

Change is in the Air: Guidance and Rules for Section 404 reporting

The Securities and Exchange Commission (SEC) recently issued interpretive guidance to help public companies strengthen their internal control over financial reporting while reducing unnecessary costs. The guidance allows management to develop an independent evaluation process and authorizes both management and auditors to apply a "top-down, risk-based" approach to develop a process tailored to each company's specific circumstances. The goal of the guidance is to enhance compliance under Section 404 of the Sarbanes-Oxley Act of 2002 by focusing management on the internal controls that best protect against the risk of a material financial misstatement. The SEC also worked closely with the Public Company Accounting Oversight Board (PCAOB) to align the interpretive guidance with the newly issued Accounting Standard No. 5, and approved several rule amendments.

Under Section 404, public companies must evaluate the effectiveness of their internal controls annually and include the results of that evaluation in their annual report to shareholders. The companies' auditors also submit a report on these internal controls. The Section 404 rules have been required for large US public companies since 2004, but will apply to large foreign companies and the remaining (smaller) US public companies in 2007. While the interpretive guidance is intended to help public companies of all sizes, the smaller companies, which will join the Section 404 ranks this year, should benefit most from its scalability and flexibility. The interpretive guidance and new rules have been issued to coincide with the smaller companies' official initiation into Section 404 in an effort to facilitate compliance. Management must include their report on internal controls over financial reporting this year (2007). Auditors' opinions on management's 2007 report are due next year (2008).

For the past two and a half years, the SEC and the PCAOB have been working together to improve the implementation of Section 404 as a result of widespread and growing criticism that the internal reporting process has been made excessively complicated and unduly expensive. The SEC's goal of the interpretive guidance is to reduce uncertainty about what constitutes a reasonable approach to management's evaluation while maintaining flexibility for companies that have already developed their own assessment procedures and tools that serve the company and its investors well. The revised rules are designed to be "principles-based" and give management the ability to scale and tailor their internal control evaluation procedures.

SEC Interpretive Guidance

The interpretive guidance is intended to allow management to focus on the internal controls that best protect against the risk of a material financial misstatement. The SEC believes that companies of all sizes and complexities will be able to implement the Section 404 rules more effectively and efficiently by following the two principles within the guidance, which are as follows:

Principle 1 - Management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner.



Principle 2 - Management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. Management can align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate). Management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas, and perform more extensive testing in high-risk areas.

SEC Rule Changes

In addition to the interpretive guidance, the SEC made three changes to its Section 404

rules, as follows:

"Safe Harbor Rule" – The SEC accedes that management's annual obligation to evaluate internal control is satisfied if the evaluation is in accordance with the SEC's interpretive guidance.

"Auditor Clarification Rule" – The SEC eliminated the auditors' opinion relating to the evaluation of management's evaluation process to clarify that the auditor's attestation report is opining directly on internal control over financial reporting.

"Definition Clarification Rule" – The SEC changed the definition of the term "material weakness" to "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material financial misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

Note: The above rule names were designed to be descriptive for the reader's convenience and are not official titles of the SEC's rule changes.

New PCAOB Standard

The PCAOB issued Accounting Standards No. 5 (AS 5), which completely replaces AS No. 2. AS 5 attempts to simplify the standard by focusing the audit on the most important matters, eliminating excessive procedures and providing "scaling" for smaller companies.

The PCAOB also approved Rule 3525, which requires auditors to comply with specified documentation and other procedures when requesting audit committee pre-approval of internal control-related services. These requirements mirror the auditors' responsibility for pre-approval of tax services for audit clients under Rule 3524.



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