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www.joneswalker.com
corporatesecurities@joneswalker.com

SEC AND PCAOB ISSUE GUIDANCE REGARDING IMPLEMENTATION OF INTERNAL CONTROL REPORTING REQUIREMENTS

By Douglas N. Curault II and Amos J. Oelking, III

In response to issues raised at the SEC-sponsored Roundtable on Implementation of Internal Control Reporting Provisions in April 2005, the SEC and the Public Company Accounting Oversight Board (PCAOB) have issued additional guidance on the implementation of the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002. The SEC Staff Statement and the PCAOB Policy Statement, both issued on May 16, 2005, do not represent new rules but rather address and attempt to clarify many of the issues raised during the Roundtable in order for the Section 404 implementation process to be more cost-efficient and effective.

The SEC Staff Statement

The overarching principle of the SEC Staff Statement on Management's Report on Internal Control Over Financial Reporting is the responsibility of management to determine the form and level of controls appropriate for each company and scope their assessment and testing accordingly. The SEC Staff Statement provides the following guidance to public companies and their auditors regarding the implementation of Section 404:

- in assessing the company's internal control over financial reporting, management should focus on whether the company's controls provide "reasonable assurance" regarding the reliability of the company's financial reporting process; reasonable assurance does not mean absolute assurance, as a company's internal controls cannot prevent or detect all errors, misstatements or fraud;

- management and auditors should use a "top-down, risk-based" approach, versus a one-size-fits-all, mechanical, "check-the-box" approach, whereby the controls and processes that are identified, documented and tested are those that are significant to the company's financial reporting and that present a greater risk (relative to the company's other controls and processes) of a material misstatement in the company's financial statements;

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- auditors should recognize that there is a “zone of reasonable conduct” by companies that should be recognized as acceptable; thus, for example, in implementing Section 404 in a given situation, there will often be more than one acceptable testing methodology from which management can choose;

- in determining the appropriate scope of its assessment, management should step back from focusing on the detail and consider whether combinations of controls identified individually constitute the actual control that contributes to financial statement assurance; not every individual step comprising a control is required to be tested in order to determine that the overall control is operating effectively;

- testing and assessment of a company’s internal control over financial reporting need not be done only during the period surrounding the company’s fiscal year-end, but may, and in many cases should, be accomplished over a longer period of time;

- if control deficiencies are identified, an important part of the assessment is the consideration of the significance of those deficiencies and whether the risk is mitigated by compensating controls;

- companies that conclude that their internal control over financial reporting is ineffective (*i.e.*, that their internal controls have one or more material weaknesses) should consider disclosing (1) the nature of the material weaknesses; (2) their impact on the company’s financial reporting and internal controls; and (3) management’s plans for correcting the weaknesses;

- in the event of a restatement of a company’s financial statements due to an error, neither Section 404 nor the SEC’s related rules require a conclusion that a material weakness in the company’s internal control over financial reporting exists; rather, management and the company’s auditors should determine why a restatement was necessary and whether the need for restatement resulted from a material weakness in the company’s internal controls; and

- management and auditors are encouraged to engage in frequent and frank dialogue; as long as management, and not the auditors,

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determines the accounting to be used and designs and implements the company's internal controls and accounting policies, the auditors' involvement is consistent with the SEC's auditor independence requirements and is not, alone, indicative of a deficiency in the company's internal control over financial reporting. *(Click here to link to the full text of the SEC Staff Statement.)*

The PCAOB Policy Statement

The PCAOB Policy Statement Regarding Implementation of Auditing Standard No. 2 sets forth many of the same concepts expressed in the SEC Staff Statement in providing additional guidance to auditors regarding Auditing Standard No. 2, which is the standard auditors must use to satisfy their Section 404 obligations. The PCAOB staff also issued a related series of questions and answers regarding implementation of Section 404.

The PCAOB Policy Statement focuses on the scope of internal control audits and how much testing of a company's internal control over financial reporting is required Specifically, the PCAOB Policy Statement expresses the PCAOB's view that in planning and performing an audit of a company's internal control over financial reporting, auditors should

- integrate their audit of the company's internal controls with their audit of the company's financial statements;
- tailor their audits to the risks facing individual audit clients rather than using standardized checklists;
- use a "top-down" approach that begins with company-level controls, identifies for further testing only those accounts and processes that are relevant to the company's internal control over financial reporting and eliminates from further consideration accounts that have only a "remote likelihood" of containing a material misstatement;
- take advantage of the significant flexibility that Auditing Standard No. 2 provides to use the work of others, namely the work of the company's internal auditors; and

- communicate with management in a timely manner when management seeks the auditors' views on internal control or accounting issues before management makes decisions on such issues, implements internal controls or processes under consideration or finalizes the company's financial statements. *(Click here to link to the full text of the PCAOB Policy Statement.)*

The PCAOB staff's questions and answers "seek to correct the misimpression that certain provisions of Auditing Standard No. 2 need to be applied in a rigid manner" and supplement the questions and answers published by the PCAOB staff in June 2004, October 2004, November 2004 and January 2005. *(Click here to link to a cumulative index of the PCAOB staff's questions and answers regarding Auditing Standard No. 2.)*

Section 404 of Sarbanes-Oxley and the related rules promulgated by the SEC require public companies to include in their Forms 10-K a management report on internal control over financial reporting and related auditor attestation report. *(Click here to link to our July 2003 E*Zine discussing the SEC's internal control over financial reporting requirements in further detail.)* Public companies that are "accelerated filers" were first required to comply with the internal control reporting requirements for their first fiscal year ending on or after November 15, 2004, whereas public companies that are not "accelerated filers" will first be required to comply with the requirements for their first fiscal year ending on or after July 15, 2006.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

Curtis R. Hearn
Jones Walker
201 St. Charles Ave., 51st Fl.
New Orleans, LA 70170-5100
ph. 504.582.8308
email chearn@joneswalker.com

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Corporate and Securities Practice Group

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