



TRENDS

I N F I N A N C I A L M A N A G E M E N T

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How to Comply with Section 404? The PCAOB Offers Guidance

► **EXACTLY TWO WEEKS AFTER THE** Securities & Exchange Commission extended the compliance dates for Section 404 of the Sarbanes-Oxley Act, the Public Company Accounting Oversight Board (PCAOB) issued its long-awaited standard on how external auditors should comply with it.

Under Section 404, most senior managers of public companies will have to report and certify the adequacy of their companies' internal financial controls and financial reporting procedures to prevent financial abuse and fraud. But a company's independent auditors must attest to management's assessments of its controls and financial reporting procedures. That's the thrust of the standard, officially called "An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements."

Based on a PricewaterhouseCoopers analysis of the PCAOB's 211-page standard, here are some of the main points:

Auditor's Report. The external

auditor must evaluate and issue two opinions, one on management's process for making its Section 404 assessment and another on the effectiveness of the company's internal control over financial reporting.

Use of Management Testing. The external auditor may use some of management's testing in areas such as IT controls and controls over the period-end financial reporting process.

Audit Committee Effectiveness. The auditor's evaluation of the board of directors' audit committee is part of the auditor's evaluation of internal control over financial reporting.

Material Weakness. A material weakness of internal control is defined as a likelihood that a material misstatement of the annual or interim financial statements won't be prevented or detected. A material weakness must result in an "adverse opinion" from the auditor.

Walkthroughs. The transactions on which the auditor must perform walkthroughs are limited to those that are significant to the compa-

ny's financial statements.

Small and Medium-Sized Companies. While small or medium-sized companies aren't exempt from maintaining an effective system of internal control over financial reporting, their controls may be less formal and structured.

Auditor Independence. The auditor can't provide internal control-related services and also audit that company's financial statements without authorization from the audit committee of the board of directors.

The PCAOB released an exposure draft of the standard for public comment in October 2003. The comment period ended in late January 2004. All comments for this standard can be downloaded from the PCAOB's website, www.pcaobus.org/pcaob-rulemaking.asp, under "All Comments to Date on Audits of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (17.7MB ZIP)." The complete rule can be found at www.pcaobus.org/rules/Release-20040308-1.pdf. ■