</sup> This guidance is intended to assist the management of smaller companies in understanding and applying the COSO framework. It is expected that COSO's new guidance will outline principles fundamental to the five components of internal control described in the COSO framework. The guidance will define each principle and describe the attributes of each, list a variety of approaches that smaller companies can use to apply the principles, and include examples of how smaller companies have applied the principles. As noted in the May 17, 2006 announcement, we anticipate that this guidance will help organizations of all sizes to better understand and apply the COSO framework as it relates to internal control over financial reporting.

We are issuing this Concept Release to understand better the extent of public interest in the development of additional guidance for management regarding its evaluation and assessment of internal control over financial reporting. As noted in our May 17, 2006 announcement, so that this guidance might be helpful to all companies, the Commission currently intends that any future guidance we issue will be scalable and responsive to individual circumstances. We also are interested in understanding what additional guidance accelerated filers would find helpful.<sup>18</sup>

<sup>15</sup> GAO Report at 58.

<sup>16</sup> See transcript of Roundtable on Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 1, 2, 3, and 5; letter from The Institute of Internal Auditors (IIA) (May 1, 2006); letter from Institute of Management Accountants (IMA) (May 4, 2006); letter from Canadian Bankers Association (CBA) (April 28, 2006); letter from Deloitte & Touche LLP (May 1, 2006); letter from Ernst & Young LLP (May 1, 2006); letter from KPMG LLP (May 1, 2006); letter from PricewaterhouseCoopers LLP (May 1, 2006) and letter from Pfizer Inc. (May 1, 2006).

<sup>17</sup> See letter from Larry Rittenberg, COSO (May 16, 2006) [File Number 4-511].

<sup>18</sup> We emphasize that the publication of this Concept Release does not reflect a general

1. Would additional guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting be useful? If so, would additional guidance be useful to all reporting companies' subject to the Section 404 requirements or only to a sub-group of companies? What are the potential limitations to developing guidance that can be applied by most or all reporting companies' subject to the section 404 requirements?

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

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

4. Are there additional topics, beyond what is addressed in this Concept Release, that the Commission should consider issuing guidance on? If so, what are those topics?

5. Would additional guidance in the format of a Commission rule be preferable to interpretive guidance? Why or why not?

6. What types of evaluation approaches have managements of accelerated filers found most effective and efficient in assessing internal control over financial reporting? What approaches have not worked, and why?

7. Are there potential drawbacks to or other concerns about providing additional guidance that the Commission should consider? If so, what are they? How might those drawbacks or other concerns best be mitigated? Would more detailed Commission guidance hamper future efforts by others in this area?

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

dissatisfaction by the Commission with the assessments accelerated filers have completed to date. Rather, we are issuing this Concept Release because we are committed to doing as much as we can to reduce any concerns about the nature and extent of assessment procedures that management must establish and maintain, to assist in making the requirements scalable for companies of all sizes and complexity, and to help companies evaluate internal control over financial reporting in a practical and cost-efficient manner.

companies benefit from the development of additional frameworks?

9. Should the guidance incorporate the May 16, 2005 "Staff Statement on Management's Report on Internal Control Over Financial Reporting"? Should any portions of the May 16, 2005 guidance be modified or eliminated? Are there additional topics that the guidance should address that were not addressed by that statement? For example, are there any topics in the staff's "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised October 6, 2004)"<sup>19</sup> that should be incorporated into any guidance the Commission might issue?

10. We also seek input on the appropriate role of outside auditors in connection with the management assessment required by section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by section 404(b). Should possible alternatives to the current approach be considered and if so, what? Would these alternatives provide investors with similar benefits without the same level of cost? How would these alternatives work?

### III. Risk and Control Identification

While companies have been required to establish and maintain internal accounting controls since the enactment of the Foreign Corrupt Practices Act in 1977,<sup>20</sup> section 404 of the Sarbanes-Oxley Act re-emphasized the importance of the relationship between effective internal controls and reliable financial reporting. An integral element of establishing and maintaining effective internal control over financial reporting involves identifying risks to reliable financial reporting and designing appropriate internal controls that address the risks. The controls that management identifies as addressing risks to financial reporting include those that operate at a company level and are pervasive to many individual account balances and disclosures, as well as those that are specific to certain individual account balances or disclosures. Echoing the Commission's statement in its May 16, 2005 guidance that management must bring reasoned judgment to the process, the staff stated

<sup>19</sup> Available at <http://www.sec.gov/info/accountants/controlfaq1004.htm>.

<sup>20</sup> Title I of Public Law No. 95-213. The FCPA required the Commission to adopt rules requiring public companies to make and keep accurate financial records, and to maintain a system of internal accounting controls. See Exchange Act section 13(b).

that management should use its cumulative knowledge, experience, and judgment (applying both qualitative and quantitative factors) in identifying these controls and designing the appropriate procedures for their documentation and testing.<sup>21</sup>

Feedback that the Commission has received indicates that, in implementing the requirements of section 404, many companies did not efficiently and effectively identify risks to reliable financial reporting and relevant internal control functions, ultimately leading to the identification, documentation, and testing of an excessive number of controls.<sup>21</sup> We are also skeptical of the large number of internal controls that some companies have identified, documented and tested. While there were likely numerous contributing factors to these implementation issues, one cause may have been the overly conservative application of AS No. 2 by auditors in the initial years.

The Commission also has heard that companies had difficulty in determining how controls related to the prevention of fraud should be included in their risk assessment.<sup>22</sup> However, as noted in the May 16, 2005 staff guidance, while no system of internal control can prevent or detect every instance of fraud, effective internal control over financial reporting can help companies deter fraudulent financial accounting practices or detect them earlier.

As noted above, the Advisory Committee observed that the distinct characteristics of smaller public companies affect the financial reporting risks and the controls needed to address them. For example, the significant risk of management override that arises from wider spans of control and more direct channels of communication may create an increased need for entity level controls and board oversight. Moreover, the difficulty in segregating duties and changing business processes may impact the implementation of internal controls at these companies.

We anticipate additional guidance in this area would cover a number of the implementation issues that have arisen during the first two years of compliance. Guidance issued in this area would address how management should determine the overall objectives for internal control over financial reporting

<sup>21</sup> See transcript of Roundtable on Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 2 and 3; letter from Protiviti Inc. (April 28, 2006); letter from Computer Sciences Corporation (CSC) (April 28, 2006); and letter from IMA (May 4, 2006).

<sup>22</sup> See letter from QUALCOMM Inc. (April 27, 2006); and letter from Diane Allen, 3M (Allen) (April 28, 2006).

and identify the related risks. In determining the objectives for internal control over financial reporting, the guidance would discuss how management might address company-level, financial statement account and disclosure level considerations, as well as fraud risks. Additionally, we anticipate that we would provide additional guidance on how management identifies the controls to address the recognized risks. This would include guidance on common issues that exist in identifying controls (e.g. materiality considerations, multi-location issues, concept of "key" controls).

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

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

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

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

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

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

in the guidance? If so, how should that guidance reflect the special characteristics and needs of smaller public companies?

17. Should the Commission provide management with guidance about fraud controls? If so, what type of guidance? Is there existing private sector guidance that companies have found useful in this area? For example, have companies found the 2002 guidance issued by the AICPA Fraud Task Force entitled "Management Antifraud Programs and Controls"<sup>23</sup> useful in assessing these risks and controls?

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

#### IV. Management's Evaluation

As noted, the Commission's and the staff's May 16, 2005 guidance emphasized that management's assessment should be based on the particular risks of individual companies, and recommended a top-down, risk-based approach to determine the accounts and related processes that management should consider in its assessment. Therefore, management's judgments about the significance and complexity of the risk areas it has identified should form the basis not only for determining what controls to evaluate, but also for determining the nature, timing, and extent of its evaluation procedures. A risk-based evaluation can allow management to assess whether the company's internal control over financial reporting is effective at a "reasonable assurance" level.<sup>24</sup>

One of the reasons cited most frequently by accelerated filers for the higher than anticipated costs in their first year of compliance with the section 404 requirements is that too much work was done to test and document low-risk areas.<sup>25</sup> The Commission continues to hear that management has difficulty applying a top-down, risk-based

<sup>23</sup> Management Antifraud Programs and Controls: Guidance to Help Prevent and Deter Fraud, commissioned by the Fraud Task Force of the American Institute of Certified Public Accountants' Auditing Standards Board (2002), available at <http://www.aicpa.org/download/members/div/auditstd/AU-00316.PDF>.

<sup>24</sup> See Rules 13a-15(f) and 15d-15(f) of the Exchange Act.

<sup>25</sup> See transcript of Roundtable on Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 2 and 3; letter from Watson Wyatt Worldwide (March 31, 2006); letter from QUALCOMM Inc. (April 27, 2006); and letter from Association for Financial Professionals (May 1, 2006).

approach in their individual assessments and some believe that compliance costs are, and may continue to be, higher than necessary.<sup>26</sup>

The Commission's rules require that management's assessment be "as of" the company's fiscal year end, but the rules do not preclude management from obtaining evidence to support its assessment through cumulative knowledge it acquires throughout the year and in prior years. In fact, management's daily interactions with its internal controls may provide it with an enhanced ability to make informed judgments regarding the areas that present the greatest risk to the reliability of the financial statements, as well as how to evaluate the relevant controls. We have heard anecdotal evidence that, in some cases, management may have unnecessarily tested controls using separate evaluation-type testing in connection with its annual assessment, rather than relying on its ongoing monitoring activities, which may include, for example, cumulative knowledge and experiences from its daily interactions with controls.

In addition to testing, another key part of management's assessment process is the evaluation of control deficiencies it discovers in the process of its evaluation. Paramount to evaluating the significance of an individual control deficiency, or combination of control deficiencies, is to have a comprehensive understanding of 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 effective compensating controls exist.<sup>27</sup> Management must exercise judgment in a reasonable manner in the evaluation of deficiencies in internal control, considering both quantitative and qualitative factors.<sup>28</sup>

As noted above, the Advisory Committee observed that the distinct characteristics of smaller public companies affect the assessment of financial reporting risks and the controls implemented to address them. These characteristics may also affect how those companies evaluate their internal control.

Another area where the Commission continues to hear that companies are having difficulty in completing their assessment of internal control over

financial reporting involves the impact of information technology (IT) processes. For example, some commenters have expressed concerns over the extent to which IT processes should be included in the scope of their assessment.<sup>29</sup> As the staff's May 16, 2005 staff guidance indicates, Section 404 is not a one-size-fits-all approach to assessing controls, and for that reason, while we believe that controls not related to internal control over financial reporting should not be included in the assessment, providing a list of the exact general IT controls that should be included in an assessment may not be practical. Given that fact, we would like to explore whether there are specific areas related to IT where additional guidance could be provided.

Based on the cumulative feedback received, we believe that guidance on management's evaluation process and revisions to AS No. 2 may help reduce or eliminate the excessive testing of internal controls by improving the focus on risk and better use of entity-level controls. We anticipate that the guidance would cover topics such as the overall objective of evaluation procedures; methods or approaches available to management to gather evidence to support its assessment (*i.e.* on-going monitoring, benchmarking, and updating prior evaluations); and factors that management should consider in determining the nature, timing and extent of its evaluation procedures. This guidance would address whether and how entity-level controls may adequately address risk at the financial statement and disclosure level and considerations as to the extent information technology general controls are included in the scope of management's assessment. Further, we anticipate the guidance would cover considerations of management in determining the severity of an identified control deficiency.

19. What type of guidance would help explain how entity-level controls can reduce or eliminate the need for testing at the individual account or transaction level? If applicable, please provide specific examples of types of entity-level controls that have been useful in reducing testing elsewhere.

20. Would guidance on how management's assessment can be based on evidence other than that derived from separate evaluation-type testing of

controls, such as on-going monitoring activities, be useful? What are some of the sources of evidence that companies find most useful in ongoing monitoring of control effectiveness? Would guidance be useful about how management's daily interaction with controls can be used to support its assessment?

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

22. In situations where management determines that separate evaluation-type testing is necessary, what type of additional guidance to assist management in varying the nature and extent of the evaluation procedures supporting its assessment would be helpful? Would guidance be useful on how risk, materiality, attributes of the controls themselves, and other factors play a role in the judgments about when to use separate evaluations versus relying on ongoing monitoring activities?

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

24. What type of guidance would be appropriate regarding the evaluation of identified internal control deficiencies? Are there particular issues in evaluating deficient controls that have only an indirect relationship to a specific financial statement account or disclosure? If so, what are some of the key considerations currently being used when evaluating the control deficiency?

25. Would guidance be helpful regarding the definitions of the terms "material weakness" and "significant deficiency"? If so, please explain any issues that should be addressed in the guidance.

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

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

<sup>26</sup> See transcript of Roundtable on Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 1 and 2; letter from Pfizer Inc. (May 1, 2006); letter from Sotheby's Holdings, Inc. (May 1, 2006); and letter from U.S. Chamber of Commerce (May 3, 2006).

<sup>27</sup> See May 2005 Staff Guidance at B.

<sup>28</sup> *Id.*

<sup>29</sup> See transcript of Roundtable on Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 2 and 3; letter from IIA (May 1, 2006); letter from CSC (April 28, 2006); letter from Allen (April 28, 2006); letter from WPS Resources Corp. (May 5, 2006); and letter from R.G. Scott & Associates, LLC (April 8, 2006).

company's internal control over financial reporting?

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

29. Is guidance needed to help companies determine which IT general controls should be tested? How are companies determining which IT general controls could impact IT application controls directly related to the preparation of financial statements?

30. Has management generally been utilizing proprietary IT frameworks as a guide in conducting the IT portion of their assessments? If so, which frameworks? Which components of those frameworks have been particularly useful? Which components of those frameworks go beyond the objectives of reliable financial reporting?

#### V. Documentation to Support the Assessment

Developing and maintaining an appropriate amount of evidential matter is an inherent element of effective internal control.<sup>30</sup> This evidential matter should provide reasonable support for the assessment of whether controls are designed to prevent or detect material misstatements or omissions; for the conclusion that tests to assess the effectiveness of internal control were appropriately planned and performed; and for the conclusion that the results of such tests were appropriately considered in management's conclusion about effectiveness.<sup>31</sup> Further, public accounting firms that attest to, and report on, management's assessment of

<sup>30</sup> Section 13(b)(2)(A) of the Exchange Act requires companies to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." We have previously stated, as a matter of policy, that under section 13(b)(2) "every public company needs to establish and maintain records of sufficient accuracy to meet adequately four interrelated objectives: appropriate reflection of corporate transactions and the disposition of assets; effective administration of other facets of the issuer's internal control system; preparation of its financial statements in accordance with generally accepted accounting principles; and proper auditing." Statement of Policy Regarding the Foreign Corrupt Practices Act of 1977, Release No. 34-17500 (January 29, 1981) [46 FR 11544].

<sup>31</sup> Instruction 1 to Item 308 of Regulations S-K and S-B, Instruction 1 to Item 15 of Form 20-F and Instruction 1 to paragraphs (b), (c), (d), and (e) of General Instruction B.6 to Form 40-F provide that: "the Registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting."

the effectiveness of the company's internal control over financial reporting may review evidential matter supporting management's assessment.<sup>32</sup>

Feedback that the Commission received in connection with its 2005 Roundtable and other feedback on the first year of compliance indicates that, in implementing the requirements of section 404 for the first time, many companies approached risk and control identification more formally than they may have historically and, consequently, companies may have incurred significant documentation costs.<sup>33</sup> This documentation consisted of, among other things, detailed process maps describing controls over initiating, recording, processing and reconciling account balances, classes of transactions, and disclosures included in the financial statements. Many companies also have indicated that in their initial implementation of section 404, too many controls were identified, which resulted in excessive documentation.<sup>34</sup> Frequently, this excessive documentation was blamed, at least in part, on the auditors and their application of AS No. 2. Further, we have anecdotally heard that this documentation, in many cases, substantially exceeded that normally produced by financial institutions under the Federal Deposit Insurance Corporation Improvement Act of 1991.<sup>35</sup>

<sup>32</sup> AS No. 2 sets forth the criteria auditors should use when evaluating whether management's documentation provides reasonable support for its assessment of internal control over financial reporting. See ¶¶ 42-46 of PCAOB Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

<sup>33</sup> See transcript of Roundtable on Implementation of Internal Control Reporting Provisions, April 13, 2005; letter from Mortgage Bankers Association (February 25, 2005); letter from Paula Jourde (March 4, 2005); letter from White Mountains Insurance Group (March 29, 2005); and letter from Intel Corporation (March 31, 2005).

<sup>34</sup> See transcript of Roundtable on Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 1 and 2; letter from IIA (May 1, 2006); letter from America's Community Bankers (May 1, 2006); letter from Stephan Stephanov (March 27, 2006); and letter from Institute of Chartered Accountants in England and Wales (March 28, 2006).

<sup>35</sup> 12 U.S.C. 1831m. Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 added section 36, "Independent Annual Audits of Insured Depository Institutions," to the Federal Deposit Insurance Act. Section 36 required the Federal Deposit Insurance Corporation, in consultation with appropriate federal banking agencies, to promulgate regulations requiring each insured depository institution with at least \$150 million in total assets, as of the beginning of its fiscal year, to have an annual independent audit of its financial statements performed in accordance with generally accepted auditing standards, and to provide a management report and an independent public accountant's attestation concerning both the effectiveness of the institution's internal control

notwithstanding substantially similar statutory language to that found in section 404.

In its report, the Advisory Committee suggested that smaller public companies have unique characteristics and needs for flexibility that make the documentation elements of section 404 particularly burdensome for those companies. In its opinion, the section 404 internal control reporting requirements as currently applied in practice might impose a lack of flexibility on smaller public companies that would put them at a competitive disadvantage. We have also heard that excessive documentation demands might impose extra or particularly burdensome costs on smaller public companies.

The Commission anticipates that management would benefit from additional guidance on the appropriate and required levels of documentation to support their assertion on the effectiveness of internal control over financial reporting. Topics addressed might include clarifying the overall objectives of the documentation, including factors that might influence documentation requirements and other common documentation concerns (e.g. updating of previously created documentation or how to address controls for which operation does not result in documented evidence). We also anticipate that guidance might be helpful in addressing the flexibility and cost containment needs of smaller public companies in particular.

31. Were the levels of documentation performed by management in the initial years of completing the assessment beyond what was needed to identify controls for testing? If so, why (e.g., business reasons, auditor required, or unsure about "key" controls)? Would specific guidance help companies avoid this issue in the future? If so, what factors should be considered?

32. What guidance is needed about the form, nature, and extent of documentation that management must maintain as evidence for its assessment of risks to financial reporting and control identification? Are there certain factors to consider in making judgments about the nature and extent of documentation (e.g., entity factors, process, or account complexity factors)? If so, what are they?

33. What guidance is needed about the extent of documentation that management must maintain about its evaluation procedures that support its

structure and procedures for financial reporting and its compliance with designated safety and soundness laws.

annual assessment of internal control over financial reporting?

34. Is guidance needed about documentation for information technology controls? If so, is guidance needed for both documentation of the controls and documentation of the testing for the assessment?

35. How might guidance be helpful in addressing the flexibility and cost containment needs of smaller public companies? What guidance is appropriate for smaller public companies with regard to documentation?

#### VI. Solicitation of Additional Comments

In addition to the areas for comment identified above, we are interested in any other issues that commenters may wish to address relating to companies' compliance with the SEC's rules related to management's assessment of internal control over financial reporting. For example, we are interested in whether commenters believe that there are additional topics not addressed in this Concept Release for which guidance would be useful. We also invite commenters to provide to us

descriptions of, or actual process plans, that they have utilized or created for portions or all of management's assessment. Please be as specific as possible in your discussion and analysis of any additional issues. Where possible, please provide empirical data or observations to support or illustrate your comments.

By the Commission.

Dated: July 11, 2006.

**Jill M. Peterson,**

*Assistant Secretary.*

[FR Doc. E6-11226 Filed 7-17-06; 8:45 am]

BILLING CODE 8010-01-P

**Corbett, Bryan N.**

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**From:** Shimkus, Matthew [SHIMKUSM@SEC.GOV]  
**Sent:** Wednesday, August 09, 2006 10:31 AM  
**To:** undisclosed-recipients  
**Subject:** SEC Offers Further Relief from Section 404 Compliance for Smaller Public Companies and Many Foreign Private Issuers

## **SEC OFFERS FURTHER RELIEF FROM SECTION 404 COMPLIANCE FOR SMALLER PUBLIC COMPANIES AND MANY FOREIGN PRIVATE ISSUERS**

**FOR IMMEDIATE RELEASE**  
**2006-136**

*Washington D.C., Aug. 9, 2006* - The Securities and Exchange Commission today issued two releases to grant smaller public companies and many foreign private issuers further relief from compliance with Section 404 of the Sarbanes-Oxley Act of 2002. The relief is in furtherance of the "next steps for Sarbanes-Oxley implementation" (SEC Press Release 2006-75) announced on May 17, 2006, and includes some new initiatives not previously announced.

Today's releases follow the July 11, 2006, publication of a Concept Release soliciting public comment on guidance for management the SEC plans to issue to assist companies in assessing their internal controls over financial reporting.

"The actions taken in these releases continue the Commission's efforts to be sensitive and responsive to the particular needs of smaller public companies and foreign private issuers, and to minimize the burdens that Section 404 may impose on them," said SEC Chairman Christopher Cox. "By offering further relief for smaller companies and most foreign issuers, today's actions will allow time for the Commission and the PCAOB to redesign Section 404 implementation in a way that is efficient and cost effective for investors."

A summary of the subjects of the two releases appears below:

- 1. Relief from Section 404 Compliance Dates for Smaller Companies (Non-Accelerated Filers).** The Commission is proposing to grant relief to smaller public companies by extending the date by which non-accelerated filers must start providing a report by management assessing the effectiveness of the company's internal control over financial reporting. The initial compliance date for these companies would be moved from fiscal years ending on or after July 15, 2007, until fiscal years ending on or after Dec. 15, 2007. The Commission also proposes to extend the date by which non-accelerated filers must begin to comply with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports. This deadline would be moved to the first annual report for a fiscal year ending on or after Dec. 15, 2008. This proposed extension would result in all non-accelerated filers being required to complete only the management's portion of the internal control requirements in their first year of compliance with the requirements. This proposal is intended to provide cost savings and efficiency opportunities to smaller public companies and to assist them as they prepare to comply fully with Section 404's reporting requirements. This proposed extension will provide these issuers and their auditors an additional year to consider, and adapt to, the changes in Auditing Standard No. 2 that the Commission and the Public Company Accounting Oversight Board intend to make, as well as the guidance for management the SEC intends to issue, to improve the efficiency of the Section 404(b) auditor attestation report process.

Approximately 44% of the domestic companies and 38% of the foreign private issuers that file periodic reports with the Commission are non-accelerated filers.

The Commission seeks public comment on all aspects of this proposal. Comments should be submitted within 30 days of the proposal's publication in the Federal Register.

2. **Relief from Section 404(b) Compliance Date for Certain Foreign Private Issuers.** The Commission is granting relief from Section 404(b) compliance for foreign private issuers that are accelerated filers (but not large accelerated filers), and that file their annual reports on Form 20-F or 40-F. These companies will have their compliance deadline extended for an additional year, so that they will not begin complying with the Section 404(b) requirement to provide an auditor's attestation report on internal control over financial reporting in their annual reports until fiscal years ending on or after July 15, 2007. This group of issuers will be required to comply only with the Section 404 requirement to include management's report in the Form 20-F or 40-F annual report filed for their first fiscal year ending on or after July 15, 2006. They will not need to comply with the requirement to provide the registered public accounting firm's attestation report until they file a Form 20-F or 40-F annual report for a fiscal year ending on or after July 15, 2007.

The Commission's data indicate that about 23% of the approximately 1,200 foreign private issuers that are subject to the Exchange Act reporting requirements are accelerated filers that will receive the one-year extension of the compliance dates for the Section 404(b) auditor attestation requirement. Because approximately 38% of foreign private issuers are non-accelerated filers that will benefit from the steps outlined in Item 1 above, over 60% of the community of foreign private issuers will receive a measure of relief as a result of the actions we're announcing today. The Commission's actions today do not change the date by which a foreign private issuer that is a large accelerated filer must comply with both the Section 404(a) and (b) requirements. These filers are required to include both a report by management and an attestation report by the issuer's registered accounting firm on internal control over financial reporting in their Form 20-F or 40-F filed for a fiscal year ending on or after July 15, 2006.

This extension is a final Commission action and will be effective shortly, on the date that the Commission release granting the extension is published in the Federal Register.

3. **Proposed Transition Relief for Newly Public Companies.** In the same release in which it proposes an extension of the Section 404 compliance dates for non-accelerated filers, the Commission also proposes a transition period for newly public companies. This transition relief would apply to any company that has become public through an IPO or a registered exchange offer, or that otherwise becomes subject to the Exchange Act reporting requirements. It would include a foreign private issuer that is listing on a U.S. exchange for the first time. To provide meaningful relief to companies that are new to the U.S. markets and our reporting requirements, the Commission is proposing to amend its rules so that a company would not be required to provide either a management assessment or an auditor attestation report until it has previously filed one annual report with the Commission. This relief is being proposed in recognition of the fact that preparation of a newly public company's first annual report can be a time and resource intensive process that may quickly follow an IPO or initial listing. By not requiring the Section 404 reports until a newly public company files its second annual report with the SEC, the Commission hopes to increase the efficiency and effectiveness with which those companies ultimately meet their Section 404 compliance obligations.

The Commission seeks public input on this proposal from foreign and domestic companies, their financial and other advisors, investors and other interested members of the public. As with the proposed extension for smaller public companies, comments on this proposal

should be submitted within 30 days of publication in the Federal Register.

"We have heard that the Section 404 reporting requirements impose a special burden on foreign private issuers, smaller companies and newly public companies. These companies play an important role in our capital markets, and these releases illustrate the Commission's commitment to improving the efficiency and effectiveness of Section 404 implementation for them," said John W. White, Director of the Division of Corporation Finance. "We believe our proposed transition relief for newly public companies should enhance the attractiveness and cost-effectiveness of participating in our markets both for companies contemplating IPO's and for foreign companies considering listing in the U.S. for the first time, without sacrificing important investor protections, and we look forward to receiving comment from a diversity of interested parties on that proposal."

The Commission will continue to work on its own, and with the Public Company Accounting Oversight Board, to take several additional steps previously outlined on May 17, 2006, in SEC Press Release 2006-75 to improve the implementation of Section 404 so that it will work efficiently and effectively for companies and auditors of all sizes.

► Additional materials: [Release No. 33-8730](#); [Release No. 33-8731](#)

**SEC Spotlight On:**  
**Internal Control Reporting Provisions**  
<http://www.sec.gov/spotlight/soxcomp.htm>



## U.S. Securities and Exchange Commission

### SEC Announces Next Steps for Sarbanes-Oxley Implementation

**FOR IMMEDIATE RELEASE  
2006-75**

Washington, D.C., May 17, 2006 - The Securities and Exchange Commission today announced a series of actions it intends to take to improve the implementation of the Section 404 internal control requirements of the Sarbanes-Oxley Act of 2002.

The actions the Commission intends to take include issuing SEC guidance for companies and working with the Public Company Accounting Oversight Board (PCAOB) on revisions of its internal control auditing standard. These actions are based on extensive analysis and commentary in recent months from investors, companies, auditors, and others. The expected actions will also include SEC inspections of PCAOB efforts to improve Section 404 oversight and a brief further postponement of the Section 404 requirements for the smallest company filers, although ultimately all public companies will be required to comply with the internal control reporting requirements of Section 404.

"The steps we are announcing today are designed to further improve the reliability of financial statements and to better protect investors while making the Section 404 process more efficient and cost effective," said SEC Chairman Christopher Cox. "As we go forward, we will consider the special concerns of all companies that fall under our jurisdiction -- large and small, foreign and domestic. By providing practical guidance to companies, by working with the Public Company Accounting Oversight Board on their forthcoming revised standard for auditors, and by examining how the PCAOB inspection process is succeeding in increasing the efficiency and cost-effectiveness of the audit process, we will take a giant step toward 'getting it right' when it comes to Section 404 compliance."

In recent months, the Commission has obtained comment from a variety of sources concerning the operation and effects of Section 404, including:

- The May 10, 2006, SEC Roundtable on Second-Year Experiences with Internal Control Reporting and Auditing Provisions;
- Written comments received in connection with the Roundtable;
- The April 23, 2006, Report of the SEC Advisory Committee on Smaller Public Companies;
- The April 2006 Report from the U.S. Government Accountability Office entitled *Sarbanes-Oxley Act, Consideration of Key Principles Needed*

*in Addressing Implementation for Smaller Public Companies; and*

- Feedback from issuers, auditors, investors, and others since the Sarbanes-Oxley internal control reporting requirements went into effect.

"The actions the Commission is announcing today represent key steps toward addressing issues raised by participants involved in the critical process of reporting to investors on the effectiveness of companies' internal control over financial reporting," said John White, Director of the Commission's Division of Corporation Finance. "We will be working on our own, and with the PCAOB, to improve the implementation of Section 404 so that it will work efficiently and effectively for companies and auditors of all sizes and types while still maintaining the important investor protections it provides."

The actions the Commission expects to take include:

- **Guidance for Companies.** The Commission has received many requests for additional guidance for management on how to complete its assessment of internal control over financial reporting, as required by Section 404(a) of the Sarbanes-Oxley Act. To prepare for the issuance of management guidance, the Commission intends to take the following steps:
  - **Concept Release and Opportunity for Public Comment.** The Commission expects to issue a Concept Release covering a variety of issues that might be the subject of Commission guidance for management. With the Concept Release, the Commission will solicit views on the management assessment process to ensure that the guidance the Commission ultimately proposes addresses the needs and concerns of all public companies. We will also seek input on the appropriate role of outside auditors in connection with the management assessment required by Section 404(a) of Sarbanes-Oxley, and on the manner in which outside auditors provide the attestation required by Section 404(b), to assist in our consideration of possible alternatives to the current approach.
  - **Consideration of Additional Guidance from COSO.** The Commission has long been supportive of the Committee of Sponsoring Organizations of the Treadway Commission (COSO) as it works to provide guidance on COSO's 1992 Internal Control - Integrated Framework to address the needs of smaller companies. The Commission anticipates that this forthcoming guidance will help organizations of all sizes to better understand and apply the control framework as it relates to internal control over financial reporting. As the SEC develops guidance for management on how to assess its internal control over financial reporting, we will consider the extent to which the additional guidance that COSO provides is useful to smaller public companies in completing their Section 404(a) assessments.
  - **Issuance of Guidance.** Commentary submitted to the Commission has suggested that management assessments

under Section 404 have not fully reflected the top-down, risk-based approach the Commission intended. Building from the information gathered in response to the Concept Release, and from the anticipated COSO guidance, the Commission currently anticipates that it will issue guidance to management to assist in its performance of a top-down, risk-based assessment of internal control over financial reporting. To ensure that this guidance is of help to non-accelerated filers and smaller public companies, the Commission intends that this future guidance will be scalable and responsive to their individual circumstances. The guidance will also be sensitive to the fact that many companies have already invested substantial resources to establish and document programs and procedures to perform their assessments over the last few years. The form of the guidance has yet to be determined.

- **Revisions to Auditing Standard No. 2.** The PCAOB announced today that it intends to propose revisions to its Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements. Any final revision of AS No. 2 would be subject to SEC approval. The proposed revisions would:
  - Seek to ensure that auditors focus during integrated audits on areas that pose higher risk of fraud or material error;
  - Incorporate key concepts contained in the guidance issued by the PCAOB on May 16, 2005; and
  - Revisit and clarify what, if any, role the auditor should play in evaluating the company's process of assessing internal control effectiveness.

The Commission will work closely with the PCAOB to ensure that the proposed revisions to AS No. 2 are in the public interest and consistent with the protection of investors.

- **SEC Oversight of PCAOB Inspection Program.** The PCAOB announced on May 1, 2006, that it would focus its 2006 inspections on whether auditors have achieved cost-saving efficiencies in the audits they have performed under AS No. 2, and on whether auditors have followed the guidance that the PCAOB issued in May and November 2005 urging them to do so. As part of the Commission's oversight of the PCAOB, the Commission staff inspects aspects of the PCAOB's operations, including its inspection program. Among other things, upon completion of the PCAOB's 2006 inspections, the staff will examine whether the PCAOB inspections of audit firms have been effective in encouraging implementation of the principles outlined in the PCAOB's May 1, 2006, statement.
- **Extension of Compliance for Non-Accelerated Filers.** In order to permit non-accelerated filers and their auditors to have the benefit of the management guidance that the SEC intends to issue, and to have the opportunity to evaluate and implement the revisions that the PCAOB plans to make to AS No. 2, the Commission expects to issue a

short postponement of the effective date of the Commission's rules implementing Section 404 for non-accelerated filers. It is anticipated that any such postponement would nonetheless require all filers to comply with the management assessment required by Section 404(a) of Sarbanes-Oxley for fiscal years beginning on or after Dec. 16, 2006.

The Commission is also taking this opportunity to express again its appreciation to its Advisory Committee on Smaller Public Companies for their significant efforts and valuable contributions to the Commission's work, both with regard to Section 404 and other issues affecting smaller companies.

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<http://www.sec.gov/news/press/2006/2006-75.htm>

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## Standards and Related Rules

### **Auditing Standard No. 2: An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements**

This standard was approved by the Securities and Exchange Commission on June 17, 2004, and is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002.

Auditing Standard No. 2

Policy Statement Regarding Implementation of Auditing Standard No. 2 (5/16/2005)

Report on the Initial Implementation of Auditing Standard No. 2 (11/30/2005)

Staff Questions and Answers on Auditing Standard No. 2:

- Questions 1 - 26 (June 23, 2004, Revised July 27, 2004)
- Questions 27 - 29 (October 6, 2004)
- Questions 30 - 36 (November 22, 2004)
- Question 37 (January 21, 2005)
- Questions 38 - 55 (May 16, 2005)

Conforming Amendments to PCAOB Interim Standards Resulting from the Adoption of PCAOB Auditing Standard No. 2

The conforming amendments were approved by the Securities and Exchange Commission on November 17, 2004. For integrated audits of financial statements and internal control over financial reporting, the conforming amendments become effective at the same time that PCAOB Auditing Standard No. 2 becomes effective. For issuers that are not considered to be accelerated filers under Securities Exchange Act Rule 12b-2 and for issuers that are not required to comply with section 404 of the Sarbanes-Oxley Act of 2002, the conforming amendments become effective for audits of financial statements for periods ending on or after July 15, 2005. The part of the conforming amendments that supersedes AT sec. 501, "Reporting on an Entity's Internal Control Over Financial Reporting," was effective immediately upon approval. Section D, "Effective Date," and section E, "Effect of Auditing Standard No. 2 on Audits of Financial Statements Only," of the Board's Release that accompanies the conforming amendments provide more detailed information regarding effective dates and the effect of Auditing Standard No. 2 on audits of financial statements only.

Rulemaking Docket: Link to information related to the rulemaking process of this standard, including proposing and adopting releases, public comments, and board statements.

PCAOB and SEC Roundtable on Internal Control Reporting Requirements (5/10/2006)

Statement Regarding the PCAOB's Approach to Inspections of Internal Control Audits in the 2006 Inspection Cycle (5/1/2006)

Briefing Paper: Standing Advisory Group Meeting - Implementation of Section 404 and Auditing Standard No. 2 (6/8-9/2005)

Briefing Paper: Standing Advisory Group Meeting - Challenges of Section 404 (11/17-18/2004)

Board Release: Auditing Standard No. 2 (3/9/2004)

Roundtable: Reporting on Internal Control (7/29/2003)

Briefing Paper: Roundtable on Reporting on Internal Control (7/10/2003)

Auditing Standard No. 4: Reporting on Whether a Previously Reported Material Weakness Continues to Exist

Overview of Auditing Standard No. 4

Related Securities and Exchange Commission Documents



## U.S. Securities and Exchange Commission

### SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-49884; File No. PCAOB 2004-03)

June 17, 2004

#### **Public Company Accounting Oversight Board; Order Approving Proposed 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")**

#### **I. Introduction**

On March 17, 2004, the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") filed with the Securities and Exchange Commission (the "Commission") proposed 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"), pursuant to Section 107 of the Sarbanes-Oxley Act of 2002 (the "Act") and Section 19(b) of the Securities Exchange Act of 1934 (the "Exchange Act"). Auditing Standard No. 2 would provide the professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of internal control over financial reporting under Section 404 of the Act. Notice of the proposed standard was published in the *Federal Register* on April 16, 2004,<sup>1</sup> and the Commission received 31 comment letters. For the reasons discussed below, the Commission is granting approval of the proposed standard.

#### **II. Description**

The Act establishes the PCAOB to oversee the audits of public companies and related matters, to protect investors, and to further the public interest in preparation of informative, accurate and independent audit reports.<sup>2</sup> Section 103(a) of the Act directs the PCAOB to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports as required by the Act or the rules of the Commission. The Board has defined the term "auditing and related professional practice standards" to mean the standards established or adopted by the Board under Section 103(a) of the Act.

Section 404 of the Act requires that registered public accounting firms attest to and report on an assessment of internal control made by management, and that such attestation "shall be made in accordance with standards for attestation engagements issued or adopted by the Board." The Board's proposed Auditing Standard No. 2 provides the professional standards and related performance guidance for independent auditors to

attest to, and report on, management's assessment of the effectiveness of internal control over financial reporting under Section 404 of the Act. A significant aspect of this proposed standard is the requirement of the independent auditor to attest on two items. The auditor has to evaluate management's assessment process to be satisfied that management has an appropriate basis for its conclusion. Additionally, the auditor must test and evaluate both the design and the operating effectiveness of internal control to be satisfied that management's conclusion is correct and, therefore, fairly stated. The auditor's report on internal control over financial reporting will express two opinions — an opinion on whether management's assessment of the effectiveness of internal control over financial reporting as of the end of the most recent fiscal year is fairly stated, and an opinion on whether the company has maintained effective internal control over financial reporting as of that date.

### **III. Discussion**

The Commission received 31 comment letters in response to its request for comments on Auditing Standard No. 2. The comment letters came from issuers, registered public accounting firms, professional associations and others. In general, issuers expressed opposition to the proposed standard, and accounting firms, professional associations, and others expressed support for the proposed standard. Most commenters, irrespective of affiliation or position on the proposed standard, recommended that the Commission and the PCAOB provide additional guidance with respect to a number of different issues. Several commenters recommended that the Commission limit the scope of management's assessment of the effectiveness of internal control over financial reporting by excluding entities that are consolidated but over which the issuer lacks control.

Issuers and many of the professional associations also expressed concern with the cost of compliance in terms of management time, consultant fees and audit fees. One commenter requested that the PCAOB closely monitor the impact of the proposed standard on small and medium-sized companies. Other requests included clarifying that an adverse internal control report would not of itself result in regulatory action; delaying the effective date of the proposed standard; providing a one-year deferral to issuers that meet the definition of an accelerated filer for the first time in 2004; and deferring the accelerated filing date for Forms 10-K filed for year-end 2004. The PCAOB gave careful consideration to the issues raised by these commenters in the course of revising the proposed standard prior to its adoption by the Board. The resulting standard is a reasonable exercise of the Board's standards-setting authority under the Act.

### **IV. Conclusion**

On the basis of the foregoing, the Commission finds that proposed Auditing Standard No. 2 is consistent with the requirements of the Act and the securities laws and is necessary and appropriate in the public interest and for the protection of investors.

IT IS THEREFORE ORDERED, pursuant to Section 107 of the Act and Section 19(b)(2) of the Exchange Act, that proposed Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (File No. PCAOB-2004-

03) be and hereby is approved.

By the Commission.

Margaret H. McFarland  
Deputy Secretary

<sup>1</sup> Release No. 34-49544 (April 8, 2004); 69 FR 20672 (April 16, 2004).

<sup>2</sup> Section 101(a) of the Act.

<http://www.sec.gov/rules/pcaob/34-49884.htm>

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Modified: 06/18/2004

# PCAOB

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POLICY STATEMENT REGARDING  
IMPLEMENTATION OF AUDITING STANDARD  
NO. 2, *AN AUDIT OF INTERNAL CONTROL  
OVER FINANCIAL REPORTING PERFORMED IN  
CONJUNCTION WITH AN AUDIT OF FINANCIAL  
STATEMENTS*



PCAOB Release No. 2005-009  
May 16, 2005

## Summary

This Policy Statement discusses some of the issues raised during the first year of auditors' 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* ("Auditing Standard No. 2"), which implements Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act") by establishing a process for auditing public companies' internal control over financial reporting in conjunction with an audit of financial statements. Many of these issues were raised, among other occasions, at the Securities and Exchange Commission's ("SEC" or "Commission") Roundtable on Implementation of Internal Control Reporting Provisions, on April 13, 2005. While Roundtable participants generally supported the objectives of Section 404, many expressed concerns about compliance costs and offered constructive comments about how the implementation process can be improved.

This Policy Statement considers several of the auditing practices observed in the first year of implementation that may be ineffective or inefficient means of meeting the objectives of Auditing Standard No. 2. It also describes how the PCAOB intends to supervise implementation of the standard, from providing additional guidance to make audits of internal control more effective and cost-efficient to driving improvements in implementation through our inspections of registered public accounting firms.

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Specifically, this Policy Statement expresses the Board's view that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should –

- ***integrate their audits*** of internal control with their audits of the client's financial statements, ***so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits;***
- ***exercise judgment to tailor their audit plans to the risks facing individual audit clients***, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);
- ***use a top-down approach*** that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and ***use the risk assessment required by the standard*** to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;
- take advantage of the significant flexibility that the standard allows to ***use the work of others;*** and
- ***engage in direct and timely communication with audit clients*** when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

### **Background**

The Sarbanes-Oxley Act has had a profound effect on the integrity of financial reporting in U.S. capital markets. The Act has strengthened and reformed almost every aspect of the financial reporting process, from the composition and role of the audit committee to preparers' certifications of accuracy, covering the integrity of gatekeepers such as analysts, lawyers and auditors in between. Although some of these changes have been in place for some time, the participants in the financial reporting process are now implementing one of the most challenging – but also one of the most promising – provisions of the Act.

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Section 404 of the Act aims to strengthen the internal controls that underpin the accuracy and reliability of a company's published financial information. That section, along with the SEC's implementing rule, requires a public company to annually report its assessment of the effectiveness of its internal control over financial reporting. The section also requires such a company to provide its auditor's attestation to, and report on, the company's assessment. Auditing Standard No. 2 governs the auditor's responsibilities under Section 404.

In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it maintains adequate internal control over the preparation of accurate financial statements. Companies have been required to have internal control over their accounting since the Congress enacted the Foreign Corrupt Practices Act in 1977. There is no doubt, however, that the Act's requirement for annual assessments, and auditor attestations to those assessments, has led to a renewed emphasis on internal control over financial reporting and significant improvements in companies' controls.

Many of the larger public companies have recently filed their first assessments of the effectiveness of their internal controls, as well as the related reports from their auditors. There is evidence that the benefits of the internal control requirements are already being realized,<sup>1/</sup> and investors have expressed strong support for the goals of Section 404, including the increased transparency that the provision provides.<sup>2/</sup> Section

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<sup>1/</sup> Seventy-nine percent of the 222 financial executives surveyed by Oversight Systems, Inc. reported that their companies have stronger internal controls after complying with Section 404. Seventy-four percent said that their companies benefited from compliance with Sarbanes-Oxley, and, of those, 33 percent said that compliance lessened the risk of financial fraud. See Oversight Systems, Inc., The 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley (December 2004).

<sup>2/</sup> See, e.g., Remarks of Mark Anson, Chief Investment Officer, California Public Employees' Retirement System, Transcript of SEC Roundtable on Implementation of Internal Control Reporting Provisions (Apr. 13, 2005) ("Roundtable Tr."); Remarks of Ann Yerger, Executive Director, Council of Institutional Investors, Roundtable Tr.; Remarks of Damon Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organizations, Roundtable Tr.; Letter from Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System, to William H. Donaldson, Chairman, SEC (Mar. 1, 2005); see also Remarks of

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404 has, however, proven to be an enormous challenge for those involved in its implementation. Companies have found the requirements costly and demanding, and many have questioned whether the benefits are worth the cost.

We take these concerns seriously and are committed to learning from the first year's experience implementing Section 404. As part of this effort, on April 13, 2005, we participated in the Commission's Roundtable. The Roundtable was an opportunity for us and the Commission to hear directly from issuers, auditors, and investors on the front line of the Section 404 implementation process. Many participants at the Roundtable expressed their support for Section 404's purpose. One of the most valuable aspects of the Roundtable, however, has been the constructive criticism provided by many of those currently involved in the implementation process.

The cost of Section 404 compliance was the primary concern raised at the Roundtable.<sup>3/</sup> Among other reasons, commenters suggested that costs were too high because companies and their auditors did not sufficiently focus their efforts on higher risk areas of internal control over financial reporting. In addition, commenters expressed the view that auditors did not use the work of others sufficiently or fully integrate the audit of internal control with the audit of the financial statements. Some Roundtable participants also stated that auditors are often less willing than they were previously to provide guidance to clients on accounting issues for fear of compromising independence or triggering a material weakness finding.

At the conclusion of the Roundtable, the Board agreed to take several steps to promote an internal control audit process that is both effective and cost-efficient. Today, we take the first two of these steps.<sup>4/</sup> First, we are separately publishing a

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Gregory Jonas, Managing Director of Accounting Specialists Group, Moody's Investors Service, Roundtable Tr.

<sup>3/</sup> One survey found that for 217 public companies with average revenues of \$5 billion, first year Section 404 compliance cost, on average, \$4.36 million and consumed an average of nearly 27,000 hours. See Financial Executives International, FEI Special Survey on SOX Section 404 Implementation (March 2005).

<sup>4/</sup> The Board also intends to devote the agenda of the upcoming meeting of its Standing Advisory Group, scheduled for June 8 and 9, 2005, to a discussion about implementation of Auditing Standard No. 2.

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series of additional staff questions and answers related to Auditing Standard No. 2.<sup>5/</sup> These questions and answers further explain and clarify provisions in Auditing Standard No. 2. In particular, these questions and answers seek to correct the misimpression that certain provisions of Auditing Standard No. 2 need to be applied in a rigid manner that constrains professional judgment and prevents the conduct of an audit in a manner that is both effective and cost-efficient. Second, we are also issuing today this Policy Statement, which amplifies some of the themes in those questions and answers and articulates our policy with respect to administering Auditing Standard No. 2.

Failure to apply the concepts discussed in this Policy Statement may reflect poor audit planning and result in unnecessary cost. Indeed, although we have not performed a detailed analysis, it is sufficiently clear to us that the costs to date associated with the implementation of Section 404 have been too high. For the Section 404 process to be sustainable, these costs must be reduced in future years. Some of this excess expense is attributable to first-year, start-up costs that should not recur in future years; nevertheless, we are concerned that auditors may not sufficiently be using several features of our standard, described below, that are designed to reduce costs without sacrificing quality.

### The Integrated Audit Concept

As auditing has evolved over the last century from a process of detailed examination of individual transactions and account balances into a process of testing samples, internal control over financial reporting has emerged as the foundation not only of the financial reporting process but also of the financial statement audit. Since 1941, the SEC's regulations have required auditors to consider a company's internal controls in planning an audit.<sup>6/</sup> In addition, if controls had been adequately designed and were operating effectively, then longstanding auditing standards permitted the

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<sup>5/</sup> The Staff Questions and Answers are available on the Board's Web site, at [http://www.pcaobus.org/Standards/Staff\\_Questions\\_and\\_Answers/index.asp](http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/index.asp).

<sup>6/</sup> Amendment of Rules 2-02 and 3-07 of Regulation S-X, Accounting Series Release No. 21, 11 Fed. Reg. 10921 (Feb. 5, 1941) (amending Regulation S-X to provide that "[i]n determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff.").

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auditor to rely on less costly and time-consuming procedures.<sup>7/</sup> Conversely, if an auditor determined that a control was inadequate in its design or operation (or elected not to test the control), then the auditor could not rely upon that control.<sup>8/</sup> In this event, the auditor would take a considerably more detailed approach by relying almost exclusively on detailed tests of account balances and transactions.

Sections 103 and 404 of the Act, and Auditing Standard No. 2, changed that audit model. Today, auditors of companies subject to Section 404 must not only obtain an understanding of internal control, but they must also examine the design and operating effectiveness of internal control sufficient to render an opinion as to that effectiveness, as required by Section 103(a)(2)(A)(iii). To reap the most benefit from this examination, and to make the overall audit process as efficient as possible, we designed in Auditing Standard No. 2 an integrated audit model.

An integrated audit combines an audit of internal control over financial reporting with the audit of the financial statements, such that the objectives of the two audits are achieved simultaneously through a single coordinated process. In an integrated audit, the auditor's examination of internal control is validated by the findings in the audit of the financial statements. In addition, the auditor's findings and conclusions reached during the audit of internal control help the auditor better plan and conduct the auditing procedures designed to determine whether the financial statements are fairly presented. The two processes are mutually reinforcing. In this way, the integrated audit helps to improve the quality and integrity of both corporate controls over financial reporting and independent financial statement audits. We also believe that an integrated audit is more cost-effective than performing two distinct processes to audit internal control and the financial statements separately.

As a practical matter, integration of the two audits means that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits.

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<sup>7/</sup> See AU Section 319.03, *Consideration of Internal Control in a Financial Statement Audit*. Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, temporary rules that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"), including AU Section 319. These standards are reproduced on our Web site at [http://www.pcaobus.org/Standards/Interim\\_Standards/index.asp](http://www.pcaobus.org/Standards/Interim_Standards/index.asp).

<sup>8/</sup> See AU Section 319.04, *Consideration of Internal Control in a Financial Statement Audit*.

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This kind of coordination of work requires an auditor to plan and conduct his or her work with both audits in mind. Failing to integrate these audits not only wastes resources, but it also jeopardizes the quality of the overall audit and, potentially, misses key insights that could identify and uproot a budding accounting or reporting problem.<sup>9/</sup>

Some auditors have acknowledged that, for a variety of reasons, they did not achieve fully integrated audits this year. As a result, audit costs may have been substantially higher than necessary. According to a recent survey commissioned by the largest U.S. accounting firms, auditors believe that the total costs of compliance with Section 404 will decline by 46 percent next year.<sup>10/</sup> Among the factors cited to support this prediction was auditors' expectations that integration will be improved.<sup>11/</sup> We, too, expect that auditors will better integrate their audits in the coming years. This should meaningfully affect both audit costs and audit quality.

### The Importance of Professional Judgment

Auditing Standard No. 2 is no different from any other auditing standard in that it does not prescribe detailed audit programs. For as long as the profession has established auditing standards, auditors have used those standards to tailor their own audit plans, in a manner that addresses the nature and complexity of the audit client.

Many participants in the Roundtable, as well as others, have noted, however, that some auditors have in fact failed to use tailored audit plans in their first year of auditing internal control over financial reporting under Section 404 of the Act and Auditing Standard No. 2. Those auditors have instead used a one-size-fits-all audit plan driven by standardized checklists that may have little to do with the unique issues and risks of the particular client's financial reporting processes. This is a disappointing development indicative of poor training and audit planning. Not only do audit fees

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<sup>9/</sup> PCAOB Staff Question and Answer No. 50 issued today provides additional guidance on integrating the audit of internal control over financial reporting with the audit of the financial statements.

<sup>10/</sup> See Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies (Apr. 2005).

<sup>11/</sup> See Letter from Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers to Jonathan G. Katz, Secretary, SEC (Apr. 11, 2005).

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increase when, for example, an audit plan calls for less experienced auditors on the engagement team to devote endless hours to process-level control testing, but audit quality also decreases, because such a plan contributes little to the search for material weaknesses in internal control that could identify a financial reporting problem.

The overall objective of Auditing Standard No. 2 is for the auditor to obtain evidence that a company's control system reasonably assures that its financial statements do not contain material misstatements. To accomplish this, the auditor must not only exercise judgment to determine how to apply the standard to audit clients in different industries and of different sizes, but also exercise judgment to focus their work on areas that pose higher risks of misstatement, due either to errors or fraud. Reliance on standardized checklists that lead to a focus on controls in low-risk areas obviously fails to meet this objective.

### **The Top-down Approach and Role of Risk Assessment**

Auditing Standard No. 2 was designed to be applied from the top down. That is, the standard focuses the auditor first on company-level controls and then on significant accounts, which lead the auditor to significant processes and, finally, individual controls at the process, transaction, or application levels. Knowledge obtained at each step guides the auditor toward the higher risk areas within the next succeeding level of controls. By approaching the task in this way, the auditor is naturally steered toward higher risk areas and away from those with less potential to have a material impact on the financials. This approach also provides a road map through the control system to ensure that the individual controls selected for testing are, in fact, relevant to internal control over financial reporting.

An auditor who chooses another approach needlessly risks adding to the audit's cost and reducing its quality. For example, starting at the bottom increases the risk that the auditor will become bogged down in testing that may ultimately prove pointless, in light of the primary objective of preventing or detecting material misstatements of the financial statements, resulting in increased and unnecessary costs.

A risk-based approach to the auditor's testing strategy can further reduce costs while increasing audit effectiveness. The auditor should consider the overall risk related to each significant account identified to determine whether he or she should alter the nature, timing, and extent of testing of the controls over that specific account. By doing so, the auditor will be able to eliminate from further consideration accounts that have only a remote likelihood of containing a material misstatement and, in any event, devote

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less audit attention to areas of low risk. In addition, the auditor should look to the individual control being tested and consider the nature, frequency, and importance of that specific control in order to determine whether the testing strategy should be revised further.

Finally, the auditor should consider, as part of his or her risk assessment, the strength of the company-level controls, to determine whether the result of testing these controls will alter the nature, timing, and extent of testing. Although the auditor may not rely solely on testing company-level controls,<sup>12/</sup> strong company-level controls should lead the auditor to do less work than he or she otherwise would have performed or rely to a greater degree on the work of others.

### Using the Work of Others

An auditor who applies Auditing Standard No. 2 from the top down and appropriately assesses risk should naturally identify areas where use of the work of others is not only appropriate but is also the most efficient way to perform the audit. Redoing work in these areas may unnecessarily increase costs without producing a corresponding increase in audit quality. Spending auditor resources in areas in which the auditor could rely on the work of others also may cause the auditor to focus too much on low-risk controls. As discussed earlier, this could be an early warning sign of poor audit planning.

Auditing Standard No. 2 provides the auditor with considerable flexibility to use the work of others, consistent with the profession's longstanding auditing standard on using the work of internal auditors in the financial statement audit.<sup>13/</sup> There is some

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<sup>12/</sup> See Auditing Standard No. 2, paragraph 54. PCAOB Staff Questions and Answers Nos. 38-43 issued today provide additional guidance on how to plan and perform an audit of internal control over financial reporting using both a top-down and a risk-based approach.

<sup>13/</sup> See AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. This standard provides that the work of competent and objective internal auditors may affect the nature, timing and extent of the audit. Specifically, if internal auditors are competent and objective, then external auditors may rely on work performed by internal auditors in the ordinary course of their duties. For example, "for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved

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concern that auditors have been reluctant to use Auditing Standard No. 2's flexibility to rely on the work of others because the standard also requires the external auditor to obtain the principal evidence supporting his or her opinion as to whether internal control is effective overall. These provisions are not in conflict. The principal evidence provision of Auditing Standard No. 2 requires the auditor to perform sufficient auditing to reach his or her own, independent opinion as to the effectiveness of a company's internal control over financial reporting. In broad terms, it prevents auditors from merely passing on to investors the judgments and opinion of others.

As one of the questions and answers issued today explains, the principal evidence requirement is "primarily qualitative."<sup>14/</sup> Indeed, under Auditing Standard No. 2 the amount of work necessary to meet the principal evidence test "is not susceptible to precise measurement."<sup>15/</sup>

In practical terms, this means two things. First, the auditor should perform more work directly in high-risk areas and seek to use the work of others in areas of lesser risk. Second, in evaluating whether the auditor has met the principal evidence test, the auditor should ascribe more weight to the work he or she performs in high-risk areas.<sup>16/</sup>

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in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work ... performed by internal auditors ..., that ... testing of the assertions directly by the auditor may not be necessary." See id. at paragraph 22. In addition, this standard also permits auditors to request direct assistance from the internal auditors, such that internal auditors will work under the direct supervision of the external auditor. See id. at paragraph 27. PCAOB Staff Question and Answer No. 54 issued today provides additional guidance on using the work of others. See also PCAOB Staff Question and Answer No. 36 (Nov. 22, 2004) (stating that external auditors may "use internal auditors to provide direct assistance in the audit of internal control over financial reporting").

<sup>14/</sup> PCAOB Staff Question and Answer No. 54 (May 16, 2005).

<sup>15/</sup> See Auditing Standard No. 2, note to paragraph 108.

<sup>16/</sup> In other words, principal evidence is not meant to be assessed by simply adding up hours or numbers of controls tested in a mechanical fashion; rather, such an approach would likely detract from the standard's goal of allowing the auditor to use the work of others in an efficient and appropriate manner.

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In this manner, following the risk-based principles regarding using the work of others will, in most circumstances, result in the auditor having obtained the principal evidence supporting his or her opinion.

### **The Auditor's Ability to Provide Advice to Audit Clients**

Finally, we are concerned about a misconception that, as a result of Auditing Standard No. 2, companies may no longer look to their auditors for advice on difficult accounting and internal control issues. This misconception appears to manifest itself in two particularly problematic ways. First, we have heard at the Roundtable and elsewhere that auditors have been unwilling to provide accounting advice to their audit clients; second, auditors have apparently encouraged audit clients to finish their assessments of internal control and their financial statements before the auditor begins audit work to attest to the fairness of those assessments and financial statements. Such practices are neither necessary nor advisable.

Auditing Standard No. 2 provides that an auditor's detection of a material misstatement in financial statements is a "strong indicator" of a material weakness in internal control. In addition, longstanding rules on auditor independence prohibit the auditor from preparing a client's financial statements and from making financial reporting decisions on behalf of management.<sup>17/</sup> The prospect of PCAOB inspectors examining for compliance with these independence rules seems to have led some to conclude that management and the auditor should not consult on accounting and internal control questions or that the auditor should not review draft financial statements that, because they are not finished or complete, may contain misstatements or misapplications of Generally Accepted Accounting Principles ("GAAP"). When auditors are unwilling, or believe that they are unable, to provide advice on accounting or internal control, management may be forced to retain other accounting experts, or to make accounting decisions without the benefit of access to the auditor's technical knowledge.

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<sup>17/</sup> See Rule 2-01(c)(4)(i) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(i) (stating that an auditor is not independent of an audit client if it "prepar[es] the audit client's financial statements"); Rule 2-01(c)(4)(vi) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(vi) (stating that an auditor is not independent of an audit client if it "perform[s] any decision-making, supervisory, or ongoing monitoring function for the audit client"); see also Meeting of PCAOB Standing Advisory Group, February 16, 2005, available on the Board's Web site <http://www.pcaobus.org>.

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Nothing in Auditing Standard No. 2 requires this result. Determining when it is appropriate for the auditor to provide accounting advice requires professional judgment and common sense. Auditors may not, of course, make accounting decisions for their clients, and management may not abandon its responsibility for quality financial reporting and simply rely on auditors to catch errors. Where management makes its own informed decisions regarding how applicable accounting principles apply to its company's circumstances, however, the auditor may discuss freely with management the meaning and significance of those principles.

To help dispel confusion on this issue, our staff addressed last June the question of whether audit clients may – or should – share draft financial statements with their auditors. The answer is decidedly yes. Indeed, information-sharing on a timely basis between management and the auditor is necessary. When reviewing draft financial statements, in determining the point at which the auditor must draw the line for purposes of identifying when a deficiency exists, the auditor should be concerned primarily about instances in which the company completed its financial statements and disclosures without recognizing a potential material misstatement. If it is clear that all applicable controls have not yet operated, then a conclusion as to whether a material misstatement in draft financial statements demonstrates a control deficiency would be premature.<sup>18/</sup>

Auditors may also provide audit clients technical advice on the proper application of GAAP, including offering suggestions for management's consideration to improve disclosure and financial statement quality and giving updates on recent developments with accounting standards-setters. In addition, management may provide and discuss with the auditor preliminary drafts of accounting research memos, spreadsheets, and other working papers in order to obtain the auditor's views on the assumptions and methods selected by management. Although the auditor may determine that some of these communications need to be made in writing, timely and open communication will often be best accomplished orally.

For example, a company that is contemplating a transaction may ask the auditor for assistance in determining the proper accounting for the transaction. In this situation,

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<sup>18/</sup> See PCAOB Staff Question and Answer No. 7 (revised July 27, 2004) (explaining that Auditing Standard No. 2 requires an auditor to judge whether, once all applicable controls have operated, the company is able to prepare financial statements that are free of material misstatements).

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the auditor may provide substantial help, including explaining how applicable accounting principles apply to the transaction, offering sample journal entries, and reviewing management's preliminary conclusions. This is very different from a situation in which the auditor identifies a potential misapplication of applicable accounting principles in connection with a transaction that the auditor learns of outside of the consultation process, such as during a quarterly review, or after management has completed its financial statements and disclosures, in which case the auditor would have to consider whether management's failure to recognize the potential misapplication of applicable accounting principles constitutes a significant deficiency or material weakness.

### **The Board's Approach to Oversight of Implementation of Auditing Standard No. 2**

We take seriously our responsibility to oversee implementation of Auditing Standard No. 2. This includes issuing additional guidance to explain or interpret the standard as necessary, as well as supervising auditors' implementation of the standard. In particular, we intend to use our upcoming inspections to evaluate how firms have conducted the first round of audits under Auditing Standard No. 2.

Our inspections should drive improvements in the effectiveness and efficiency of registered firms' audits of internal control in two ways. First, as we have described above, Auditing Standard No. 2 leaves auditors considerable flexibility to apply the standard in a manner that is appropriate to each audit. Indeed, the standard requires auditors to use professional judgment to tailor their audit plans to the specific risks facing each audit client. In our inspections, we will look for audits that suffer from poor planning and risk assessment, such as by using standardized checklists without appropriately tailoring the procedures to the circumstances or focusing the audit on areas that are unlikely to lead to the discovery of material weaknesses in internal control at the expense of adequately auditing high-risk areas. When we detect such shortcomings, we will demand improvements.

Second, we have also described above, as well as in the staff questions and answers issued today and in the past, several approaches to the audit of internal control that we believe improve both the effectiveness and the efficiency of these audits. When we review audits that do not apply the approaches described above, we will expect auditors to justify their decisions and to be able to explain how the audit plan nevertheless met the objectives of the standard.

At the Roundtable, a number of the participants focused on the role our inspections will play in shaping implementation of Auditing Standard No. 2. Some

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suggested that our inspections should require auditors to reduce costs overall. Others suggested that, if our inspections are narrowly focused on technical compliance, they could have the perverse effect of promoting a checklist mentality and discouraging the use of judgment and tailored audit planning.

We intend for our inspections to do neither. By focusing on the conduct of a high-quality audit as described above, we believe our inspections will promote efficiency without the need for us to get involved in auditors' billing practices. And, by focusing on appropriate use of judgment and risk assessment, we are deliberately planning our inspections in a manner that promotes an audit of internal control that is both thoughtful and risk-focused. In other words, we do not intend to second-guess good faith audit judgments. If we believe, however, that an auditor has approached the audit in a way that is mechanistic and does not reflect the application of professional judgment to the specific risks associated with the audit client's financial reporting system, we will not hesitate to demand changes to the auditor's approach to implementing Auditing Standard No. 2.

### **Conclusion**

The first year's implementation of Section 404 required a tremendous effort on the part of management and auditors, as well as the commitment of substantial corporate resources. The lessons learned so far – and to be learned as we complete our first cycle of inspections of audits under Auditing Standard No. 2 – should provide a solid basis for substantial improvement in the process, including significant cost reduction in the future.