August 12, 2004

The Fundamentals of Section 404 of The Sarbanes-Oxley Act of 2002—Key Questions Public Companies Should Ask*

With the Securities and Exchange Commission’s approval of An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (“Auditing Standard No. 2” or “A/S No. 2”), as adopted by the Public Company Accounting Oversight Board (the “PCAOB”) on March 9, 2004, the legal framework for implementing Section 404 of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley” or “SOX”) is now set for public companies beginning late this year. To assist public companies in their compliance with these new requirements, this memorandum provides (1) a brief background of Section 404 and the related history of the SEC and PCAOB rulemaking and (2) answers to questions facing a board of directors and management as they prepare for compliance with Section 404 and the related internal controls rules.

BACKGROUND OF SARBANES-OXLEY SECTION 404 AND RELATED RULEMAKING

Statutory Background

Section 404(a) of Sarbanes-Oxley directed the SEC to adopt rules requiring (1) management of a reporting company to assess the company’s internal controls and include an annual report on its assessment in the company’s Form 10-K (Section 404(a)) and (2) the auditors of a reporting company to “attest to, and report on, the assessment made by management” in accordance with standards adopted by the PCAOB.

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Section 103 of Sarbanes-Oxley separately required the PCAOB to adopt auditing standards related to internal controls. According to Section 103, these standards must require each registered public accounting firm to describe, in its audit report, the scope of the auditor’s testing of internal controls as required by SOX Section 404(b) and the findings of the auditor from its testing of internal controls. The report must also include the auditor’s evaluation of whether the internal controls (1) include maintenance of records that in reasonable detail reflect the transactions and dispositions of the issuer, (2) provide reasonable assurance that transactions are recorded in a manner permitting preparation of financial statements in accordance with generally accepted accounting principles, and (3) contain any material weaknesses.

SEC Rulemaking

On June 5, 2003, the SEC promulgated rules under Section 404 of Sarbanes-Oxley requiring:

- disclosure of management’s assessment of the effectiveness of a company’s internal controls;\(^1\)
- a public company auditor to attest to management’s assessment;\(^2\) and
- a public company to disclose in its annual and quarterly reports any changes in internal controls that have materially affected or are reasonably likely to materially affect the company’s internal controls.\(^3\)

Public companies today are required to comply with the third requirement above.\(^4\) The remaining two requirements must be met in a company’s annual report on Form 10-K for fiscal years ending on or after November 15, 2004 (in the case of “accelerated filers”) or July 15, 2005 (for other companies, including foreign private issuers).


\(^2\) Item 308(a) of Regulation S-K, 17 C.F.R. § 229.308(a).

\(^3\) Item 308(b) of Regulation S-K, 17 C.F.R. § 229.308(b).

\(^4\) Item 308(c) of Regulation S-K, 17 C.F.R. § 229.308(c).

\(^5\) See Question 28 below for a discussion of Item 308(c).
PCAOB Rulemaking

On June 17, 2004, the SEC approved Auditing Standard No. 2.6 As directed by Section 103 of Sarbanes-Oxley, the PCAOB originally proposed a version of this standard on October 7, 2003 for public comment. In response to nearly 200 comment letters from auditors, investors, internal auditors, issuers, regulators and others, a revised auditing standard was approved by the PCAOB on March 9, 2004 and filed with the SEC on March 18, 2004. Auditing Standard No. 2 is the professional standard governing the auditor’s attestation and reporting on management’s assessment of the effectiveness of internal controls. It addresses the work an auditor is required to perform concerning internal controls and the relationship of such internal controls audit to the audit of a public company’s financial statements.7

Guidance from the Staffs of the SEC and PCAOB

After approval of Auditing Standard No. 2, the SEC staff issued frequently asked questions related to Item 308 of Regulation S-K and the PCAOB staff issued questions and answers relating to Auditing Standard No. 2.8 While these questions and answers are not officially binding on the SEC or the PCAOB, they do provide limited guidance in this complex area.

QUESTIONS AND ANSWERS—
SOX 404 AND AUDITING STANDARD NO. 2

Management’s Assessment and Report -- Item 308(a) of Regulation S-K

1. What must management’s report on internal controls contain?

Other than the specific disclosures required by Item 308(a) of Regulation S-K, there is little guidance as to what management’s report should include. Item 308(a) requires the following basic elements:

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7 A/S No. 2 ¶¶ 145 – 158.

The Fundamentals of Section 404 of The Sarbanes-Oxley Act of 2002—
Key Questions Public Companies Should Ask

- a statement of management’s responsibility for establishing and maintaining adequate internal controls;\(^9\)

- a statement identifying the framework\(^{10}\) used by management to evaluate the effectiveness of the company’s internal controls;

- management’s assessment of the effectiveness of the company’s internal controls as of the end of the most recent fiscal year, including a statement as to whether or not internal controls are effective and identifying whether any material weaknesses exist.\(^{11}\) (Importantly, management may not conclude that its internal controls are effective if there is an identified material weakness.\(^{12}\)); and

- a statement that the company’s auditor has issued an attestation report on management’s assessment of the company’s internal controls.

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\(^9\) Rule 13a-15(f), 17 C.F.R. § 240.13a-15(f), and Rule 15d-15(f), 17 C.F.R. § 240.15d-15(f), under the Securities Exchange Act of 1934, as amended (the “Exchange Act”) define internal controls as a process designed by, or under the supervision of, the CEO and CFO to provide “reasonable assurance” regarding the reliability of the company’s financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles.


\(^{11}\) The SEC Staff FAQ provides that the SEC staff will apply the definitions of “significant deficiency” and “material weakness,” which are set forth in A/S No. 2, to all of the SEC’s internal controls-related rules. SEC Staff FAQ, Question 13.

\(^{12}\) Paragraphs 9 and 10 of A/S No. 2 provide definitions of “significant deficiency” and “material weakness,” indicating that a “material weakness” can result from a combination of significant deficiencies that result in “more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.” Paragraph 140 of A/S No. 2 illustrates a number of circumstances that should be considered at least significant deficiencies and are “strong indicators” of material weaknesses, and Appendix D to A/S No. 2 provides some examples of significant deficiencies and material weaknesses.
Companies should keep in mind, however, that management must state a direct, unqualified conclusion about whether the company’s internal controls are effective. Management cannot qualify its conclusion. Item 308(a) does not prohibit management from including mitigating or other information in management’s report, though it must make a direct conclusion on the effectiveness of internal controls.

2. Does a conclusion by management that the company’s internal controls are ineffective preclude a company’s CEO and CFO from providing the required Section 302 certifications (paragraph 4(b))?

Paragraph 4(b) of the Section 302 certifications requires a company’s CEO and CFO to certify as to whether or not the company’s internal controls are “designed” to provide reasonable assurance regarding the reliability of the company’s financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles. In contrast, Exchange Act Rules 13a-15(c) and 15d-15(c) require management to assess the “effectiveness” of internal controls as of the end of the most recent fiscal year and Item 308(a) of Regulation S-K requires management to present its conclusion as to effectiveness in a report filed with the Form 10-K. Accordingly, a conclusion by management that the company’s internal controls are ineffective would not preclude the company’s CEO and CFO from certifying to the “design” of internal controls per paragraph 4(b) of the Section 302 certifications.

3. Does management have to disclose significant deficiencies?

Importantly, the SEC staff has now stated that companies need not disclose a significant deficiency in management’s report or elsewhere in its periodic reports. However, if the significant deficiency, when combined with other

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13 Adopting Release, 68 Fed. Reg. at 36,642 n.62 and A/S No. 2 ¶ 163. The SEC Staff FAQ states that management “may not state that the registrant’s controls and procedures are effective except to the extent that certain problems have been identified or express similar qualified conclusions.” Management, instead, must take such problems into account when making its assessment. SEC Staff FAQ, Question 5.

14 Item 601(b)(31) of Regulation S-K, 17 C.F.R. 229.601(b)(31). It is important to note that internal controls should be designed to provide “reasonable assurance” as to the reliability of the financial statements as opposed to “absolute” assurance. While “reasonable assurance” is a high standard, it recognizes the inherent limitations in any system of internal controls. Adopting Release, 68 Fed. Reg. at 36,647 (recognizing that the concept of “reasonable assurance” has been built into the definition of internal controls); A/S No. 2 ¶ 16 (noting that “[internal controls] cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations”).

15 SEC Staff FAQ, Question 11.
The Fundamentals of Section 404 of The Sarbanes-Oxley Act of 2002—
Key Questions Public Companies Should Ask

significant deficiencies, constitutes a material weakness, the company must disclose the material weakness and, to the extent material to an understanding of the disclosure, disclose the nature of the significant deficiencies.

A company may, however, choose to disclose a significant deficiency when, for example, it has made material changes to its internal controls in response to a significant deficiency and such change is required to be disclosed under Item 308(c), as discussed below.16 Or, a company may choose to disclose a significant deficiency in a capital-raising context or for other reasons.

4. Where does management’s report appear in a Form 10-K?

The SEC rules do not specify exactly where management's report must appear within the annual report. The SEC has stated that the report should be in close proximity to the corresponding attestation report issued by the company’s auditors.17 The SEC further noted its expectation that many companies would choose to place the report near the MD&A disclosure or immediately preceding the financial statements.

5. Under what circumstances can management’s assessment exclude an entity?

The SEC staff recognizes two situations in which management may narrow the scope of its internal controls assessment, while still concluding that the company’s internal controls are effective. The SEC staff indicated that when management narrows the scope of its assessment in these limited circumstances, the Form 10-K should contain a section entitled “Scope of Management’s Report on Internal Control Over Financial Reporting” where a description of the scope limitation would be placed. Management’s report should cross-reference to that section.

Non-controlled Consolidated Entities. The SEC staff explicitly recognized that management may carve out from its assessment the internal controls of certain entities that were (i) in existence prior to December 15, 2003, (ii) that are consolidated in the company’s financial statements pursuant to FASB Interpretation 46 and (iii) over which the company does not have the authority or ability to assess internal controls.18 Management may conclude the company’s internal controls

16 Id.


18 SEC Staff FAQ, Question 1. This guidance also applies to entities accounted for via proportionate consolidation pursuant to EITF Issue No. 00-1.
are effective notwithstanding this exclusion. The disclosure in the Form 10-K should state that the consolidated entity’s internal controls have not been evaluated and are not included in management’s determination of effective internal controls. Further, the disclosure should include key financial measures (e.g., total and net assets, revenue and net income) attributable to the consolidated entity.

Business Combinations. The SEC staff also explicitly recognized that management may carve out from its assessment recently-acquired businesses. The Staff recognized that to the extent a company has consummated a material purchase business combination during the fiscal year covered by management’s internal controls report, it may not be possible to assess controls of the purchased entity on a timely basis. Management would nevertheless be able to conclude that the company’s internal controls are effective. In the Form 10-K, management must identify the acquired business excluded from its assessment and indicate the significance of the acquired business to the company’s consolidated financial statements. Management may exclude the acquired business from its assessment only for a period of one year from the date of the acquisition.

6. **If certain entities are so excluded from management’s assessment, what effect will such exclusion have on the auditor’s report?**

When management excludes from its assessment a non-controlled consolidated entity or a recently-acquired business, such exclusions would not preclude the auditor from issuing an unqualified opinion on management’s assessment or on the company’s internal controls. As with management’s report, the auditor’s report must identify those specific exclusions.

7. **Does management have to document and test internal controls with respect to equity method investees?**

The SEC staff recognized that since the accounts of an equity method investee are not consolidated on a line-by-line basis in the financial statements of the investor, controls over the recording of transactions into the investee's accounts are not part of the company's internal control structure. The company, however, must have controls in place regarding the recording of amounts related to the investment that are recorded in the company’s consolidated financial statements.

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19 SEC Staff FAQ, Question 3.

20 PCAOB Staff Q&A, Question 19.

21 SEC Staff FAQ, Question 2.
8. What is the deadline for management to complete its documentation and testing of internal controls for purposes of completing its assessment?

Management must assess the effectiveness of internal controls as of the end of the fiscal year. Management may only take into account those controls that are designed, documented and implemented as of the end of the fiscal year. It is critical that the testing of internal controls occur over a sufficient period of time to determine whether the internal controls are effective. Corrective actions taken after the end of the fiscal year may only be included in management’s report for mitigating purposes. Management cannot consider these corrective actions in determining whether the company’s internal controls are effective.

9. What responsibilities must management satisfy in order for the company’s auditor to be able to complete its audit of internal controls?

In order for the auditor to complete its audit of internal controls, management must fulfill certain responsibilities. If the auditor concludes that management has not fulfilled these responsibilities, the auditor is required to disclaim any opinions on management’s assessment and on the company’s internal controls. These responsibilities require management to:

- accept responsibility for the effectiveness of the company's internal control over financial reporting;
- evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria;
- support its evaluation with sufficient evidence, including documentation;

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22 A/S No. 2 ¶ 165.

23 A/S No. 2 ¶ 190.

24 A/S No. 2 ¶¶ 20 and 21.

25 The SEC pointed out that a company is required to maintain evidence, including documentation, to reasonably support management's assessment of the effectiveness of the company's internal control for financial reporting. This evidence should provide reasonable support for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions, for conclusions that tests were appropriately planned and performed and that the results of the tests were appropriately considered. Adopting Release, 68 Fed. Reg. at 36,643.

A/S No. 2 indicates that this documentation should, among other things, include the design of controls over relevant assertions related to significant accounts, information...
present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

10. **Is management required to provide representations to the company’s auditor in order for the auditor to provide its attestation report?**

A/S No. 2 provides that, if management refuses to make certain representations to the auditor, such refusal will be considered a management-imposed scope limitation on the auditor’s audit requiring the auditor to disclaim any opinions or withdraw from the engagement. The auditor should\(^n{26}\) obtain written representations from management:

- acknowledging its responsibility for establishing and maintaining internal controls;
- stating that it has performed an assessment of effectiveness of internal controls;
- stating that it did not use the auditor’s procedures (during its audit of either the financial statements or internal controls) as part of the basis for management’s assessment;
- stating its conclusion about the effectiveness of company’s internal controls;
- stating that it has disclosed to the auditor all deficiencies in the design or operation of internal controls identified as part of its assessment.

\(^n{26}\) On June 18, 2004, the PCAOB filed a proposed rule under Exchange Act Rule 19b-4 (File No. PCAOB-2004-06). The proposed rule includes the addition of Rule 3101, Certain Terms Used in Auditing and Related Professional Practice Standards. Under proposed Rule 3101, the word “should” indicates responsibilities that are presumptively mandatory, meaning that auditors would be required to comply with requirements of this type unless they demonstrated that alternative actions followed in the circumstances were sufficient. In contrast, the words “must,” “shall” and “is required” connote unconditional responsibilities of auditors. This rule proposal may be viewed at http://www.pcaobus.org/documents/rulemaking/009/PCAOB%202004-06%20Form%2019b-4%20Certain%20Terms.pdf.
including separately disclosing what it has identified as significant deficiencies or material weaknesses;

■ describing any material fraud or any other fraud that, though not material, involves senior management or other employees with a significant role in the company’s internal controls;

■ stating whether control deficiencies (material weaknesses and significant deficiencies) identified and communicated by the auditor to the audit committee during previous engagements have been resolved, specifically identifying those that were not; and

■ stating whether, subsequent to the date being reported on, there have been any changes to internal controls or other factors that may significantly affect the internal controls.27

Auditor Attestation and Report on Internal Controls -- Item 308(b) of Regulation S-K and Auditing Standard No. 2

11. What is an “attestation”? 

Item 308(b) of Regulation S-K requires companies to provide in their Form 10-K an attestation report by the company’s auditors on management’s assessment of the effectiveness of the company’s internal controls. Although SOX Section 404(b) refers to an auditor’s “attestation,” Auditing Standard No. 2 clarifies that the process by which the auditor evaluates management’s assessment and the company’s internal controls is considered an “audit” and the attestation of management’s assessment constitutes the result of that audit.28

12. What opinions will a company’s auditor give?

Auditing Standard No. 2 requires auditors to give two opinions:

■ an opinion on management’s assessment of the effectiveness of internal controls; and

■ the auditor’s own opinion on the effectiveness of the company’s internal controls.

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27  A/S No. 2 ¶ 142.

28  A/S No. 2 ¶ 3.
13. **What different types of opinions may auditors issue?**

Auditors may issue only three types of opinions on (1) management’s assessment and (2) the company’s internal controls:

- **Unqualified Opinion** – an opinion of the auditor that (1) management’s assessment is fairly stated (regardless of whether management concludes effective or ineffective internal controls) and (2) that the company’s internal controls are effective in all material respects.

- **Qualified in Scope Opinion** – an opinion of the auditor that, except for the effect of certain limitations on the scope of the auditor’s engagement, (1) management’s assessment is fairly stated and (2) the company’s internal controls are effective in all material respects.

- **Adverse Opinion** – an opinion of the auditor that, due to a material weakness, (1) management’s assessment is not fairly stated (as it concluded that the company’s controls were effective) and (2) the company’s internal controls are ineffective.

Notwithstanding the choices above, in certain circumstances, the auditor is permitted to disclaim any opinion or to withdraw from the engagement.

14. **When will an auditor issue an unqualified opinion?**

**Opinion on Management’s Assessment.** If management concludes in its assessment that internal controls are effective, the auditor may give an unqualified opinion on such assessment to the extent there are no identified material weaknesses and no limitations on the auditor’s ability to opine on the company’s internal controls.

If management’s assessment concludes that internal controls are ineffective, the auditor may give an unqualified opinion on management’s assessment of ineffective internal controls, to the extent there are no limitations on the auditor’s ability to opine on the company’s internal controls.\(^{29}\)

**Opinion on Internal Controls.** The auditor may give an unqualified opinion on the effectiveness of a company’s internal controls, but only if there have been no

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\(^{29}\) A/S No. 2 indicates that an auditor should evaluate whether management’s report properly discloses material weaknesses identified in the company’s internal controls. A/S No. 2 ¶ 166. If the auditor identifies material weaknesses that have not been properly disclosed in management’s report, it is possible that the auditor could issue an adverse opinion on management’s assessment, despite the fact that management concluded that the company’s internal controls were ineffective.
identified material weaknesses and no limitations on the auditor’s ability to opine on the company’s internal controls.\textsuperscript{30}

15. \textit{When will an auditor issue an opinion that is qualified in scope?}

\textit{Opinion on Management’s Assessment}. The auditor may issue a qualified as to scope opinion on management’s assessment (i.e., with the exception of certain scope limitations, management’s assessment is fairly stated), if there is a scope limitation on the auditor’s engagement imposed by the circumstances.

\textit{Opinion on Internal Controls}. The auditor may issue a qualified as to scope opinion on the company’s internal controls (i.e., with the exception of certain scope limitations, the company’s internal controls are effective), if there is a scope limitation on the auditor’s engagement imposed by the circumstances.

Note that depending on the auditor’s assessment of the importance of the omitted procedures on its ability to form an opinion, the auditor may alternatively disclaim any opinion or withdraw from the engagement.\textsuperscript{31}

An example of a scope limitation “imposed by the circumstances” is when management makes changes to internal controls in order to correct a material weakness prior to the date of its report, and believes the changes were in place for a sufficient period of time to have been effectively tested and concludes that the material weakness no longer exists, but the auditor believes that there was not sufficient time to test the new controls effectively.\textsuperscript{32}

Another example of a scope limitation is if management’s documentation does not provide reasonable support for its assessment. Inadequate documentation will cause the auditor to determine whether there is a limitation on the scope of the engagement.\textsuperscript{33} Additionally, if the auditor determines that management’s process for evaluating the company’s internal controls is inadequate, the auditor’s opinion should be qualified in scope.\textsuperscript{34}

\textsuperscript{30} A/S No. 2 ¶ 129. This result is consistent with Item 308(a) of Regulation S-K, which prohibits management from concluding that the company’s internal controls are effective if there is a material weakness.

\textsuperscript{31} A/S No. 2 ¶ 178.

\textsuperscript{32} A/S No. 2 ¶ 179.

\textsuperscript{33} A/S No. 2 ¶¶ 42 – 46.

\textsuperscript{34} A/S No. 2 ¶ 174.
16. **When will an auditor issue an adverse opinion?**

*Opinion on Management’s Assessment.* If management’s assessment concludes that the company’s internal controls are effective and if the auditor has identified a material weakness, the auditor must issue an adverse opinion on management’s assessment.

*Opinion on Internal Controls.* The auditor must issue an adverse opinion on the company’s internal controls, if it has identified a material weakness.35

17. **When will an auditor disclaim an opinion or withdraw from the engagement?**

The auditor should either disclaim any opinions on management’s assessment and on the company’s internal controls or withdraw from the engagement, if:

- there is any scope limitation imposed by management (e.g., management’s refusal to furnish certain written representations to the auditor); or

- the auditor determines that the scope limitation imposed by the circumstances prevents the auditor from forming an opinion.36

Additionally, if the auditor determines that management has not fulfilled its responsibilities, it is required to disclaim any opinions. In this circumstance, the auditor should communicate its decision to disclaim its opinions in writing to management and the audit committee.37

If the auditor disclaims an opinion, the auditor must explain the reasons for its inability to provide an opinion in its report.38 If the auditor identifies a material weakness in any limited procedures it performs prior to determining that it should disclaim an opinion, the auditor should also disclose in its report the existence of these material weaknesses.39

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35 It is unclear whether an auditor can issue an opinion that is both qualified in scope and adverse as, for example, when there is a scope limitation imposed by the circumstances and the auditor has identified material weaknesses.

36 A/S No. 2 ¶ 178.

37 A/S No. 2 ¶¶ 20 – 21.

38 Item 2-02(f) of Regulation S-X, 17 C.F.R. § 212.2-02(f), provides that, “[i]f an overall opinion cannot be expressed, [the auditor must] explain why.”

39 A/S No. 2 ¶ 180.
18. How will an auditor evaluate management’s report?

In evaluating management’s report, the auditor needs to determine whether:

- management has properly stated its responsibility for establishing and maintaining adequate internal control over financial reporting;

- the framework used by management to conduct the evaluation is suitable (e.g., the COSO Framework);

- management's assessment of the effectiveness of internal control over financial reporting, as of the end of the company's most recent fiscal year is free of material misstatement;

- management has expressed its assessment in an acceptable form; and

- material weaknesses identified in the company's internal control over financial reporting, if any, have been properly disclosed, including material weaknesses corrected during the period.40

19. How will an auditor determine which controls to test? To what extent will controls be tested?

In performing its audit of internal controls, auditors should obtain evidence of the effectiveness of internal controls with regard to all relevant assertions related to all significant accounts and disclosures in the company’s financial statements. The auditor should first identify significant accounts, relevant assertions and significant processes.

Once these items have been identified, the auditor should consider the following factors in determining which controls should be tested:

- points at which errors or fraud could occur;

- nature of controls implemented by management;

- significance of each control in achieving the objectives of the control criteria and whether multiple controls achieve the particular objective or are needed to achieve the objective;

- risk that a control may not be operating effectively;

40 A/S No. 2 ¶ 166.
The auditor should perform at least one walkthrough for each major class of transactions. In a walkthrough, the auditor traces a transaction from its origination through the company’s information systems until it is reflected in the company’s financial reports. This process should cover the initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant processes identified.

20. How will an auditor determine which controls to test when the company has multiple office locations and business units around the world?

A/S No. 2 provides direction on determining which controls to test and the extent of such testing when a company has multiple locations or business units. This determination is generally based on the financial significance, either individually or in the aggregate, of each location or business unit and the risk of a material misstatement arising from such location or business unit. A/S No. 2 recognizes several categories of locations or business units that an auditor should test: (1) financially significant business units or locations, (2) locations or business units that involve specific risks and (3) locations or business units that, when aggregated with other locations or business units, are financially significant.

Auditors are generally required to test a “large portion” of the company’s operations or financial position. For those companies that have a relatively small number of individually significant business units that comprise a “large portion” of their operations or financial position, an auditor will not have to test as many locations or business units. In contrast, if a company has a large number of individually insignificant business units or locations, an auditor will have to expand the number of business units or locations that it tests. The PCAOB staff has indicated that in this circumstance an auditor may satisfy its obligations by testing a representative sample of the company’s locations or business units.

41 A/S No. 2 ¶ 83.
42 A/S No. 2 ¶¶ 79 – 82.
43 A/S No. 2, Appendix B.
44 PCAOB Staff Q&A, Questions 17 & 18.
21. When must an auditor perform tests of internal controls?

The auditor must perform tests and controls over a period of time adequate to determine whether, as of the end of the fiscal year, the controls necessary for achieving the objectives of the control criteria are operating effectively. The period of time over which the auditor tests will vary “with the nature of the controls being tested and with the frequency with which specific controls operate and specific policies are applied.” As Auditing Standard No. 2 notes, some controls operate continuously (e.g., controls over sales) while others operate only at certain times (e.g., controls over quarterly or monthly physical inventory counts). The auditor’s testing of the operating effectiveness of controls should occur at the time the controls are operating.

22. What effect will events related to internal controls that have occurred after the end of the fiscal year have on an auditor’s opinions?

If the auditor obtains knowledge about events occurring after the end of the fiscal year that materially and adversely affect the effectiveness of the company’s internal controls as of the date specified in management’s assessment, the auditor should issue an adverse opinion on the effectiveness of internal controls and, if management’s report does not appropriately assess the effect of the subsequent event, an adverse opinion on management’s assessment of internal controls. If the auditor cannot determine the effect of the subsequent event on the effectiveness of the company’s internal controls, it should disclaim any opinions. The auditor, however, may not take into account actions or events that positively affect the company’s internal controls.

If management’s report contains information in addition to its assessment on the company’s internal controls (e.g., disclosures regarding corrective actions or plans to implement new controls), the auditor should disclaim an opinion on such information in its audit report.

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45 A/S No. 2 ¶ 98.
46 Id.
47 A/S No. 2 ¶ 99.
48 A/S No. 2 ¶¶ 186-189.
49 A/S No. 2 ¶ 188.
50 A/S No. 2 ¶ 190-192.
23. **What assistance may an auditor provide to a public company client with regard to internal controls without jeopardizing its independence?**

The auditor may not design or implement controls, as this work would place the auditor in a management role and result in the auditor auditing its own work. The auditor may, however, make substantive recommendations as to how management may improve the design or operation of the company’s internal controls as a by-product of an audit.

The Adopting Release acknowledges that, because the auditor must attest to management’s assessment, management and the external auditor will need to coordinate their processes for documenting and testing internal controls. The Adopting Release elaborates that auditors may assist management in documenting internal controls, but that management must be actively involved in the process and cannot delegate its responsibility to assess its internal controls to the auditor.

Unless specifically pre-approved by the audit committee, the company’s independent auditor may not accept an engagement to provide internal controls related services for a company for which the auditor also audits the financial statements.

24. **Will an auditor perform an assessment of the audit committee? How will this assessment affect the auditor’s opinions?**

Recognizing the role of the audit committee within the internal controls infrastructure, A/S No. 2 directs the auditor to assess the effectiveness of the audit committee as part of its evaluation of internal controls. This assessment will focus on factors relating to the effectiveness of the committee’s oversight function. For example, the auditors may assess the independence of the audit committee from management, whether the responsibilities of the audit committee are well-articulated, the audit committee’s involvement and interaction with the

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51 A/S No. 2 ¶ 32.


53 A/S No. 2 ¶¶ 55 – 59. To clarify that it is not the auditor’s responsibility to perform a separate and distinct evaluation of the audit committee, Paragraph 56 recognizes that this responsibility rests with the company’s board of directors. See Section 303A.07(c)(ii) of the NYSE Listed Company Manual (requiring audit committee charters to contain an annual performance evaluation); Commentary to Section 303A.09 of the NYSE Listed Company Manual (providing that the corporate governance guidelines must address an annual performance evaluation by the board as to whether the board and its committees are operating effectively).
The Fundamentals of Section 404 of The Sarbanes-Oxley Act of 2002—Key Questions Public Companies Should Ask

auditor and key members of financial management and whether or not the audit committee raised the “right questions . . . including questions that indicate an understanding of the critical accounting policies and judgmental accounting estimates.” Ineffective oversight by the audit committee should be considered at least a significant deficiency and is a strong indicator of a material weakness.54

25. Can a public company use one auditor to audit its financial statements and a different auditor to provide the required attestation on management’s report?

The same auditor that audits the company’s financial statements is required to attest to and report on management’s assessment of the company’s internal controls.55 Auditing Standard No. 2 provides for an integrated audit of the financial statements and internal controls.

26. What is the relationship between the audit of internal controls and the audit of financial statements?

The audit of the financial statements is considered to be directly related to the audit of internal controls.56 Consequently, the auditor’s conclusions on the effectiveness of internal controls should take into account the results of any additional tests performed with respect to its opinion on the company’s financial statements.57 If an auditor determines that its opinion on the company’s financial statements is not affected by an adverse opinion on the company’s internal controls, it should include a statement to this effect in its internal controls audit report (or in the combined audit report).58

27. Will the auditor’s report on internal controls be combined with the auditor’s report on our financial statements?

The auditor’s attestation report may be combined with the report on the company’s financial statements or it may be a separate report.59 In determining whether to combine the report on internal controls with the report on the financial

54  A/S No. 2 ¶¶ 55 – 59.
55  A/S No. 2 ¶ 2.
56  AS No. 2 ¶¶ 145 – 158
57  A/S No. 2 ¶ 149.
58  A/S No. 2 ¶ 194.
59  Item 2-02 of Regulation S-X, 17 C.F.R. § 210.2-02.
statements, the SEC staff noted that an auditor should consider whether (1) the auditor expects that it will reissue the audit report or (2) the audit report will be incorporated by reference into a filing under the Securities Act of 1933, as amended. In light of the potential for incorporation into other filings where the attestation is not required, auditors are expected to issue separate reports.

Changes in Internal Controls -- Item 308(c) of Regulation S-K

28. What internal controls disclosures are companies required to make in their quarterly reports?

Item 308(c) of Regulation S-K requires public companies to disclose, on a quarterly basis in its Form 10-Q (or Form 10-K in the case of the fourth quarter of the company’s fiscal year), any changes in internal controls that occurred during the most recent quarter that have materially affected or are reasonably likely to materially affect the company’s internal control. Before a company has provided its first management’s report pursuant to Item 308(a), the SEC staff has indicated that only material changes with respect to internal controls that are subsumed by disclosure controls should be disclosed under Item 308(c). The SEC staff has now clarified that a company is not required to disclose changes made to the company’s internal controls in preparation for the company’s first management report on internal controls. It, however, limited this comfort by indicating that a company should carefully consider disclosing any identified material weaknesses and related remedial steps taken by the company.

With respect to each Form 10-Q filed after the company’s first required management report under Item 308(a), management will need to evaluate whether or not any change to its internal controls – whether or not in response to a control deficiency – has materially affected, or is reasonably likely to materially affect, the company’s internal controls. If so, these changes must be disclosed.

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60 SEC Staff FAQ, Question 15.

61 Question 22 of the SEC Staff’s Sarbanes-Oxley Act of 2002 – Frequently Asked Questions issued on Nov. 8, 2002 (revised on Nov. 14, 2002) at http://www.sec.gov/divisions/corpfin/faqs/soxact2002.htm (discussing the predecessor to Item 308(c), Item 307(b)). Since disclosure controls and procedures and internal controls substantially overlap, it is often difficult to determine whether an internal control is subsumed by disclosure controls and procedures. It appears that companies are cautious when deciding whether or not to disclose changes to internal controls under Item 308(c), and there have been frequent Item 308(c) disclosures since the disclosure obligation became effective.

62 SEC Staff FAQ, Question 9.

63 Id.
Item 308(c) does not, however, require a company to disclose or otherwise elaborate on the reasons for the material change. In the Adopting Release, the SEC noted that companies should use a “facts and circumstances” test to determine whether “the reasons for the change, or other information about the circumstances surrounding the change, constitute material information necessary to make the disclosure about the change not misleading.”

If a company makes a change to its internal controls after the period covered by a quarterly report, it is not required to disclose the change under Item 308(c). A company may, however, choose to make this disclosure for various reasons. For example, a company making a disclosure of a significant deficiency or material weakness that existed as of the end of the period covered by the report may wish to disclose post-period corrective actions in order to inform investors of steps taken to resolve the significant deficiency or material weakness.

29. Is an auditor involved in quarterly disclosures of changes to internal controls?

The company will need to consult with its auditors with respect to its quarterly internal controls disclosures in light of the auditor’s obligation to perform limited procedures in this area.

Auditing Standard No. 2 provides for an “up-the-ladder” reporting procedure to management and the audit committee when the auditor determines that material changes to internal controls have not been properly disclosed and reminds the auditor of its responsibilities under AU Section 317, Illegal Acts by Clients, and Section 10A of the Exchange Act.

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65 A/S No. 2 ¶¶ 201 - 206.
66 A/S No. 2 ¶ 205.
PREPARING FOR COMPLIANCE WITH SECTION 404

30. **What should management be doing now?**

The Section 404 compliance deadline is fast approaching and the process for documenting and testing internal controls should already be well underway.

Management should:

- choose and familiarize themselves with the COSO Framework (or other appropriate framework) for assessing internal controls;

- continue communicating with the company’s auditor regarding the company’s internal controls, such as any factors or thresholds that the auditor will consider when characterizing internal controls deficiencies as significant deficiencies or material weaknesses;

- continuously assess internal controls to identify deficiencies and, as deficiencies are identified, determine whether they rise to the level of significant deficiencies or material weaknesses;

- place a high priority on taking timely corrective actions to cure internal controls deficiencies as they are identified (particularly those that are significant deficiencies or material weaknesses) and satisfactorily complete testing for purposes of A/S No. 2;

- identify special areas that may require more attention or may raise complex issues, such as multiple business units, foreign business operations and recently-acquired businesses;

- consider and plan for various scenarios that may arise and affect management’s report and the types of opinions the company’s auditor could provide;

- begin drafting management’s report (and related Items 307 and 308 disclosures) well in advance; and

- as to the foregoing, communicate with the audit committee on a regular, structured basis and facilitate communications between the company’s auditor and the audit committee.
CONCLUSION

How well Auditing Standard No. 2 and Item 308 of Regulation S-K will work together is uncertain. What is certain is that there are substantial implementation burdens on public companies’ management, boards of directors and outside auditors. A great deal has yet to be learned about how these new legal requirements will work in practice.

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