

# Heads Up

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Audit and Enterprise Risk Services

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## SEC and PCAOB Approve New Section 404 Guidance: No Additional Delay for Non-Accelerated Filers

*By National Office, Deloitte & Touche LLP*

### Introduction

Last week, responding to concerns many constituents have raised about the internal control reporting requirements of Section 404, the Securities and Exchange Commission (SEC or "Commission") and the Public Company Accounting Oversight Board (PCAOB) approved their respective proposals related to this section of the Sarbanes-Oxley Act of 2002. Although the PCAOB's [Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements \(AS 5\)](#), still needs the Commission's formal approval, look for the SEC guidance and the new PCAOB auditing standard to be applied in 2007.<sup>1</sup>

At its May 23, 2007, open meeting, the SEC approved guidance (proposed in December) for management of registrants to use in evaluating internal control over financial reporting (ICFR). The next day, the PCAOB approved AS 5. These and related developments are explained in greater detail in the sections that follow.

### SEC Approves Management Guidance and Related Rules for ICFR Evaluations

#### Management Guidance on the Assessment of Internal Controls

The SEC unanimously approved new guidance intended to help registrants' management tailor ICFR evaluations according to the complexities and risks inherent in their companies.

Although the guidance has not yet been issued in final form, Zoe-Vonna Palmrose, deputy chief accountant in the SEC's Office of the Chief Accountant, noted in her remarks at the open meeting that a staff review of comments indicated that "wholesale changes to the proposed guidance were not warranted." The final guidance will keep the focus on identifying the areas with the greatest risk for causing inaccuracies in the

<sup>1</sup> The PCAOB auditing standard, if approved, will be effective for audits of entities with fiscal years ending on or after November 15, 2007 (earlier adoption will be permitted). With respect to the SEC's management guidance, it is expected that such guidance can be implemented upon issuance by the SEC. However, the SEC has made it clear that management can continue to use effective ICFR evaluation processes already in place.

financial statements, identifying controls in place to address those risks, and evaluating how effectively those controls are operating. The modifications to the proposed guidance (refer to Deloitte & Touche's [January 8, 2007, Heads Up](#) for additional details of the proposed guidance) include changes:

- To better align it with the PCAOB's auditing standard.
- To further emphasize the importance of entity level controls.
- To clarify the relationship of ongoing monitoring activities to management's evaluation (including management's ability to use information obtained from monitoring activities performed in the normal course of business to support its assessment).
- To enhance the discussion of management's fraud risk assessment.

### Separate Audit Opinion on Management's Assessment No Longer Required

The SEC approved a rule amendment eliminating the requirement that auditors issue a separate audit opinion on management's assessment of ICFR. Auditors who have performed an integrated audit of a registrant's ICFR and financial statements will now issue one opinion on the effectiveness of ICFR, together with an opinion on the financial statements. This change will take place on the effective date of the PCAOB's revised auditing standard.

### Management's Use of New Guidance to Satisfy Section 404 Requirements

A company that performs its ICFR evaluation in accordance with the new guidance will satisfy the SEC's Section 404 requirements, according to rule amendments approved at the meeting. However, the SEC also emphasized that management can satisfy these requirements by continuing to use effective processes already in place and noted that accelerated filers have been complying with Section 404 requirements for several years.

### Defining Material Weakness

The SEC approved a rule amendment to include the definition of a "material weakness" in its rules. The SEC also voted to propose and seek comment on a revised definition of "significant deficiency." These definitions are the same as those used by the PCAOB in its revised auditing standard, as discussed below.

### Section 404 Compliance Dates for Non-Accelerated Filers

SEC Chairman Christopher Cox stated that the SEC will not provide any further extensions for non-accelerated filers to comply with the provisions of Section 404. Accordingly, the following deadlines apply to these companies:

Section 404 Compliance Dates for Non-Accelerated Filers	
Management's Report	Auditor's Attestation
Annual reports for fiscal years ending on or after December 15, 2007	Annual reports for fiscal years ending on or after December 15, 2008

The SEC's ICFR guidance [press release](#) and the statements made by [Zoe-Vonna Palmrose](#) and by [John W. White](#), director of the SEC's Division of Corporation Finance can be found on the SEC's Web site.

### PCAOB Approves New Standard for Auditing ICFR

The PCAOB unanimously approved AS 5 and noted that the "changes made to the proposal reflect refinements, rather than significant shifts in approach."

Some of the notable differences between AS 5 and Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* (AS 2), include AS 5's:

- Emphasis on the importance of the application of a top-down, risk-based approach and the importance of entity-level controls. The standard clarifies that entity-level controls vary in nature and precision and includes an explanation of how different kinds of entity-level controls vary in their effects on the selection and testing of controls. For example, entity-level controls that monitor the operation of other controls in a sufficiently precise manner may reduce, or in some cases eliminate, the need for testing of the underlying, process-level controls.
- Emphasis on scoping multi-location testing according to assessed risk rather than on attaining coverage over a "large portion," as described in AS 2.
- Elimination of the "principal evidence" provision, as described in AS 2, while maintaining the auditor's responsibilities to obtain reasonable assurance regarding ICFR and to obtain sufficient competent evidential matter to support the auditor's opinion.
- Allowance for the use of work of others in all areas, except for work performed to understand likely sources of misstatement. In this area, the work of others can only be used in a direct assistance capacity.
- Allowance for consideration of knowledge gained from previous audits in performing the current year audit.
- "Scalability" considerations for audits of entities of differing sizes and complexities.
- Elimination of the requirement to provide an opinion on management's assessment of ICFR and the associated requirement to evaluate management's process. However, it is still important for auditors to understand management's process as part of assessing ICFR effectiveness and determining the extent to which they can use management's work.
- Emphasis on fraud risk and anti-fraud controls to encourage integration of the auditor's fraud risk assessment in the evaluation of ICFR.\*
- Requirement to consider the criteria in the PCAOB's interim auditing standard AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*, to evaluate the competence and objectivity of any persons whose work the auditor plans to use to determine the extent to which the auditor may use that work.\*
- Emphasis on the requirement to obtain an understanding of likely sources of potential misstatements and identifying controls to test, rather than on the manner in which this understanding is to be obtained. While the standard does not explicitly require the performance of walkthroughs, it indicates that walkthroughs are likely the most effective way of achieving the objectives set forth in the standard.\*
- Revision, as follows, of the definition of "material weakness" to align with final SEC guidance:
  - A deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis.\*
- Revision, as follows, of the definition of "significant deficiency" to align with the definition the SEC has proposed to include in its guidance:
  - A deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting.\*
- Modification of the guidance on "strong indicators" of a material weakness. AS 5 now includes a shorter list of indicators of material weakness, but has eliminated the requirement to consider these indicators as at least significant deficiencies and strong indicators of material weaknesses.\*
- Elimination of guidance on indicators of circumstances that should be considered at least significant deficiencies.\*

\* These items represent differences between AS 5 and both AS 2 and the revised standard proposed by the PCAOB in December 2006 (refer to Deloitte & Touche's [January 8, 2007, Heads Up](#) for additional details of the proposed standard).

AS 5, [available on the PCAOB's Web site](#), must be approved by the SEC (requiring a second public comment period). Assuming approval, AS 5 will be effective for years ending on or after November 15, 2007. Once approved, auditors may early adopt AS 5's provisions.

The PCAOB also approved Rule 3525, *Audit Committee Pre-Approval of Services Related to Internal Control*, as proposed, and approved conforming amendments to the PCAOB auditing standards. Additional information on this rule and other PCAOB actions are available in its [press release](#).

## Other Developments

### PCAOB Declines to Adopt Proposed Standard on the Use of Work of Others

The PCAOB also decided not to adopt its proposed auditing standard related to using the work of others. Rather, the Board determined that the current audit standard (AU Section 322) provides an appropriate framework for considering the use of work of others. Consequently, as indicated above, the Board incorporated guidance in AS 5 instructing auditors to apply the appropriate guidance in AU Section 322 relating to using the work of others in the context of an integrated audit.

### SEC Approves Proposals Affecting Smaller Public Companies

To address issues raised by the SEC's 2006 Advisory Committee on Smaller Public Companies, the SEC approved proposals that:

- Combine the "small business issuer" and "non-accelerated filer" categories into a new combined category called "smaller reporting companies." Regulation S-B will be integrated into Regulation S-X, and the "SB" forms (e.g., Form 10-KSB and Form 10-QSB) will no longer exist. Rather, registrants previously eligible to use these forms (as well as non-accelerated filers) will use the scaled reporting and disclosure requirements.
- Amend Form S-3 and Form F-3 rules to allow registrants with a public float below \$75 million to utilize shelf registrations, subject to certain conditions.
- Add additional exemptions to Section 12(g) of the Securities Exchange Act of 1934 for the registration of compensatory employee stock options.
- Among other changes to Rules 144 and 145, shorten the Rule 144 holding period applicable to restricted securities from one year to six months, for certain issuers.

Details of these proposals, as well as several other proposals made by the Division of Corporate Finance, can be found in the related [press release](#) on the SEC's Web site.

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