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404 Guidance: Real Change or Just Window Dressing?

In December, both the Securities & Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB) released for comment their long-awaited new guidance for assessing internal control over financial reporting. The SEC's "interpretive" guidance, "Management's Report on Internal Control over Financial Reporting" (Release No. 33-8762), is designed for management to use in a top-down, risk-based assessment method. A major objective of the SEC proposal is to provide guidance to public companies that is less prescriptive and better aligned with the objectives of Sarbanes-Oxley (SOX) Section 404. The PCAOB's counterpart (PCAOB Release No. 2006-007), which is a proposed replacement of Auditing Standard No. 2, "An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements," was released for comment to a public eager for a totally new approach to the external audit of internal control over financial reporting.

The SEC's proposal is intended to allow management to scale and tailor their evaluation procedures to fit the facts and circumstances of a particular organization. This should result in less effort and lower cost of compliance as compared to the existing practice, which consists of following external auditing standards that appear to fit only the largest public corporations. Less effort should also be required to focus on only yearly changes in risks and controls rather than the current practice of annually identifying all major reporting risks and evaluating related controls.

The SEC release also directs external auditors to express only one opinion on a client's internal control over financial reporting rather than the current practice of expressing an opinion on both the control system itself as well as management's assessment of the system. The exposure draft outlines the principles-based nature of the guidance and addresses four specific areas:

- Identification of risks to reliable financial reporting and the related controls that management has implemented to address those risks,
- Evaluation of the operating effectiveness of controls,
- Reporting the overall results of management's evaluation, and
- Documentation.

The most critical omission from the new SEC guidance is any emphasis of how critically important an ethical corporate climate is to the effectiveness of internal controls.

The PCAOB's proposed Standard likewise fails to emphasize the importance of the control environment—including integrity and ethical values—to effective internal control. Although the PCAOB press release notes that the proposals are designed primarily "to focus the audit on the matters most important to internal control," this is stated to be "directing the auditor's testing to the most important controls" over transactions—and not to the control environment.

While intending to focus the external auditor's attention on matters most important to internal controls, the PCAOB's Standard, in fact, primarily concentrates on testing details of routine transactions. The focus on specific financial statement assertions, even while considering company-level controls, is evident: "In a top-down approach, if company-level controls are strong and *link directly to the process-level controls* [emphasis added]...the auditor will likely be able to reduce the testing of controls at the process level." This seems to contradict the PCAOB's public stance of emphasizing reliance on company-level controls. Despite the promised reduction in detailed testing of routine transactions, the new Standard seems to revert to the old emphasis of testing transaction process controls from a bottom-up perspective.

Paragraph 19 of the new Standard states that the external auditor "must evaluate the control environment at the company." Five general steps that the auditor should take in making this evaluation are listed. This requirement is in the section of the Standard involving identification of controls the external auditor should document and later test rather than in the in the section prescribing control testing methods.

Concerning testing the design of controls, paragraph 48 of the draft Standard notes that "the auditor ordinarily performs procedures sufficient to evaluate design effectiveness during the performance of the walkthrough." The major objective of a walkthrough is to trace "a transaction from origination through the company's processes, including information systems, until it is reflected in the company's financial records." Thus, the prescriptive nature of the new Standard contemplates little, if any, testing of a company's design of company-level controls, including the control environment.

In regard to testing the operational effectiveness of internal controls, paragraph 49 of the draft Standard notes that "the auditor should test the operating effectiveness of a control by determining whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively." It appears that the new Standard contemplates most testing of controls will involve only routine transaction processes and not the promised top-down approach of company-wide controls.

Paragraph 55 of the PCAOB draft Standard describes the nature of tests of controls. It notes that walkthroughs generally consist of a combination of "inquiry, observation, inspection of relevant documentation, and reperformance of a control." Again, this guidance fails to require auditors to use techniques designed to ascertain the state of the ethical climate in an organization or other elements of the control environment. The Standard should suggest using interviews; employee surveys; the presence and effectiveness of help/hot lines; reports from a properly resourced, independent, and competent internal auditing activity; and evaluation of the quality of oversight provided by the audit committee of the board of directors.

While the draft Standard does note in paragraph 79 that an ineffective control environment is a strong indicator that a material weakness in internal control does exist, only two circumstances are cited as examples:

- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies that have been communicated to management and the audit committee and remain uncorrected after some reasonable period of time.

Other strong indicators of a material weakness are listed, but they aren't linked to the control environment, the most important aspect of internal control. These indicators also don't focus on the significance of ethics and compliance systems.

It appears that the both the SEC and the PCAOB have largely ignored new guidance published in 2006 by COSO (the Committee of Sponsoring Organizations of the Treadway Commission) that was designed to help the assessment and attestation of internal control over financial reporting.

Emphasizing its earlier guidance on internal control, COSO's guidance, titled *Internal Control over Financial Reporting: Guidance for Smaller Public Companies*, contains new insights designed to facilitate internal control evaluation. Of the 20 principles included, seven involve the control environment. The control environment remains only one—albeit the most important—of the five internal control components that must be effective so that an organization's internal control as a whole can be considered effective. According to the new COSO guidance, "The control environment is the foundation upon which all other components of internal control are based and sets the tone of the organization." The seven new COSO principles that affect the control environment are:

1. Integrity and Ethical Values—Sound integrity and ethical values, particularly of top management, are developed and understood. These set the standard of conduct for financial reporting.

2. Board of Directors—The board of directors understands and exercises oversight responsibility related to financial reporting and related internal control.

3. Management's Philosophy and Operating Style—Management's philosophy and operating style support achieving effective internal control over financial reporting.

4. Organizational Structure—The company's organizational structure supports effective internal control over financial reporting.

5. Financial Reporting Competencies—The company retains individuals competent in financial reporting and related oversight roles.

6. Authority and Responsibility—Management and employees are assigned appropriate levels of authority and responsibility to facilitate effective internal control over financial reporting.

7. Human Resources—Human resource policies and practices are designed and implemented to facilitate effective internal control over financial reporting.

In terms of expectations, the SEC's new guidance is likely to be most valuable to public companies. It splits the management assessment of internal control from the excessive auditing constraints set by the PCAOB. But the guidance proposed by both the SEC and the PCAOB fails to demonstrate the leadership necessary for implementing hoped-for reforms that recognize the importance of the ethical culture in an organization and other top-level, company-wide processes. In short, the PCAOB draft fails to address the excessive auditing costs of "proving" that effective internal control exists over the many details of transaction processing.

Both the SEC and PCAOB solicit comments on their guidance proposals. Details of how to do so are contained on their respective websites at www.sec.gov and www.pcaob.com. ■

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