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Auditors at the gate: Section 404 of the Sarbanes–Oxley Act and the increased role of auditors in corporate governance

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ABSTRACT

KEYWORDS: Sarbanes–Oxley Section 404, Auditing Standard No. 2, Public Company Accounting Oversight Board, internal control over financial reporting

Section 404 of the Sarbanes–Oxley Act of 2002 is one of the most far-reaching components of recent US securities reforms. Under Section 404, management must prepare an annual report assessing the effectiveness of their company's internal control over financial reporting and the company's auditors must attest to, and report on, management's assessment.

After examining the basic requirements of Section 404, this paper focuses on the extensive review required by auditors under Section 404 and related auditing standards, which require the auditor to monitor certain fundamental aspects of corporate governance. The paper then considers the impact of Section 404 on the auditor-company relationship, and the increased rigidity and formalisation that is likely to result from Section 404's implementation. Finally, the paper outlines the many uncertainties that surround Section 404. These uncertainties include questions concerning the implementation of Section 404 and the related Auditing Standard No. 2, the strains many European companies face as they attempt to comply with Section 404's requirements at the same time that they are transitioning to International Financial Reporting Standards and the potential new grounds for liability that both companies and auditors may confront.

INTRODUCTION

No one disputes that the effects of the Sarbanes–Oxley Act of 2002[1] have been far-reaching. Passed in response to corporate governance and accounting scandals in the USA, the Sarbanes–Oxley Act enacted a series of reforms that has transformed corporate governance in the USA and has had a profound influence abroad.

The scandals that provided the impetus to enact the Sarbanes–Oxley Act resulted in large part from the perceived weakness of management, auditors and attorneys. In response to these problems, the Sarbanes–Oxley Act focused to a significant extent on increasing the enforcement role of 'gatekeepers', such as attorneys and auditors. The Sarbanes–Oxley Act created the Public Company Accounting Oversight Board (PCAOB) to set standards for and police auditors, strengthened auditor independence rules and placed the audit committee, not management, in charge of the auditor's engagement. Attorneys representing companies before the Securities and Exchange Commission (SEC) were also required to

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report findings of material violations of relevant laws 'up the ladder' of the company, beyond management if necessary.

Although the flurry of rulemaking and other activity surrounding the Sarbanes–Oxley Act has largely settled, one of the most significant components of the Sarbanes–Oxley Act, Section 404, is just entering into full force. Section 404 of the Act requires the management of US reporting companies to assess the effectiveness of their company's internal control over financial reporting and requires the company's independent auditors to attest to, and report on, management's assessment.[2]

The full ramifications of Section 404 are not yet known. But one aspect of the provision is apparent — Section 404's reliance on auditors to monitor significant aspects of a company's corporate governance. The auditor will engage in a wide-ranging examination of the company's internal policies through its Section 404-mandated review of the company's internal control over financial reporting. As part of this review, the auditor will examine items ranging from the subject company's code of corporate ethics to the effectiveness of the company's audit committee and internal control function, in addition to the company's compliance with applicable law. By charging auditors with this task, and combining these enhanced responsibilities with an increased focus on auditor reporting requirements under Section 10A of the Exchange Act, Section 404 imposes one of the strongest external checks on management and corporate governance under the Sarbanes–Oxley Act, with profound implications for the relationship between public companies and their auditors.

This paper first summarises the history of the internal control requirement imposed on public companies by the US securities laws and describes the basic requirements of Section 404. It then examines the extensive review required by auditors under Section 404 and Auditing Standard No. 2, and how this review enhances the role of auditors as central gatekeepers, establishing the auditor as the monitor of certain fundamental principles of corporate governance. The paper then analyses the other changes to the auditor–client relationship likely to result from Section 404 and Auditing Standard No. 2, focusing on the increased formalisation of the relationship, and discusses its potential impact on the quality of financial information. Finally, the paper outlines some of the uncertainties companies and auditors face as they prepare to comply with the new internal control rules. These uncertainties include questions relating to the practical application of key Section 404 concepts, the strains that many European companies will face as they attempt to comply with Section 404's requirements at the same time that they are transitioning to International Financial Reporting Standards (IFRS) and the potential new grounds for liability that both companies and auditors may face.

SECTION 404

Section 404 of the Sarbanes–Oxley Act requires management to include an internal control report in the company's annual report filed with the SEC. The internal control report must (i) state that management is responsible for establishing and maintaining an adequate internal control over financial reporting and (ii) contain an assessment of the effectiveness of internal control over financial reporting as of the end of the company's most recent fiscal year. Section 404 also requires every public accounting firm that prepares or issues the audit report of the company to attest to, and report on, management's report in accordance with procedures established by the PCAOB. The auditor's report is also included in the company's annual report.

The SEC promulgated final rules implementing Section 404 in June 2003.[3] In

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March 2004, the PCAOB issued proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, which sets forth the professional standards and related performance guidance to be used by auditors to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting for the purposes of Section 404.[4] The SEC approved the proposed standard on 17th June, 2004,[5] and management reports on internal control over financial reporting and auditor reports thereon are required to be included for US companies that are accelerated filers in their annual report for the first fiscal year ending on or after 15th November, 2004 and for all other filers, including non-US issuers, in their annual report for the first fiscal year ending on or after 15th July, 2005.[6] On 30th November, 2004, the SEC issued an exemptive order that, subject to certain conditions, granted accelerated filers with a public common equity float of less than $700m and a fiscal year ending on or between 15th November, 2004 and 28th February, 2005 an additional 45 days after the date on which their annual reports would be due to prepare and file their management's internal control report and the accompanying auditor's attestation.[7] In addition, the SEC and PCAOB have each issued a series of questions and answers to provide additional guidance on issues related to the implementation of Section 404.[8]

Context of Section 404

To a certain extent, focusing attention on internal controls is nothing new. The subject of internal controls began appearing in auditing and SEC literature over 60 years ago. Since 1989, Codification of Statements on Auditing Standards (AU) §325, Communication of Internal Control Related Matters Noted in an Audit, has required auditors to report to the company certain significant deficiencies in the design or operation of internal controls at the company that come to the auditor's attention during the course of an audit of the company's financial statements.[9] AU §319, Consideration of Internal Control in a Financial Statement Audit, has since 1990 required auditors to 'obtain an understanding of internal control sufficient to plan the audit by performing procedures to understand the design of controls relevant to an audit of financial statements and determining whether they have been placed in operation'.[10]

Prior to the adoption of these provisions, in 1977 the US Congress enacted the Foreign Corrupt Practices Act (FCPA).[11] The FCPA requires US reporting companies to maintain a system of internal accounting controls that includes maintenance of books and records and ensures that transactions are undertaken in accordance with management's authorisation. In addition, since 1993, the Federal Deposit Insurance Corporation has required federally insured depository institutions with total assets of over $500m to prepare a management report concerning the institution's internal control structure and procedures for financial reporting.[12]

Nevertheless, the SEC had twice proposed, and twice failed, to enact rules that would require US reporting companies to prepare an internal control report. In 1979, following enactment of the FCPA, the SEC proposed that management file a report stating, among other things, its opinion as to whether the company's internal accounting control systems provided reasonable assurance that transactions were executed in accordance with management's authorisation and were properly recorded.[13] Reaction to the proposal ranged from complaints that the reports would require management to report on compliance with the FCPA to hope that voluntary codes would

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provide the necessary information with respect to company compliance with applicable requirements. Eventually, the SEC withdrew the rule.[14]

In 1988, the SEC again proposed that management prepare a report on the effectiveness of its internal control over material matters, which would include a description of actions taken in response to recommendations made by internal auditors and independent accountants.[15] Comments on the proposed rules, however, objected to disclosing management responses to auditor recommendations, and again pointed to private sector groups that were developing standards for reporting on the effectiveness of a company's internal controls. The proposed rules were never adopted.[16]

In addition, AU §319's existing requirement that auditors consider a company's internal controls in conducting an audit of the company's financial statements does not require a review that is nearly as extensive as that which auditors will be required to perform under the PCAOB's new auditing standard. In contrast to AU §319's requirement that auditors understand a company's internal controls so that they can plan the audit of the company's financial statements, Auditing Standard No. 2 requires an audit of the company's internal control over financial reporting.[17] In the words of the SEC's deputy chief accountant, the review of internal control over financial reporting represents 'the most significant change [ ] in auditing in fifty years'.[18]

Section 404's comprehensive review of internal control over financial reporting makes it widely viewed as the most expensive provision of the Sarbanes–Oxley Act.[19] A survey of 224 public companies with average revenues of $2.5bn reported that, on average, surveyed companies expected to pay an estimated $3.14m in Section 404 compliance costs, with auditors receiving an average of $823,200 for attestations of internal controls.[20] Another survey determined that Section 404 compliance costs would reach $5.1m for the average US company.[21] General Electric has stated publicly that it expects to pay $30m to comply with Section 404 this year,[22] and the chief executive officer of the New York Stock Exchange has blamed Section 404 compliance for the reduction in new listings from European companies on the exchange.[23] Supporters of Section 404 have acknowledged these costs, but suggest that the benefits from Section 404's implementation, including the restoration of investor confidence through disclosure that the internal controls of US reporting companies are sound, should more than compensate for these costs.[24]

Internal control over financial reporting

The touchstone of Section 404 is the public company's 'internal control over financial reporting'. In its release promulgating the final rules under Section 404, the SEC defined the term 'internal control over financial reporting' as:

> 'A process designed by, or under the supervision of, the [company's] principal executive and principal financial officers, or persons performing similar functions, and effected by the [company's] board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:
>
> (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the [company];
>
> (2) Provide reasonable assurance that transactions are recorded as necessary

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to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the [company] are being made only in accordance with authorizations of management and directors of the [company]; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the [company's] assets that could have a material effect on the financial statements.'[25]

In drafting this definition of internal control over financial reporting, the SEC relied heavily on the internal control framework published in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which focused on three categories of control — 'effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations'.[26] The SEC's definition of internal control over financial reporting focuses on controls related to financial reporting, but not on the other elements of the COSO definition (at least to the extent those elements are not related to the preparation of financial statements).[27] Although this definition may appear to be quite narrow, in reality it can be quite far-reaching.

Management report

Section 404 requires management of US reporting companies to prepare a report on their company's internal control over financial reporting as of the end of each fiscal year for inclusion in the company's annual report.[28] The management report must include:

- 'A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Management's 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, including a statement as to whether or not the company's internal control over financial reporting is effective. . . ;
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.'[29]

The SEC has explained that management's review of the company's internal control over financial reporting must be based on a control framework that is 'suitable' and 'recognized' and promulgated by a group using due process procedures, including submission of the framework for public comment. More specifically, the framework must 'be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted; and be relevant to an evaluation of internal control over financial reporting'.[30] The SEC has indicated that the COSO framework, the Turnbull Report published by the Institute of Chartered Accountants in England & Wales and the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants are all suitable frameworks on which management review can be based.[31]

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Assessment of effectiveness

In preparing its assessment of the effectiveness of the company's internal control over financial reporting, management must review its internal controls to identify any deficiencies. The SEC has expressly stated that there is no specific method or procedure that management should use to conduct its evaluation, and that it expects review procedures to differ among companies.[32] Although no specific procedure is specified, the review is comprehensive, and would be expected to include an examination of:

> '[C]ontrols over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements; controls related to the initiation and processing of non-routine and non-systematic transactions; controls related to the selection and application of appropriate accounting policies; and controls related to the prevention, identification and detection of fraud.'[33]

Importantly, management must retain appropriate documentary support to provide evidence of its assessment of the company's internal control over financial reporting. The SEC has stated that this documentary evidence should be sufficient to provide reasonable support for the conclusion that the relevant controls were designed to prevent or detect material misstatements or omissions and conclude that the tests were properly planned, conducted and evaluated.[34]

Deficiencies identified by management as part of its internal control assessment are classified under Auditing Standard No. 2 into one of three categories: control deficiencies, significant deficiencies and material weaknesses. A control deficiency exists under Auditing Standard No. 2 when 'the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis'.[35] A significant deficiency is in turn defined as:

> '[A] control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.'[36]

A material weakness is 'a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected'.[37] Management is precluded from concluding that the company's internal control over financial reporting is effective if, during the course of its review, it identifies one or more material weaknesses in its internal controls.[38]

Central to evaluating whether a significant deficiency or combination of significant deficiencies rises to the level of a material weakness is (i) the likelihood that such deficiencies would result in a misstatement of an account balance or disclosure and (ii) the magnitude of such a potential misstatement.[39] Appendix D to Auditing Standard No. 2 provides just over four pages of examples of significant deficiencies and material weaknesses, while the standard itself lists seven factors to be considered in evaluating the likelihood that a deficiency could result in a misstatement of an account balance or disclosure.[40] Nevertheless, the

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PCAOB has acknowledged that these definitions inherently include a degree of subjective evaluation, noting that auditor judgment remains 'integral and essential to the audit process (including in determining the severity of control weaknesses)'.[41]

Despite the degree of auditor judgment required, it is clear that these definitions set a very low threshold for the detection of significant deficiencies, a fact to which many commentators on Auditing Standard No. 2 objected.[42] The chance of a misstatement occurring is 'remote' for the purposes of definition of material weakness and significant deficiency if '[t]he chance of the future event [] or events occurring is slight'.[43] Moreover, the definition of significant deficiency, which relies on the 'more than inconsequential' standard, is intended to reach potential misstatements in amounts that are less than material.[44] Specifically, under Auditing Standard No. 2, a control deficiency will not rise to the level of a significant deficiency only if a reasonable person would be able to conclude that a relevant misstatement that may occur as a result of such deficiency, either alone or together with other misstatements 'would clearly be immaterial to the financial statements'.[45]

Audit of internal control over financial reporting

Section 404 also requires the auditors of US reporting companies to attest to, and report on, management's assessment of the company's internal control over financial reporting. The PCAOB's Auditing Standard No. 2 sets forth the standards that auditors are to apply when conducting their review of a company's internal control over financial reporting, and requires that auditors issue an opinion on management's assessment of the effectiveness of the company's internal control over financial reporting.[46] In order to comply with the requirements of the Sarbanes–Oxley Act and Auditing Standard No. 2, auditors must plan their audit to obtain reasonable assurance that there are no material weaknesses in the company's internal control over financial reporting.[47] This standard is a stringent one — the auditor generally must obtain evidence that the company's controls are effective for all significant accounts and disclosures included in the company's financial statements.[48] Indeed, the PCAOB expressly referred in Auditing Standard No. 2 to an 'audit' of internal control over financial reporting instead of an 'attestation' of management's assessment of internal control in order to emphasise that the auditor is expressing an actual opinion on management's assessment of the company's internal control.[49] Auditing Standard No. 2 makes clear that '[t]here is no difference in the level of work performed or assurance obtained by the auditor when expressing an opinion on management's assessment of effectiveness or when expressing an opinion directly on the effectiveness of internal control over financial reporting'.[50]

In order to audit a company's internal control over financial reporting, the auditor must:

(1) Plan the overall audit;
(2) Evaluate management's assessment process;
(3) Understand the company's internal control over financial reporting;
(4) Test and evaluate the design effectiveness of the company's internal control over financial reporting;[51]
(5) Test and evaluate the operating effectiveness of the company's internal control over financial reporting;[52] and
(6) Form an opinion on the effectiveness of internal control over financial reporting.[53]

Auditing Standard No. 2 also generally requires auditors to conduct at least one 'walkthrough' for each major class of

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transaction at the company so that the auditor will acquire a better understanding of the company's internal control over financial reporting.[54]

The auditor's report must express an adverse opinion on the company's internal control over financial reporting if either management or the auditor identifies a material weakness in the company's internal control structure.[55] Interestingly, in appropriate circumstances auditors may still deliver an unqualified audit report on a company's financial statements, even if they deliver an adverse opinion on the effectiveness of the company's internal control over financial reporting. Such a split opinion may be issued, for example, if the auditors did not rely on the materially deficient control in their review of the financial statements because they were able to perform additional procedures instead to evaluate the relevant part of the financial statements.[56] The auditor's internal control report is filed with the SEC as part of the company's annual report.

Specific applications of Section 404

As noted above, the SEC and the PCAOB have published a series of frequently asked questions that provide interpretive guidance to parties implementing and applying Section 404 and Auditing Standard No. 2. In particular, the SEC and the PCAOB have clarified in their questions and answers the relief available to companies in situations involving recent acquisitions, certain special purpose entities and equity-method investees.

Recent acquisitions

The SEC has recognised that it may not always be possible for management to conduct an assessment of an acquired business's internal control over financial reporting in the period between the consummation of the acquisition and the date that management's internal control report is due.[57] When the internal controls of an acquired business cannot be assessed by management, the SEC has stated that it will permit management to exclude the acquired business from its internal control report for a limited period if it discloses the identity of the excluded business, notes that the acquired business has been excluded from management's conclusion regarding the company's internal control over financial reporting, and indicates the significance of the acquired business to the company's consolidated financial statements.[58] Any material change to a company's internal control over financial reporting as a result of the acquisition must still be disclosed.[59] In addition, management may only omit the acquired business from its assessment of the company's internal control over financial reporting for one year from the date of acquisition, and may not exclude the acquired business from its internal control assessment for more than one annual internal control report.[60] Auditor reports must also note the exclusion of the acquired business from both management's assessment and the auditor's audit of the company's internal control over financial reporting, although the exclusion will not constitute a restriction on the scope of the audit that would prevent the auditor from issuing an unqualified audit report on the company's internal control over financial reporting.[61] Importantly, auditors should also evaluate whether management's decision to exclude the acquired business satisfies the SEC's standard for exclusion and whether the disclosure related to the exclusion is appropriate.[62]

Special purpose entities

Financial Accounting Standards Board Interpretation No. 46, Consolidation of Variable Interest Entities — An Interpretation of ARB No. 51 (FIN 46) requires that companies consolidate certain entities, such as special purpose entities, even if they

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do not have voting control over the entity. Similarly, management may not have control over an entity that the company accounts for under the proportionate consolidation method pursuant to Emerging Issues Task Force Issue No. 00-01, Investor Balance Sheet and Income Statement Display under the Equity Method for Investments in Certain Partnerships and Other Ventures (EITF 00-1). In both of these situations, management may not be able to assess the relevant entity's internal control over financial reporting.[63]

The SEC has stated that entities consolidated pursuant to FIN 46 that were in existence before 15th December, 2003 do not have to be included in the company's assessment of its internal control over financial reporting if the entity would not have been consolidated but for the application of FIN 46, and the company does not have the authority to assess the entity's internal controls directly or in practice. Entities accounted for through proportionate consolidation under EITF 00-1 can be excluded from the internal control examination if the company does not have the right or authority to dictate or modify the entity's internal controls and, in practice, does not have the ability to assess such controls. In the case of both FIN 46 and EITF 00-1 exclusions, the relevant company's annual report must disclose that the excluded entity has not been part of management's assessment of its internal control over financial reporting and that the conclusion regarding internal controls does not extend to that entity, disclose key subtotals such as total and net assets, revenues and net income that result from consolidation of the entity, and disclose the inability of the company to dictate, modify or assess the internal controls at the entity.[64] Auditor reports must contain similar disclosure concerning the exclusion of the relevant entity from both management's assessment and the auditor's audit of the company's internal control over financial reporting.[65] Again, however, this exclusion will not be considered to be a restriction on scope that would prevent the auditor from issuing an unqualified report on the company's internal control over financial reporting.

Importantly, auditors should also evaluate whether management's decision to exclude the relevant entity satisfies the SEC's standard for the internal control exclusion and whether the disclosure related to the exclusion is appropriate.[66]

Equity-method investees

The SEC and the PCAOB have also clarified that companies are not required to evaluate the internal control over financial reporting within entities that the company accounts for using the equity method of accounting.[67] Generally, under the equity method of accounting, a company includes in its income statement the proportion of the net income of a company in which it has invested, and over which it exercises significant influence, equal to its percentage ownership interest in that company. The SEC's position that the internal controls of entities included in a company's financial statements under the equity method of accounting may be excluded from the company's Section 404 review is supported by the fact that equity-method investees are not consolidated in the company's financial statements on a line-by-line basis and, as a result, the investees' internal controls are not part of the relevant company's internal controls.[68] The SEC has emphasised, however, that the company must have proper controls in place to ensure that the amounts related to its investment in the investee are properly recorded in the company's consolidated financial statements.[69]

ENHANCING THE AUDITOR GATEKEEPER FUNCTION

Many aspects of the Sarbanes–Oxley Act aim at enhancing the role of gatekeepers as

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part of the Act's system of checks and balances to police management conflicts of interest and other governance failures. Auditors play a central role in the system of checks and balances established by the Sarbanes–Oxley Act, which, in addition to Section 404, also established the PCAOB and set forth more stringent auditor independence rules.[70]

When its full ramifications become apparent, Section 404 is likely to be recognised as the most significant element in the expansion of the auditor's gatekeeper role effected by the Sarbanes–Oxley Act. Section 404 has established the auditor as the monitor of key aspects of corporate governance, in large part due to the breadth of the mandate given to the auditor by Auditing Standard No. 2. Under Section 404 and Auditing Standard No. 2, an auditor must evaluate the effectiveness of a company's audit committee and of a company's internal audit function, examine controls related to compliance with applicable law and controls related to fraud, which can include an examination of items such as corporate codes of conduct and consideration of the 'tone at the top'. The auditor must also review and check the accuracy of certain items of the company's non-financial disclosure.

Evaluation of the audit committee

Section 404, through Auditing Standard No. 2, requires auditors to evaluate the effectiveness of the audit committee by examining the audit committee's oversight of the company's financial reporting and internal control over financial reporting.[71] This provision caused significant controversy, with commentators arguing that it created a conflict of interest between the auditor and the entity responsible for hiring the auditor, and called for expertise that the auditors did not possess.[72] The PCAOB did revise the provision in response to comments that it received, clarifying that the evaluation of the audit committee is part of the auditor's overall review of the company's control environment, and not a separate evaluation. Guidance notes directing auditors to consider compliance with listing standards and sections of the Sarbanes–Oxley Act were also deleted because they were viewed as either outside the scope of the auditor's expertise or outside the scope of internal control over financial reporting.[73] In addition, the revised provision clarified that the company's board of directors is ultimately responsible for evaluating the effectiveness of the audit committee.[74]

Despite these changes, the audit committee evaluation can include auditor review of items such as the strength of the audit committee's charter, evaluation of the audit committee's involvement with internal and independent auditors and members of financial management, and consideration of the degree to which the audit committee demonstrates its understanding of applicable critical accounting policies, pursues difficult issues with management and responds to issues raised by the auditors. Under Auditing Standard No. 2, an ineffective audit committee is classified as a significant deficiency and is a 'strong indicator' of a material weakness that would have to be disclosed publicly.[75] Any finding that an audit committee is ineffective is to be reported by the auditor to the company's full board of directors.[76]

Controls related to compliance with applicable laws and regulations

The auditor's responsibility under Auditing Standard No. 2 includes a review of 'controls that focus primarily on the effectiveness and efficiency of operations or compliance with laws and regulations [that] also have a material effect on the reliability of financial reporting'.[77] The PCAOB has clarified that this review of legal compliance reaches beyond the requirements of AU

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§317, Illegal Acts by Clients, which only requires an auditor to consider laws and regulations that are generally recognised to have a '*direct and material* effect on the determination of financial statement amounts'.[78] AU §317 also requires auditors to conduct procedures if specific information comes to the auditor's attention suggesting that the company may have engaged in illegal acts that have an indirect effect on the financial statements, but does not generally require 'audit procedures specifically designed to detect illegal acts'.[79] Auditing Standard No. 2 reaches further, however, to include a review of controls over compliance with laws and regulations that have a material effect on the reliability of the company's financial reporting, even if that effect is indirect.[80] It requires the auditor not only to examine items that come to the auditor's attention, but also to review 'controls over the identification, measurement, and reporting of all material actual loss events which have occurred, including controls over the monitoring and risk assessment of areas in which, given the nature of the company's operations, such actual loss events are reasonably possible'.[81]

The PCAOB did pull back from proposed language that would have directed auditors to find a material weakness in a company that operates in a highly regulated industry if the company were found to have an ineffective regulatory compliance function generally, concluding that such a requirement would have required auditors to pass on information that reached beyond internal control over financial reporting.[82] Auditing Standard No. 2 now states that ineffective regulatory compliance functions only constitute a material weakness with respect to 'those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting'.[83] The PCAOB's modified approach, however, may be more of a change in form than substance. It is difficult to understand how an ineffective regulatory compliance programme, especially in a heavily regulated industry, could ever not have a material effect on a company's financial statements given the almost certain financial liability associated with such non-compliance.

The SEC appears to have endorsed this broad approach, although Question 10 of the SEC's published questions and answers, which addresses this issue, may be susceptible to different interpretations. In particular, in the context of considering the appropriate scope of management control reports, the SEC has stated that management's evaluation of internal control over financial reporting includes an examination of whether there are appropriate controls in place to ensure that the effects of non-compliance with applicable laws are recorded in the company's financial statements.[84] Given this position, it is difficult to ascertain which applicable laws and regulations can be excluded from management's (and the auditors') internal control review, especially given the possibility that any claim for failure to disclose a potential liability would be coloured by hindsight (and, presumably, the realisation of the potential liability in question).[85]

Auditor review of controls related to fraud

In addition to the heightened role that auditors will now play in reviewing a company's compliance with applicable law, auditors have also assumed a greater responsibility for detecting fraud that may affect the company's financial statements. Fraud has been at the heart of almost all of the corporate scandals both prior to and after the adoption of the Sarbanes–Oxley Act. Auditing Standard No. 2 requires auditors to evaluate all controls applicable to detecting or preventing fraud 'that have at least a reasonably possible likelihood of

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having a material effect on the company's financial statements'.[86] Because controls related to fraud prevention and detection pervade the entire company, the focus on these controls by Auditing Standard No. 2 expands the scope of the auditors' review of internal controls in significant ways. Auditing Standard No. 2 specifically directs the auditors to review items such as the company's codes of ethics and conduct, especially provisions related to conflicts of interest, related party transactions, illegal acts, and the monitoring of the code by management and the audit committee or board of directors; the adequacy of the internal audit activity and whether the internal audit function reports directly to the audit committee; the extent of the audit committee's involvement and interaction with the company's internal audit function; and the adequacy of the company's procedures for handling complaints and for accepting confidential submissions of concerns about questionable accounting or auditing matters.[87]

> Auditing Standard No. 2 also emphasises the importance of evaluating a company's ethical 'tone at the top', which can be an important component of antifraud programmes and requires a wide-ranging review by auditors.

AU §316, Consideration of Fraud in a Financial Statement Audit, sets forth the standards auditors should apply when evaluating whether a company's financial statements are free from material misstatements caused by either error or fraud. An exhibit to AU §316 provides guidance on management antifraud programmes and controls, and emphasises the importance of setting the right ethical 'tone at the top', with senior management emphasising the importance of ethical and honest behaviour through their acts and deeds.[88] Auditing Standard No. 2 reiterates the importance of management setting the proper tone at the top and maintaining high ethical standards, requiring management and entities such as the company's audit committee to 'create and maintain a culture of honesty and high ethical standards; and establish appropriate controls to prevent, deter and detect fraud'.[89] These factors are likely to be highly judgmental. In addition, the PCAOB has indicated that the identification of fraud of any magnitude by senior management that comes to the attention of auditors is at the very least a significant deficiency, and a strong indicator of a material weakness (even if the fraud was detected by the company's own internal controls).[90]

This sensitivity to fraud in the review of internal control over financial reporting is also reinforced by statements from SEC officials indicating that an ineffective tone at the top may well constitute grounds for finding a material weakness.[91] The chairman of the SEC has made it clear that '[t]he tone set by top management is the most important factor contributing to the integrity of the financial reporting process'.[92] Others have noted that it is a key part of establishing a 'culture of compliance' at a company, which is required to create 'an ethical culture as part of the "essential DNA" of the corporate body itself' and 'demonstrate ethics, integrity, honesty, and transparency' in an effort to instil 'in every employee an obligation to do what's right . . .'.[93]

Review of disclosure

Section 404 and Auditing Standard No. 2 also require the auditor to review the quality of the company's disclosure of its internal controls. In conducting its review of management's internal control report, auditors are directed to consider whether material weaknesses identified in the company's internal control over financial reporting have been properly disclosed and whether management's internal control

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report is otherwise free of material misstatements, complies with the required form and satisfies certain other criteria.[94]

Auditors are also directed to review aspects of management's Section 302 certification included in the company's annual and, if applicable, quarterly reports filed with the SEC. Section 302 of the Sarbanes–Oxley Act requires the principal executive and financial officers of the company filing the report to certify, among other things, that the company's internal control over financial reporting has been designed to provide reliable financial reporting and that any material changes in the company's internal control over financial reporting occurring during the period covered by the report have been disclosed.[95] The auditor should inform management 'as soon as practicable' if it determines that the company's disclosure needs to be modified so that the Section 302 certification with respect to the company's internal control over financial reporting is accurate, and should inform the audit committee if it does not judge management's response to be appropriate.[96]

Section 10A of the Exchange Act

Section 404 of the Sarbanes–Oxley Act combines with Section 10A of the Exchange Act to create a strong enforcement structure for auditor action. Section 10A imposes certain reporting obligations on auditors who discover illegal activities at the company during the course of their audit of a company's financial statements.[97] Copies of the auditor's 10A report documenting the alleged wrongdoing must be delivered to the SEC if the auditor determines that the company has not taken appropriate action in response to its report of illegal activity and that the illegal action has a material effect on the company's financial statements.[98]

Auditors are under heightened pressure to issue Section 10A notices where appropriate, as the SEC has brought an increasing number of enforcement actions against auditors for failing to comply with the requirements of that section.[99] As one commentator has noted, auditors 'that fail to heed the requirements of Sarbanes–Oxley and Section 10A of the Exchange Act risk suffering the fate of Arthur Andersen'.[100] A Section 10A report can have dramatic consequences for a company. Section 10A reports are made public, and formal SEC investigations and auditor resignations often follow in the wake of the notice.[101]

Increased focus on Section 10A by the regulator and auditing firms alike may increase the gate-keeping authority of auditors under Section 404 and Auditing Standard No. 2, forming the background to many aspects of the enhanced role that these provisions impose upon the auditor. Indeed, Auditing Standard No. 2 specifically directs auditors to consider issuing 10A reports when it deems management's evaluation of, or disclosure related to, the company's internal controls is inadequate. Auditors, for example, must review additional information related to a company's internal control over financial reporting, regardless of whether it is included in management's internal control report or elsewhere in the quarterly or annual report.[102] Auditors are also specifically instructed to consider their reporting obligations under Section 10A if management refuses to correct any material misstatement in such information that the auditor identifies.[103] In addition, the auditor must consider the use of Section 10A when the company does not take required action to correct any information that the auditor views as necessary in order for senior management to give the certifications required under Section 302 of the Act or when the auditor discovers possible illegal activities, including fraud, as part of its audit of internal control over financial reporting.[104]

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FORMALISATION OF THE AUDITOR–CLIENT RELATIONSHIP

The auditor's opinion concerning a company's internal control over financial reporting serves as an important part of the checks and balances imposed by the Sarbanes–Oxley Act, but at the same time places the auditor in a more adversarial position *vis-à-vis* the company. The effects of this shift are not clear. Communications between auditors and companies may become more restrained, as companies fear that any mistake they make or potential liability they discuss with an auditor may provide grounds for the auditor finding a significant deficiency or material weakness in the company's internal controls.[105] Aspects of the Section 404 internal control process that may contribute to this effect include requirements that auditors report any material weakness they discover during their internal control audit, the broad legal review that the auditor may be required to undertake and the heightened documentation requirements applicable to communications between a company and its auditor.

The impact of documenting material weaknesses

The fact that auditor internal control reports documenting material weaknesses at the company will be made public as part of an annual report may serve to make companies much more wary of their auditor. One of the best examples of the possible dynamics involved in such a situation relates to auditor reviews of draft company financial statements. In current practice, companies are often in the process of finalising their financial statements at the same time that the auditor is completing its auditing procedures. This simultaneous review is frequently done to save time in the review process, a factor that will become increasingly important as SEC filing deadlines are accelerated. During this process, auditors may detect material misstatements in the financial statements that are brought to the attention of management and corrected before the financial statements are published. Auditing Standard No. 2 would eliminate this practice, requiring an auditor to report a material weakness in internal control if it identifies a material misstatement in a company's financial statements that was not previously identified by the company's internal control over financial reporting, even if management subsequently corrects the error.[106]

The PCAOB has taken this position because it emphasises that a company's internal controls, not an auditor's preliminary review, should provide reasonable assurance that the financial statements prepared by the company are presented fairly.[107] The PCAOB recommends that companies wanting to give preliminary drafts of their financial statements to their auditors in order to reduce time delays or for other reasons specify to the auditors, either in writing or orally, the portions of the statements which they view as final and the portions over which relevant controls have not yet been applied.[108] The PCAOB has said that management is free to discuss items such as emerging accounting issues with their auditors, provided that in each such discussion there is 'clear communication between management and the auditor about the purpose for which the auditor is being involved . . .'[109]

Any errors found by the auditors in the portions of the financial statements designated as ready for their review, however, would have to be considered to determine whether they present a significant deficiency or a material weakness. Similarly, in order to minimise the risk that any conversation with the company auditors may result in providing the auditor with evidence of a material weakness, management will have to carefully consider, and appropriately frame, each conversation that he or she has with the company's auditors.

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These arrangements may well restrict what should be robust discussions on the ways in which new and/or particularly complex accounting standards should be reflected in the company's financial statements. Management may also seek to withhold drafts of the company's financial statements from its auditors until the statements are in near-final form, which could have the counter-productive result of reducing audit quality because of the reduced amount of time that the auditor would have to audit the company's financial statements.

Indeed, the chilling effect of a finding of a material weakness applies beyond the context of a review of draft financial statements. Section 404 provides companies with a strong incentive not to approach auditors about any issue of concern for fear of the auditors discovering a reportable significant deficiency or material weakness. This effect reaches all the way to one of the key reforms of the Sarbanes–Oxley Act, the strengthened audit committee. The requirement that auditors evaluate the effectiveness of the company's audit committee to determine whether its role constitutes a significant deficiency or material weakness establishes a tension between the auditor and the body at the company directly responsible for managing the auditor's engagement.[110] Audit committees may not ask auditors all of the questions they need to in order to fully understand what can often be complex accounting concepts for fear of appearing ignorant to the auditors, who will be evaluating their performance.

The impact of auditor review of company compliance with applicable laws and regulations

Under Section 404, auditors must now reach much more deeply into the operations of the companies they audit. In investigating a company's compliance with applicable law and regulations, and searching for sources of potential fraud, the auditors will enter into a realm often reserved for counsel. Unlike counsel, however, auditors investigating potential wrongdoing as part of an audit of the company's internal audit over financial reporting will not be subject to the rules of privilege and the work-product doctrine. The Supreme Court has rejected the theory that work-product immunity should apply to public accountants auditing a company's financial statements because of the responsibility that auditors bear to the public, in contrast to attorneys, who serve a private role as a client's advisor and advocate.[111] Without the protection of any claim of privilege or immunity, and with the threat of public disclosure, companies may be reticent to discuss areas of potential liability with auditors. Section 404's interaction with the auditor's responsibilities under Section 10A of the Exchange Act will probably only reinforce a company's reticence to discuss potential legal liabilities with its auditors.

The impact of written documentation

Section 404 places a premium on written communication between the company and its auditors, introducing additional formality and rigidity to the relationship. Auditing Standard No. 2 requires that auditors communicate to management in writing all deficiencies in internal control over financial reporting (even if they do not rise to the level of a significant deficiency). In addition, the auditor must communicate in writing to management, the audit committee and, in certain circumstances, the full board of directors, all significant deficiencies and material weaknesses identified during the audit, even if management has subsequently taken steps to correct these deficiencies and they no longer exist at the time that the auditor issues its internal control report.[112]

The requirement that auditors report in writing to management, the audit committee and the full board of directors, as

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appropriate, all deficiencies discovered in its internal control audit increases the likelihood that these deficiencies will be taken seriously by the company. Nevertheless, these written reports of wrongdoing may well decrease the open conversations between the company and its auditors. A company may decide not to go to auditors for assistance with investigating whether potential wrongdoing has taken place at the company or for recommendations on how to design controls to prevent such wrongdoing in the future if it fears that the auditors will disclose publicly in their report such an item as a material weakness. In addition, such written notifications of wrongdoing, presumably not subject to any type of privilege, may prove a boon for a plaintiff's attorney.

Indeed, the SEC has expressly acknowledged these potential shortcomings in connection with its 'up the ladder' reporting rules applicable to attorneys appearing before it. In deciding not to adopt rules that would require attorneys to document all reports to and responses from appropriate persons at the company reporting potential violations of the US securities or related laws, the SEC found persuasive arguments that requiring such documentation may constrain conversations between the client and the attorney.[113] It also noted that documenting the violations might create a conflict of interest between the attorney and the client because the attorney would be creating a favourable record to protect them from potential liability while at the same time advising the client. Moreover, it was noted that these written records might create a 'treasure trove of selectively damning evidence' in any litigation to which the company became subject.[114] Although auditors do not occupy the same position as attorneys and face a higher degree of public accountability, many of the considerations deemed applicable to attorneys by the SEC are equally applicable to auditors and suggest the degree of uncertainty that has been introduced into the auditor–company relationship.

CONCLUSION: A TIME OF UNCERTAINTY

As the first internal control reports begin to be filed, many uncertainties remain as to Section 404's ultimate effects. The accounting firm PricewaterhouseCoopers recently reported that only 20 per cent of its clients that it informally surveyed were on schedule to complete their internal control reviews, while 10 per cent were at 'severe risk' of not completing their review on time, and an additional 20 per cent were in danger of joining that group.[115] The SEC has delayed the due date of the initial management and auditor reports on internal control over financial reporting for an additional 45 days for smaller companies.[116] In addition, the SEC has delayed the final phase-in period for the accelerated filing of periodic reports which, when eventually implemented, will require accelerated filers to file annual reports within 60 days after their fiscal year end and quarterly reports within 35 days of their quarter end instead of the current 75 days and 40 days, respectively.[117] The SEC acted in order to address concerns that earlier filing deadlines would impede company efforts 'to implement the internal control requirements [of Section 404] carefully and completely'.[118]

In addition, no one is sure of the number of material weaknesses that will be reported by companies, or what the effects of such reporting will be. The SEC's chief accountant has acknowledged that there are 'widely differing predictions about the number of [reporting companies] who will report material weaknesses in internal controls. These predictions vary from a few percent to 10 percent, 20 percent or even more'.[119] It may be because of this ambiguity that members of the SEC staff have indicated that both the SEC and the PCAOB will

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evaluate the impact of Section 404 following the filing of the first round of internal control reports, and consider what changes, if any, should be made.[120]

One of the greatest sources of uncertainty under Section 404, not surprisingly, involves the implementation of Section 404 and Auditing Standard No. 2. The application of almost any new accounting standard requires an initial period in which ambiguities are discovered and work-arounds formulated. Auditing Standard No. 2, weighing in at over 150 pages, is certainly no exception. It will take both companies and their auditors some time to determine what precisely constitutes a 'significant deficiency' and a 'material weakness'. The PCAOB defined these terms and provided relevant examples in an effort to reduce the degree of auditor judgment involved in interpreting these provisions, making auditors more accountable for their decisions and providing companies with guidance as to what they should avoid.[121] Nevertheless, the PCAOB has acknowledged that auditor judgment will continue to play a significant role in the application of these definitions to deficiencies identified at each company, and it will doubtless take time for a general base of knowledge to develop among auditors and companies as to the facts that warrant a finding of a significant deficiency or a material weakness, especially in relation to potentially wide-ranging and ambiguous concepts related to evaluating items such as the 'tone at the top' of a company.[122]

Uncertainty also surrounds the precise situations that will lead auditors to conclude that a company does not have appropriate controls in place to account for possible liabilities resulting from violations of applicable law or regulations, or sufficient documentation to provide evidence of the procedures that the company has put in place to maintain its internal control over financial reporting. Open dialogue between auditors and the audited companies would undoubtedly assist all parties in finding the right answers to these and other questions. Unfortunately, the potential consequences of such a discussion, which may alert an auditor to possible reportable conditions, might prevent such a dialogue from taking place. Indeed, the increased formalisation of the auditor–company relationship may well only exacerbate the uncertainty surrounding the implementation of Section 404 and Auditing Standard No. 2.[123]

The difficulties faced by entities implementing Section 404 will be compounded for many European companies that are in the process of changing their account reporting from local generally accepted accounting practices to IFRS. In general, companies must prepare their annual accounts in conformity with IFRS if they are governed by the law of a member state of the European Union and have securities admitted to trading on a regulated market of any member state.[124] In order to prepare proper 2005 accounts, companies will have been required to implement IFRS during 2004 so that they can provide comparable prior period information.

The implementation of IFRS will necessarily include a component of trial and error. Companies which are also subject to the Sarbanes–Oxley Act are likely to be constrained in communicating with their auditors on a host of issues that will arise in the context of implementing IFRS by the knowledge that any recommendations of the auditor that they do not accept, any deficiency uncovered during the conversion process, or any mistake that the auditor discovers before the company does may be reported by the auditor as a material weakness or be disclosed to the company in writing and provide a target for subsequent discovery requests by a plaintiff's attorney.

Moreover, companies will be working to implement IFRS at the same time that they are implementing and reviewing internal control procedures in response to Section

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404. The burden of undertaking two major overhauls at once may strain the resources of many companies and exacerbate existing tensions.

Recent developments indicate that the SEC may be sympathetic to the concerns of companies implementing IFRS. The Chairman of the SEC recently acknowledged the 'seismic' change that the implementation of IFRS represents in many European countries, and has requested the SEC staff to consider whether the SEC should delay the 15th July 2005 date after which non-US companies must comply with IFRS. It remains to be seen, however, whether the SEC ultimately takes any action to grant relief to these companies.[125]

The implications of Section 404 in terms of company and auditor liability is another significant unknown. Companies for which management and/or auditors issue an internal control report documenting a material weakness may well provide a public invitation to plaintiffs to file class action lawsuits alleging fraud and other corporate wrongdoing. In addition, files of written communications between auditors, management and board members documenting every deficiency uncovered in a company's internal control over financial reporting, regardless of whether it constitutes a significant deficiency or material weakness, will almost certainly provide a 'treasure trove' for plaintiffs.[126]

These implications are perhaps even more significant for auditors. The opinion that auditors issue with respect to management's assessment of the effectiveness of a company's internal control over financial reporting will signal to investors that fundamental components of sound corporate governance have been implemented by the company and are functioning effectively.

Auditing Standard No. 2 requires that an auditor needs to find that a company's internal controls only exhibit a 'remote likelihood' that material misstatements would not be prevented or detected before it can issue an internal control opinion, which is a very high standard.[127] As a result of this low threshold, and the auditor's broad mandate under Section 404 and Auditing Standard No. 2, it is difficult to consider how auditors will be able to avoid liability for most financial statement restatements or any other corporate governance failure. Have auditors been made to be effective insurers against corporate governance failures for the companies that they audit? One can imagine that there will be no shortage of plaintiffs ready to argue that they are. The impact of Section 404 on an auditing profession that has been no stranger to liability remains to be seen.

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References

1 Sarbanes–Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 746, Sec. 404 (codified in scattered sections of 15 U.S.C.) [hereinafter the 'Sarbanes–Oxley Act' or the 'Act'].

2 As used in the paper, 'US reporting companies' means companies, other than registered investment companies, that file annual reports with the US Securities and Exchange Commission (SEC) pursuant to Section 13(a) or 15(d) of the US Securities Exchange Act of 1934, as amended (the 'Exchange Act'). See Exchange Act, 15 U.S.C. §78a *et seq.*

3 Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 34-47986, 68 Fed. Reg. 36,636 (5th June, 2003) (codified in scattered sections of 17 C.F.R.) [hereinafter '404 Release'].

4 PCAOB, Auditing Standard No. 2, File No. PCAOB-2004-03, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements (9th March, 2004) [hereinafter 'Auditing Standard No. 2'].

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5 Public Company Accounting Oversight Board, Order Approving Proposed Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements, Exchange Act Release No. 34-49884, File No. PCAOB 2004-03, 69 Fed. Reg. 35,083 (17th June, 2004).

6 Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 34-49313, 69 Fed. Reg. 9,722 (24th February, 2004). As defined under Rule 12b-2 of the Exchange Act, an accelerated filer is a company that, as of the end of its fiscal year, has a public float of at least $75 million, has been subject to the Exchange Act's reporting requirements for at least 12 calendar months, has previously filed at least one annual report with the SEC and is not eligible to use forms 10-KSB and 10-QSB.

7 Securities Exchange Act of 1934; Order Under Section 36 of the Securities Exchange Act of 1934 Granting an Exemption from Specified Provisions of Exchange Act Rules 13a-1 and 15d-1, Release No. 50754, 69 Fed. Reg. 70,291 (30th November, 2004). In conjunction with the SEC's order, the PCAOB adopted, and the SEC approved, complementary transitional rules to allow auditors to submit their report on management's internal control assessment after the auditor's audit report on the financial statements, which would otherwise not be permitted under Auditing Standard No. 2. See Public Company Accounting Oversight Board; Notice of Filing and Order Granting Accelerated Approval of Proposed Temporary Transitional Rule Relating to PCAOB Auditing Standard No. 2 'An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements', Exchange Act Release No. 34-50794, File No. PCAOB-2004-08 (3rd December, 2004); see also Auditing Standard No. 2, supra note 4, at para. 171.

8 US Securities and Exchange Commission, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions (6th October, 2004) [hereinafter 'SEC FAQ']; US Securities and Exchange Commission, Exemptive Order on Management's Report on Internal Control Over Financial Reporting and Related Auditor Report: FAQ (21st January, 2005); Public Company Accounting Oversight Board, Staff Questions and Answers: Auditing Internal Control Over Financial Reporting (22nd November, 2004) [hereinafter 'PCAOB November FAQ']; Public Company Accounting Oversight Board, Staff Questions and Answers: Auditing Internal Control Over Financial Reporting (6th October, 2004) [hereinafter 'PCAOB October FAQ']; Public Company Accounting Oversight Board, Staff Questions and Answers: Auditing Internal Control Over Financial Reporting (27th July, 2004) [hereinafter 'PCAOB July FAQ']; Public Company Accounting Oversight Board, Staff Questions and Answers: Auditing Internal Control Over Financial Reporting (21st January, 2005).

9 Codification of Accounting Standards and Procedures, §325.02 (American Institute of Certified Pub. Accountants 2004) [hereinafter 'AU'].

10 *Ibid.* at §319.02.

11 15 U.S.C. §78m(b)(2).

12 12 U.S.C §1831m; see generally 404 Release, ref. 3 above, at 36,648.

13 Statement of Management on Internal Accounting Control, Exchange Act Release No. 34-15772, 44 Fed. Reg. 26,702 (proposed 30th April, 1979); see also Disclosure Required by Sections 404, 406 and 407 of the Sarbanes–Oxley Act of 2002, Exchange Act Release No. 34-46701, 67 Fed. Reg. 66,208, 66,218 (proposed 22nd October, 2002) [hereinafter '404 Proposing Release'].

14 Statement of Management on Internal Accounting Control, Exchange Act Release No. 34-16877, 45 Fed. Reg.

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40,134 (6th June, 1980); see also 404 Proposing Release, ref. 13 above, at 66,218.

15 Report of Management's Responsibilities, Exchange Act Release No. 34-25925, 53 Fed. Reg. 28,009 (proposed 19th July, 1988); see also 404 Proposing Release, ref. 13 above, at 66,219.

16 404 Proposing Release, ref. 13 above, at 66,219; see also Regulatory Flexibility Agenda and Rules Scheduled for Review, Exchange Act Release No. 34-30630, 57 Fed. Reg. 18,421, 18,424 (24th April, 1992) (announcing SEC's determination to terminate consideration of the proposed rule).

17 Auditing Standard No. 2, ref. 4 above, at para. 145. The PCAOB has explained that an internal control audit must also include an audit of the relevant company's financial statements because an audit of the financial statements is required in order for the auditor 'to have a high level of assurance that his or her conclusion on the effectiveness of internal control over financial reporting is correct.' *Ibid.* at App. E, para. E128. In addition, this approach is consistent with the language of Section 404(b) of the Act, which states that the internal control audit should not be the subject of a separate engagement.

18 Andrew D. Bailey, Jr., Deputy Chief Accountant, US Securities and Exchange Commission, Remarks Before the 2004 AICPA National Conference on Current SEC and PCAOB Developments (6th December, 2004). Indeed, the chairman of the SEC has stated that '[f]or many companies, the new rules on internal control reports will represent the most significant single requirement associated with the Sarbanes–Oxley Act.' William H. Donaldson, Chairman, US Securities and Exchange Commission, Testimony Concerning Implementation of the Sarbanes–Oxley Act of 2002 Before the Senate Committee on Banking, Housing and Urban Affairs (9th September, 2003) [hereinafter 'Donaldson Testimony'].

19 See generally, D. Roberts and D. Wighton, 'Business leaders welcomed tighter rules after the scandals involving US companies but now some claim the reforms are doing more harm than good', *Financial Times*, 1st June, at 15 (characterising Section 404 as the 'most expensive reporting requirement stemming from Sarbanes–Oxley').

20 Press release, Financial Executives International (2004) 'Sarbanes–Oxley compliance cost estimates soar 62 per cent since January 04', 11th August, at 1 [hereinafter 'FEI Release']. Some have estimated that audit fees in connection with Section 404 will range from 20 per cent to 100 per cent of pre-Section 404 audit costs, depending, among other things, on the state of the company's existing internal control over financial reporting. O'Kelley, G. (2004), 'Happy second birthday, Sarbanes–Oxley', *Financial Times*, 30th July, at 19.

An additional $1m in Section 404 software purchases and IT consulting fees was also expected by companies responding to the FEI survey (FEI Release at 2). Indeed, reports suggest that companies such as Microsoft, Oracle and PeopleSoft have released approximately 60 new programs to assist companies in complying with the new Section 404 regime. See Shevory, K. (2004) 'Compliance efforts come with big accounting bills', *Seattle Times*, 3rd October, at E10. The FEI survey also indicated that responding companies expected to spend an average of 25,667 internal hours and 5,037 external hours to become Section 404 compliant (FEI Release, at 2).

21 Johnson, C. (2004) 'Audit compliance deadline proves costly to companies', *Washington Post*, 15th November, at A14.

22 Roberts, D. (2004) 'GE says it faces dollars 30m bill for governance, *Financial Times*, 29th April, at 15.

23 Norris, F. (2004) 'US and European securities officials vow cooperation', *New York Times*, 5th June, at 3.

24 See Donald T. Nicolaisen, Chief Accountant, US Securities and Exchange Commission, Keynote Speech at 11th Annual Midwestern Financial Reporting Symposium (7th October, 2004).

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25 404 Release, ref. 3 above, at 36,640 (footnotes omitted).
26 *Ibid.* at 36,639-40.
27 *Ibid.* at 36,640. In 1994 COSO published an addendum to its definition of internal control to clarify that it included requirements related to the safeguarding of assets to protect against unauthorised acquisition. This concept is included in the third prong of the SEC's definition of internal control over financial reporting. *Ibid.* at 36,641.
28 Management of reporting companies (other than foreign private issuers) must also evaluate each quarter any change in their company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. These changes should be disclosed in the company's next quarterly or annual report. *Ibid.* at 36,644, 36,646. Foreign private issuers must disclose material changes to their internal control over financial reporting that have occurred during the period covered by their annual report. *Ibid.* at 36,644.
29 *Ibid.* at 36,642 (footnotes omitted).
30 *Ibid.*
31 *Ibid.* at 36,642 and n. 67. The Financial Reporting Council has published a guide for non-US companies registered with the SEC that expect to use the Turnbull Report to meet their obligations under Section 404. Financial Reporting Council, The Turnbull Guidance as an Evaluation Framework for the purposes of Section 404(a) of the Sarbanes–Oxley Act (16th December, 2004).
32 404 Release, ref. 3 above, at 36,643.
33 *Ibid.*
34 *Ibid.*
35 Auditing Standard No. 2, ref. 4 above, at para. 8.
36 *Ibid.* at para. 9.
37 *Ibid.* at para. 10.
38 404 Release, ref. 3 above, at 36,642. Similarly, management cannot state that the company's controls and procedures are effective subject to certain identified problems or other qualifications. SEC FAQ, ref. 8 above, at 4 (Question 5). Instead, the identified issues must be taken into account as part of the overall assessment of the effectiveness of the company's internal control over financial reporting. *Ibid.*
39 Auditing Standard No. 2, ref. 4 above, at para. 131.
40 *Ibid.* at para. 133, App. D.
41 *Ibid.* at App. E, paras. E75-76.
42 *Ibid.* at App. E, para. E79 (noting that 'most' commentators on Auditing Standard No. 2 objected to the definition of significant deficiency and material weakness).
43 *Ibid.* at para. 9.
44 *Ibid.* at App. E, para. E88.
45 *Ibid.* at para. 9.
46 *Ibid.* at App. E, paras. E3, E10, E12. Sections 103(a)(2)(A) and 404(b) of the Sarbanes–Oxley Act direct the PCAOB to establish these professional standards.
47 *Ibid.* at para. 27.
48 *Ibid.* at paras. 148, 150.
49 *Ibid.* at App. E, para. E20. Some commentators objected to the use of the term 'audit' instead of 'attestation' in Auditing Standard No. 2 on the grounds that Section 404 uses the term 'attestation' instead of 'audit' and, more substantively, because it was inappropriate to require a degree of work beyond that which would be required for an attestation. *Ibid.* In rejecting this view, the PCAOB explained that the use of the term 'audit' was appropriate because it emphasised the level of work the PCAOB determined the auditor was required to perform and clarified that the auditor was expressing an opinion on management's assessment of the company's effectiveness of internal control over financial reporting. The PCAOB also noted that it was consistent with Auditing Standard No. 2's integrated audit of both internal control over financial reporting and the financial statements. *Ibid.* at App. E, paras. E20, E22-24.
50 *Ibid.* at para. 19.
51 An examination of design effectiveness considers whether 'the controls complied with would be expected to prevent or detect errors or fraud that could result in

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material misstatements in the financial statements'. *Ibid.* at para. 88.

52 An examination of operating effectiveness considers whether the control operates as designed and whether the person who performs the control process has the necessary authority and qualifications to effectively exercise the control. *Ibid.* at para. 92.

53 *Ibid.* at para. 28.

54 *Ibid.* at para. 79. A 'major class of transaction' is a class of transactions that is significant to the company's financial statements. *Ibid.* at para. 71. As part of a walkthrough, auditors trace a transaction from its origination, through the company's information systems and to its ultimate inclusion in the company's financial statements. Interviews with company personnel at each stage of the process, and review of the documents generated from the process, form critical parts of the walkthrough. *Ibid.* at para. 80 and App. E, para. E51.

55 *Ibid.* at para. 175. The auditor is also required to either express a qualified opinion, disclaim an opinion or withdraw from an engagement if the auditor is not able to apply all of the procedures necessary to complete its audit of the company's internal control over financial reporting because there have been restrictions on the scope of the auditor's work. *Ibid.* at para. 178.

56 *Ibid.* at para. 193.

57 SEC FAQ, ref. 8 above, at 3 (Question 3).

58 *Ibid.* For these purposes, the term 'business' includes 'those acquisitions that would constitute a business based upon the facts and circumstances as outlined in Article 11-01(d) of Regulation S-X'. *Ibid.* at n. 2.

59 Although US issuers must evaluate any material changes to internal controls on a quarterly basis, in the case of an acquired business, a company may wait to disclose the material changes until publication of the first annual internal control report that covers the acquired business. The SEC staff has also confirmed that this grace period applies to the certifications made by the chief executive and financial officers of the company made pursuant to Section 302 of the Sarbanes–Oxley Act.

60 *Ibid.* at 3.

61 PCAOB July FAQ, ref. 8 above, at 17 (Question 19).

62 Auditing Standard No. 2, ref. 4 above, at App. B, para. B16.

63 SEC FAQ, ref. 8 above, at 2 (Question 1).

64 *Ibid.*

65 PCAOB July FAQ, ref. 8 above, at 17 (Question 19).

66 Auditing Standard No. 2, ref. 4 above, at App. B, paras. B16-17. The inquiry under Section 404 and Auditing Standard No. 2 is separate from any disclosure of off-balance sheet arrangements that may be required under Section 401 of the Sarbanes–Oxley Act and the SEC rules thereunder.

67 SEC FAQ, ref. 8 above, at 2-3 (Question 2).

68 *Ibid.*

69 *Ibid.* at 3; see also Auditing Standard No. 2, ref. 4 above, at App. B, para. B15.

70 Sarbanes–Oxley Act, ref. 1 above, at §101, §§201–203, §206.

71 Auditing Standard No. 2, ref. 4 above, at para. 55.

72 *Ibid.* at App. E, para. E65.

73 *Ibid.* at App. E, para. E68.

74 *Ibid.* at App. E, para. E69.

75 *Ibid.* at para. 59.

76 *Ibid.* at App. E, para E69.

77 *Ibid.* at para. 15.

78 AU, ref. 9 above, at §317.05 (emphasis added).

79 *Ibid.* at §317.05, §§317.08–317.11.

80 PCAOB October FAQ, ref. 8 above, at 1–2 (Question 27).

81 *Ibid.* at 3.

82 Auditing Standard No. 2, ref. 4 above, at para. 140 and App. E, para. E99.

83 *Ibid.* at para. 140.

84 SEC FAQ, ref. 8 above, at 6 (Question 10); see also PCAOB October FAQ, ref. 8 above, at 3–4 (Question 27) (noting that the interpretation it provided on this subject 'is consistent with the SEC staff's views regarding management's responsibilities for assessing internal control over financial reporting'.).

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85 Indeed, an example in the PCAOB's frequently asked questions concerning Section 404 illustrates the full ramifications of the type of review an auditor is expected to undertake with respect to company controls related to legal compliance. In the example, the PCAOB notes that an examination of internal control over financial reporting at a waste disposal company would typically include a review of controls used to identify and measure environmental liabilities associated with current and new landfills, even if no government review or other action were currently underway. PCAOB October FAQ, ref. 8 above, at 3 (Question 27).

86 Auditing Standard No. 2, ref. 4 above, at para. 24.

87 *Ibid.*

88 AU, ref. 9 above, at §316.86.

89 Auditing Standard No. 2, ref. 4 above, at para. 25.

90 *Ibid.* at para. 140. The PCAOB has explained that 'Because of the critical role of tone-at-the-top in the overall effectiveness of the control environment and due to the significant negative evidence that fraud of any magnitude on the part of senior management reflects on the control environment, the [PCAOB] decided that it is appropriate to include this circumstance in the list [of significant deficiencies and strong indicators of material weakness], regardless of whether the company's controls detected the fraud.' *Ibid.* at App. E, para. E99.

91 Nicolaisen, ref. 24 above (noting that one category of material weakness 'might include an ineffective control environment, such as the tone at the top . . .'); see generally Stephen M. Cutler, Director, Division of Enforcement, US Securities and Exchange Commission, Second Annual General Counsel Roundtable: Tone at the Top: Getting It Right (3rd December, 2004).

92 Donaldson Testimony, ref. 18 above.

93 Lori Richards, Director, Office of Compliance Inspections and Examinations, US Securities and Exchange Commission, Remarks before the National Society of Compliance Professionals 2004 National Membership Meeting, 28th October, 2004 (quoting William H. Donaldson, Chairman, US Securities and Exchange Commission, Remarks at the 2003 Washington Economic Policy Conference, 24th March, 2003).

94 Auditing Standard No. 2, ref. 4 above, at para. 166. Auditors must also ascertain whether management has properly excluded entities from its assessment of internal control over financial reporting under relevant exemptions applicable to recently acquired businesses, FIN 46 entities, or otherwise, and ascertain whether management has appropriately disclosed the restricted nature of its review. *Ibid.* at App. B, para. B16; see the section entitled 'Specific applications of Section 404' above. In addition, auditors must review the adequacy of management's disclosure, in its control report or elsewhere in the relevant annual or quarterly report, with respect to additional explanatory and even mitigating language that management may include regarding the company's internal control over financial reporting. See *ibid.* at paras. 190–92.

95 *Ibid.* at para. 200. Auditors need to perform only limited procedures on a quarterly basis to ascertain whether there are any material modifications required to the applicable disclosure in order for the Section 302 certifications to be accurate. *Ibid.* at para. 202. Foreign private issuers must only provide this information on an annual basis. *Ibid.* at para. 203.

96 *Ibid.* at para. 204.

97 15 U.S.C. §78j-1.

98 Under Section 10A of the Exchange Act, the auditors must report evidence of any illegal act discovered by them during their audit to the company's management and audit committee, regardless of whether the act would have a material effect on the company's financial statements (unless the illegal act is clearly inconsequential). If appropriate action is not taken in response to that notice and the auditors conclude that the illegal action has a material effect

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on the company's financial statements, the auditors must forward the report to the full board of directors of the company, which must in turn inform the SEC of such report by no later than the next business day after receipt of the report, providing a copy of the notice to the auditor. If the auditor does not receive a copy of the notice, the auditor must furnish a copy of its report to the SEC, and may resign from the engagement. Although in practice the same facts leading an auditor to issue a 10A report may also result in a finding of a material weakness, the two concepts operate independently, such that a finding of a material weakness would not necessarily require an auditor to issue a 10A report, and the issuance of a 10A report would not necessarily require a company or its auditors to conclude that a material weakness existed in the company's internal control over financial reporting.

99 See Daniel V. Dooley, Section 10A Audit Requirements Under the Securities Exchange Act of 1934: A Play in Five Acts, 1 Securities Litig. 1, 4–5 (2004) (collecting recent enforcement actions brought by the SEC under Section 10A of the Exchange Act).

100 *Ibid.* at 3.

101 *Ibid.*

102 Auditing Standard No. 2, ref. 4 above, at para. 190. Management, for example, may include in its report on internal control over financial reporting information that relates to any corrective actions taken by the company after the date of management's assessment, plans to implement new controls or a statement that the cost of correcting a material weakness exceeds the benefits from implementing new controls. *Ibid.*

103 *Ibid.* at para. 191.

104 *Ibid.* at paras. 205, 213; see text accompanying refs. 94–96 above.

105 A certain level of communication, however, would be required. Company management must, for example, represent to the company's auditors that they have communicated to the auditors *all* deficiencies in the company's internal control over financial reporting. Auditing Standard No. 2, ref. 4 above, at para. 142; see also, PCAOB November FAQ, ref. 8 above, at 9 (Question 34). This is in addition to other provisions of the Sarbanes–Oxley Act and its implementing rules that require management to inform the auditors and the company's audit committee of all significant deficiencies and material weaknesses. See 404 Release, ref. 3 above, at 36,646–47; PCAOB November FAQ, ref. 8 above, at 9; *cf.* Dooley, ref. 99 above, at 6 (describing provisions that require company personnel to report to the company's auditors potential illegal acts that may have a direct and material effect on the company's financial statements, thereby triggering provisions of Section 10A of the Exchange Act).

106 Auditing Standard No. 2, ref. 4 above, at para. 140.

107 *Ibid.* at App. E, para. E99; PCAOB July FAQ, ref. 8 above, at 5 (Question 7).

108 PCAOB July FAQ, ref. 8 above, at 5 (Question 7).

109 *Ibid.* at 7.

110 To a certain extent, it recreates one of the conflicts of interest that the Sarbanes–Oxley Act sought to remove when it restricted the influence that management had over the hiring and firing of auditors and vested greater authority in the audit committee, which, for listed companies, must be composed only of independent directors. See Sarbanes–Oxley Act, ref. 1 above above, at §202, §301, §303; Auditing Standard No. 2, ref. 4 above, at App. E, para. E65. Commentators on Auditing Standard No. 2 also suggested that evaluating the audit committee would involve auditors making judgments involving business concerns and legal requirements for which they were ill-suited. Auditing Standard No. 2, ref. 4 above, at App. E, para. E65. The PCAOB recognised this tension, but retained the requirement.

111 *United States v. Arthur Young & Co.*, 465 US 805, 817–18 (1984).

112 Auditing Standard No. 2, ref. 4 above, at para. 207; PCAOB November FAQ, ref.

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8 above, at 8 (Question 33). If the significant deficiency or material weakness is a result of ineffective oversight by the audit committee, these letters should be directed to the full board of directors, not the audit committee. Auditing Standard No. 2, ref. 4 above, at para. 208. If the auditor is only aware of a significant deficiency or material weakness as of an interim date because management has already identified the deficiency and started to take corrective action, the auditor need not communicate the deficiency in writing to management and the audit committee. PCAOB November FAQ, ref. 8 above, at 9.

113 The SEC had initially proposed a documentation requirement on the grounds that communications in writing may be handled more carefully than those only communicated orally, and might assist attorneys in any lawsuit to which they might be subject as a result of the possible malfeasance. Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 34-47276, 68 Fed. Reg. 6,296, 6,306 (29th January, 2003).

114 *Ibid.* at 6,306-07 (internal quotation marks omitted).

115 Johnson, ref. 21 above, at A14; Byrnes, N. (2004) 'Sarbanes–Oxley: The struggle to catch up', *BusinessWeek Online*, 12th November.

116 See text accompanying ref. 7 above.

117 Temporary Postponement of the Final Phase-In Period for Acceleration of Periodic Report Filing Dates, Exchange Act Release No. 34-50684, 69 Fed. Reg. 68,232 (17th November, 2004).

118 *Ibid.*

119 Nicolaisen, ref. 24 above; see also Johnson, ref. 21 above, at A14 ('Top regulatory officials repeatedly have warned that a significant minority of companies, from a few hundred to a thousand, may report serious weaknesses in their fiscal checks and balances . . .').

120 Bailey, ref. 18 above; see also Beller, Alan L., Director, Division of Corporate Finance, US Securities and Exchange Commission, Investors, the Stock Market and Sarbanes–Oxley's New Section 404 Requirements (12th January, 2005).

121 Auditing Standard No. 2, ref. 4 above, at para. 140, App. D, App. E, paras. E75–76.

122 *Ibid.* at App. E, paras. E75–76, E97–98.

123 See the section entitled 'formalisation of the Auditor–Client Relationship'. The SEC has indicated that reporting companies are not required to disclose changes made to internal controls in anticipation of complying with Section 404, which may encourage a more open discussion between auditors and companies at the outset. SEC FAQ, ref. 8 above, at 5 (Question 9). Nevertheless, the SEC has also stated that if in conducting such an initial review a material weakness were identified, the company 'should carefully consider whether that fact should be disclosed', possibly restricting any benefit from the relief granted by the SEC. *Ibid.*

124 Commission Regulation 1606/2002 of 19th July, 2002 on the Application of International Accounting Standards, Art. 4, 2002 *O.J.* (L 243) 1, 3. Member states may delay implementation of this regulation to financial years starting on or after January 2007 for companies that only have debt securities admitted on a regulated market or that have securities admitted to public trading in a non-member state and have been using internationally accepted accounting standards since a financial year preceding the publication of the regulation. *Ibid.* at Art. 9 2002 *O.J.* (L 243) 4.

125 Donaldson, William H., Chairman, US Securities and Exchange Commission, US Capital Markets in the Post-Sarbanes–Oxley World: Why Our Markets should Matter to Foreign Issuers (25th January, 2005).

126 See text accompanying refs. 112–114.

127 Auditing Standard No. 2, ref. 4 above, at paras. 16–17.

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