

Heads Up

Audit and Enterprise Risk Services

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SEC Discusses Improvements to Section 404 of the Sarbanes-Oxley Act

by Deloitte & Touche LLP's Accounting Standards and Communications and Assurance Services Groups

Work progresses in making the internal control provisions of Section 404¹ more efficient and cost effective. At an open meeting last week, the SEC² discussed collaboration with the PCAOB³ on potential modifications to the standards proposed in December by the PCAOB: *An Audit of Internal Control Over Financial Reporting [ICFR] That Is Integrated With an Audit of Financial Statements, and Considering and Using the Work of Others in an Audit*. Also, to promote harmony with the proposed ICFR standard, the SEC discussed its proposed interpretive guidance to help management improve Section 404 implementation (see Deloitte & Touche LLP's January 8, 2007, *Heads Up*).

According to SEC Chairman Christopher Cox, the purpose of the meeting was to consider the PCAOB's progress toward finalizing the proposed auditing standard and to ensure coordination between the PCAOB and the SEC. According to the SEC staff, both the SEC guidance and the PCAOB standard would be in place in time for fiscal 2007 audits.

The SEC staff recommended, and the commissioners unanimously endorsed, a number of steps aimed at achieving collaboration in four broad areas, outlined in the table below:

Areas for Collaboration	Steps Endorsed by the SEC Commissioners
Improving the alignment between the PCAOB's forthcoming auditing standard and the SEC's proposed new management guidance under Section 404	<ul style="list-style-type: none">• Identifying and eliminating any unnecessary prescriptive audit requirements.• Harmonizing the key terms and definitions.

¹ Section 404 of the Sarbanes-Oxley Act of 2002: Management Assessment of Internal Controls.
² U.S. Securities and Exchange Commission.
³ Public Company Accounting Oversight Board.

Areas for Collaboration	Steps Endorsed by the SEC Commissioners
Scaling the Section 404 audit to the particular facts and circumstances of companies — particularly smaller companies	<ul style="list-style-type: none"> • Extending the scaling concepts throughout the PCAOB proposals rather than in a separate section. • Ensuring the appropriate integration of the financial statement audit. (Editor's note: the SEC staff repeatedly emphasized the importance and efficiencies of an integrated audit.) • Ensuring the applicability of scaling concepts without any unnecessary conditions.
Encouraging auditors to use professional judgment in the Section 404 process	<ul style="list-style-type: none"> • Ensuring that the auditor has latitude to base the level of required evidence on the auditor's assessment of risk. • Ensuring that the auditor can make appropriate use of management's risk-assessment and monitoring activities. • Exploring the relationship between the auditor's communication of significant deficiencies to the audit committee and management responsibilities in this area.
Following a principles-based approach to determining when and to what extent the auditor can use the work of others	<ul style="list-style-type: none"> • Providing principles-based definitions of competence and objectivity. • Increasing the opportunities for the auditor to use management's work related to monitoring activities.

Both PCAOB Chairman Mark W. Olson and the SEC staff pointed out that no final decisions have been made on specific changes. Turn to the [Appendix](#) for our detailed observations in each of these areas. Also see the SEC's [press release](#), *SEC Commissioners Endorse Improved Sarbanes-Oxley Implementation to Ease Smaller Company Burdens, Focusing Effort on 'What Truly Matters.'*

What are the next steps? Look for the PCAOB to submit its final standards to the SEC by the end of May or early June. Typically, the SEC approval process would then call for a second, shorter public comment period. The SEC is expected to finalize its management guidance around the same time.

Appendix: Detailed Observations — Four Areas of Collaboration

SEC Open Meeting: April 4, 2007

1. Improving the alignment between the PCAOB's forthcoming auditing standard and the SEC's proposed new management guidance under Section 404

- The SEC staff noted that because the PCAOB's proposed standard was more prescriptive than the SEC's proposed management guidance, this might (according to comments received) drive more work than necessary.
- The SEC staff emphasized the importance of the auditor's ability to tailor its approach to the facts and circumstances of each registrant and noted that the auditor's ability to exercise judgment is the key to high-quality audits.
- The SEC staff will work with the PCAOB to limit the use of "must" and "should" throughout the PCAOB proposals to make clear which procedures are mandatory, or presumptively mandatory, and to consider which might impede the auditors' use of judgment or give rise to unnecessarily excessive documentation requirements.
- The SEC staff also will collaborate with the PCAOB to better align terminology. In particular, the SEC pointed out minor differences between their respective definitions of "material weakness." The SEC staff also discussed resolving differences in what is considered a strong indicator of a material weakness.

2. Scaling the Section 404 audit to the particular facts and circumstances of companies — particularly smaller companies

- The SEC staff expressed support for a single, scalable Internal Control Over Financial Reporting (ICFR) auditing standard for all companies, regardless of size, noting that comments it received included requests for more clarity about how the auditor might tailor the nature, timing, and extent of testing for smaller public companies.
- The SEC staff suggested that the PCAOB should incorporate, throughout its guidance, discussion and examples of how scalability may be achieved and clarify that audits should be tailored to the company's control systems (rather than companies tailoring their controls to the audit standard requirements).
- The SEC staff emphasized the need to consider all facts and circumstances in a company, including both size and complexity, when scaling the audit for any size company. The SEC staff specifically noted that complexity can vary among different control areas of the same company.
- The SEC staff also emphasized the importance of considering how the financial statement portion of the integrated audit can bring about efficiencies in the ICFR portion.

3. Encouraging auditors to use professional judgment in the Section 404 process

- The SEC staff emphasized that it wants to ensure that the proposed audit standard allows auditors to exercise judgment in making risk assessments and, on that basis, determine the nature, timing, and extent of procedures used and the necessary level of audit evidence.
- The SEC staff also observed that varying the nature, timing, and extent of testing is appropriate, but explicitly stated that it does not support the concept of rotating the testing of significant accounts and processes among multiple years.

- The SEC staff would like to explore whether the requirement for the auditor to report significant deficiencies to the audit committee is affecting the scope of the audit.
- The SEC staff would like to explore whether the standard should require communication of control deficiencies to the audit committee, because other existing requirements address matters that management and the auditor must communicate to the audit committee.

4. Following a principles-based approach to determining when and to what extent the auditor can use the work of others

- The SEC staff is considering advising the PCAOB to accept a recommendation favoring amendments to the existing interim auditing standards rather than use the proposed standard, *Considering and Using the Work of Others in an Audit*, as a replacement for existing guidance.
- The SEC staff explained that it would like to explore making the standard more principles-based — especially when defining “objectivity” and “competence” — to allow the auditor to use judgment in deciding when it is appropriate to use the work of others, including those outside of internal audit.

The SEC also indicated that management's monitoring activities are key to the effectiveness of ICFR and that the auditor should not be precluded from using such work of management when appropriate.

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