

# SEC UPDATE



## SEC Announces New Internal Control Initiatives

In the wake of continued significant concerns raised in respect of the cost-benefit of the internal control requirements of Section 404 of the Sarbanes-Oxley Act, the SEC this week announced the following initiatives:

- First, it expects to issue guidance for companies and management on how to complete the assessment of internal control over financial reporting and, in connection with that initiative, it announced that it expects to:
  - issue a concept release covering a variety of related issues and soliciting views on (i) the management assessment process required by Section 404(a), (ii) the appropriate role of outside auditors in connection with the management assessment and (iii) the manner in which outside auditors provide the attestation required by Section 404(b);
  - consider seeking additional guidance from the Committee of Sponsoring Organizations of the Treadway Commission (COSO) for smaller public companies in completing their Section 404(a) assessments;
  - issue, on the basis of the concept release and the further guidance from COSO, guidance to management to assist in its performance of a top-down, risk-based assessment of internal control over financial reporting. To assist non-accelerated filers and other smaller public companies, the guidance is expected to be scalable and be responsive to their individual circumstances and be sensitive to the fact that many companies have already invested substantial resources to establish and document programs and procedures to perform their assessments;
- Second, as part of its oversight of the PCAOB and its authority to approve PCAOB auditing standards, it expects to work with the PCAOB on its proposed revisions of Auditing Standard No. 2 (An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements) to ensure that the proposed revisions are in the public interest and consistent with the protection of investors. The PCAOB has separately announced that its proposed revisions would:
  - seek to ensure that auditors' primary focus during integrated audits is on areas that pose higher risk of fraud or material error;
  - incorporate key concepts contained in the guidance issued by the PCAOB on May 16, 2005;
  - revisit and clarify what, if any, role the auditor should play in evaluating the company's process of assessing internal control effectiveness;
  - clarify the concepts of "significant deficiency" and "material weakness";
  - reconsider the "strong indicators of a material weakness" to allow more judgment in determining whether a deficiency exists;

- clarify materiality and scope decisions; and
- emphasize the integration of the internal control audit and the financial statement audit;
- Third, as part of its oversight of the PCAOB, the SEC announced that it will evaluate whether the PCAOB inspection program has been effective in encouraging implementation of PCAOB principles; and
- Finally, the SEC announced that it expects to issue an order postponing the effective date for Section 404 implementation by non-accelerated filers, until fiscal years beginning on or after December 16, 2006.

These steps are intended to improve the effectiveness, efficiency and reliability of Section 404 compliance. SEC Chairman Christopher Cox stated that:

“[t]he steps we are announcing today are designed to further improve the reliability of financial statements and to better protect investors while making the Section 404 process more efficient and cost effective[.] As we go forward, we will consider the special concerns of all companies that fall under our jurisdiction -- large and small, foreign and domestic. By providing practical guidance to companies, by working with the Public Company Accounting Oversight Board on their forthcoming revised standard for auditors, and by examining how the PCAOB inspection process is succeeding in increasing the efficiency and cost-effectiveness of the audit process, we will take a giant step toward 'getting it right' when it comes to Section 404 compliance.”

The one clear message from the SEC is that no reporting company will be exempt from the Section 404 requirements. Although the SEC, together with the PCAOB, will seek to improve the process by providing greater guidance, the essential requirements of Section 404 appear here to stay.

This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul, Weiss Securities Group, including:

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